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# The Emerging Need For Hybrid Entities: Why California Should Become The Delaware Of "Social Enterprise Law"

Ross Kelley

*J.D. Candidate, May 2014, Loyola Law School, Los Angeles*

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# **THE EMERGING NEED FOR HYBRID ENTITIES: WHY CALIFORNIA SHOULD BECOME THE DELAWARE OF “SOCIAL ENTERPRISE LAW”**

*Ross Kelley\**

*Recognizing the limitations and restraints posed on socially conscious for-profit organizations, several states have begun to develop a legislative model that blends attributes of traditional for-profit and not-for-profit entities into “hybrid” organizations. Chief among these states is California, which has emerged as a leader of this new social enterprise reform. California is the only state to allow a business to incorporate as a Benefit Corporation or a Flexible Purpose Corporation. Additionally, the state legislature has proposed a third type of hybrid entity—the Low-Profit Limited Liability Company. By addressing the limitations of the traditional corporate structure, California’s new hybrid entities afford directors, founders, and officers not only with increased legal protection, but also promote confidence to pursue social and environmental causes. This Article explains why California is the preferred choice for social enterprises and how an influx of social enterprises could benefit the state.*

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\* J.D. Candidate, May 2014, Loyola Law School, Los Angeles; B.S. in Finance and Entrepreneurship, Washington University in St. Louis, May 2010. I am truly grateful to Professor Therese Maynard for her continual guidance, seemingly infinite knowledge, and contagious enthusiasm. I would also like to thank the editors and staffers of the *Loyola of Los Angeles Law Review* for their support and encouragement. Lastly, I would like to thank my parents, who not only served as my personal writing tutors throughout my childhood, but also served as my inspiration for this paper by teaching me that success can be measured any way you want to define it.

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## I. INTRODUCTION

Traditionally, American businesses have measured their success by their ability to maximize profits and, in turn, shareholder wealth.<sup>1</sup> However, this narrow purview ignores a small but emerging group of businesses that measure success not just by financial gains, but also by evaluating the company's social and environmental impacts.<sup>2</sup> Dubbed "social enterprises," the directors of these companies seek to maximize profits while actively pursuing a social purpose.<sup>3</sup> No two companies have better embodied this evolving business philosophy than Ben & Jerry's, a Vermont-based ice cream manufacturer,<sup>4</sup> and Patagonia, a California-based outdoor-apparel retailer.<sup>5</sup>

Both Ben & Jerry's and Patagonia trace their unwavering dedication to social missions to their exuberant, steadfast founders.<sup>6</sup> With the 1978 creation of Ben & Jerry's, Ben Cohen and Jerry Greenfield wanted to create not just a new ice cream flavor, but a new ice cream experience.<sup>7</sup> Similarly, Yvon Chouinard believed that he could create better outdoor apparel and equipment, and created Patagonia in 1972.<sup>8</sup> As Ben & Jerry's and Patagonia's brands gained recognition and their sales began to increase, the founders focused on not just the bottom-line profits, but improving their communities as well.<sup>9</sup> Chouinard, Greenfield, and Cohen chose to veer away from

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1. Anthony Bisconti, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?*, 42 LOY. L.A. L. REV. 765, 770 (2009).

2. Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 591 (2011).

3. *Id.*

4. *Company Overview of Ben & Jerry's Homemade Inc.*, BUS. WK., <http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=109887> (last visited July 7, 2013).

5. *Company Overview of Patagonia, Inc.*, BUS. WK., <http://investing.businessweek.com/research/stocks/private/snapshot.asp?privcapId=7901350> (last visited July 7, 2013).

6. *See infra* notes 7–10 and accompanying text.

7. *Our History*, BEN & JERRY'S, <http://www.benjerry.com/company/history> (last visited July 7, 2013).

8. *Company Info: Our History*, PATAGONIA, <http://www.patagonia.com/us/patagonia.go?assetid=2047&ln=140> (last visited July 7, 2013). The original name of the company was Chouinard Equipment. *Id.*

9. Cohen and Greenfield affectionately referred to this approach as the "double dip." Antony Page & Robert A. Katz, *The Truth About Ben and Jerry's*, STAN. SOC. INNOVATION REV. 39, 39 (2012), available at [http://www.ssireview.org/articles/entry/the\\_truth\\_about\\_ben\\_and](http://www.ssireview.org/articles/entry/the_truth_about_ben_and)

the traditional corporate maxim that profits should be valued above all else, and instead measured their companies' success by using a "double bottom line": maximizing profits and social objectives.<sup>10</sup>

Both Patagonia and Ben & Jerry's prescribed to this dual-purpose approach, which ultimately led the companies to develop and pursue similar societal and environmental initiatives.<sup>11</sup> Patagonia and Ben & Jerry's donated a percentage of their revenues to charities,<sup>12</sup> created and funded new charitable campaigns,<sup>13</sup> paid local vendors a premium for ingredients,<sup>14</sup> limited their waste output and carbon footprint,<sup>15</sup> treated their employees better than their competitors did,<sup>16</sup> and even initiated campaigns to protect

\_jerrys [hereinafter Page, *Truth About Ben & Jerry's*]. Chouinard dubbed it the "slow company" because of its long-term, sustainable focus. *Firms with Benefits*, *ECONOMIST*, Jan. 7, 2012, available at <http://www.economist.com/node/21542432>.

10. See *supra* note 9.

11. See *infra* notes 12–17 and accompanying text.

12. Compare Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 *VT. L. REV.* 211, 219 (2010) [hereinafter Page, *Freezing Out Ben & Jerry*], and Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 *TRANSACTIONS: TENN. J. BUS. L.* 221, 222 (2012) (stating that Ben & Jerry's donated 7.5 percent of pretax profits to charity), with Seth Stevenson, *Patagonia's Founder Is America's Most Unlikely Business Guru*, *WALL ST. J.*, Apr. 26, 2012, <http://online.wsj.com/article/SB10001424052702303513404577352221465986612.html#articleTabs%3Darticle> (stating that Patagonia donates at least 1 percent of total revenues to grassroots causes).

13. Compare Page, *Truth About Ben & Jerry's*, *supra* note 9, at 40, and Plerhoples, *supra* note 12, at 222 (stating that Ben & Jerry's created the Ben & Jerry's Foundation), with Stevenson, *supra* note 12 (stating that Patagonia created the "1% for the Planet" campaign).

14. Compare Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 211, 220–21 (stating that Ben & Jerry's paid a premium for local Vermont milk, Brazilian nuts from impoverished villages, and other Fair-Trade certified and organic ingredients), with Stevenson, *supra* note 12 (stating that Chouinard switched "from conventional to organic cotton—despite the fact that it initially tripled his supply costs").

15. Compare Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 221 (stating that Ben & Jerry's created eco-friendly packaging containers), with Marc Lifsher, *Businesses Seek State's New 'Benefit Corporation' Status*, *L.A. TIMES*, Jan. 4, 2012, available at <http://articles.latimes.com/2012/jan/04/business/la-fi-benefit-corporations-20120104> [hereinafter Lifsher, *Businesses Seek*] (stating that Patagonia uses sustainable manufacturing techniques), and Patagonia, *Inc.*, B LAB, <http://www.bcorporation.net/community/directory/patagonia> (last visited Apr. 7, 2013) (75 percent of materials used are recycled or environmentally preferred), and Stevenson, *supra* note 12 (Patagonia created the Sustainable Apparel Coalition, which has "craft[ed] clear, quantifiable standards for environmentally responsible clothing production").

16. Compare Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 223 ("Ben & Jerry's was also committed to paying its employees a living wage and generous benefits, including being one of the first companies to offer health care benefits to employees' same sex partners."), and Plerhoples, *supra* note 12, at 222 ("[T]he company disbursed five percent of the company's pretax profits to employees as cash bonuses each year"), with Patagonia, *Inc.*, *supra* note 15 (stating that

endangered rain forests.<sup>17</sup> In turn, Ben & Jerry's and Patagonia's socially conscious management style yielded tremendous benefits for each company's employees, communities, and the environment.<sup>18</sup> Even shareholders, satisfied with their stock returns, initially supported their companies' commitment to social causes.<sup>19</sup> Given these positive gains, Chouinard, Greenfield, and Cohen were confident that their companies could sustain their societal and environmental initiatives into the foreseeable future.<sup>20</sup>

Unfortunately for Cohen and Greenfield, some Ben & Jerry's shareholders began to question their founders' societal enthusiasm as the company's financial growth—and thus the shareholders' returns—slowed in the mid-1990s.<sup>21</sup> Recognizing discontent among some of Ben & Jerry's investors, several companies staged takeover attempts by tendering offers to the company's shareholders.<sup>22</sup> The takeover attempts culminated in 2000, when Unilever, a multinational consumer goods corporation, made a tender offer of \$43.60 per share to Ben & Jerry's shareholders.<sup>23</sup>

Fearing that Unilever would undo Ben & Jerry's longstanding social and environmental initiatives to increase short-term profits,

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Patagonia “extend[ed] health benefits to part-time, retail, [and] warehouse staff”), and Stevenson, *supra* note 12 (stating that Patagonia offered free on-site day care and flex-time work hours to employees).

17. Compare Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 222 (describing Ben & Jerry's “Rain Forest Preservation” initiatives), with Christopher Pummer, *Buttons May Help Save Rain Forests*, L.A. TIMES, Sept. 25, 1990, [http://articles.latimes.com/1990-09-25/local/me-1058\\_1\\_plastic-buttons](http://articles.latimes.com/1990-09-25/local/me-1058_1_plastic-buttons) (describing Patagonia's campaign to save a 245,000-acre area in Ecuador's Esmeraldas province).

18. Ben & Jerry's social contributions and sales “grew impressively” in the 1990s. Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 221–24. Patagonia continued to increase its environmental and social donations as it experienced “overambitious growth” in the late 1980s. See Stevenson, *supra* note 12.

19. See Page, *Truth About Ben & Jerry's*, *supra* note 9, at 40.

20. Greenfield and Cohen sought to create a company “dedicated to a sustainable corporate concept of linked prosperity.” Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 219. Chouinard has stated repeatedly that he wanted to “build a company that could last 100 years.” *B-Corp*, PATAGONIA, <http://www.patagonia.com/eu/enCZ/patagonia.go?assetid=70725> (last visited Apr. 7, 2013).

21. See Page, *Truth About Ben & Jerry's*, *supra* note 9, at 40 (stating that as the company's financial growth began to slow down in the mid-1990s, some investors began to argue “that the company's social mission was a luxury it could no longer afford”).

22. See *id.* A tender offer is a public offer to shareholders that is higher than the current market stock price. Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 231.

23. Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 226; Page, *Truth About Ben & Jerry's*, *supra* note 9, at 39–40.

Cohen and Greenfield pieced together a counteroffer to shareholders.<sup>24</sup> Despite their best efforts, the founders could not match Unilever's offer.<sup>25</sup> Afraid of the impending class action lawsuits against them<sup>26</sup> and the future legal consequences for not maximizing shareholder wealth,<sup>27</sup> the Ben & Jerry's board (including Cohen and Greenfield) begrudgingly accepted the buyout by Unilever.<sup>28</sup>

As Cohen and Greenfield anticipated, once it obtained control, Unilever promptly began to eliminate Ben & Jerry's social missions.<sup>29</sup> In fact, within three years after the sale to Unilever, the new management of Ben & Jerry's had terminated 20 percent of the company's workforce and stopped distributing a 7.5 percent share of profits to its charitable foundation.<sup>30</sup>

Although Patagonia, like Ben & Jerry's, experienced periods of slow growth in the mid-1990s, it has been able to avoid a fate similar to Ben & Jerry's.<sup>31</sup> Chouinard ensured the longevity of Patagonia's social missions by maintaining Patagonia as a closely held private company wholly owned by him and his wife.<sup>32</sup> By doing so,

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24. *The Scoop on Ben & Jerry's Sellout*, SLATE (Apr. 12, 2000, 3:05 PM), [http://www.slate.com/articles/business/moneybox/2000/04/the\\_scoop\\_on\\_ben\\_jerrys\\_sellout.html](http://www.slate.com/articles/business/moneybox/2000/04/the_scoop_on_ben_jerrys_sellout.html).

