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SYMPOSIUM ARTICLES

CHOOSE YOUR OWN MASTER: SOCIAL ENTERPRISE, CERTIFICATIONS, AND BENEFIT CORPORATION STATUTES

J. HASKELL MURRAY*

In the wake of the most recent financial crisis, interest in social enterprise has increased exponentially. Disillusioned with the perceived shareholder wealth focus of corporate law, entrepreneurs, investors, customers, and governments have become more receptive to new paradigms. In the past four years, nineteen states have passed at least one of five different types of social enterprise statutes and many additional states are considering similar legislation. Focusing primarily on the benefit corporation form, this Article examines three main issues: (1) whether social enterprise statutes are potentially useful; (2) how social enterprise law can be improved; and (3) whether the social enterprise movement will be sustainable. First, regarding usefulness, this Article recognizes that the traditional legal framework already provides social entrepreneurs most of the flexibility they seek, but posits that the social enterprise statutes may better combat perceptions of a shareholder wealth maximization norm arising from existing for-profit corporation law (especially in Delaware). As a potential alternative to social enterprise statutes, this Article suggests that states like Delaware could simply amend their existing corporate codes to expressly allow for a societal- or environmental-focused objective in a corporation's charter. Second, regarding improvements to existing social enterprise law, the Article suggests: (i) statutorily requiring social

* J. Haskell Murray is an assistant professor at *Regent University School of Law*. This Article was prepared for the *American University Business Law Review* Symposium "Profits Plus Philanthropy: The Emerging Law of 'Social Enterprises.'" The author thanks for their comments and thoughts: Bill Baxley, Cass Brewer, Bill Callison, Thomas Folsom, Joan MacLeod Heminway, Lyman Johnson, Joseph Leahy, Alicia Plerhoples, and Dana Brakman Reiser. Samuel Moultrie and Christie McGinley provided excellent research assistance. The opinions expressed and any errors made are solely those of the author.

entrepreneurs to choose their own primary master; (ii) recognizing modified versions of traditional corporate law concepts; (iii) lowering transaction and uncertainty costs; and (iv) eliminating or modifying certain mandatory rules. Third, regarding sustainability, this Article concludes that the most intensive social enterprise branding efforts should be left to the private sector organizations like B Lab; and social investors, perhaps using new vehicles like crowdfunding and Social Impact Bonds, must fill the funding gap left by hesitant traditional investors.

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INTRODUCTION

Yvon Chouinard, the esteemed founder of the outdoor apparel company Patagonia, Inc., opens his book, *Let My People Go Surfing: The Education of a Reluctant Businessman*, with these words:

> I've been a businessman for almost fifty years. It's as difficult for me to say those words as it is for someone to admit to being an alcoholic or a lawyer. I've never respected the profession. It's business that has to take the majority of the blame for being the enemy of nature, for destroying native cultures, for taking from the poor and giving to the rich, and for poisoning the earth with the effluent from its factories.
>
> Yet, business can produce food, cure disease, control population, employ people, and generally enrich our lives. And it can do these good things and make a profit, without losing its soul.[1]

Unfortunately, over the past dozen years, the headlines have not been dominated by corporations enriching lives. Rather, the media has focused on corporations—including Enron, WorldCom, Tyco, Adelphia, Lehman Brothers, Bear Stearns, AIG, BP, Massey, Olympus, and MF Global—that have led the way to massive economic, social, and environmental destruction.[2] In the wake of these headlining corporate misdeeds, some entrepreneurs, managers, governments, and investors have become more

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1. YVON CHOUINARD, LET MY PEOPLE GO SURFING: THE EDUCATION OF A RELUCTANT BUSINESSMAN 3 (2006) [hereinafter CHOUINARD, BUSINESSMAN]. *See generally* YVON CHOUINARD & VINCENT STANLEY, THE RESPONSIBLE COMPANY (2012) (drawing on both authors' experience at Patagonia over the past forty years to "articulate the elements of responsible business for our time").

2. *See* Richard W. Hamilton, *The Crisis in Corporate Governance: 2002 Style*, 40 HOUS. L. REV. 1, 6–12, 20–28 (2003) (discussing the various corporate governance problems that came to light in 2001 and 2002, including the Enron, WorldCom, Adelphia, and Tyco scandals); Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 541, 549–55 (2011) (describing Lehman Brothers, AIG, and Bear Stearns's contributions to the financial collapse of 2008); Azam Ahmed & Ben Protess, *MF Global Investigator Sheds New Light on Chaos at Firm*, N.Y. TIMES, Feb. 7, 2012, at B4 (describing the MF Global scandal where approximately $1.2 billion in customer money was reported missing from the collapsed trading firm); Campbell Robertson & John Collins Rudolph, *Cleanup and Questions Continue*, N.Y. TIMES, Nov. 3, 2010, at A16–17 (reporting on the uncertainty of the long-term environmental damage caused by the BP oil spill in the Gulf Coast); Hiroko Tabuchi & Makiko Inoue, *Olympus Shareholders Vote in Favor of Directors*, N.Y. TIMES, Apr. 21, 2012, at B2 (stating that Olympus shareholders replaced the company's board of directors after the company admitted to hiding losses on investments for decades); Tom Zeller, Jr., *Shareholders Offer a Spate of Climate and Environmental Resolutions*, N.Y. TIMES, Feb. 19, 2011, at B3 (stating that the environmental destruction caused by the BP oil spill and the Massey coal mining accident led to an increase in shareholder resolutions relating to environmental issues at various oil and coal companies during the 2011 proxy season).

open to rethinking the traditional corporation.[3] From this openness has sprung an impassioned social enterprise movement.[4]

Recently, a number of states have passed statutes to facilitate the creation of social enterprises, businesses that focus on creating "blended value"[5] to benefit a triple-bottom line of "people, planet and profit."[6] To date, nine states—Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Vermont, and Wyoming—have passed low-profit limited liability company ("L3C") statutes,[7] and twelve states—California, Hawaii, Illinois, Louisiana, Maryland, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia—have passed benefit corporation statutes.[8] Additional states are currently considering

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3. In this Article, the term "traditional corporation" will be used to refer to non-social enterprise, for-profit corporations.

4. The term "social enterprise" has not been well-defined by the literature. In Europe, "[s]ocial enterprises, as defined by the UK law on the Community Interest Company in 2005, and by the Italian law on the *Impresa Sociale* in 2006, are public-benefit organisations that pursue the satisfaction of social needs through the imposition of at least a partial non-profit constraint and by devoting the majority of their positive residuals and patrimony to socially-oriented activities." Carlo Borzaga, Sara Depedri & Ermanno Tortia, *The Role of Cooperative and Social Enterprises: A Multifaceted Approach for an Economic Pluralism* (Euricse Working Papers, Working Paper No. 000 | 09, 2009). In the United States, the term has taken a broader meaning. Professor Cassady Brewer notes that "[p]opularly defined, social enterprise means using traditional business methods to accomplish charitable or socially beneficial objectives." Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2011); *see* MARC LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS 3–7 (2011) (discussing a variety of definitions for social enterprise and then defining social enterprise as any company with a significant mission-driven motive, regardless of whether profit is the primary objective). Some have suggested a narrower definition, arguing that social enterprises must "directly address social needs through their products and services or through the numbers of disadvantaged people they employ." Social Enterprise Alliance (SEA), *Social Enterprise: A Powerful Engine for Economic and Social Development*, SAGEGLOBAL at 1, http://www.sageglobal.org/files/pdf/social-enterprise-white-paper.pdf. This more narrow definition would exclude companies like Patagonia and Ben & Jerry's, which is not the intention of this Article. Here, the term "social enterprise" will be used broadly to refer to companies that "openly eschew" the shareholder wealth maximization norm in favor of societal focus. The term will also be used in this Article to refer to companies formed under one of the social enterprise statutes or certified, by an organization like B Lab, as a social enterprise.

5. ANTONY BUGG-LEVINE & JED EMERSON, IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE 10–11 (2011) (defining "blended value" to describe the mix of economic, social, and environmental value that social enterprises produce). Jed Emerson coined the term "blended value." *See Why Focus Our Conversation on the Nature of Value?*, BLENDED VALUE, http://www.blendedvalue.org/.

6. In his book CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS (1997), John Elkington describes how social enterprises pursue a "triple-bottom line" to benefit "people, profit and planet."

7. *See Latest L3C Tally*, INTERSECTOR PARTNERS (Dec. 16, 2012), L3C, http://www.intersectorl3c.com/l3c_tally.html.

