Social Entrepreneurship and Public Benefit Corporations

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Approximately 18 months ago, Etsy Inc., the online retailer describing itself as "a marketplace where people around the world connect, both online and offline, to make, sell and buy unique goods" launched its initial public offering on the NASDAQ. What made Etsy's debut on the stock exchange a cause célèbre was the company's unique status as a social enterprise entity. Social enterprise entities can be defined as a corporate entity that uses "commercial activity to drive revenue with the common good as its primary purpose."[1] Etsy's IPO and the development of social enterprise entities are part of a wider trend. Most of the nation's most prestigious business schools, including Harvard, Columbia, Cornell, UNC, BU and Yale, now offer multiple courses that integrate social impact into their curriculum. Wharton now has a Director of Social Impact and the Berkeley Haas School of Management has a Center for Public and Non-Profit Leadership, many others have similar programs or centers.

With new MBAs increasingly exposed to concepts of social impact and responsibility it is reasonable to expect social enterprise entities will receive more attention. However, the existence of these entities is relatively new and burgeoning social entrepreneurs who wish to form businesses with missions beyond maximizing shareholder profit may find the current options confusing. This article will address some of the basic options for creating a social enterprise entity and some of the potential fund raising and corporate governance issues founders should contemplate.

Public Benefit Corporations

Since 2010, over thirty states, including Delaware and Massachusetts, have amended their corporation laws to permit the formation of public benefit corporations or benefit corporations ("PBCs"). PBCs are a form of social enterprise entity governed by the statutes of their state of incorporation. PBCs are for-profit entities and should not be confused with non-profit organizations. PBCs do not receive any of the special tax treatment of a non-profit. PBCs have stockholders, a board of directors and may pursue goals very similar to traditional corporations. The key difference is that PBCs must be "managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the PBC's conduct, and the public benefit or public benefits identified in its certificate of incorporation."[2] In Massachusetts in addition to a general for-profit purpose, a PBC must have the "purpose of creating general public benefit" and may have one or more "specific public benefit" purposes.[3]

What is a "Public Benefit"?

PBCs have wide latitude in determining what public benefits to pursue. In Delaware, a public benefit is a "positive effect or a reduction of negative effects" that impact one or more categories of "persons, entities, communities or interests." The effects may include, but are not limited to, "effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature." In Massachusetts a PBC must pursue the general public benefit which is defined as "a material, positive impact on society and the environment, taken as a whole, as measured by a third-party standard." In addition to pursuing the general public benefit, Massachusetts PBCs may pursue a "specific public benefit" enumerated in the statute which can be any of the following: (1) providing low-income or underserved individuals or communities with beneficial products or services; (2) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal

course of business; (3) promoting the preservation and conservation of the environment; (4) improving human health; (5) promoting the arts, sciences, access to and advancement of knowledge; (6) increasing or facilitating the flow of capital and assets to entities with a general public benefit purpose; or (7) conferring any other particular benefit on society or the environment.

Forming a Public Benefit Corporation

The formation of a PBC is very simple. An incorporator files incorporation documents that specifically state that the corporation will be a public benefit corporation (or "benefit corporation" in Massachusetts). In Delaware the corporation must identify within its statement of purpose one or more specific public benefits it will promote and the name of the entity may include "public benefit corporation", "P.B.C." or "PBC" as opposed to "corporation", "Inc.", "LLC" or other more traditional designations. The rules are similar in Massachusetts except that naming a specific public benefit the corporation intends to pursue is optional. In both Delaware and Massachusetts existing corporations may become PBCs or merge into PBCs.

Duties of the Board of Directors of a Public Benefit Corporation

The Massachusetts public benefits statute has been criticized for not providing sufficient guidance for directors. The Massachusetts statute mandates that in discharging their duties and in considering the best interest of the corporation, directors of a PBC must consider the effect on seven distinct constituencies, including (1) the shareholders of the PBC; (2) the employees and workforce of the PBC and its suppliers; (3) the interest of customers or clients as beneficiaries of the general public benefit or specific public benefit purposes of the PBC; (4) community and societal factors, including those of each community in which offices or facilities of the PBC or its suppliers are located; (5) the local, regional and global environment; (6) the short-term and long-term interests of the PBC; and (7) the ability of the PBC to accomplish its general public benefit purpose and any specific public benefit purpose. Additionally, Massachusetts PBC directors may consider the interests of the state, regional and national economy and "other pertinent factors" the directors deem appropriate. This wide latitude combined with the fact that Massachusetts PBCs are not required to name a specific public benefit leaves the directors with great flexibility but little resources or direction when they attempt to exercise their fiduciary duties.

Delaware has provided more direction. In Delaware the board of directors must manage the business of the PBC in a manner that balances (1) the pecuniary interests of the stockholders, (2) the best interests of those materially affected by the PBC's conduct, and (3) the specific public benefit or public benefits identified in the PBC's certificate of incorporation. This direction, combined with the fact that Delaware PBCs must name a specific public benefit they are working towards, provides directors with more guidance when carrying out their duties.

The Delaware and Massachusetts statutes specifically state that the directors have no fiduciary duties to any person that is a beneficiary of the general or specific public benefit purpose of the PBC arising from the status of the person as a beneficiary. However, both statutes allow shareholders to bring shareholder derivative suits to specifically enforce the public benefit the PBC is pursuing and the Massachusetts statute allows the PBC to extend the right to sue to any other person specified in its formation documents.