25. Page, *Freezing Out Ben & Jerry*, *supra* note 12, at 225–26.

26. *Id.* at 229 (“Indeed, three class action lawsuits alleging that the directors were breaching their fiduciary duties to shareholders by failing to maximize shareholder value were filed while the [Unilever] deal was being negotiated.”).

27. *Id.* at 228–29.

28. *Id.* at 229 (“Cohen . . . [said that corporate law] ‘required the board of directors of Ben & Jerry’s to take an offer, to sell the company despite the fact that they did not want to sell the company.’ Greenfield agreed: ‘[W]e were a public company, and the board of directors’ primary responsibility is the interest of the shareholders. . . . It was nothing about Unilever; we didn’t want to get bought by anybody.’”).

29. *Id.* at 225–28.

30. *Id.* at 243 (“In the three years since 4-11 [2000], Ben & Jerry’s has seen its social mission begin to seep away—Unilever has laid off one in five B&J employees, stopped donating 7.5 percent of profits to the Ben & Jerry’s Foundation, and hired a CEO Cohen didn’t approve of.” (Citation omitted)).

31. *See generally Company Info*, PATAGONIA, <http://www.patagonia.com/us/patagonia.go?assetid=2047&ln=140> (last visited Sept. 17, 2013) (“Staying true to our core values during thirty-plus years in business has helped us create a company we’re proud to run and work for.”).

32. *See* Stevenson, *supra* note 12 (explaining Chouinard’s ability to grow a multimillion dollar company without bringing in outside equity investors or borrowing substantial sums is a rare and difficult feat). *See generally* James Clear, *5 People Who Turned \$1,000 into \$1 Million*, US NEWS (Mar. 15, 2012), [money.usnews.com/money/blogs/my-money/2012/03/15/5-people-who-turned-1000-into-1-million](http://money.usnews.com/money/blogs/my-money/2012/03/15/5-people-who-turned-1000-into-1-million) (noting that “[b]uilding a million-dollar business from scratch isn’t easy . . .”).

Chouinard was able to eliminate the possibility that disgruntled shareholders would file derivative actions against the board for failing to maximize shareholder wealth.<sup>33</sup> However, with his retirement on the horizon, the seventy-three-year-old recently became concerned about the long-term protection of his company's social missions.<sup>34</sup>

The growing concerns of socially conscious founders, like Chouinard, combined with the unraveling of double bottom line businesses, like Ben & Jerry's, prompted several state legislatures to create new corporate forms for socially concerned companies.<sup>35</sup> These new hybrid corporate forms seek to combine elements of traditional nonprofit and for-profit entities.<sup>36</sup> California has emerged as one of the leaders of this new social enterprise reform.<sup>37</sup>

Seeking to protect the legacy of his company's social missions, Chouinard, whose company is based in Ventura, California, took immediate actions to take advantage of California's new social enterprise forms.<sup>38</sup> In fact, Patagonia became the first company to register as one of California's new social hybrid entities<sup>39</sup> when it filed to become a Benefit Corporation<sup>40</sup> on January 3, 2012.<sup>41</sup> Whatever path Chouinard decides to take in the future, his company's social and environmental missions are now better protected under California's new social hybrid forms.<sup>42</sup>

This Note argues that California's new social enterprise forms are a necessary vehicle for socially geared businesses that seek to

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33. See Stevenson, *supra* note 12.

34. *Id.*

35. See, e.g., MARK DESAULNIER, ANALYSIS OF ORIGINAL BILL—SB 201 (2011), available at [www.ftb.ca.gov/law/legis/11\\_12bills/sb201\\_020811.pdf](http://www.ftb.ca.gov/law/legis/11_12bills/sb201_020811.pdf). When California lawmakers discussed the purpose for creating the Flexible Purpose Corporation entity they cited that “[t]he story of Ben and Jerry’s Ice Cream is an example of why a new entity form is sought.” *Id.* at 2.

36. See *infra* Part III.

37. See *infra* notes 132–35 and accompanying text.

38. Bart King, *Patagonia Is First to Register for ‘Benefit Corporation’ Status in California*, SUSTAINABLE BRANDS (Jan. 4, 2012), [http://www.sustainablebrands.com/news\\_and\\_views/articles/patagonia-first-register-%E2%80%98benefit-corporation%E2%80%99-status-california](http://www.sustainablebrands.com/news_and_views/articles/patagonia-first-register-%E2%80%98benefit-corporation%E2%80%99-status-california); John Tozzi, *Patagonia Road Tests New Sustainability Legal Status*, BLOOMBERG (Jan. 4, 2012), <http://www.bloomberg.com/news/2012-01-04/patagonia-road-tests-new-sustainability-legal-status.html>.

39. See Stevenson, *supra* note 12.

40. See *infra* notes 171–89 and accompanying text.

41. Stevenson, *supra* note 12.

42. See King, *supra* note 38; Lifsher, *Businesses Seek*, *supra* note 15.



pursue societal and environmental missions without compromising profits and growth, or fearing adverse financial and litigation repercussions. Part II describes the traditional corporate forms under California law and explains the limitations that both forms place on social enterprises. Part III first examines two new California corporate forms, the Flexible Purpose Corporation and the Benefit Corporation, and one proposed California corporate form, the Low-Profit Limited Liability Company, before analyzing the impact that each of these forms could have on California social enterprises. Part IV clarifies the need for these new social hybrids by describing how the new forms remedy the limitations that are imposed on social enterprises under the traditional corporate structure. Lastly, Part V explains why California is a preferred choice for social enterprises, illustrates how the influx of social enterprises could benefit the state, and ultimately, proposes immediate steps California should take to secure its position as the leader of social enterprise law.

## II. BACKGROUND

To examine why Cohen and Greenfield were unable to protect Ben & Jerry's from a corporate takeover, it is important to understand the traditional structure of corporate and nonprofit law. The U.S. Supreme Court has continually restricted "the growth of federal law into the areas of state corporate law."<sup>43</sup> As a result, each state's corporate code<sup>44</sup> is a unique product of its own state's legislature.<sup>45</sup>

### A. Traditional Corporate/Nonprofit Structure

Traditionally, states have required incorporating businesses to

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43. See Francis J. Facciolo & Richard L. Stone, *Avoiding the Inevitable: The Continuing Viability of State Law Claims in the Face of the Primary Jurisdiction and Preemption Challenges Under the Securities Exchange Act of 1934*, 1995 COLUM. BUS. L. REV. 525, 548–49 (1995).

44. J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 9 (2011). This Note will focus on California corporate law.

45. If a conflict of law arises between two states, the "internal affairs doctrine" will apply. *Vaughn v. LJ Int'l, Inc.*, 94 Cal. Rptr. 3d 166, 173 (Ct. App. 2009). This doctrine, which is incorporated in California under Corporations Code section 2116, will apply the law of the state of incorporation (with limited exceptions). 9 B.E. WITKIN, SUMMARY OF CALIFORNIA LAW § 239 (10th ed. 2005).

make an election of either a for-profit or a not-for-profit entity.<sup>46</sup> This traditional binary system poses many problems for social enterprises that wish to simultaneously pursue apparently inconsistent goals: maximizing societal gains (as a nonprofit entity would) and maximizing financial gains (as a for-profit entity would).<sup>47</sup>

### 1. Nonprofit Entities

The creation of the nonprofit code was an important step for the socially conscious businessman because it allowed a business to pursue a social mission irrespective of profits.<sup>48</sup> Not only did the code initially grant managerial flexibility to socially conscious directors,<sup>49</sup> but the Internal Revenue Service (IRS) also granted unique financial advantages to nonprofits.<sup>50</sup> Most notably, the IRS granted nonprofit organizations tax-exempt status.<sup>51</sup> In addition, the IRS decided that a donation to a qualifying nonprofit would yield a tax deduction for the donor.<sup>52</sup> As a result of these deductions, the nonprofit form has been more likely to receive capital from established charities or foundations.<sup>53</sup>

However, to protect against potential abuses, the IRS also imposed several strict limitations on nonprofits.<sup>54</sup> These restrictions hamper a nonprofit's ability to make a profit in several ways.<sup>55</sup> First, nonprofits are restricted in what activities the business can pursue,<sup>56</sup> because nonprofits must pursue "public or charitable purposes."<sup>57</sup> The IRS also monitors each nonprofit to ensure that its activities

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46. Felicia R. Resor, *Benefit Corporation Legislation*, 12 WYO. L. REV. 91, 93 (2012).

47. See *infra* notes 48–86 and accompanying text.

48. I.R.C. § 501(c)(3) (2012). To qualify as a tax-exempt entity, the IRS actually requires that nonprofits pursue a mission (e.g., religious or charitable) over profits. *Id.*

49. See *id.* (listing the social purposes that a nonprofit can pursue).

50. See *id.* § 501(a).

51. *Id.* Thus, a qualifying nonprofit pays no income taxes. *Id.* § 501(a), (c)(3).

52. I.R.C. § 170(a), (c) (2012); Christen Clarke, *California's Flexible Purpose Corporation: A Step Forward, A Step Back, or No Step at All?*, 5 J. BUS. ENTREPRENEURSHIP & L. 301, 303–04 (2011).

53. See Clarke, *supra* note 52, at 303–04.

54. See *infra* notes 55–60 and accompanying text.

55. Resor, *supra* note 46, at 95.

56. Clarke, *supra* note 52, at 303–04.

57. CAL. CORP. CODE § 5111 (West 2012). These purposes must be set out in the nonprofit's articles of incorporation, a legal document that each California business entity must file with the Secretary of State before it can come into legal existence. *Id.* §§ 200(c), 5133.

remain within the scope of its stated charitable or public purposes.<sup>58</sup> If the IRS determines that the nonprofit's activities are unrelated to its charitable purpose,<sup>59</sup> the agency has the power to strip the nonprofit of its tax-exempt status.<sup>60</sup> The fear of losing their coveted tax-exempt status keeps many nonprofits from pursuing new, possibly profitable, business opportunities.<sup>61</sup>

Second, the nonprofit form constrains the potential earnings for founders and directors.<sup>62</sup> Owners and directors of a nonprofit cannot appropriate their firm's revenues "for their personal benefit."<sup>63</sup> Even during the course of a sale, an owner is precluded from selling his nonprofit "beyond reasonable compensation."<sup>64</sup>

Third, nonprofits have a limited ability to expand or grow.<sup>65</sup> A California nonprofit cannot offer stock, equity, or even a salary to equity investors.<sup>66</sup> As a result, nonprofits must rely solely on donations, debt, and retained earnings.<sup>67</sup> With a limited pool of donors and a strict policy of enforcing the pursuit of a charitable mission over profitability, a nonprofit may struggle to gain the capital it needs to expand.<sup>68</sup>

For some social entrepreneurs, the tax advantages and ability to receive donations make the nonprofit form a viable option for their businesses.<sup>69</sup> However, for others, the severe restrictions on business activities, personal earnings, and expansion make the nonprofit

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58. See I.R.C. § 501(b) (2012); COMPLIANCE GUIDE FOR 501(C)(3) PUBLIC CHARITIES, INTERNAL REVENUE SERV. 14, 23 (2009), available at <http://www.irs.gov/pub/irs-pdf/p4221pc.pdf>.