8. *State by State Legislative Status*, BENEFIT CORP. INFO. CTR., http://www.benefitcorp.net/state-by-state-legislative-status (last visited Dec. 16, 2012).

similar statutes.[9] Further, a few states have passed social enterprise statutes outside of the L3C and benefit corporation molds, including Maryland's benefit limited liability company statute ("BLLC"),[10] California's flexible purpose corporation statute ("FPC"),[11] and the State of Washington's social purpose corporation ("SPC").[12] Patagonia, mentioned in the opening paragraph of this Article, became one of the first California benefit corporations when the statute became effective in January of 2012.[13]

Within the social enterprise world, this Article focuses primarily, though not exclusively, on the benefit corporation model and its cousin, the Certified B Corporation.[14] Part I lays out the shareholder wealth maximization norm that the social enterprise movement attacks and analyzes concerns that social enterprise is attempting to solve a problem that does not exist. Part II examines the social enterprise solutions to the perceived problems associated with the shareholder wealth maximization norm, including solutions pre-dating the social enterprise statutes and certifications. Part III discusses the hurdles the social enterprise movement must clear for social enterprise statutes to be sustainable frameworks for business organizations. The Conclusion reiterates the Article's primary message: that whether traditional corporate statutes or new social enterprise statutes are utilized by a state, the statutes should expressly allow corporations to deprioritize shareholder value and should require that corporations choose their primary master while clearly stating their corporate objective.

I. THE SHAREHOLDER WEALTH MAXIMIZATION NORM

A. The Academic Debate

Should the directors of traditional corporations focus primarily on

9. *See* BENEFIT CORP. INFO. CTR., *supra* note 8 (showing that Connecticut, Michigan, North Carolina, and Washington, D.C. have introduced benefit corporation legislation); *see also* J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking*, 66 U. MIAMI L. REV. 1, 4 (2011) (stating that over seventeen other states are at some stage of considering L3C statutes).

10. MD. CODE ANN., CORPS & ASS'NS §§ 4A-1101 to -1108 (LexisNexis 2011).

11. CAL. CORP. CODE §§ 2500–2517 (West 2012).

12. WASH. REV. CODE §§ 23B.25.005–23.B.25.150 (West 2012). Also, the City of Philadelphia recently passed a sustainable business tax credit. PHILA., PA., CODE § 19-2604 (10)(a)–(d) (2011).

13. *See* John Tozzi, *Patagonia Road Tests New Sustainability Legal Status*, BLOOMBERG (Jan. 4, 2012, 7:57 AM), http://www.bloomberg.com/news/2012-01-04/patagonia-road-tests-new-sustainability-legal-status.html.

14. Currently, the two most popular social enterprise statutes are the benefit corporation and the L3C. For a more in-depth discussion of the L3C, see generally Murray & Hwang, *supra* note 9 (discussing the four major problems with the L3C statutes and proposing solutions).

shareholder wealth maximization in their decision-making? This question has been at the heart of scholarly debate for decades and has spawned numerous corporate theories and models, but no simple answers.

In the 1930s, through a series of articles in the *Harvard Law Review*, law professors Adolf A. Berle and E. Merrick Dodd famously sparred on this topic.[15] In these articles, Professor Berle argued in favor of shareholder wealth maximization as the objective of a corporation,[16] while Professor Dodd argued that a corporation should serve shareholders and other constituents.[17] In the 1970s, Milton Friedman famously stated, "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits."[18] In the 1990s, Professor Stephen Bainbridge defended the "shareholder wealth maximization norm"[19] (which has been described as one element of

15. *See generally* A. A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049 (1931) [hereinafter Berle, *Corporate Powers as Powers in Trust*]; A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932) [hereinafter Berle, *For Whom Corporate Managers Are Trustees*]; E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932).

16. *See* Berle, *Corporate Powers as Powers in Trust*, *supra* note 15, at 1049–50 (arguing that management should exercise its power "only for the ratable benefit of all the shareholders"); *see also* Berle, *For Whom Corporate Managers Are Trustees*, *supra* note 15, at 1365–67 (responding to Professor Dodd's article and the argument that stockholder profit should not be the sole focus of management).

17. *See* Dodd, *supra* note 15, at 1147–48, 1153–54 (arguing that corporations have a social purpose, in addition to a profit-making purpose).

18. Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32–33, 122–26, *available at* http://www.colorado.edu/studentgroups/libertarians/issues/friedman-soc-resp-business.html [hereinafter Friedman, *The Social Responsibility of Business Is to Increase Its Profits*]; MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (2002) [hereinafter FRIEDMAN, CAPITALISM AND FREEDOM] ("Few trends could so thoroughly undermine the very foundation of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their shareholders as possible. This is a fundamentally subversive doctrine. If businessmen do have a social responsibility other than making maximum profits for stockholders, how are they to know what it is? Can self-selected private individuals decide what the social interest is? Can they decide how great a burden they are justified on themselves or their stockholders to serve that social interest?"). Also, in the 1970s, Professor Michael Jensen and Dean William Meckling published a highly-cited article that described corporate managers as "agents" for the corporate shareholder "principals." Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 303, 308 (1976). Professor Lynn Stout credits the Jensen and Meckling article and a book by Frank H. Easterbrook and Daniel R. Fischel as the origin of much of shareholder-focused thinking. *See* LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 34–35 (2012); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

19. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423–25 (1993) [hereinafter Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm*] (arguing that corporate law is and should be committed to the

"shareholder primacy")[20] in his reply to Professor Ronald Green's argument for a "multi-fiduciary stakeholder perspective."[21] Also in the 1990s, the American Law Institute entered the debate with Section 2.01 (The Objective and Conduct of the Corporation) of its Principles of Corporate Governance.[22] From the late 1990s until the present, Professors Margaret Blair and Lynn Stout have written numerous articles on their team production theory, which rejects the shareholder wealth maximization norm and claims the board of directors should act like a "mediating hierarch" that considers all stakeholders and attempts to prevent stakeholders from exploiting each other.[23] In addition, the current

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shareholder wealth maximization norm set forth in *Dodge v. Ford Motor Co.*).

20. Shareholder primacy theory generally focuses on two questions: "First, which constituency's interests will prevail when the ultimate decision maker is presented with a zero sum game? Second, in which organ of the corporation is that ultimate power of decision vested?" Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 86 (2004) [hereinafter Bainbridge, *The Business Judgment Rule as Abstention Doctrine*]. In answering the first question, Professor Bainbridge and most shareholder primacy theorists agree that the shareholders' should prevail in the stated circumstances. *Id.* at 86 n.14; *see also* D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 278 n.1 (1998) (explaining that the phrases "shareholder primacy norm" and "shareholder wealth maximization norm" are sometimes used interchangeably in academic literature). Professor Bainbridge, the father of director primacy, departs from shareholder primacists on the second question and argues that directors control the corporation. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 548–50 (2003) [hereinafter Bainbridge, *Director Primacy*]. Part I of this Article will primarily focus on the debate regarding the first question—which constituent's interest should ultimately prevail? The Article then examines the implications of social enterprise.

21. Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1411–19 (1993).

22. AMERICAN LAW INSTITUTE: PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 2.01 (1994). With Section 2.01, the ALI seems to have attempted to balance the two primary views. In Sub-part (a), the principle states that generally "a corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain." *Id.* § 2.01(a). The drafters used "enhancing" over the stronger and more typical modifier "maximizing," but still acknowledge the shareholder and profit focus. Sub-part (b), however, which Sub-part (a) is subject to, states that "[e]ven if corporate profit and shareholder gain are not enhanced" the corporation is *obliged* to "act within the boundaries set by law" and *may* take into account *reasonable* ethical considerations and "*may* devote a *reasonable* amount of resources to public welfare, humanitarian, educational, and philanthropic purposes." *Id.* § 2.01(a)(3) (emphasis added). The guarded, careful language in Section 2.01 was likely necessary to achieve consensus and shows that this is an area of intense debate. Further, Comment (a) to the Section admits that "[p]resent law on the matters within the scope of § 2.01 cannot be stated with precision." *Id.* § 2.01 cmt. (a).

23. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) [hereinafter Blair & Stout, *A Team Production Theory of Corporate Law*]; Margaret M. Blair & Lynn A. Stout, *Team Production in Business Organizations: An Introduction*, 24 J. CORP. L. 743, 745 (1999) [hereinafter Blair & Stout, *Team Production in Business Organizations*]; Margaret M. Blair & Lynn A. Stout, *Director Accountability and the Mediating Role of the Corporate Board*, 79 WASH. U. L. Q. 403 (2001) [hereinafter Blair & Stout, *Director Accountability and the Mediating Role of the Corporate Board*]; Margaret Blair,

Chancellor of the highly influential Delaware Court of Chancery, Chancellor Leo E. Strine, Jr., has entered the fray on at least three occasions—most recently in a 2012 *Wake Forest Law Review* article.[24]

For the purpose of this Article, the corporate governance scholars will be divided into two camps: (1) scholars who support the shareholder wealth maximization norm and (2) those who do not, including communitarian and team production scholars.[25] In extremely simple terms, scholars in the first group argue that it is and should be the directors' duty to focus on maximizing shareholder wealth as the primary corporate objective.[26]

Corporate Law and the Team Production Problem (forthcoming), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2037240 [hereinafter Blair, *Corporate Law and the Team Production Problem*]; STOUT, *supra* note 18.