Special Concerns Upon the Sale of the Company

In the event of a sale of the company, directors of Delaware corporations generally have fiduciary duties to pursue the highest price available. The creation of PBCs naturally raises concerns over how directors will exercise their fiduciary duties to maximize shareholder value in a sale and to balance the public benefit the PBC is pursuing. What happens when an offer to purchase the PBC is made by an entity that may not share its mission? There is little case law to provide directors of PBCs with clear guidance but academics tend to believe that stockholder financial gain would not be the only permissible objective.[4] In the context of a sale of the company, director actions receive heightened scrutiny from courts and courts will ask whether a

person of "ordinary sound judgment" would approve the directors' decisions. But directors of PBCs must take into account the various competing interests discussed in the section above. What would a person of ordinary sound judgment do if the highest bidder for a PBC does not intend to adopt the PBC's stated public benefit purpose? Can directors approve a sale at significantly lower prices to another PBC that shares their mission? Conversely, can directors approve a sale to a company they know will dismantle the PBC's public benefit purpose if the price is high enough? Directors of PBCs who enter into a sale transaction are wading into very murky waters. It is still unclear what level of scrutiny these directors will receive and how courts will balance the competing interests PBC directors must weigh.

Directors of Massachusetts PBCs have less concern. Massachusetts corporation directors are already allowed to consider other constituencies than stockholders, including the interests of the corporation's employees, suppliers, creditors and customers, the economy of the state, the region and the nation, community and societal considerations, and the long-term and short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation. As discussed above, the Massachusetts PBC statute changes the factors to be considered when taking corporate actions but the impact is less significant on Massachusetts PBC directors than on those in Delaware.

Institutional Investors and Social Enterprise Entities

There is a lack of evidence to conclude how electing to become a PBC will impact a corporation's ability to raise capital from institutional investors. Some academics have attempted to draw conclusions by comparing investment behavior by institutional investors in other alternative purpose firms. These academics have concluded that pursuing alternative purpose entity designations did not significantly alter investors' willingness to invest but their results are not convincing and entrepreneurs looking to raise traditional venture capital financing should be wary.[5] There are examples of PBCs that have successfully raised millions in venture financing and there are specific funds designed to invest in social enterprise entities but traditional venture funds prefer to invest in standard Delaware corporations. Entrepreneurs considering forming a PBC or social enterprise entity should consider their financing needs and sources carefully before forming a PBC.

Periodic Benefit Reporting and Third Party Standards

PBCs in both Delaware and Massachusetts must provide periodic reports detailing their public benefit impact. In Delaware the statement must include: (1) the objectives the board of directors has established to promote its public benefit; (2) the standards the board of directors has adopted to measure the corporation's progress in promoting such public benefit; (3) objective factual information based on those standards regarding the corporation's success in meeting the objectives for promoting such public benefit; and (4) an assessment of the corporation's success in meeting the objectives and promoting such public benefit.

The reporting requirements in Massachusetts are much more onerous than in Delaware and Massachusetts PBCs must make the benefit report available to the public on the PBC's website. Massachusetts PBC's reports must use a third-party standard for defining, reporting and assessing overall corporate, social and environmental performance of the PBC. The third-party standard must be (1) comprehensive, (2) developed or performed by a person or organization independent of the PBC, (3) not materially financed by the PBC, (4) developed by people with credible expertise, and (5) transparent. Additionally, Massachusetts PBCs must appoint one director as a "benefit director" and such director is responsible for drafting an opinion included with the PBC's report which must detail, amongst other things, whether the PBC acted in accordance with its public benefit purpose and what impact the PBC's status as a benefit corporation is having on its business, including client or consumer opinions, returns on investment, impacts on shareholders and impacts on employees. In Delaware PBC have the option but are not required to use a third-party reporting standard. The reporting and third-party standard obligations in Massachusetts are significant and may be an important factor in determining where to incorporate a PBC.

Alternatives to Delaware and Massachusetts

As mentioned above, most states have adopted some form of PBC legislation. The vast majority have adopted rules based on the Model Benefit Corporation Legislation. Massachusetts is one of the jurisdictions that followed the model and most states' legislation is similar to the Massachusetts regulations. However, each state is unique and entrepreneurs should review their state's PBC statute before incorporating or converting into a PBC. A popular alternative to PBC incorporation is to become a certified "B Corp." B Corps are for-profit companies certified by the nonprofit B Lab. According to B Lab's website, B Corps meet "rigorous standards of social and environmental performance, accountability, and transparency." Any entity, regardless of corporate structure, state, or country of incorporation can become a certified B Corp – in other words you do not necessarily need to form a PBC for your social enterprise entity to become a B Corp. According to B Lab's website, B Corp certification costs between $500 and $50,000 per year based on the B Corp's revenues. It is important to note that B Lab is not a government agency and B Corp certification is not an official designation or registration made by or with any government body. A useful analogy may be to products that are label "Certified Humane" which is a standard set by an international non-profit certification organization vs. "Organic" which is an official designation set forth by the US Department of Agriculture. Corporations should weigh whether becoming a PBC or a B Corp is the right route to take.

Footnotes.

1. See Social Enterprise Innovation: Delaware's Public benefit Corporation Law, J. Haskell Murray, Harvard Business Law Review (2014).

2. References to the Delaware Statute are to Subchapter XV of the Delaware General Corporation Law.

3. References to the Massachusetts Statute are to Chapter 156E of the Massachusetts General Law.

4. See M&A Under Delaware's Public Benefit Corporation Statue: A Hypothetical Tour, Frederick Alexander, Lawrence Hamermesh, Frank Martin & Normal Monhait, Harvard Business Law Review (2014).

5. See Institutional Investing When Shareholders are Not Supreme, Christopher Geczy, Jessica Jeffers, David Musto & Anne Tucker, Harvard Business Law Review (2015).