59. Clarke, *supra* note 52, at 303–04. This income is commonly called the unrelated business taxable income (UBTI). *Id.*

60. *Id.*

61. Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 83 (2010).

62. *Id.* at 67.

63. *Id.*

64. *Id.* at 75. Further devaluing the sale price of a nonprofit, the "nonprofit compensation is calculated retrospectively and not prospectively. As a result, founder and controllers may decline to sell (or 'convert') a nonprofit organization to a for-profit entity . . ." *Id.* at 94–95.

65. See *infra* notes 66–68 and accompanying text.

66. Katz & Page, *supra* note 61, at 67. A salary cannot be offered to equity investors as a "pretext for distributing profits to them." *Id.*

67. *Id.* at 94. Retained earnings are the revenues left over after all debts, taxes, and costs of a business are paid off. A nonprofit is not likely to yield high retained earnings as their focus is on charitable purposes, not profit margins. *Id.* at 94–95.

68. Murray & Hwang, *supra* note 44, at 10.

69. See *supra* text accompanying notes 48–53.

model an unattractive vehicle for social enterprises.<sup>70</sup> Thus, many social enterprises adopt the structure of the for-profit corporation in an attempt to fulfill the needs of their growing businesses.<sup>71</sup>

## 2. For-Profit Entities

Compared to nonprofits, the profit-making advantages of for-profit entities have made them significantly more popular with Californian entrepreneurs.<sup>72</sup> Although California offers several different for-profit forms, the relative advantages of the corporation and the limited liability company form have made them a perennial favorite among modern entrepreneurs.<sup>73</sup>

Unlike a nonprofit company, a for-profit company is unrestricted in its purpose and can engage in “any lawful business activity.”<sup>74</sup> Thus, a for-profit can quickly expand or diversify its operations to capitalize on new business opportunities.<sup>75</sup> This flexibility to pursue different business activities generally enables for-profits to generate higher returns than nonprofits.<sup>76</sup> Additionally, the California Corporations Code provides for-profits a vital source of capital that is unavailable to nonprofits: equity investors.<sup>77</sup> Unlike a charitable contribution, where the donor seeks no financial return, investors in for-profit companies buy an ownership stake<sup>78</sup> in that

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70. See Murray & Hwang, *supra* note 44, at 10.

71. See Clarke, *supra* note 52, at 310.

72. Compare *California Counties: Tax Exempt/Nonprofit Organizations*, TAXEXEMPTWORLD.COM, <http://www.taxexemptworld.com/organizations/california-counties.asp> (last visited Apr. 7, 2013) (stating that there are 217,335 nonprofit entities in California), with *Number of California Small Businesses*, GAEBLER.COM, <http://www.gaebler.com/Number-of-Small-Businesses-in-California.htm> (last visited Apr. 7, 2013) (listing that California is home to 3,320,977 small businesses).

73. See W. Derrick Britt et al., *Frequently Asked Questions: The Flexible Purpose Corporation and Senate Bill 201*, BUS. FOR GOOD (Mar. 7, 2011), <http://www.businessforgood.co/2011/03/frequently-asked-questions-proposed.html>. “Entrepreneurs . . . have historically been limited to two primary corporate vehicles—the corporation and the limited liability company.” *Id.* For this reason, this Note will be referring to both corporations and limited liability companies when it refers to “for-profits.”

74. CAL. CORP. CODE § 17002(a) (West 2013) (referring to the purpose of a Limited Liability Corporation). Corporations use nearly the same language: “the purpose of the corporation is to engage in any lawful act or activity.” *Id.* § 202 (b)(1)(A).

75. See Murray & Hwang, *supra* note 44, at 21–22.

76. See *id.* at 10.

77. CAL. CORP. CODE § 400 (West 2013); Katz & Page, *supra* note 61, at 62.

78. The ownership stake is commonly referred to as purchasing stock or shares of equity. See CAL. CORP. CODE § 184 (West 2013).

company, and thus are entitled to receive financial returns.<sup>79</sup> Because for-profit entities have the potential to yield a return exceeding the tax savings given for making an equivalent donation to a charity, the vast majority of investors would rather invest in for-profits than donate to nonprofits.<sup>80</sup>

The quest to maximize profits, however, does not come without its pitfalls.<sup>81</sup> Pursuing profits above all else commonly forces social enterprises to sacrifice social and environmental initiatives.<sup>82</sup> Directors of for-profit entities are required by California law to act in the “best interests of the corporation and its shareholders.”<sup>83</sup> If a director acts in a way that does not adhere to this standard, the director may be liable<sup>84</sup> to the corporation’s shareholders for breach of fiduciary duty.<sup>85</sup> Fearing possible lawsuits from shareholders, some directors forego social and environmental initiatives to comply with the shareholder wealth-maximization norm.<sup>86</sup>

### *B. Unsuccessful Attempts to Bridge Binary Corporate Structure*

Recognizing the weak alternatives for social ventures that were technically neither for-profit nor nonprofit, some states attempted to safeguard social entrepreneurs through judicially created

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79. See CAL. CORP. CODE § 400 (West 2013).

80. See Jim Witkin, *The L3C: A More Creative Capitalism*, TRIPLE PUNDIT (Jan. 15, 2009), <http://www.triplepundit.com/2009/01/the-l3c-a-more-creative-capitalism>.

81. See *infra* notes 82–86 and accompanying text.

82. See, e.g., *eBay Domestic Holdings v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010) (“The corporate form in which [Defendant] craigslist operates, however, is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment.”).

83. CAL. CORP. CODE § 309(a) (West 2013).

84. Evangeline Gomez, *The Rise of the Charitable For-Profit Entity*, FORBES (Jan. 13, 2012, 6:16 PM), <http://www.forbes.com/sites/evangelinegomez/2012/01/13/the-rise-of-the-charitable-for-profit-entity>.

85. Resor, *supra* note 46, at 95. Fiduciary duties include serving the best interests of the corporation in “good faith” and with “such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” CAL. CORP. CODE § 309(a).

86. See Plerhopes, *supra* note 12, at 239 (“[R]isk-averse directors of a social enterprise—fearing liability for a breach of fiduciary duties—may feel obligated to recommend an acquisition by an entity that intends to scale back or even abandon the social or environmental mission of the social enterprise.”). Although California courts do not explicitly adopt the shareholder wealth-maximization norm, the notion is prevalent in Delaware case law. See *infra* notes 106–22 and accompanying text.

presumptions and legislatively created statutes.<sup>87</sup> Specifically, states tried to fashion sweeping constituency statutes<sup>88</sup> or grant more deference under the age-old “business judgment rule.”<sup>89</sup> While both the constituency statutes and the business judgment rule do provide some additional safeguards for social ventures, neither provides adequate protection.<sup>90</sup>

### 1. Constituency Statutes

Constituency statutes, if enacted by a state legislature, enable a corporation to consider stakeholders’ and other constituencies’<sup>91</sup> interests alongside shareholders’ interests.<sup>92</sup> Although a majority of states<sup>93</sup> have passed corporate constituency statutes,<sup>94</sup> the statutes remain relatively untested in state and federal courts.<sup>95</sup> With few cases defining the scope and validity of these statutes, directors of corporations remain wary that corporate constituency statutes will fully protect them.<sup>96</sup> Constituency statutes hold even less efficacy for California businesses as California has not passed a constituency statute.<sup>97</sup> Simply put, overarching constituency statutes do not provide sufficient protection to allow otherwise risk-averse directors to make socially beneficial decisions.<sup>98</sup>

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87. See *infra* notes 88–89.

88. ERIC L. TALLEY, CORPORATE FORM AND SOCIAL ENTREPRENEURSHIP: A STATUS REPORT FROM CALIFORNIA (AND BEYOND), 1, 3 (2012) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2144567](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2144567) (follow “Download This Paper” hyperlink); see *infra* notes 91–92.

89. See Plerhoples, *supra* note 12, at 241.

90. See *infra* notes 91–104 and accompanying text.

91. Britt et al., *supra* note 73 (stating that constituencies include “shareholders, employees, customers, suppliers, creditors, communities, society as a whole, and long-term interests”).

92. TALLEY, *supra* note 88, at 3 (stating that constituency statutes “provide legal protection for corporate directors who wish to weigh stakeholder considerations alongside shareholder return”).

93. TALLEY, *supra* note 88, at 4 n.7; Britt et al., *supra* note 73.

94. TALLEY, *supra* note 88, at 4 n.7 (noting that thirty states have passed constituency statutes).

95. See Britt et al., *supra* note 73 (stating that “state courts have almost unanimously failed to interpret such provisions”).

96. *Id.*

97. TALLEY, *supra* note 88, at 4; Britt et al., *supra* note 73. Delaware, the leader of corporate law, also does not have an “other constituencies” statute. TALLEY, *supra* note 88, at 4 n.7.

98. See *supra* notes 95–97 and accompanying text.

## 2. Business Judgment Rule

The business judgment rule (BJR) is a judicially created doctrine that presumes directors make business decisions that are in the company's best interest.<sup>99</sup> California courts have recognized the BJR as a "judicial policy of deference to the business judgment of corporate directors in the exercise of their broad discretion in making corporate decisions."<sup>100</sup> Recognizing that business directors are better suited to make their company's decisions than the courts, the BJR presumption is meant to act as a shield for all prudent, reasonable, and well-intentioned director decisions.<sup>101</sup> However, courts are still uncertain of the BJR's outer boundaries,<sup>102</sup> because the rule offers limited protection when: (1) shareholder wealth is sacrificed for societal gains; (2) the sale of a company is imminent; or (3) the individual seeking to apply the rule is an officer, not a director.<sup>103</sup> This uncertainty often serves to narrow or constrain the decision making of corporate managers when they are considering the implementation of social or environmental policies for at least three significant reasons.<sup>104</sup>

First and foremost, courts have held that the BJR offers limited protection for company officials that place social and environmental considerations ahead of shareholder welfare.<sup>105</sup> *Dodge v. Ford Motor*

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99. Clarke, *supra* note 52, at 317 n.157.

100. Everest Investors 8 v. McNeil Partners, 8 Cal. Rptr. 3d 31, 45 (Ct. App. 2003) (certified for partial publication); Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 710 (Ct. App. 1989). California has codified the BJR presumption. Cal. Corp. Code § 309 (West 2013); Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 897 (Ct. App. 2009).

101. Clarke, *supra* note 52, at 317 n. 157.

102. Peter Smith, *Are the Managers of Traditional Corporations "Really" Required to Maximize Profits to Shareholders? A Review of eBay v. Craigslist et al., in the Argument Supporting "Hybrid" Social Enterprises*, APEX LAW GRP. (June 6, 2012), <http://www.apexlg.com/?p=305>. ("It's unclear where the business judgment rule's outer boundaries are located . . .").