24. *See* Leo E. Strine, Jr., Lecture and Commentary, *The Social Responsibility of Boards of Directors and Stockholders in Charge of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169, 1175 (2002) [hereinafter Strine, *The Social Responsibility of Boards of Directors and Stockholders in Charge of Control Transactions*] (stating that Delaware courts have given directors substantial freedom in making decisions in the best interest of the corporation, outside of change of control transactions); Leo E. Strine, Jr., Keynote Address, *Toward Common Sense and Common Ground? Reflections on the Shared Interests of Managers and Labor in a More Rational System of Corporate Governance*, 33 J. CORP. L. 1 (2007) [hereinafter Strine, *Toward Common Sense and Common Ground?*]. Here, Chancellor Strine appears to take a middle ground in this debate, stating that corporations are akin to "social institutions," but recognizing that corporations have "the ultimate goal of producing profits for stockholders." *Id.* at 3. *See also* Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 151–54 (2012) [hereinafter Strine, *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*] (siding with the defenders of the shareholder wealth maximizing norm and stating that "[t]he well-intentioned efforts of many entrepreneurs and company managers, who have a duty to their investors to deliver a profit, to be responsible employers and corporate citizens is undoubtedly socially valuable. But it is no adequate substitute for a sound legally determined baseline. By so stating, I do not mean to imply that the corporate law requires directors to maximize short-term profits for stockholders. Rather, I simply indicate that the corporate law requires directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders.").

25. WALTER A. EFFROSS, CORPORATE GOVERNANCE: PRINCIPLES AND PRACTICES 4–22 (2010) (describing different models and theories of the corporation). *See* Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm*, *supra* note 19, at 1428–29 (defending the shareholder wealth maximizing norm); Blair & Stout, *A Team Production Theory of Corporate Law*, *supra* note 23, at 247, 248–55 (describing team production theory); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1378–84 (1993) (describing the communitarian viewpoint).

26. *See generally* Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm*, *supra* note 19. The text accompanying this footnote focuses on fiduciary duties because Professor Bainbridge does not "think it's useful to ask the question of 'what purpose does the law mandate the corporation pursue?'" Instead, Bainbridge argues "it is far more preferable to operationalize this discussion as a question of the fiduciary duties of corporate officers and directors than as a corporate purpose." Stephen Bainbridge, *Is It Useful to Think About Corporations as Having a "Purpose"?*, PROFESSORBAINBRIDGE.COM (May 6, 2012, 1:56 PM), http://www.professorbainbridge.com/professorbainbridgecom/2012/05/is-it-useful-to-think-about-corporations-as-having-a-purpose.html. Questions about the purpose of a corporation and the object of officer and director fiduciary duties are often closely tied.

Communitarians and team production theorists, on the other hand, posit that directors should widen the aperture and focus on the corporation as a whole, including various non-shareholder stakeholders, such as employees, creditors, and even the society at large.[27] The debate continues today, as within mere weeks of each other in 2012, corporate law academics vigorously debated the shareholder wealth maximization norm on corporate law blogs.[28] Chancellor Strine published a law review article entitled *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*,[29] economist Paul Rubin defended shareholder wealth maximization in the *Wall Street Journal*,[30] Professor Margaret Blair uploaded a working paper on team production theory that argued that shareholder wealth maximization thinking is in decline,[31] and Professor Lynn Stout published a book entitled *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*.[32]

These debates over whether directors must or should focus shareholder wealth as an exclusive or primary value have been repeated in countless forms, without much movement towards a satisfying consensus.[33]

This Article recognizes that occasionally some cited commenters are addressing the former, and some the latter, often without clear distinction. For the purpose of this Article, both questions are looked at together, as they both impact the same core question of how corporations should be governed.

27. *See* EFFROSS, *supra* note 25, at 19–22. *See generally* Blair & Stout, *A Team Production Theory of Corporate Law*, *supra* note 23.

28. *See, e.g.*, Stephen Bainbridge, *The Shareholder Wealth Maximization Norm*, PROFESSORBAINBRIDGE.COM (May 5, 2012 12:51 PM), http://www.professorbainbridge.com/professorbainbridgecom/2012/05/the-shareholder-wealth-maximization-norm.html; Haskell Murray, *Benefit Corporations: Traditional Paradigm*, THE CONGLOMERATE (May 3, 2012), http://www.theconglomerate.org/2012/05/benefit-corporations-corporate-purpose.html#comment-519407841.

29. *See* Strine, *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, *supra* note 24.

30. Paul H. Rubin, *A Tutorial for the President on "Profit Maximization,"* WALL ST. J., May 24, 2012, at A17 (stating that "[a]ny argument against 'profit maximization' is an argument against consumer welfare").

31. *See* Blair, *Corporate Law and the Team Production Problem*, *supra* note 23.

32. *See generally* STOUT, *supra* note 18. Academics debating the shareholder wealth maximization norm "are often like ships passing in the night." *Cf.* William Klein, *Criteria for Good Laws of Business Association*, 2 BERKELEY BUS. L.J. 13, 15 (2005). For example, opponents of the norm focus on the problems stemming from directorial focus on *short-term* profits, while many proponents of the norm recognize that a short-term focus can have a devastating impact and focus instead on the obligation to maximize (or "enhance") *long-term* shareholder wealth. *Compare* STOUT, *supra* note 18, at 50–52 (likening shareholder primacy to fishing with dynamite), *with* Bainbridge, *Director Primacy*, *supra* note 20 (stating that director primacy theory supports the shareholder wealth maximization norm "pursuant to which directors are obliged to make decisions based solely on the basis of *long-term* shareholder gain") (emphasis added).

33. *See* Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631, 631 (2009) ("[S]ince the 1930s, the debate concerning the purpose of the corporation has pervaded modern corporate law. Even today, the question of whether the purpose of the

B. Dodge v. Ford *and Day-to-Day Decisions*

Proponents of the benefit corporation legislation have focused on two main cases to show the need for their bill: *Dodge v. Ford*[34] and *eBay v. Newmark*.[35] Benefit corporation supporters also focus on Ben & Jerry's "forced" takeover by Unilever as an example of why states and companies need benefit corporation statutes.[36] This section will address *Dodge v. Ford*, and the next section, which focuses on areas of heightened scrutiny, including the evaluation of takeover defenses, will address *eBay v. Newmark* and the Ben & Jerry's situation.

In *Dodge v. Ford*, the Michigan Supreme Court famously ordered Ford to make a cash distribution to its shareholders despite Henry Ford's claim that he wished to use the excess capital in the corporation to benefit society.[37] Proponents of benefit corporation legislation tend to gloss over the fact that *Dodge v. Ford* is not a Delaware case ("Delaware is recognized as a pacesetter in the area of corporate law"),[38] is nearly 100

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corporation is to serve the interests of shareholders—to the exclusion of all other interests—or whether it can also consider the interests of other corporate constituencies remains unsettled."). *See generally* Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385 (2008); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005); Lyman Johnson, *The Delaware Judiciary and the Meaning of Corporate Life and Corporate Law*, 68 TEX. L. REV. 865 (1990); Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible Shareholder,"* 10 STAN. J.L. BUS. & FIN. 31 (2005); Brian M. McCall, *The Corporation as Imperfect Society*, 36 DEL. J. CORP. L. 509 (2011); Millon, *supra* note 25, at 1378–84 (stating that the rift between corporate law theorists is "deep and likely to persist"); Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063 (2001); Smith, *supra* note 20; Judd F. Sneirson, *The Sustainable Corporation and Shareholder Profits*, 46 WAKE FOREST L. REV. 541 (2012); Lynn A. Stout, *Bad and Not-So-Bad Arguments for Shareholder Primacy*, 75 S. CAL. L. REV. 1189 (2002).

34. Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919).

35. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1 (Del. Ch. 2010).

36. *See, e.g.*, Angus Loten, *With New Law, Profits Take Back Seat*, WALL ST. J., Jan. 19, 2012, at B1, B5 (arguing that the socially-focused Ben & Jerry's was forced to sell to Unilever against the wishes of its founders). Loten also cites Ben & Jerry's current chairman for the proposition that if benefit corporations had existed in 2000 (and Ben & Jerry's was a benefit corporation) the sale would not have happened. *Id. See also* April Dembosky, *Protecting Companies that Mix Profitability, Values*, NPR MORNING EDITION (Mar. 9, 2010), http://www.npr.org/templates/story/story.php?storyId=124468487. Co-founder Ben Cohen is cited for stating that Ben & Jerry's social mission would have been safer if the company had remained independent, but corporate law appeared to side with shareholders. *Id. But see* Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211, 230–37 (2010) (arguing that corporate law did not require that the board of directors sell the company to Unilever).