103. See *infra* notes 105–126 and accompanying text.

104. See Plerhoples, *supra* note 12, at 248–49.

105. TALLEY, *supra* note 88, at 4 (stating that "for decisions that obviously sacrifice shareholder welfare for the benefit of other considerations (including social purposes), the BJR provides no protection"); Plerhoples, *supra* note 12, at 248 (stating the BJR offers "limited protection for directors and officers who attempt to consider *all* business decisions in light of both the social mission and profit motives of the corporation"); Smith, *supra* note 102 (stating that "there are limits to the business judgment rule and the ability for management to consider social and environmentally friendly policies at the expense of shareholder value in the traditional for-profit corporate structure").

*Co.*<sup>106</sup> was the seminal case that illustrated the limitations of BJR protection when shareholder wealth was sacrificed for a social purpose.<sup>107</sup> Despite yielding sufficient profits, Henry Ford, the President and majority shareholder of Ford Motor Company,<sup>108</sup> and Ford Motor's board of directors withheld a shareholder dividend and instead reinvested the money back into Ford Motors.<sup>109</sup> The board intended to use the retained earnings of the company to benefit the company's stakeholders, particularly its employees.<sup>110</sup> The Supreme Court of Michigan rejected the board's business decision, holding that a corporation "is organized and carried on primarily for the profit of the stockholders."<sup>111</sup> Because Ford's decision to invest in his employees did not directly maximize shareholder wealth, the court found that Ford breached his fiduciary duty to his shareholders.<sup>112</sup> Cases protecting shareholder wealth maximization, like *Dodge v. Ford*, provide a chilling effect on directors contemplating social and environmental objectives.<sup>113</sup>

Second, the strength of the BJR diminishes greatly during the sale or changing of control of a company.<sup>114</sup> The *Revlon* Rule<sup>115</sup> imposes "heightened judicial scrutiny"<sup>116</sup> on directors to acquire the "best price available"<sup>117</sup> for shareholders when a change in control becomes inevitable,<sup>117</sup> and does not allow directors to consider a company's social mission.<sup>118</sup> Likewise, the BJR presumption is

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106. 170 N.W. 668 (Mich. 1919).

107. *See id.* at 684. Although this case was decided by a Michigan court, and not in California, it still carries great weight.

108. *Id.* at 671.

109. *Id.*

110. *Id.* at 671–72 (stating that Ford's actions were motivated by his ambition "to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes").

111. *Id.* at 684.

112. *Id.* at 685.

113. Although the courts of California have appeared to give little weight to this Michigan case, *Dodge v. Ford Motor Co.* has not been formally rejected by California courts and continues to be directly followed by many states. *See, e.g.,* Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 348–49 (1986) (citing *Dodge v. Ford Motor Co.* to assert that "managers, of course, must exercise the privilege in a manner consistent with their fiduciary duty to act in the best interests of the corporation . . .").

114. Plerhopes, *supra* note 12, at 248–49; Smith, *supra* note 102.

115. Smith, *supra* note 102.

116. Plerhopes, *supra* note 12, at 226.

117. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

118. Plerhopes, *supra* note 12, at 226 ("Under certain circumstances, once a social enterprise



effectively limited during hostile takeover attempts.<sup>119</sup> The *Unocal* Rule initially imposes a stricter judicial review on directors' decisions to implement antitakeover measures.<sup>120</sup> The policy behind this heightened judicial standard is to protect the wealth of shareholders from the possibly self-interested actions of directors.<sup>121</sup> Although the *Revlon* Rule and *Unocal* Rule are not explicitly accepted under California law, California state courts have cited to these doctrines approvingly.<sup>122</sup>

Third, the BJR protections do not extend to corporate officers.<sup>123</sup> Citing the clear omission of the word "officers" from section 309 of the California Corporations Code, California's codified version of the BJR,<sup>124</sup> California courts do not extend the BJR presumption to officers of corporations.<sup>125</sup> Some courts have even used California's strict interpretation of section 309 to deny directors the BJR protection by treating them as mere officers.<sup>126</sup>

Ignoring the ambiguous boundaries of the BJR and the shareholder wealth maximization norm, and assuming arguendo that directors are protected from liability for pursuing a double bottom line, the traditional corporate structure still provides inadequate

offers itself for sale, Delaware's *Revlon* rule would impose heightened judicial scrutiny of the transaction and would require the directors to obtain the best sale price reasonably available, without considering the social enterprise's social and environmental efforts.").

119. See *infra* notes 120–21 and accompanying text.

120. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954–55 (Del. 1985).

121. *Id.* at 954. ("Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.").

122. TALLEY, *supra* note 88, at 4–5, n.9 (stating that "there appears to be no published opinion by a California state court at any level that rejects the [*Revlon*] doctrine, and the handful that cite *Revlon* appear to do so approvingly").

123. *Gaillard v. Natomas Co.*, 256 Cal. Rptr. 702, 711 (Ct. App. 1989) (stating that the "judicial deference afforded under the business judgment rule therefore should not apply" to the defendants because they "were acting as officer employees of the corporation"); *F.D.I.C. v. Van Dellen*, No. CV 10–4915, 2012 WL 4815159, at \*6 (C.D. Cal. Oct. 5, 2012) ("California courts have not extended the [business judgment] rule to officers, and this Court declines to do so.").

124. *Berg & Berg Enters., LLC v. Boyle*, 100 Cal. Rptr. 3d 875, 897 (Ct. App. 2009); *Gaillard*, 256 Cal. Rptr. at 710–11.

125. See *Berg*, 100 Cal. Rptr. 3d at 897; *Gaillard*, 256 Cal. Rptr. at 710–11.

126. See, e.g., *Gaillard*, 256 Cal. Rptr. at 711 (holding that "as a matter of law, our review of the conduct of the inside directors is not governed by section 309" because the directors were not "perform[ing] the duties of a director" as specified in section 309"); *F.D.I.C. v. Castetter*, 184 F.3d 1040, 1046 (9th Cir. 1998) (referring to the same principle illustrated in *Gaillard* but stating that the BJR does not apply if the director "abdicated his corporate responsibility").

safeguards for the long-term sustainability of social missions.<sup>127</sup> Shareholders have a difficult time monitoring their company's social impact because traditional corporate forms have limited transparency and accountability requirements with respect to social and environmental policies.<sup>128</sup> Risk-averse directors generally prefer conservative stances on social initiatives for fear of shareholder litigation.<sup>129</sup> At times, even founders of social ventures struggle to ensure that their company's social missions will not suffer from "mission creep," the eventual discontinuation of that social mission over time.<sup>130</sup>

### III. CALIFORNIA'S NEW HYBRID ENTITIES

As the Ben & Jerry's story illustrates, the traditional black-and-white distinction between for-profit and nonprofit does not provide adequate protection or guidance in the evolving area of social enterprise law. Recognizing the limitations and restraints posed on socially geared for-profit organizations, several states have begun to develop a legislative model that blends attributes of traditional for-profit and nonprofit entities into "hybrid" organizations.<sup>131</sup>

Chief among these states is California, which has emerged as a leader of this new social enterprise law.<sup>132</sup> California is the only state to allow a business to incorporate as a Benefit Corporation ("B Corp") or a Flexible Purpose Corporation (FPC).<sup>133</sup> Additionally, the

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127. See *infra* notes 128–30 and accompanying text.

128. Resor, *supra* note 46, at 99.

129. Plerhopes, *supra* note 12, at 248–49 ("[E]ven if the business judgment rule would provide liability protection for specific business decisions based on the dual objectives of the corporation, directors remain risk-averse and take conservative positions due to the threat of litigation."); Britt et al., *supra* note 73 ("Because these rules are judicially created and interpreted, and because litigation is prevalent, even where judicial guidance exists, directors and their lawyers tend to apply risk-averse interpretations.").

130. Katz & Page, *supra* note 61, at 95–96. Mission creep is also referred to as "legacy problems," "mission drift," or a lack of a "mission anchor." It relates to the fact that even if the company is able to pursue its social missions while making a profit, the social purpose is at risk of changing or even disappearing with the addition of new management. Resor, *supra* note 46, at 99.

131. See *L3C Tally*, INTERSECTOR PARTNERS, L3C, [http://www.intersectorl3c.com/l3c\\_tally.html](http://www.intersectorl3c.com/l3c_tally.html) (last updated Aug. 24, 2014); *State by State Legislative Status*, B LAB, <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Sept. 28, 2014).

132. See *infra* notes 237, 241, and accompanying text.

133. TALLEY, *supra* note 88, at 1.

state legislature has proposed a third type of hybrid entity—the Low-Profit Limited Liability Company (“L3C”).<sup>134</sup> The creation of these hybrid entities now protects socially responsible California corporations, like Patagonia, and provides directors with protection to pursue social and environmental causes.<sup>135</sup>

The FPC became law in California on January 1, 2012.<sup>136</sup> As of January 2013, California remains the only state to have passed legislation authorizing the FPC.<sup>137</sup> Senator Mark DeSaulnier introduced the FPC in Senate Bill 201—The Corporate Flexibility Act of 2011—on February 8, 2011.<sup>138</sup> The FPC was the “brainchild of the California Working Group for New Corporate Forms,”<sup>139</sup> a group of ten California lawyers dedicated to giving greater flexibility to socially responsible for-profit businesses.<sup>140</sup> It appears that California businesses have been a bit cautious in adopting this new form, as only thirty-one California companies have registered to become FPCs in the first seventeen months since the law’s enactment.<sup>141</sup>

Sponsored by assembly member Jared Huffman and the American Sustainable Business Council,<sup>142</sup> California passed the Benefit Corporations Code on the same day that the FPC was

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134. S.B. 323, 2011–2012 Leg. § 17701.02 (Cal. 2011).

135. See B CORPORATION, 2012 B CORPORATION ANNUAL REPORT 27 (2012), available at [http://www.bcorporation.net/sites/all/themes/adaptivetheme/bcorp/pdfs/BcorpAP2012\\_Web-Version.pdf](http://www.bcorporation.net/sites/all/themes/adaptivetheme/bcorp/pdfs/BcorpAP2012_Web-Version.pdf) (“B Corp enshrines Patagonia’s nearly 50 year old model of business into law. And that makes it easier for other businesses to adopt this model and use it in their own search for stewardship and sustainability.”).

136. DEBRA BOWEN, SECRETARY OF STATE, TWO NEW TYPES OF CORPORATIONS EFFECTIVE JANUARY 1, 2012 (2011), available at <http://www.sos.ca.gov/business/be/forms/flexible-purpose-corp-and-benefit-corp.pdf>.

137. It is worth noting that the state of Washington has adopted an entity called the “social purpose corporation.” Page, *Truth About Ben & Jerry’s*, *supra* note 9, at 42. Despite the different titles, the language of Washington’s social purpose corporation is very similar to the language of California’s FPC. Compare CAL. CORP. CODE §§ 2500–3503 (West 2013) (specifying the requirements for California’s FPC), with WASH. REV. CODE §§ 23b.25.005–.25.150 (West 2013) (specifying the requirements for Washington’s social purpose corporation).

138. Clarke, *supra* note 52, at 321.

139. David Adelman, *Just What California Needs: A New Corporate Form*, L.A. LAW., Apr. 2011, at 68, 68.

140. Clarke, *supra* note 52, at 316.

141. DEBRA BOWEN, SECRETARY OF STATE, SUPPLEMENTAL LANGUAGE REPORT BUDGET LETTER 12-16 (2013), available at [www.sos.ca.gov/admin/reports/2013/flexible-purpose-corporations-report.pdf](http://www.sos.ca.gov/admin/reports/2013/flexible-purpose-corporations-report.pdf).

142. *State by State Legislative Status*, *supra* note 131.

adopted into California law—January 1, 2012.<sup>143</sup> On a national and state level, B Corp legislation has been more widespread than the FPC.<sup>144</sup> Maryland became the first state to adopt the B Corp in 2010.<sup>145</sup> There are now twenty-six states that have passed B Corp laws<sup>146</sup> and twelve more states that have proposed B Corp legislation.<sup>147</sup> Since enactment, over one hundred companies have registered as California B Corps.<sup>148</sup>

The L3C was the first profit/nonprofit hybrid entity adopted in the United States.<sup>149</sup> After Vermont adopted its legislation in 2008, eight other states enacted L3C legislation.<sup>150</sup> Entrepreneur Robert Lang championed the notion of the L3C after he became the CEO of his family's foundation.<sup>151</sup> The L3C concept is now being introduced and promoted in various state legislatures by the Americans for Community Development (a group funded by Lang's foundation) and L3C Advisors.<sup>152</sup>

### A. Flexible Purpose Corporation

Unlike traditional corporate entities, the Flexible Purpose Corporation<sup>153</sup> form allows California businesses to freely pursue social or environmental objectives without exposing directors to liability for not maximizing profits.<sup>154</sup> Expanding the protection of traditional for-profit forms, the FPC protects directors, shareholders, and stakeholders of socially conscious businesses in three significant ways.

First, the FPC allows a company to pursue one or more “special

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143. BOWEN, *supra* note 136; TALLEY, *supra* note 88, at 4 n.4.

144. *See* TALLEY, *supra* note 88, at 6.

145. *See* Plerhoples, *supra* note 12, at 224 n.22.

146. *State by State Legislative Status*, *supra* note 131. The District of Columbia has also passed B Corp legislation. *Id.*

147. *Id.*

148. BOWEN, *supra* note 141. Data was measured from January 2012 to June 2013. *Id.*

149. *See* Clarke, *supra* note 52, at 312.

150. *See* L3C Tally, *supra* note 131.

151. Malika Zouhali-Worrall, *For L3C Companies, Profit Isn't the Point*, CNN MONEY (Feb. 9, 2010, 10:49 AM), [http://money.cnn.com/2010/02/08/smallbusiness/l3c\\_low\\_profit\\_companies](http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies). Lang felt the need to create the L3C model so that private foundations, like the one he ran, could donate “Program-Related Investments” to charitable organizations. *Id.*

152. Witkin, *supra* note 80. Lang and other early adopters created L3C Advisors to help jumpstart and finance other L3Cs. L3C Advisors was the first L3C created. *Id.*

153. *See* CAL. CORP. CODE §§ 2500–3503 (West 2013).

154. *See infra* notes 155–58 and accompanying text.

purposes”<sup>155</sup> in addition to simply maximizing profits.<sup>156</sup> The FPC code gives great flexibility to what constitutes a special purpose. Specifically, this special purpose can be a “charitable or public purpose activit[y] that a nonprofit public benefit corporation is authorized to carry out,” or a means to improve or advocate for the FPC’s employees, suppliers, customers, creditors, community, society, or the environment.<sup>157</sup> This flexibility shields directors from personal liability if they make decisions that favor the company’s special purpose over the company’s financial profits.<sup>158</sup>

Second, in addition to aiding socially conscious directors, the FPC code also ensures full disclosure and adequate transparency to socially conscious shareholders. FPCs must send an annual report to all shareholders.<sup>159</sup> The report must contain a balance sheet, income statement, statement of cash flows, and a report from independent accountants (if the company used one).<sup>160</sup> Moreover, an FPC must issue a “[special purpose] management discussion and analysis,” which identifies and evaluates how the company is meeting its special purpose objectives.<sup>161</sup> These extensive and detailed reports provide an added measure of transparency and accountability that a traditional for-profit corporation is not required to provide.<sup>162</sup>

Third, the long-term protection from mission creep<sup>163</sup> better safeguards stakeholders’ interests.<sup>164</sup> In fact, a supermajority vote of at least two-thirds is required to eliminate or drastically alter the FPC’s special purpose,<sup>165</sup> convert the FPC into a solely for-profit corporation,<sup>166</sup> sell substantially all of the FPC’s assets,<sup>167</sup> merge the

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155. CAL. CORP. CODE § 2602(b)(2) (West 2013). “Special purpose” is a term unique to the FPC. See *id.* § 2513; Clarke, *supra* note 52, at 318–19.

156. A special purpose must be specified in the articles of incorporation. Clarke, *supra* note 52, at 318–19.

157. CAL. CORP. CODE § 2602(b)(2)(A)–(B) (West 2013).

158. Clarke, *supra* note 52, at 319.

159. CAL. CORP. CODE § 3500 (West 2013).

160. *Id.* § 3500(a).

161. *Id.* § 3500(b). If the board withholds expenditures that might relate to the company’s special purpose, the company will also have to issue a “special purpose current report.” *Id.* § 3501.

162. See Resor, *supra* note 46, at 99.

163. See *supra* text accompanying note 130.

164. See *infra* notes 165–69 and accompanying text.

165. CAL. CORP. CODE § 3002(c) (West 2013).

166. *Id.*

167. *Id.* § 3100.

FPC into a corporation,<sup>168</sup> or reorganize the FPC.<sup>169</sup> When businesses are organized as FPCs, owners feel secure that their companies' special purpose(s) will survive in the long-term, even in the event of a sale, merger, or reorganization.<sup>170</sup>

### B. Benefit Corporations

Similar to an FPC, a Benefit Corporation<sup>171</sup> allows its directors to pursue a dual purpose without constantly fearing legal ramifications for actions that may not maximize shareholder wealth.<sup>172</sup> However, the B Corp has some distinct differences from the FPC that provide even more transparency to a B Corp's shareholders and the general public. While appearing to give similar protection to directors as the FPC, the B Corp requires a more structured and defined social purpose.<sup>173</sup> A B Corp requires that a company pursue a "general public benefit,"<sup>174</sup> which must have a "material positive impact on society and the environment."<sup>175</sup> In addition to a general benefit, a B Corp may also identify any "specific public benefit" in its articles of incorporation that it wishes to pursue.<sup>176</sup>

The biggest difference between the FPC and the B Corp is that the B Corp provides added transparency and enhanced accountability to shareholders.<sup>177</sup> Unlike the FPC, which gives nearly unfettered

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168. *Id.* § 3201.

169. *Id.* § 3401.

170. *See supra* notes 165–69 and accompanying text. *See also B Corp*, PATAGONIA, <http://www.patagonia.com/eu/enCZ/patagonia.go?assetid=70725> (last visited Apr. 7, 2013). (quoting Chouinard stating that California's new social enterprise legislation "creates the legal framework to enable mission-driven companies . . . to stay mission-driven through succession, capital raises, and even changes in ownership, by institutionalizing the values, culture, processes, and high standards put in place by founding entrepreneurs").

171. CAL. CORP. CODE §§ 14600–31 (West 2013).

172. *See infra* notes 173–76 and accompanying text.

173. TALLEY, *supra* note 88, at 5.

174. CAL. CORP. CODE § 14610(a) (West 2013).

175. *Id.* § 14601(c). While the text of section 14601(c) technically states "society *and* the environment" (emphasis added), it practically refers to a material benefit on the environment, shareholders, employees, customers, *or* the community. *See Clarke, supra* note 52, at 319.

176. CAL. CORP. CODE §§ 14601(e), 14610(b) (West 2013).

177. *Compare id.* § 3502(b) (mentioning FPCs are given the benefit of a presumption if they use "best practices" to measure their special purpose), *with id.* § 14601(c) (stating that B Corps must have a "material positive impact on society and the environment, taken as a whole, as assessed against a third-party standard").

discretion to its directors to measure its social purpose initiatives, the B Corp requires an independent third-party evaluation.<sup>178</sup> This annual comprehensive assessment<sup>179</sup> analyzes whether the B Corp benefit corporation dutifully fulfilled its identified public benefit(s).<sup>180</sup> Accompanying the annual third-party evaluation, a California B Corp must also send out a comprehensive annual report to all its shareholders.<sup>181</sup> Unlike the annual report required for an FPC, the B Corp's "benefit report" must contain the following: a "narrative" describing how the B Corp selected its third-party standard and how it pursued its general public benefit(s) and specific public benefit(s),<sup>182</sup> "an assessment of [its] overall social and environmental performance,"<sup>183</sup> and the "name of each person that owns 5 percent or more of [the company's] outstanding shares."<sup>184</sup>

Lastly, the B Corp creates additional safeguards for socially conscious shareholders.<sup>185</sup> Specifically, the entity creates a new right of action called a "benefit enforcement proceeding."<sup>186</sup> A shareholder, director, individual, or an entity explicitly mentioned in the bylaws or articles of incorporation, or the B Corp itself may bring a benefit enforcement proceeding<sup>187</sup> if the B Corp fails to pursue one of its listed general or specific public benefits, or fails to deliver its annual benefit report to shareholders.<sup>188</sup> Additionally, a two-thirds supermajority vote is required to eliminate or amend the B Corp's special purpose.<sup>189</sup>

### C. Low-Profit Limited Liability Company

Differing greatly from the organizational structure of the B Corp

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178. *Id.* § 14601(g) ("Third-party standard" means a standard for defining, reporting, and assessing overall corporate social and environmental performance."). *Id.* Two companies that are commonly used for the "third-party standard" are B Lab and Global Reporting Initiative. Resor, *supra* note 46, at 110.

179. CAL. CORP. CODE § 14601(g)(1) (West 2013).

180. *Id.*

181. *Id.* § 14630.

182. *Id.* § 14630(a)(1).

183. *Id.* § 14630(a)(2).

184. *Id.* § 14630(a)(3).

185. See *infra* notes 186–89 and accompanying text.

186. CAL. CORP. CODE § 14623 (West 2013).

187. *Id.* § 14623(b).

188. *Id.* § 14601(b).

189. *Id.* §§ 14601(d)(1)(B); 14610(d).

and the FPC, the last hybrid model, the L3C, offers very distinct advantages to social entrepreneurs.<sup>190</sup> Although the L3C concept has not been enacted in California, it was proposed on February 14, 2011, in Senate Bill 323.<sup>191</sup>

Similar to the other hybrid entities, the L3C allows directors to pursue a social purpose, and therefore, directors do not need to be solely concerned with maximizing shareholder wealth.<sup>192</sup> However, unlike the other California hybrid models, profits cannot be a significant purpose of the company.<sup>193</sup> Instead, the primary purpose of the L3C must be to accomplish a charitable or educational purpose.<sup>194</sup>

Although this restriction on profits may serve to limit capital investments from traditional investors, the L3C concept was created to increase the total capital available for social entrepreneurs,<sup>195</sup> primarily through IRS-sanctioned Program Related Investments (PRIs),<sup>196</sup> which are loans or investments from private, charitable foundations.<sup>197</sup> To qualify as a PRI, “the investment must relate to the Foundation’s mission and the risk/reward ratio must exceed that of a standard market-driven investment.”<sup>198</sup> Because the main goal of for-profit companies is to make money—a goal that is incompatible with most foundations’ charitable missions—the L3C creates the first for-profit entity that is PRI compatible.<sup>199</sup> Additionally, the ability of the L3C model to make actual returns for investors might attract new

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190. See *infra* notes 195–99 and accompanying text.