37. *See generally Dodge*, 170 N.W. at 668.

38. *In re* Prudential Ins. Co. Derivative Litig., 659 A.2d 961, 969 (N.J. Super. Ct. Ch. Div. 1995); *see* 1 STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE 6–11 (6th ed. 2009) (compiling numerous quotes from courts of various jurisdictions recognizing Delaware courts as leaders in the area of corporate law).

years old, and "was atavistic even at its date of publication."[39] The theories vary on why so few cases like *Dodge v. Ford* exist. The Delaware Chancellors who called the case "atavistic" write that "[t]here is a reason why *Dodge v. Ford* is in all the books: there are no other cases that really stand for the position of shareholder sovereignty as opposed to director sovereignty."[40] Similarly, Professor Stephen Bainbridge argues that the director primacy model and abstention-style business judgment rule explain why the shareholder wealth maximization norm is rarely enforced like it was in *Dodge v. Ford*.[41] In contrast, Professor Gordon Smith argues against a broad application of the shareholder wealth maximization norm and explains *Dodge v. Ford* as a close corporation case involving minority shareholder oppression, not widely applicable outside of that context.[42] Professor Lynn Stout explained away *Dodge v. Ford* as a "judicial mistake" from "a state court [Michigan] that plays only a marginal role in the corporate law arena."[43]

Even though they may disagree on why, commenters appear to agree that the *Dodge* court's ordering of directors to act in favor of shareholders (in the day-to-day context) is a rare outcome.[44] Numerous corporate law cases,

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39. William T. Allen & Leo E. Strine, Jr., *When the Existing Economic Order Deserves a Champion: The Enduring Relevance of Martin Lipton's Vision of the Corporate Law*, 60 BUS. LAW. 1383, 1385 n.7 (2005).

40. *Id. See* DEL. CODE ANN. tit. 8 § 141(a) (2012) (stating that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of the board of directors"); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (stating that "[t]he business judgment rule is an acknowledgment of the managerial prerogatives of Delaware directors under Section 141(a)").

41. *See* DEL. CODE ANN. tit. 8 § 141(a); *Aronson*, 473 A.2d at 812; *see also* Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 20, at 86 (explaining that "the business judgment rule is justified precisely because judicial review threatens the board's authority"); Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm*, *supra* note 19; Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1 (2002) [hereinafter Bainbridge, *The Board of Directors as Nexus of Contracts*]; Stephen M. Bainbridge, *Director Primacy*, *supra* note 20, at 547; Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735 (2006) [hereinafter Bainbridge, *Director Primacy and Shareholder Disempowerment*].

42. Smith, *supra* note 20, at 323 ("Conflicts among shareholders have long been analyzed under the doctrine of minority oppression rather than the shareholder primacy norm. Despite the link between the modern doctrine of minority oppression and the shareholder primacy norm, the shareholder primacy norm is broader than necessary to resolve problems of minority oppression in closely held corporations.").

43. *See* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163, 168, 176 (2008). Stout also argues that "*Dodge v. Ford* is indeed bad law, at least when cited for the proposition that the corporate purpose is, or should be, maximizing shareholder wealth. *Dodge v. Ford* is a mistake, a judicial 'sport,' a doctrinal oddity largely irrelevant to corporate law and corporate practice." *Id.* at 166. *But see generally* Jonathan R. Macey, *A Close Read of an Excellent Commentary on* Dodge v. Ford, 3 VA. L. & BUS. REV. 177 (2008) (challenging Professor Stout's reading of *Dodge v. Ford*).

44. *See* Allen & Strine, *supra* note 39, at 1385 n.7; *see also* Smith, *supra* note 20, at 288 ("Although it is possible for shareholders to prevail on claims that the board of

including casebook classics from various jurisdictions (like *A.P. Smith Manufacturing Co. v. Barlow*[45] and *Shlensky v. Wrigley*[46]), exhibit this view.[47] When the business judgment rule is applicable, Delaware courts "will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value."[48] However, this lack of enforcement of the shareholder wealth maximization norm does not mean the norm does not exist. Cases like *Dodge v. Ford* are rare because the business judgment rule is so powerful, and defendants are not generally so open about eschewing shareholder interests. Chancellor Strine explained in a recent law review article why Henry Ford did not get the benefit of the business judgment rule on the dividend payment issue:[49]

> Under [the business judgment] rule, the judiciary does not second-guess the decision of a well-motivated, non-conflicted fiduciary. Fundamental to the rule, however, is that the fiduciary be motivated by a desire to increase the value of the corporation for the benefit of the stockholders. By confessing that he was placing his altruistic interest in helping workers and consumers over his duty to stockholders, Henry Ford made

directors violated the shareholder primacy norm, such cases are extremely rare . . . ."); Franklin A. Gevurtz, *Getting Real About Corporate Social Responsibility: A Reply to Professor Greenfield*, 35 U.C. DAVIS L. REV. 645, 648–50 (2002) ("*Dodge* is one of the rare cases in which a court found directors abused their discretion in refusing to declare dividends. . . . The practical upshot of cases like *Dodge* and *Wrigley* is that, by and large, courts have not scrutinized business decisions to see whether directors sacrificed profit maximization to advance the interests of employees, creditors, customers, and the community. Instead, the courts almost invariably accept some rationale as to how the business decisions were in the long-range interest of the shareholders."); Macey, *supra* note 43, at 180 ("[T]here are no cases other than *Dodge v. Ford* that actually operationalize the rule that corporations must maximize profits. The goal of profit maximization is to corporate law what observations about the weather are in ordinary conversation. Everybody talks about it, including judges, but with the lone exception of *Dodge v. Ford*, nobody actually does anything about it."); WILLIAM T. ALLEN, REINIER KRAAKMAN & GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 298 (3d ed. 2009) (noting that *Dodge v. Ford* "is one of the few decisions by a U.S. Court to enforce shareholder primacy as a rule of law").

45. 98 A.2d 581, 583–84 (N.J. 1953).

46. 237 N.E.2d 776, 780–81 (Ill. App. Ct. 1968).

47. In both *A.P. Smith* and *Shlensky*, the court chose not to interfere with decisions that had tenuous connections to shareholder wealth—in *A.P. Smith*, a gift from the corporation to Princeton University, and in *Shlensky*, a decision to not install lights at Wrigley Field.

48. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 33 (Del. Ch. 2010); *accord* Aronson v. Lewis, 473 A.2d 805, 812 (1984).

49. Dodge v. Ford Motor Co., 170 N.W. 668, 684–85 (Mich. 1919) (noting that Ford *did* receive protection for the business decision to expand the business, but not for the decision regarding dividend payments).

it impossible for the court to afford him business judgment deference.[50]

Ford could have argued that he wished to pay his employees more in order to reduce turnover and encourage productivity and thus increase the long-term profits of shareholders. On the community issue, Ford could have argued that he wished to provide a less expensive car to engender goodwill and increase sales, which, even with lower margins, could increase long-term profits of shareholders. But Ford did not close the loop. Instead, Ford openly rejected the shareholder wealth maximization norm and paid for it.[51] After *Dodge v. Ford*, most defendants (and their lawyers) seem to have realized they need to tie altruistic motivations back to long-term shareholder value, making cases like *Dodge v. Ford* exceedingly rare.

C. *Ben & Jerry's,* eBay v. Newmark, *and Heightened Scrutiny*

In addition to *Dodge v. Ford*, the *eBay v. Newmark* case and the Ben & Jerry's takeover situation have been trumpeted by proponents of benefit corporation legislation as examples of why such legislation is needed. Too many promoters of benefit corporations gloss over, or ignore, the fact that both the *eBay* case and the Ben & Jerry's situation were examined in the narrow takeover defense or conflicted-interest contexts and therefore evaluated with scrutiny enhanced from the day-to-day situations described in Part II.B.[52] Many proponents also seem to ignore that a majority of states (though not Delaware) have constituency statutes that provide some protection to directors, even in the takeover context.[53]

The *eBay v. Newmark* case has been cited *ad nauseam* in the lobbying for benefit corporation statutes.[54] In *eBay*, craigslist erected numerous defensive measures in response to disagreements with its minority

50. Strine, *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, *supra* note 24, at 147–48 (emphasis added).

51. Macey, *supra* note 43, at 189–90 (claiming that the *Dodge v. Ford* case would have likely had a different outcome if Henry Ford had simply stated that he was attempting to maximize shareholder value).

52. *See, e.g.*, Jay Coen Gilbert, *TedX Philly - Jay Coen Gilbert - On Better Business*, YOUTUBE, at 9:40–10:20 (Dec. 1, 2010), http://www.youtube.com/watch?v=mGnz-w9p5FU (stating that the *eBay* case required maximizing of shareholder wealth, without mentioning that the actions overturned by the court were subject to heightened scrutiny); Loten, *supra* note 36, at B1, B5 (describing the "forced" sale of Ben & Jerry's).