191. S.B. 323, 2011–2012 Leg. (Cal. 2011). As of December 2012, the provisions of Senate Bill 323 that include the L3C entity have not been enacted into California law. CAL. S. JOURNAL, 2011–2012 Recess 5137 (2012).

192. See S.B. 323 § 17701.02 (j) (Cal. 2011).

193. *Id.* § 17701.02(j)(2). Nor can the appreciation of property be a significant purpose. *Id.*

194. *Id.* § 17701.02(j)(1)(B). Specifically, the primary purpose must be for “religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals.” 26 U.S.C. § 170(c)(2)(B) (2012).

195. Neetal Parekh, *What is an L3C? (Low-Profit Limited Liability Company)*, INNOV8SOCIAL (Oct. 31, 2011), [www.innov8social.com/2011/10/what-is-l3c-low-profit-limited.html](http://www.innov8social.com/2011/10/what-is-l3c-low-profit-limited.html).

196. *Id.*

197. Resor, *supra* note 46, at 104; Zouhali-Worrall, *supra* note 151.

198. Witkin, *supra* note 80 (emphasis omitted).

199. Clarke, *supra* note 52, at 309; Zouhali-Worrall, *supra* note 151. In fact, “[t]he New York-based Foundation Center estimates that PRIs made up less than 1% of the charitable distributions made by foundations in 2006 and 2007.” *Id.*



socially driven investors who want to be socially responsible, but lack the resources to simply donate to traditional nonprofits.<sup>200</sup>

#### IV. HYBRIDS FIX LIMITATIONS OF TRADITIONAL CORPORATE STRUCTURE

As demonstrated in this section, the FPC, B Corp, and L3C forms provide greater (1) protection, (2) transparency, (3) accountability, and (4) sustainability than the traditional corporate structure. By addressing these four limitations of the traditional corporate structure, these new social hybrids not only afford directors, founders, and officers increased legal protection but also promote confidence to pursue a double bottom line.

##### A. Greater Protection

Directors and officers of these hybrids can enjoy managerial flexibility that was not previously available to companies using the traditional corporate structure.<sup>201</sup> The restrictive traditional corporate structure has made managers of both for-profits and nonprofits leery of making decisions that might have maximized their company's social and financial gains.<sup>202</sup> Managers of traditional nonprofits were forced to restrict their managerial decisions to conform to the strict IRS rules governing nonprofits.<sup>203</sup> Managers of traditional for-profits were forced to second-guess managerial decisions in lieu of the strong shareholder wealth maximization norm and the murky boundaries of the BJR.<sup>204</sup> Formally codifying the language of the new structures in the California Corporations Code finally gives risk-averse managers and directors of social enterprises the confidence to make informed social and financial decisions without fearing adverse IRS ramifications or possible litigation from shareholders.<sup>205</sup>

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200. See Murray & Hwang, *supra* note 44, at 22.

201. See Reiser, *supra* note 2.

202. *Id.* at 609 ("Rather than fearing litigation, the founder of a for-profit social enterprise may instead worry about locking in a dual mission legacy, about sufficient access to capital, or both."). *Id.* at 610.

203. Britt et al., *supra* note 73.

204. See *supra* notes 95–97, 104, and accompanying text.

205. Britt et al., *supra* note 73.

### B. Greater Transparency

The reporting standards required for California's new social enterprises provide more transparency than a traditional corporation is required to provide.<sup>206</sup> A traditional for-profit could claim it was "socially good" or "environmentally green" without really quantifying its impact on the society or the environment.<sup>207</sup> The requirements of the FPC and the B Corp do not permit such unsubstantiated claims because both hybrid forms require comprehensive annual reports that detail the societal impact of a company's social initiatives to all shareholders.<sup>208</sup> In fact, the creator of the FPC corporate code "believes strongly these requirements will provide a strong incentive for better reporting, greater detail, and better explanation of efforts undertaken, permitting far better monitoring of greenwashing than is possible today."<sup>209</sup>

In addition to promoting and incentivizing companies to provide more detailed reports on social missions, the requirements on social impact reporting have also accelerated the area of *social impact accounting*.<sup>210</sup> Several prominent organizations, like B Lab or Global Reporting Initiative,<sup>211</sup> have recently proven that they can effectively assess a company's fulfillment of its social or environmental purpose.<sup>212</sup> Additionally, the Sustainability Accounting Standards Board "is creating standard social accounting tools in the same manner that the Financial Accounting Standards Board created

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206. *Id.* (stating that with the "additional transparency requirements, shareholders will now possess important information for determining whether a company is working in a manner and with appropriate efficacy to achieve its stated Special Purpose").

207. *Id.* ("[T]he proposal's requirements for public transparency and reporting on its efforts and success towards achieving its Special Purpose provide the opportunity for more facts than previously included in the marketplace for determining the real impact of a company's claims of achieving 'green' or 'good' results.").

208. CAL. CORP. CODE §§ 3500, 14630 (West 2013).

209. Britt et al., *supra* note 73.

210. Note that California courts have not developed a set standard for measuring social impact accounting. *See* Britt et al., *supra* note 73 (stating that there "exist[s] no single accepted, well-established standard for measurement of SROI, but rather multiple emerging standards."); Plerhoples, *supra* note 12, at 256 ("[A]lthough no standard measure for social impact accounting yet exists, best practices have emerged.").

211. *See* Resor, *supra* note 46, at 110.

212. As discussed above, this independent third-party approval is already required for California's Benefit Corporations. CAL. CORP. CODE § 14601(g) (West 2013). The third party is required to assess the B Corp's impact on its employees, subsidiaries, suppliers, customers, the community, and the local and global environment. *Id.* §§ 14601(g)(1); 14620(b)(2)–(5).

standards for financial accounting.”<sup>213</sup>

### C. Greater Accountability

These new transparency requirements also place more accountability on the managers and directors of California’s modern social enterprises.<sup>214</sup> Equipped with a new wealth of information, shareholders of these social enterprise forms now possess several ways to hold managers accountable for their social and environmental actions.<sup>215</sup> First, shareholders can vote off board members that do not adequately promote the company’s social missions.<sup>216</sup> Second, shareholders can resort to selling their stock in the company, which may ultimately reduce the company’s capital.<sup>217</sup> Third, shareholders can now bring a lawsuit for breach of fiduciary duty against directors who fail to follow the social purposes articulated in the company’s articles of incorporation.<sup>218</sup> Armed with these options, shareholders can better serve as “watchdogs” to ensure the stated social objectives are carried out.

### D. Greater Sustainability

The additional legal protection and accountability standards of California’s new hybrid forms also serve to protect the long-term sustainability of social enterprises. Mission creep<sup>219</sup> is a common fear for founders of many social ventures.<sup>220</sup> Indeed it was this fear that led the Ben & Jerry’s founders, Greenfield and Cohen, to oppose Unilever’s takeover.<sup>221</sup> The fear of mission creep can prevent owners from making beneficial decisions for their social enterprises.<sup>222</sup> For

213. See Plerhoples, *supra* note 12, at 257.

214. *Id.* at 259. (“This increased transparency is meant to give shareholders the ability to hold the flexible purpose corporation’s directors and officers accountable for their actions . . .”).

215. *Id.* (stating that “dissatisfied shareholders can attempt to vote out the board or exit the firm themselves by selling their shares.”).

216. *See id.*

217. *Id.*

218. Britt et al., *supra* note 73 (stating that “the law always permits shareholders to file suit for a director’s breach of fiduciary duties, something that will now include (equally and in the same manner) a failure to adhere to the agreed Special Purpose as it currently applies to failures to sufficiently emphasize financial returns”).

219. *See supra* text accompanying note 130.

220. *See Katz & Page, supra* note 61, at 95–96.

221. *See The Scoop on Ben & Jerry’s Sellout, supra* note 24.

222. TALLEY, *supra* note 88, at 5.

example, fearing the eventual loss of a social purpose, some founders may refuse to give up control of their companies and thus decline to entertain the issuance of new stock, merger negotiations, management changes, or a much overdue retirement—all decisions that might better the overall performance of their company.<sup>223</sup> The requirements of the new California social forms directly recognize and alleviate founders' external and internal fears of mission creep.

A founder or director under a traditional corporate structure may be concerned that a designated social purpose will succumb to an external force (i.e., a merger, major reorganization, or a management change).<sup>224</sup> Founders and directors of FPCs, B Corps, or L3Cs need not have this worry, however, as all of California's new social forms require the social purpose to be explicitly listed in the social enterprise's articles of incorporation.<sup>225</sup> Furthermore, the B Corp<sup>226</sup> and the FPC<sup>227</sup> offer an additional layer of protection to the long-term sustainability of social missions, as both require a supermajority vote of at least two-thirds to change any stated social purpose.<sup>228</sup>

Social sustainability is further increased because the new social enterprises put shareholders and potential shareholders on notice of what they are actually buying in to.<sup>229</sup> Whether it is the social and environmental purposes directly set out in each company's publicly available articles of incorporation or the distinction of being an FPC, B Corp, or L3C, all shareholders should be aware that these companies are designed to pursue a double bottom line, which may or may not align with shareholder profit maximization.<sup>230</sup> As such, traditional investors (who focus only on the financial bottom line) should temper their expectations for financial returns or, more simply, choose not to invest in these dual-purpose entities. In all

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223. See Resor, *supra* note 46, at 99, 108.

224. See Plerhoples, *supra* note 12, at 235–36 (referencing several examples of socially conscious businesses (e.g., Tom's of Maine, Inc., Burt's Bees, Inc., and Ben & Jerry's) that were acquired by profit-driven multinational corporations).

225. CAL. CORP. CODE §§ 2602(b)(2), 14610(b) (West 2013).

226. *Id.* § 14610(d).

227. *Id.* § 3002.

228. See *supra* notes 226–27.

229. Plerhoples, *supra* note 12, at 250 (“At the same time, the statement of special purpose in the corporate charter puts the world and investors on notice that both financial and non-economic values will be pursued.”).

230. *Id.* at 250 n.147.

likelihood, most investors of these hybrid corporations will be socially conscious investors who measure returns in more than just financial terms.<sup>231</sup> These investors are less demanding of financial returns than traditional investors, and are thus more likely to have greater and longer-lasting patience for and understanding of directors' decisions that do not maximize profits.<sup>232</sup>

## V. WHY SHOULD CALIFORNIA BECOME THE LEADER OF SOCIAL ENTERPRISE?

In addition to the creation of new hybrid forms, social entrepreneurship might also benefit from a state assuming a leadership position in the development of social enterprise law.<sup>233</sup> California's unique cultural and social landscape already makes it an attractive location for social enterprises.<sup>234</sup> California should continue to take steps to encourage social ventures to incorporate within the state because of the possible financial, environmental, and societal impacts these businesses might generate.

### A. *How Social Enterprises Can Benefit from California*

California is a strong, if not the ideal, candidate to become the leader of social enterprise law in the United States for three reasons. First, California already offers one of the most diverse and "tantalizingly unique" selections of social enterprise forms.<sup>235</sup> Second, California's large economy and physical geography make it an appealing location for new and existing businesses.<sup>236</sup> Third,

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231. See *id.* at 227. ("Persons or entities most likely to invest in flexible purpose corporations—namely, impact and social investors—do not want shareholder value prioritized over social and environmental considerations.").

232. See Jon Carson, *Creating an Edge with Mission: Competitive Advantages of For-Profit Social Enterprises*, HUFFINGTON POST (Apr. 26, 2012, 1:10 PM), [http://www.huffingtonpost.com/jon-carson/creating-an-edge-with-mis\\_b\\_1452162.html](http://www.huffingtonpost.com/jon-carson/creating-an-edge-with-mis_b_1452162.html) ("Social enterprises may receive slightly more patience and buy-in from investors, especially if they themselves are mission driven.").

233. See Page, *Truth About Ben & Jerry's*, *supra* note 9, at 43.

234. See *infra* notes 235–37 and accompanying text.

235. TALLEY, *supra* note 88, at 4. In addition, the largest business (in terms of revenue generated) to have incorporated as a social enterprise company is California's own Patagonia. Felicity Carus, *Patagonia: A Values-Led Business from the Start*, GUARDIAN (July 17, 2012, 11:21 AM), <http://www.guardian.co.uk/sustainable-business/patagonia-values-led-business-benefit-corp> (stating that "Patagonia now has \$600m in annual revenues . . . making it the largest company so far to sign as a benefit corporation").

236. See *infra* notes 243–46 and accompanying text.

California's strong long-arm statute provides added protection for businesses that incorporate within the state.<sup>237</sup>

### 1. Diverse Array of Business Entities

No other state offers the same variety of hybrid enterprises that California does.<sup>238</sup> In fact, there are only five other states (Illinois, Louisiana, Rhode Island, Utah, and Vermont) that offer more than one form of social enterprise.<sup>239</sup> All three of these states offer B Corps and L3Cs, but none offer the FPC.<sup>240</sup> Without the IRS's automatic qualification for L3Cs to qualify as PRIs, the L3C form provides very few advantages over the B Corp.<sup>241</sup> Thus, at the moment, California is the only state that provides two uniquely advantageous vehicles for social enterprises.<sup>242</sup>

### 2. Large Economy

California's large size (both in terms of population and geography) has prompted many companies to relocate or do business within the state's borders.<sup>243</sup> In fact, California is the national leader in "registered firms (incorporated or not), employees, and payroll."<sup>244</sup> The state is also a leading source of venture capital funding and private equity financing.<sup>245</sup> Most importantly, California currently is home to more companies that seek to pursue a double bottom line than any other state.<sup>246</sup> Armed with a wealth of resources (human capital, financial capital, and natural capital) and a trailblazing attitude towards socially conscious businesses,<sup>247</sup> California serves as an ideal location for new social enterprises.

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237. TALLEY, *supra* note 88, at 4 n.3.

238. *See infra* notes 239–41 and accompanying text.

239. *See L3C Tally, supra* note 131; *State by State Legislative Status, supra* note 131.

240. *See supra* note 239; *see also* TALLEY, *supra* note 88, at 1 (stating that "California's experiment is unique" because it is the first state to offer both the FPC and the B Corp forms).

241. The primary purpose for creating the L3C was to "attract program related investments (PRIs) from foundations." Resor, *supra* note 46, at 104.

242. *See supra* notes 238–41 and accompanying text.

243. *See* TALLEY, *supra* note 88, at 3.

244. *Id.*

245. *See* Britt et al., *supra* note 73.

246. *Id.* (stating that California contains "more companies seeking to mix mission and money than any other state").

247. *See supra* notes 243–46 and accompanying text.

### 3. Protective Long-Arm Statute

California has one of the most “comprehensive” long-arm statutes of any state.<sup>248</sup> California grants jurisdiction to its courts “on any basis not inconsistent with the Constitution of this state or of the United States.”<sup>249</sup> The sweeping language of California’s long-arm statute imposes no additional limitations on state courts that are not already outlined in the constitutions.<sup>250</sup> Accordingly, courts have held that California’s statute “authorizes the broadest possible exercise of judicial jurisdiction.”<sup>251</sup> This low jurisdictional threshold helps protect California businesses because it makes it easier for California businesses to bring lawsuits within the state.<sup>252</sup> By doing so, California businesses can avoid costly and time-consuming litigation in foreign states.<sup>253</sup>

#### *B. How California Can Benefit from Social Enterprises*

California’s emergence as a leader of social enterprise law will not only help the development of socially conscious businesses, but it could also assist the state financially. In fact, after the enactment of the B Corp into law, sponsor Jared Huffman stated, “With this new law, we are attracting new socially conscious companies, investors and consumers—we’re sending a strong message that California is open for this emerging form of business.”<sup>254</sup> Huffman hopes that California’s strong pro-social enterprise atmosphere will incentivize social entrepreneurs to create or move their socially conscious businesses within California’s borders.<sup>255</sup> This migration of social enterprises into the state would infuse more money into the local

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248. John A. Gorfinkel & Richard A. LaVine, *Long-Arm Jurisdiction in California Under New Section 410.10 of the Code of Civil Procedure*, 21 HASTINGS L.J. 1163, 1166 (1970).

249. CAL. CIV. PROC. CODE § 410.10 (West 2013).

250. *Quattrone v. Superior Court*, 118 Cal. Rptr. 548, 551 (Ct. App. 1975).

251. *Id.*

252. See generally VEDDER, PRICE, KAUFMAN & KAMM HOLZ, P.C., LONG-ARM STATUTES: A FIFTY-STATE SURVEY 18, 18–19 (2003) available at <http://euro.ecom.cmu.edu/program/law/08-732/Jurisdiction/LongArmSurvey.pdf> (referencing several cases that illustrate the strength of California’s long-arm statute).

253. See *id.*

254. Lifsher, *Businesses Seek*, *supra* note 15; *Patagonia Registers as First California Benefit Corporation*, B LAB (Jan. 3, 2012, 12:30 PM), [http://www.csrwire.com/press\\_releases/33565-Patagonia-Registers-as-First-California-Benefit-Corporation](http://www.csrwire.com/press_releases/33565-Patagonia-Registers-as-First-California-Benefit-Corporation).

255. Lifsher, *Businesses Seek*, *supra* note 15.

economy and ultimately create a larger tax base for the state.<sup>256</sup> Specifically, an influx of new social enterprises into California would (1) create more jobs, (2) open up new sources of capital for entrepreneurs, (3) generate new taxes, and (4) decrease local and state governments' spending on social and environmental initiatives.

### 1. Create New Jobs

Social enterprises that relocate into the state to take advantage of California's new hybrid structures would likely need local workers to operate.<sup>257</sup> Even if companies decide only to incorporate in California and not relocate operations, this incorporation activity should result in increased work and, correspondingly, more jobs for various state departments.<sup>258</sup>

### 2. Unlock New Sources of Capital

These new social enterprise forms will also likely open up new sources of financing and capital.<sup>259</sup> Specifically, these new social enterprise forms will be attractive for impact investors,<sup>260</sup> social investors,<sup>261</sup> venture philanthropy firms,<sup>262</sup> responsible investing funds,<sup>263</sup> and private foundations.<sup>264</sup> Although these sources of impact investing encompass significantly less capital than traditional for-profit sources, social investing has been steadily increasing in recent years.<sup>265</sup> In fact, a report by The Forum for Sustainable and

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256. See *infra* notes 259, 277–79 and accompanying text.

257. See Lifsher, *Businesses Seek*, *supra* note 15.

258. See MARK DESAULNIER, ANALYSIS OF ORIGINAL BILL – SB 1463 3 (2010), available at [www.ftb.ca.gov/law/legis/09\\_10bills/SB1463\\_021910\\_040510.pdf](http://www.ftb.ca.gov/law/legis/09_10bills/SB1463_021910_040510.pdf) (“Staff has determined that implementing this bill would have a significant impact to the department because of the new workload for collectors to collect tax, process tax clearance letters, retrain staff, and an increased number taxpayer calls.”).

259. See Plerhoples, *supra* note 12, at 252–53.

260. Impact investors make investments that “create positive impacts and social and environmental benefits beyond financial returns.” *Id.* at 253.

261. Social investors seek to make investments that have minimal “negative social and environmental impacts.” *Id.*

262. Venture philanthropy firms function like venture capital firms. However, venture philanthropy firms only acquire and distribute capital to social enterprises. *Id.* at 252–53 n.162.

263. Responsible (or sustainable) investing funds make investment decisions using “environmental, social, and governance (‘ESG’).” *Id.* at 252.

264. Private foundations maintain a set of core social missions and make investments that relate and promote their socially geared missions. *Id.* at 253.

265. See *id.* at 252 n.161.



Responsible Investment (“US SIF”) found that sustainable and responsible investing increased by nearly 16 percent in 2011 to a total of \$80.9 billion.<sup>266</sup>

Moreover, if the IRS should permit L3Cs to automatically qualify as PRIs (which California’s L3C code intentionally mirrors), California investors could also tap into previously unavailable capital from private foundations.<sup>267</sup> Currently, to keep its tax-exempt status, a private foundation is required to distribute a certain percentage (at least 5 percent<sup>268</sup>) of its assets each year.<sup>269</sup> Foundations can distribute their money in only two ways: (1) donate to nonprofit entities, where there is no possibility of financial return; or (2) invest in for-profit entities through PRIs, which allow financial returns.<sup>270</sup> With the L3C being the only for-profit entity that is meant to qualify as a PRI, this emerging hybrid form could attract substantial new capital from an otherwise relatively untapped source.<sup>271</sup>

### 3. Generate New Taxes

Even if social enterprises do not physically relocate their operations or headquarters into the state, California could still profit from social companies incorporating in the state. Delaware’s expansive case law and pro-business codes have made it the leader in corporate business law.<sup>272</sup> As a result, corporations commonly incorporate in Delaware even if they have little, if any, business

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266. *Id.* “According to a report by the US SIF Foundation, \$80.9 billion was invested by 375 sustainable and responsible investment funds in the beginning of 2011, representing a 15.9% increase from 2010.” Patrick Mitchell, *Study: “Alternative Investment” Assets in Sustainable & Responsible Investing Jumped 16 Percent in 2010*, US SIF (Oct. 26, 2011), <http://ussif.org/news/releases/pressrelease.cfm?id=181>.

267. Ron Shoemaker & Bill Brockner, *Public Charity Classification and Private Foundation Issues: Recent Emerging Significant Developments*, in IRS EXEMPT ORGANIZATION CPE TEXT FOR FY 2000 140, 140 (1999), available at <http://www.pgdc.com/pdf/CPE-FY2000.pdf> (stating that “private foundations have been hard pressed to meet their 5% minimum distribution requirement under IRC 4942”).

268. I.R.C. § 4942(e) (2012).

269. Resor, *supra* note 46, at 104; Deborah B. Andrews, *The ‘L3C’: The New Double-Hybrid Entity*, PHILANTHROPY J. (Dec. 10, 2010), <http://www.philanthropyjournal.org/resources/managementleadership/%E2%80%98new-double-hybrid-entity>.

270. Witkin, *supra* note 80.

271. See Parekh, *supra* note 195.

272. LEWIS S. BLACK, JR., DEL. DEP’T OF STATE, WHY CORPORATIONS CHOOSE DELAWARE 1–3, 10 (2007).

activities within the state.<sup>273</sup> This process has been very financially beneficial for the state of Delaware.<sup>274</sup>

Like a corporation that is incorporated in Delaware, a social enterprise that is incorporated in California can operate or hold its headquarters in any state.<sup>275</sup> Thus, California can benefit from franchise taxes on social enterprises that are incorporated but not doing business in California.<sup>276</sup> Currently, both B Corps<sup>277</sup> and FPCs<sup>278</sup> are treated as corporations under California's Corporation Tax Law and taxed at a franchise tax rate of 8.84 percent.<sup>279</sup>

#### 4. Decrease the State's Social and Environmental Burden

Lastly, an influx of social enterprises into the state would likely benefit the environment and local communities in California. These societal and environmental gains could reduce the tax burden and financial obligations of local and state governments, and ultimately allow the government to spend its coveted resources on other deserving areas.<sup>280</sup>

### C. Steps California Needs to Take

#### Recognizing the extensive benefits that the state of California

273. *See id.* at 1.