53. *See* Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 1989, 2040 tbl.6 (2009); *see also* William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 35–36 (2009).

54. *See, e.g.*, William H. Clark & Larry Vranka, *The Need and Rationale for the Benefit Corporation: Why It Is the Legal Form That Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public* 11–13 (Jan. 26, 2012), *available at* http://www.benefitcorp.net/storage/The_Need_and_Rationale_for_Benefit_Corporations_-_April_2012.pdf; *see also* Gilbert, *supra* note 52, at 9:40–10:20.

shareholder, eBay, and in an alleged effort to protect the community-focused culture of craigslist.[55] Former Chancellor Chandler ordered rescission of certain of craigslist's defensive measures, including its poison pill, and stated:

> Promoting, protecting, or pursuing nonstockholder considerations must lead at some point to value for stockholders. When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value. Under the *Unocal* standard, however, the directors must act within the range of reasonableness.[56]

The former Chancellor also wrote:

> Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. . . .
>
> Directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law.[57]

Unlike *Dodge v. Ford*, the conduct that the court challenged in *eBay v. Newmark* was not "every day" decision-making and was not afforded business judgment rule protection. Instead, the court evaluated the poison pill (also known as "the Rights Plan") in *eBay* under the intermediate scrutiny of the *Unocal* standard and evaluated the right of first refusal/dilutive issuance under the even more exacting "entire fairness"

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55. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 6–7 (Del. Ch. 2010). It is ironic that eBay plays the role of the capitalist villain in the pitches by social enterprise proponents because eBay's co-founder Jeff Skoll established the Skoll Foundation and the Skoll Centre for Social Entrepreneurship. *See* Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board's Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 625 (2007). The Skoll Foundation was created in 1999, is a world leader in social enterprise, and has "awarded more than $315 million, including investments in 91 remarkable social entrepreneurs and 74 organizations on five continents." *About*, SKOLL FOUNDATION, http://www.skollfoundation.org/about/ (last visited Nov. 11, 2012).

56. *eBay*, 16 A.3d at 33 (mentioning that Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) "did not hold that corporate culture, standing alone, is worthy of protection as an end in itself").

57. *eBay*, 16 A.3d at 34–35 (emphasis added).

standard.[58] Thus, the *eBay* case, confined to its facts, controls only in the narrow and more scrutinized takeover defense and conflicted-interest contexts.[59]

In his 2012 *Wake Forest Law Review* article, however, Chancellor Strine recently provided reason to think *eBay* may actually provide guidance in the broader debate regarding the shareholder wealth maximization norm. Chancellor Stine wrote:

> From a different political perspective come those who seem to take umbrage at plain statements like the Chancellor's [in *eBay*] for unmasking the face of capitalism. These commentators seem dismayed when anyone starkly recognizes that as a matter of corporate law, the object of the corporation is to produce profits for the stockholders and that the social beliefs of the managers, no more than their own financial interests, cannot be their end in managing the corporation.[60]

Despite the need to recognize that *eBay v. Newmark*, unlike *Dodge v. Ford*, was mostly analyzed under heightened scrutiny, *Dodge* and *eBay* have a fair bit in common. In both cases, strong-willed defendants *openly admitted* that their focus was not on maximizing shareholder wealth—not in the short term, not in the long term, not at all.[61] Henry Ford and the founders of craigslist *confessed* to the court that they made their decisions with the primary objective of benefiting non-shareholder stakeholders, appeared to have "openly eschew[ed] stockholder wealth maximization," and did not make serious attempts to tie their decisions back to benefits for the shareholders.[62] Both the Michigan Supreme Court in 1919 and the Delaware Court of Chancery in 2010 found this stance unacceptable.[63] Had the defendants made more of an effort to tie their decisions to long-term shareholder wealth maximization, the courts may have come to different conclusions.[64]

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58. *Id.* at 28–48.

59. *Id.*

60. Strine, *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, *supra* note 24, at 151.

61. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("It is said by appellants that the motives of the board members are not material and will not be inquired into by the court so long as their acts are within their lawful powers. As we have pointed out, and the proposition does not require argument to sustain it, *it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others*, and no one will contend that, if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to interfere.") (emphasis added); *eBay*, 16 A.3d at 34–35.

62. *eBay*, 16 A.3d at 35.

63. *See Dodge*, 170 N.W. at 684; *eBay*, 16 A.3d at 34–35.

64. *See supra* Part I.B; *see also* ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 44, at 298 (noting that *Dodge v. Ford* was an odd case because Henry Ford openly

Like *Dodge* and *eBay*, the Ben & Jerry's takeover by Unilever in 2000 may be informative, but it has been simplified and exaggerated by certain proponents of benefit corporations and social enterprises in general.[65] Even given the enhanced scrutiny applied in the takeover context, there is serious doubt as to whether Ben & Jerry's *had* to sell to Unilever.[66] The Ben & Jerry's situation was never tested by the courts, as the company was ultimately sold to Unilever in April of 2000 for $326 million.[67] If the situation had been brought to court, the case would have been virtually impossible for the plaintiffs to win. Even if the Ben & Jerry's founders decided not to sell, then openly admitted during a lawsuit to "eschewing shareholder wealth maximization" (like the defendants in *Dodge* and *eBay*), they would have had the added protection of Vermont's constituency statute.[68]

This and the previous section have shown that certain social enterprise proponents may have overstated the need for benefit corporation statutes, as existing corporate law—whether through the business judgment rule, constituency statutes, or express provisions in the corporate law of states outside of Delaware—already provides significant protection to directors who choose to favor or consider non-shareholder stakeholders in their decisions.[69] Despite this protection, however, the corporate law in most states is not crystal clear and lawyers and managers may be risk averse. Typically, shareholders are the only stakeholders with standing to bring a

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admitted that he focused on stakeholders other than shareholders). Similarly, the founders of craigslist openly admitted their non-shareholder focus. *eBay*, 16 A.3d at 34–35. The founders of craigslist could have argued that eBay's adding of advertisements to the website would have upset craigslist users and would have limited craigslist's growth possibilities, reducing goodwill and long-term profits. The craigslist owners could have pointed to myriad ways that eBay's plan for the company was inconsistent with *long-term* shareholder wealth maximization, and the court would have probably hesitated to question that reasonable judgment, even under *Unocal*'s intermediate scrutiny.

65. *See* Loten, *supra* note 36, at B5.

66. Page & Katz, *supra* note 36, at 233–242 (arguing that Ben & Jerry's founders had a number of options to protect the company from a takeover, if they wished to do so, including: erecting takeover defenses, avoiding *Revlon* duties, and utilizing capital structure solutions). *Cf.* Jennifer J. Johnson & Mary Siegel, *Corporate Mergers: Redefining the Role of Target Directors*, 136 U. PA. L. REV. 315, 330–31 (1987) (calling *Unocal* a "toothless standard"); *accord* Mark J. Loewenstein, *Unocal Revisited: No Tiger in the Tank*, 27 J. CORP. L. 1, 3 (2001).

67. *$326 million persuades Ben & Jerry's to sell out*, SEATTLE TIMES (Apr. 13, 2000), http://community.seattletimes.nwsource.com/archive/?date=20000413&slug=4015122.

68. *See* Page & Katz, *supra* note 36, at 236 (noting that not only did Vermont have a constituency statute, but that the statute was dubbed the "Ben & Jerry's Law" because it was adopted in 1998, at least in part, to protect Ben & Jerry's from a takeover like the one that occurred in 2000).

69. *See* Kerr, *supra* note 55, at 633–34 (arguing that socially and environmentally friendly activities can be "smart business" and arguing that the business judgment rule will generally protect traditional corporations that choose to engage in such activities).

derivative action for a breach of fiduciary duty, so directors may choose to favor shareholders even if the business judgment rule and/or constituency statutes provide significant cover.[70] Also, corporate directors are not normally as knowledgeable about the intricacies of corporate law as many of the law professors, who after decades of debate, still lack agreement on a single corporate governance model or objective of the corporation. This lack of clarity in corporate law and scholarship is something that proponents of the benefit corporation legislation can correctly point to as troubling.

D. Persistent Common Perception and Power of the Norm

What is clear from the previous three sections is that there is confusion regarding whose interest directors should primarily focus on when making decisions.[71] Despite all of the academic debate, the *persistent common perception* seems to be that directorial duties require placing shareholder wealth at the forefront.[72] The perception may stem from the pronouncements of courts in *Dodge* and *eBay*, from various academic articles, from education in business and law schools, and from the popular media.[73] The perception—as the phrase "shareholder wealth maximization

70. *See* J. Haskell Murray, *"Latchkey Corporations": Fiduciary Duties in Wholly Owned, Financially Troubled Subsidiaries*, 36 DEL. J. CORP. L. 577, 580 (2011) [hereinafter Murray, *Latchkey Corporations*] (discussing how shareholders are normally the only stakeholders with standing to bring a derivative fiduciary duty lawsuit, but explaining that Delaware courts have given creditors standing when the corporation is insolvent).

71. *See supra* Part I.A–C.

72. *See, e.g.*, Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 654–55 (2006) (citing research by the Aspen Institute Business and Society Program that "found that the norm of shareholder wealth maximization was implicit in most business school courses, and so powerful that it did not need to be defended"); Lawrence E. Mitchell, *A Critical Look at Corporate Governance*, 45 VAND. L. REV. 1263, 1288 (1992) ("Directors seem to believe that their legal duty is to the stockholders."); Lyman Johnson & Bill Callison, Comment to *Benefit Corporations: The Traditional Paradigm*, THE CONGLOMERATE (May 3, 2012), http://www.theconglomerate.org/2012/05/benefit-corporations-corporate-purpose.html (opining that the "conventional wisdom" is that the objective of a corporation is to maximize shareholder wealth); Mary C. Gentile, The Aspen Inst. Bus. & Soc'y Program, Address at the European Academy of Business in Society's Third Annual Colloquium: Corporate Governance and Accountability: What Do We Know and What Do We Teach Future Business Leaders? 3–4 (Sept. 27, 2004), *available at* http://www.caseplace.org/references/references_show.htm?doc_id=306381.

73. *See supra* Part I.B–C (discussing the *Dodge* and *eBay* cases and noting the academic literature regarding the shareholder wealth maximization norm); *see also* Hamilton, *supra* note 2, at 35 ("It has long been accepted doctrine that the primary goal of publicly held corporations should be to maximize the wealth of shareholders. . . . This proposition is accepted dogma in law and finance textbooks and is taught in law and business schools throughout the country.") (internal citations omitted). For popular media, consider Michael Douglas's famed "greed is good" speech in WALL STREET (Twentieth Century Fox 1987). Michael Douglas's character, Gordon Gekko was supposed to be a villain (and ends up in jail for insider trading), but many viewers admired the character's "profit at any cost" attitude and some told Douglas that they

norm" suggests—has arguably risen to the level of a widely recognized and influential norm.[74]

The shareholder wealth maximization norm has infiltrated corporate America. For example, the Business Roundtable listed as a guiding principle that it "is the responsibility of management, under the oversight of the board, to operate the corporation in an effective and ethical manner to produce long-term value for shareholders."[75] Further, as noted in the *Harvard Business Review*, "in an important 2007 article in the *Journal of Business Ethics*, 31 of 34 directors surveyed (each of whom served on an average of six Fortune 200 boards) said they'd cut down a mature forest or release a dangerous, unregulated toxin into the environment in order to increase profits. Whatever they could legally do to maximize shareholder wealth, they believed it was their duty to do."[76] In a 2008 law review article, Professor Lynn Stout recognized that in the minds of many people "corporations exist to make money for their shareholders. Maximizing shareholder wealth is the corporation's only true concern, its *raison d'être*."[77] Three years later, Professor Stout released a book titled *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*.[78] Professor Stout's book

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were inspired to seek jobs on Wall Street because of his character. *See, e.g.*, David C. McBride, *For Whom Does This Bell Toll*, DEL. LAW., Fall 2009, at 28, 29. It is interesting that many of the decision makers in the most recent economic crisis were in their late teens and twenties—likely the age of WALL STREET'S targeted audience—at the time of the film's release in 1987.

74. LAWRENCE LESSIG, CODE AND OTHER LAWS OF CYBERSPACE 235 (1999) (defining norms as "those normative constraints imposed not through the organized or centralized actions of a state, but through the many slight and sometimes forceful sanctions that members of a community impose on each other"); *see* Eric A. Posner, *Law, Economics, and Inefficient Norms*, 144 U. PA. L. REV. 1697, 1709 (1996) (stating that "[w]e say about most norms that people bound by them feel an emotional or psychological compulsion to obey the norms; norms have moral force"); Roe, *supra* note 33, at 2064 (stating that "[b]ecause norms are usually congruent with practices, institutions, and laws, knowing which element is critical is hard"); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1013 (1997) (stating that "all of us internalize rules and standards of conduct with which we generally try to comply"); Sneirson, *supra* note 33, at 545 ("Even if no law requires shareholder primacy, a prevalent social norm can have much the same effect."). Professor Sneirson cites the following valuable resources on the subject: Richard H. MacAdams, *The Origin, Development, and Regulation of Norms*, 96 MICH. L. REV. 338, 340 (1997); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 914 (1996); Symposium, *Norms & Corporate Law*, 149 U. PA. L. REV. 1607 (2001).

75. BUSINESS ROUNDTABLE, PRINCIPLES OF CORPORATE GOVERNANCE 2 (2010).

76. Loizos Heracleous & Luh Luh Lan, *The Myth of Shareholder Capitalism*, HARV. BUS. REV., Apr. 2010, http://hbr.org/2010/04/the-myth-of-shareholder-capitalism/ar/1 (citing Jacob M. Rose, *Corporate Directors and Social Responsibility: Ethics versus Shareholder Value*, 73 J. BUS. ETHICS 319 (2007)).

77. Stout, *supra* note 43, at 164.

78. STOUT, *supra* note 18, at 32 (stating that "[a]s far as the law is concerned, maximizing shareholder wealth is not a requirement; it is just one possible corporate

recognizes that the shareholder wealth maximization norm is engrained into our culture and into the minds of many decision makers.[79] While some may argue that the shareholder wealth maximization norm is a myth or at least rarely enforced, the norm is a powerful one and seems to have persistently impacted common perception about the duties of the directors of traditional corporations.[80]

II. SOLUTIONS FOR SOCIAL ENTERPRISE

If the purported problem is overemphasizing shareholder wealth maximization by directors—whether because of law, myth, perception, or norm—social enterprise attempts to provide a solution by increasing the emphasis on the concerns of other corporate constituents.

A. Pre-Existing Solutions

Legal solutions for social entrepreneurs predate 2008, the year the initial social enterprise statute was passed in the United States.[81] First, limited liability companies ("LLCs") are famously flexible, and operating agreements can be altered to meet the needs of social entrepreneurs.[82] Second, entrepreneurs with a social bent could use affiliated foundations or nonprofit entities along with for-profit entities to effectuate their objectives.[83] Third, some state statutes already explicitly allow a social or

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objective out of many"). Professor Stout also takes issue with the argument for shareholder wealth maximization as a normative matter.

79. *Id.* at 3 (stating that "[s]hareholder value thinking is endemic in the business world today").

80. *See* Sneirson, *supra* note 33, at 545.

81. *See* J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 273 (2010) (stating that "Vermont enacted the Nation's first 'low-profit limited liability company' (L3C) legislation in 2008"). *See generally* VT. STAT. ANN. tit. 11, §§ 3001(27), 3005(a)(2), 3023(a)(6) (West 2010).

82. *See, e.g.*, Brewer, *supra* note 4, at 680 (noting the increasing use of LLCs by social entrepreneurs); LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 7–9 (2010) (discussing the flexibility of uncorporations, including LLCs).

83. Chick-fil-A, Starbucks, and Google are a few of the major corporations that use both profit and nonprofit entities to achieve their ultimate objectives, which include certain social goals. Chick-fil-A founder and CEO, Truett Cathy, also founded the WinShape Foundation, which offers foster care services, college scholarships, marital support, and outdoor camps for children. *See* WINSHAPE FOUNDATION, http://www.winshape.com/ (last visited Nov. 11, 2012). The WinShape Foundation is listed on Chick-fil-A's website and appears to be closely connected to the corporation. *WinShape Foundation*, CHICK-FIL-A, http://www.chick-fil-a.com/Company/Winshape (last visited Nov. 11, 2012) [hereinafter, *WinShape Foundation,* CHICK-FIL-A]; *Starbucks Foundation*, STARBUCKS, http://www.starbucks.com/responsibility/community/starbucks-foundation (last visited Nov. 11, 2012) (The Starbucks Foundation was founded in 1997 to fund literacy programs. The foundation has expanded to serve a variety of social and environmental needs.); GOOGLE FOUNDATION, http://www.google.org/foundation.html (last visited Nov. 11, 2012); GOOGLE.ORG,

environmental focus.[84] Social entrepreneurs seeking to use the corporate form could simply incorporate in one of those states, and then, if desired, could search the market for a branding mechanism, such as B Lab's "Certified B Corporation."[85]

Currently, it is not crystal clear whether Delaware corporate law is flexible enough to give comfort to the social entrepreneur, but as described above, there are a number of other options for the social entrepreneur.[86] Additionally, the Delaware legislature is traditionally extremely responsive to the needs of the market, and one suggested solution in this Article is to have Delaware amend its corporate statute to explicitly provide social entrepreneurs with the flexibility they seek.[87]

Despite all of the preexisting solutions, social entrepreneurs desire

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http://www.google.org/ (last visited Nov. 11, 2012). The Google Foundation is run by Google.org, a philanthropic arm of Google, Inc., which promotes Google's community initiatives and philanthropic work. *See* Dana Brakman Reiser, *Charity Law's Essentials*, 86 NOTRE DAME L. REV. 1, 34–35 (2011) (discussing Google's use of multiple entities to reach its corporate goals); Carter G. Bishop, *Sectorization & L3C Regulatory Arbitrage of Joint Ventures with Nonprofits* (Suffolk Univ. Law Sch. Research Paper No. 12-19, Apr. 23, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2045034 (arguing that the existing nonprofit joint venture should be preferred over and utilized instead of the social enterprise form L3C).