274. *Id.* (“The people of Delaware are aware that the income received from corporation franchise taxes is an important part of the state budget and that Delaware law firms that specialize in business law matters employ significant numbers of people.”). In fact, Delaware's franchise taxes account for nearly 18 percent of the state's revenues every year. *See* STATE OF DELAWARE, DEPARTMENT OF FINANCE, DELAWARE FISCAL NOTEBOOK 29 (2011), available at [http://www.finance.delaware.gov/publications/fiscal\\_notebook\\_11/fiscal\\_notebook\\_11.pdf](http://www.finance.delaware.gov/publications/fiscal_notebook_11/fiscal_notebook_11.pdf).

275. Page, *Truth About Ben & Jerry's*, *supra* note 9, at 43 (“When a form has been enacted in one state, it is available to residents of every state.”).

276. CAL. REV. & TAX. CODE § 23153(b)(1) (West 2012) (stating that “[e]very corporation that is incorporated under the laws of this state” has to pay a franchise tax).

277. JARED HUFFMAN ET AL., FRANCHISE TAX BOARD, ANALYSIS OF AB 361 (2011), [www.ftb.ca.gov/law/legis/11\\_12bills/ab361\\_Final.pdf](http://www.ftb.ca.gov/law/legis/11_12bills/ab361_Final.pdf).

278. DESAULNIER, *supra* note 35.

279. *2014 California Tax Rates and Exemptions*, STATE OF CALIFORNIA FRANCHISE TAX BOARD, [https://www.ftb.ca.gov/forms/2014\\_California\\_Tax\\_Rates\\_and\\_Exemptions.shtml?WT.mc\\_id=Business\\_Popular\\_TaxRates](https://www.ftb.ca.gov/forms/2014_California_Tax_Rates_and_Exemptions.shtml?WT.mc_id=Business_Popular_TaxRates) (last visited Sept. 27, 2014).

280. For example, a company keeps a manufacturing plant in a city to help bolster its local community. Providing steady jobs for an otherwise struggling city could be very advantageous as this could reduce government expenditures that commonly result from unemployment. *See* Marc Lifsher, *Unemployment Payouts Push California Deeper into Debt*, L.A. TIMES (Nov. 6, 2010), <http://articles.latimes.com/2010/nov/06/business/la-fi-jobless-fund-broke-20101107> [hereinafter Lifsher, *Unemployment Payouts*] (stating that the state of California is “borrowing \$40 million a day from the federal government to provide assistance to jobless workers”).

could receive if it does truly become the leader in social enterprise, it is important that California continues to take the necessary steps in advancing its social enterprise law. To maintain its leadership position, California needs to stay educated and informed on new, emerging hybrid forms, continue to fortify the protection of social enterprises and their directors, and possibly incentivize current for-profit entities to convert to social enterprises. At the current moment, California should take the following three steps to accomplish these goals: (1) pass L3C legislation, (2) develop clear case law on the new social enterprise entities, and (3) consider tax breaks for social enterprises incorporated in California.

### 1. Pass L3C Legislation

The first step California should pursue is to repropose and pass L3C legislation.<sup>281</sup> While the L3C does not offer any distinct advantages over California's FPC or B Corp at the moment, it will be a very significant social enterprise model if the IRS decides to grant an automatic PRI qualification to this form of business entity.<sup>282</sup> Although this IRS qualification is not certain to be adopted,<sup>283</sup> it would still benefit California to become familiar with the entity (as California should be prepared to have first-mover advantage should the IRS adopt the PRI qualification).

### 2. Develop Social Enterprise Case Law

The more difficult step for California is to develop clear case law surrounding its new social enterprise entities. To date, no state or federal court has taken on the validity of these new hybrid entities.<sup>284</sup> If the California state courts could tackle the validity of these hybrid

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281. The L3C legislation could mirror the L3C language from S.B. 323, a bill that proposed the L3C form in California in 2011 but ultimately was never passed. *See supra* note 191.

282. Parekh, *supra* note 195; Zouhali-Worrall, *supra* note 151. Although California's requirements for L3Cs mimic the exact language as the IRS requirements for a PRI, the IRS has not yet recognized L3Cs as automatically qualifying PRIs. Anne Field, *IRS Rule Could Help the Fledgling L3C Corporate Form*, FORBES (May 4, 2012, 11:32 AM), <http://www.forbes.com/sites/annefield/2012/05/04/irs-rules-could-help-the-fledgling-l3c>.

283. *L3C's, B Corps and Social Enterprises*, GILLESPIE L. GROUP BLOG (Apr. 12, 2011), [http://gillespielawgroup.com/our\\_blog/2011/13cs-b-corps-and-social-enterprises](http://gillespielawgroup.com/our_blog/2011/13cs-b-corps-and-social-enterprises) (noting that the IRS has given "no indication that they will do so in the near future").

284. *See Resor, supra* note 46, at 113 (stating that no court has taken on the validity of B Corps yet).

models in court, social enterprises would know what to expect during litigation and have clear standards on how to conduct their affairs.<sup>285</sup> Setting this legal precedent would instill confidence and trust in risk-averse entrepreneurs, directors,<sup>286</sup> and socially conscious investors,<sup>287</sup> encouraging them to use California's new hybrid entities.

### 3. Consider Tax Breaks

To encourage more companies to incorporate in California, the California state legislature should also consider tax breaks for these new social enterprise forms.<sup>288</sup> Specifically, the state could lower its franchise tax on these new hybrid forms. Currently, California taxes FPCs and B Corps under the same franchise tax rate as general corporations and Limited Liability Companies,<sup>289</sup> despite the societal and environmental benefits that the social enterprises will undoubtedly provide for the state. Tax incentives for creating jobs in California or relocating headquarters to California should also be considered.<sup>290</sup>

## VI. CONCLUSION

For years, the story of the takeover of Ben & Jerry's has served as a cautionary tale for socially conscious businesses across the nation.<sup>291</sup> The plight of Cohen and Greenfield illustrates the limited protections that the traditional corporate structure provides to social entrepreneurs. Yet, in the wake of an emerging body of social

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285. See TALLEY, *supra* note 88, at 10 (suggesting that an "absence of developed case law" might be a reason why the uptake rates of California's new hybrid entities have been relatively modest).

286. See Plerhoples, *supra* note 12, at 264 ("To the extent that directors are risk-averse, the lack of corporate law precedent is a true barrier to the proliferation of these new corporate forms.").

287. See *id.* at 226 ("[C]ourts adjudicate issues facing these new corporate forms to create a body of case law, this author predicts that social entrepreneurs and social investors will remain wary of using the new corporate forms for their businesses.").

288. See, e.g., Gomez, *supra* note 84 ("While benefit corporations do not enjoy any federal or state tax benefits that are equivalent to charities, B-Corps were granted tax breaks by the City of Philadelphia.").

289. 2011 California Tax Rates and Exemptions, *supra* note 279.

290. Maureen Gorsen, *California Proposes to Create New Corporate Entity for Environmentally/Socially Conscious Companies*, ALSTON & BIRD, LLP TAX BLOG (Sept. 8, 2011), <http://www.alston.com/taxblog/blog.aspx?entry=4399>.

291. Jenna Lawrence, Making the B List, STAN. SOC. INNOVATION REV., Summer 2009 at 66.

enterprise statutes, the story of Ben & Jerry's may now serve to demonstrate how far social enterprise law has advanced. Indeed, Jeff Furman, the current chairman of Ben & Jerry's,<sup>292</sup> recently illustrated how the creation of social enterprises has altered the corporate governance landscape: "If benefit corporations had existed back in 2000, the [Ben & Jerry's] board probably wouldn't have agreed to the Unilever deal."<sup>293</sup> Confirming his confidence in the new protections afforded to social enterprises under the evolving California laws, Ben & Jerry's recently followed Patagonia's lead and incorporated as a B Corp.<sup>294</sup>

With several states adopting their own hybrid structures, it is now up to socially conscious businesses to take advantage of the distinct benefits offered by each of these new social enterprise forms. If flexibility is important to a social enterprise, convert to an FPC.<sup>295</sup> If social image is critical, convert to a B Corp.<sup>296</sup> If access to capital from foundations<sup>297</sup> is vital, convert to an L3C.<sup>298</sup> No matter which of these new hybrid forms is selected, directors and officers will have the freedom to pursue a double bottom line without the burden of strict IRS compliance or the fear of shareholder litigation for not maximizing profits.

Already equipped with the most diverse menu of social enterprise forms—the FPC, the B Corp, and legislation for the

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292. Furman was also a director of Ben & Jerry's during the buyout by Unilever. Angus Loten, *With New Law, Profits Take a Back Seat*, WALL ST. J., Jan. 19, 2012, at B1.

293. *Id.* (quoting Loten who is paraphrasing a statement made by Jeff Furman).

294. *Ben & Jerry's Joins the B Corp Movement!*, BEN & JERRY'S, <http://www.benjerry.com/company/b-corp> (last visited Apr. 7, 2013); Joe Van Brussel, *Ben & Jerry's Becomes B-Corp Certified, Adds Credibility to Impact Investing Movement*, HUFFINGTON POST (Oct. 25, 2012, 10:12 AM), [http://www.huffingtonpost.com/2012/10/23/ben-and-jerrys-b-corp-impact-investing\\_n\\_2005315.html](http://www.huffingtonpost.com/2012/10/23/ben-and-jerrys-b-corp-impact-investing_n_2005315.html) (stating that Ben & Jerry's is "the first and only wholly-owned subsidiary of a public company to become a B-Corporation").

295. See Kyle Westaway, *New Legal Structures for 'Social Entrepreneurs'*, WALL ST. J. (Dec. 12, 2011, 12:42 PM), <http://online.wsj.com/article/SB10001424052970203413304577088604063391944.html> (stating that the FPC is an ideal form for companies that want "to do good on their own terms").

296. See *id.* (stating that the B Corp form is ideal for companies that "want to create a measurable positive impact").

297. Foundational investors are nonprofit entities that donate capital to support various charitable or mission driven organizations. See, e.g., *Foundation Fact Sheet*, BILL & MELINDA GATES FOUNDATION, <http://www.gatesfoundation.org/Who-We-Are/General-Information/Foundation-Factsheet> (last visited Apr. 11, 2013) (listing mission driven organizations that the Bill & Melinda Gates Foundation has donated to in recent years).

298. See Britt et al., *supra* note 73. This is assuming California passes the L3C legislation.

L3C—California has emerged as an early trailblazer of social enterprise law. In addition to accommodating social entrepreneurs, California's focus on promoting social enterprises might also benefit the average Californian citizen.

However, even if these new social enterprise forms fail to ultimately create a substantial amount of new jobs or tax revenues for the state of California, these entities provide a critical message for socially conscious individuals: California is open for social enterprise. Directors: Your social and environmental actions can now be protected. Entrepreneurs: You can now sell, reorganize, or merge your company without the fear of mission creep. Investors: You can now finance businesses that connect the moral causes you support with a more desirable financial return. Socially conscious businessmen and businesswomen: Welcome to California.