84. *See, e.g.*, OR. REV. STAT. § 60.047 (2011) (amended in 2007 to explicitly allow inclusion in the articles of incorporation a "provision authorizing or directing the corporation to conduct the business of the corporation in a manner that is environmentally and socially responsible"); *see also* Stephen M. Bainbridge, *Does eBay Spell Doom for Corporate Social Responsibility*, PROFESSORBAINBRIDGE.COM, (Dec. 6, 2010, 12:26 PM), http://www.professorbainbridge.com/professorbainbridgecom/2010/12/does-ebay-spell-doom-for-corproate-social-responsibility.html (stating that if a company, such as "Ben & Jerry went public with a [corporate social responsibility] provision in their articles" he would have no objection).

85. *See The Non-Profit Behind B Corps, Certified B Corporations*, B LAB, http://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps (last visited Nov. 11, 2012).

86. *See, e.g.*, Stephen M. Bainbridge, *Beneficial Corporations*, PROFESSORBAINBRIDGE.COM (May 25, 2009, 11:45 AM), http://www.professorbainbridge.com/professorbainbridgecom/2009/05/beneficial-corporations.html ("State law arguably does not permit corporate organic documents to redefine the directors' fiduciary duties. In general, a charter amendment may not derogate from common law if doing so conflicts with some settled public policy. In light of the well-settled shareholder wealth maximization policy, nonmonetary factors charter amendments therefore appeared vulnerable. This problem seems especially significant for Delaware firms, as Delaware law became increasingly hostile to directorial consideration of non-shareholder interests in the takeover decision-making process.").

87. *See infra* Part II.D; *see also* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1068 (2000) (noting that part of Delaware's success in competing for corporate charters is attributable to "the responsiveness of the Delaware legislature"); *accord* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1799 n.13, 1810 n.76 (2002).

solutions without attendant doubt and clearly fitted to their needs. The next two sections examine the two primary responses: social enterprise certifications and social enterprise statutes.

B. Social Enterprise Certifications

Before any social enterprise statutes were passed in the United States, various private organizations were certifying social enterprises. The most popular certifier is a nonprofit organization named B Lab, which began dubbing companies "Certified B Corporations" in 2007.[88] B Lab likens its certification of companies to the certification of coffee as "Fair Trade" or the certification of buildings as "LEED certified" and, as of October 2012, there were more than 600 Certified B Corporations accounting for a total of over $4 billion in revenue.[89]

With the advent of the benefit corporation statutes, which B Lab has championed, many in the popular media, and even some attorneys, fail to articulate the difference between Certified B Corporations and statutorily formed benefit corporations.[90] Confusingly, both are sometimes referred to as "B Corps."[91] Certified B Corporations are certified by B Lab, while benefit corporations are formed under the state law of one of the states that

88. Mary Catherine O'Connor, *Corporations with Benefits*, TRIPLE PUNDIT (Dec. 1, 2011), http://www.triplepundit.com/2011/12/corporations-benefits; *The Nonprofit Behind B Corps*, *supra* note 85. Other social enterprise certifiers include Green Seal Business Certification and Sustainable Farm Certification. *Selecting a Third Party Standard: List of Standards*, B LAB, http://www.benefitcorp.net/selecting-a-third-party-standard/list-of-standards) (listing various third-party standards that may be used by benefit corporations, but which also separately certify social enterprises). The author suggests that "Certified B *Corporation*" should be changed to "Certified B *Company*" because B Lab certifies a wide range of entity forms, including LLCs, LLPs, and cooperatives. As of September 18, 2012, 209 of the approximately 600 Certified B *Corporations* were actually LLCs, three were LLPs, three were BLLCs, 24 were sole proprietors, and several were cooperatives. E-mail from Heather Van Dusen, B Lab (Sept. 18, 2012, 15:22 EDT) (on file with author).

89. *What are B Corps?*, B LAB, http://www.bcorporation.net/what-are-b-corps, (last visited Nov. 25, 2012); *The Non-Profit Behind B Corps*, B LAB, http://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps (last visited Nov. 25, 2012).

90. *See, e.g.*, Haskell Murray, *Etsy Becomes a Certified B Corporation*, THE CONGLOMERATE (May 9, 2012), http://www.theconglomerate.org/2012/05/etsy-becomes-a-certified-b-corporation.html [hereinafter Murray, *Etsy Becomes a Certified B Corporation*] (where this author's post led to the correction of Etsy's press release, which originally used the two terms interchangeably in the body of their announcement); Haskell Murray, *Certified B Corporations v. Benefit Corporations*, THE CONGLOMERATE (May 3, 2012), http://www.theconglomerate.org/2012/05/certified-b-corporations-v-benefit-corporations.html [hereinafter Murray, *Certified B Corporations v. Benefit Corporations*]; *Certified B Corp*, B LAB, http://benefitcorp.net/what-makes-benefit-corp-different/benefit-corp-vs-certified-b-corp (last visited Nov. 11, 2012) ("[B]enefit corporations and Certified B Corporations are often, and understandably, confused. Both are sometimes called B Corps by mistake or as shorthand.").

91. Murray, *Certified B Corporations v. Benefit Corporations*, *supra* note 90.

have passed benefit corporation statutes.[92] Benefit corporations must be measured against a "third-party standard," but the standard does not have to be B Lab's B Impact Assessment.[93] B Lab conducts on-site reviews of randomly selected Certified B Corporations, whereas no such review is mandatory for merely being a benefit corporation.[94] A company can be both a Certified B Corporation and a benefit corporation, but there are plenty of examples of companies that are one but not the other.[95]

C. *Benefit Corporation and Other Social Enterprise Statutes*

Beginning in 2008, a plethora of social enterprise statutes have sprung up to service the needs and wants of social entrepreneurs. This Article focuses on the most popular corporate form of social enterprise, the benefit corporation. Benefit corporation statutes have passed in twelve states and legislation is pending in a number of additional states.[96] Maryland passed the first benefit corporation statute in 2010.[97] The benefit corporation statutes expressly *require* the consideration of various non-shareholder stakeholders, unlike the typical *permissive* constituency statute.[98] In

92. *See* J. Haskell Murray, *Benefit Corporations: State Statute Comparison Chart* (Aug. 1, 2012) (unpublished chart), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1988556 (summarizing the provisions of the various benefit corporation statutes).

93. *See generally Selecting a Third Party Standard: List of Standards, supra* note 88 (listing various potential third-party standards).

94. *Make it Official*, B LAB, http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/120 (last visited Dec. 15, 2012).

95. *Compare The Non-Profit Behind B Corps*, *supra* note 89, *with Find a Benefit Corp*, BENEFIT CORP. INFO. CTR., http://www.benefitcorp.net/find-a-benefit-corp/search (last visited Nov. 11, 2012).

96. *See Benefit Corp. Legislation*, B LAB, http://www.benefitcorp.net/state-by-state-legislative-status (last visited Nov. 11, 2012) (listing the benefit corporation "enacted legislation" and the "introduced legislation"); *see also* Murray, *supra* note 92.

97. MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01.

98. *Compare* MODEL BENEFIT CORP. LEGIS. § 301(a) (B Lab Jan. 26, 2012), *available at* http://www.benefitcorp.net/storage/Model_Legislation.pdf (requiring the consideration of various constituencies), *and* Murray, *supra* note 92, *with* Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 461 n.290 (2002) (noting the permissive nature of most constituency statutes). Even the one state Professor Fairfax mentions as being mandatory, Connecticut, has amended its constituency statute to be permissive. CONN. GEN. STAT. ANN. § 33-756(d) (2012). Unless otherwise noted, the Model Benefit Corporation Legislation refers to the January 26, 2012 version of the legislation. After this Article was already deep in the editing process, the July 30, 2012 version of the Model Benefit Corporation replaced the January version. MODEL BENEFIT CORP. LEGIS., (B Lab July 30, 2012), *available at* http://www.benefitcorp.net/storage/documents/Model_Benefit_Corporation_Legislation.pdf [hereinafter MODEL BENEFIT CORP. LEGIS. July 2012]. The July 30, 2012 version contains relatively minor revisions, and the current state benefit corporations statutes have not yet been amended to reflect those changes. The two most significant changes (the two percent shareholder standing threshold and the ability to opt-into director liability) are both mentioned below and were both influenced by a draft of this Article. E-mail from

addition, the benefit corporation statutes require pursuit of a "general public benefit."[99] Also, the benefit corporation statutes generally require an annual benefit report, provide for a benefit enforcement proceeding, and require a super majority vote to properly adopt or terminate benefit corporation statutes.[100] Maryland is the only state with a benefit LLC statute, which largely follows the benefit corporation statutes, but is built on the LLC platform.[101]

The L3C is a social enterprise statute also built on the LLC platform and is adopted in nine states. The idea for the L3C entity form originated with Robert Lang, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation, to take advantage of program-related investments ("PRIs") from foundations.[102] However, a number of entrepreneurs have formed L3Cs without giving great weight to the possibility of receiving PRIs and instead have used the form simply as an LLC-based social enterprise form.[103] The academic literature and corporate bar have generally been quite hostile toward L3Cs, stating that the entity form does not currently help entrepreneurs obtain PRIs more easily and that the tranching model suggested by the L3Cs' initial creator is unworkable.[104]

William H. Clark, Jr. (Oct. 29, 2012, 10:46 EDT) (on file with author).

99. *See* MODEL BENEFIT CORP. LEGIS. § 201 (defining "general public benefit" as "[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation"). Most of the state benefit corporation statutes closely follow the model legislation. *See* Murray, *supra* note 92.

100. *See* MODEL BENEFIT CORP. LEGIS. § 401; *see also* Murray, *supra* note 92.

101. MD. CODE ANN., CORPS. & ASS'NS §§ 4A-1101 to -1108; Telephone Interview with William H. Clark, Jr., Partner, Drinker Biddle & Reath (Jan. 23, 2012). Mr. Clark, who is also the co-author of the Model Benefit Corporation Legislation, noted that he knew of no current plans to expand beyond Maryland with the benefit LLC legislation. *See* E-mail from William H. Clark, Jr. (Oct. 29, 2012, 10:22 EDT) (on file with author) (confirming that there is still no plan to pursue benefit LLC legislation). Mr. Clark stated that LLC law is generally flexible enough to accomplish social enterprise purposes. The benefit LLC legislation was introduced and championed by Maryland state senator and American University Washington College of Law professor Jamie Raskin. Amy Kincaid, *ChangeMatters and Substance151 Become the Nation's First Benefit LLCs*, CHANGEMATTERS (June 1, 2011), http://changematters.com/640/changematters-substance-become-nations-first-benefit-llcs/.

102. Murray & Hwang, *supra* note 9 (providing a more in-depth look at L3Cs); Arthur Wood, *Comments on the L3C* 1–2 (Am. Cmty. Dev. 2010), *available at* http://www.americansforcommunitydevelopment.org/downloads/commentsonl3cbyarthurwood.pdf (noting that Robert Lang created the L3C concept and claiming that the L3C "makes it easier to do PRI's").

103. Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163, 178 (2010) ("[M]ost of the respondents [to the author's survey] acknowledged that the possibility of PRI funding was either unimportant or not a major reason they chose the L3C business form.").

104. *See* Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 245–46 (2010) (questioning the tranche investment plan and then stating that the L3C "will likely continue to endure the same scrutiny as any other charitable venture into the business world. If so, the L3C regulatory mission will fail, and indeed, its older LLC cousin will continue its

California and Washington have each created their own unique statutory solutions. In addition to passing a benefit corporation statute, California passed the Corporate Flexibility Act of 2011 to facilitate the formation of flexible purpose corporations ("FPCs").[105] According to the California law, the articles of an FPC must include one or more of the following in its statement of corporate purpose:

> One or more charitable purpose activities that a nonprofit public benefit corporation is authorized to carry out . . . [or] promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the flexible purpose corporation's activities upon any of the following: (i) The flexible purpose corporation's employees, suppliers, customers, and creditors. (ii) The community and society. (iii) The environment.[106]

As their name suggests, FPCs are much more flexible than benefit corporations. Unlike benefit corporations, FPCs are not required to pursue the "general public benefit," are not required to consider the various stakeholders listed in the benefit corporation statute, and are not required to be assessed against a third-party standard.[107] The State of Washington passed a statute allowing the formation of "social purpose corporations" ("SPCs"), effective June 7, 2012.[108] Consideration of social purposes is permissive for directors of SPCs, which distinguishes the SPC statute from the mandatory consideration required by the benefit corporation statutes.[109]

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presence."); Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 880 (2010) [hereinafter Kleinberger, *A Myth Deconstructed*] (calling the L3C "a snare and a delusion"); Murray & Hwang, *supra* note 9, at 49–51 (offering a more optimistic view of L3Cs but noting governance and financing issues in need of reform); *see also* Daniel S. Kleinberger, *ABA Business Law Section, on Behalf of Its Committees on LLCs and Nonprofit Organizations, Opposes Legislation for Low-Profit Limited Liability Companies (L3Cs)* (Wm. Mitchell Coll. of Law 2012), *available at* http://open.wmitchell.edu/facsch/228 (including a letter and attachment sent to Minnesota Representative Steve Simon on April 19, 2012 arguing against L3C legislation). *See generally* Callison & Vestal, *supra* note 81.

105. CAL. CORP. CODE § 2500 *et seq.*

106. *Id.* § 2602(B)(2)(A)–(B). In addition, California's Corporate Flexibility Act also requires that the corporations be operated for the "benefit of the long-term and the short-term interests of the flexible purpose corporation and its shareholders." *Id.* § 2602(b)(1)(A)–(B).

107. *See* Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 594 n.22 (2011) (explaining some of the differences between benefit corporations and FPCs). *Compare* CAL CORP. CODE § 2500, *with* MODEL BENEFIT CORP. LEGIS. Some may suggest that the flexibility of FPC statutes will make flexible purpose corporations more susceptible to greenwashing than benefit corporations.

108. WASH. REV. CODE § 23B.25.005–150.

109. *Compare id.* § 23B.20.050(2) ("[Directors] *may* consider and give weight to one or more of the social purposes of the corporation as the director deems relevant.") (emphasis added), *with* MODEL BENEFIT CORP. LEGIS. § 301(a) ("[Directors] *shall*

D. Potential Statutory Solutions and Challenging the Norm

Two statutory solutions to address the concerns of social entrepreneurs who complain about the profit-focused nature of traditional corporate law may be appropriate for state legislatures to consider. The first would be for states to amend their traditional corporate statutes to expressly acknowledge that the corporation can choose its objective or master, even if that master is not enhancing shareholder wealth.[110] Second, and alternatively, legislatures could consider adopting a *thoughtful* social enterprise statute(s)—or modify their current social enterprise statutes—to address the issues raised in Part III below.[111] Both solutions allow corporations to opt into a higher level of social and environmental responsibility, unlike constituency statutes, which generally do not expressly provide similar freedom.[112]

The first solution—amending the existing corporate statute—is the most simple as it does not require a new statute. However, it may be confusing to courts and investors to have both social enterprises and traditional corporations formed under the same statute. The second solution—a separate social enterprise statute—may appeal to shareholder wealth maximization proponents because by leaving traditional corporate law unaltered it arguably allows the norm to continue, while still allowing the free market, through competition, to determine if a non-shareholder focus will prove itself useful and sustainable.[113] In addition, a separate statute

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consider the effects of any action or inaction upon: [listed stakeholders].") (emphasis added).

110. Some may argue that corporations are already free (similar to LLCs) to dictate their objective, even if it departs from the shareholder wealth maximization norm, in their articles of incorporation (at least if done as an initial matter, before shareholders purchase shares). If this is the case, state legislatures, including Delaware, should consider making the freedom to focus on non-shareholder stakeholders explicit in their corporate statutes to calm the fears of risk-adverse managers and lawyers. Oregon has already made such ability explicit in its corporate statute. *See* OR. REV. STAT. § 60.047 (2011); *see also* Jason C. Jones, *The Oregon Trail: A New Path to Environmentally Responsible Corporate Governance?*, 54 ST. LOUIS U. L.J. 335, 347–49 (2009) (discussing the purpose and rationale of this aspect of Oregon's law). If legislatures choose this route, however, they should be careful to require corporations to clearly state their objective and choose one *primary* master. Without a primary master or objective, corporate law would lose its guiding function and lose much of the very little accountability it currently provides. *See infra* Part III.A–B.

111. *See* Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1382–84 (2011) (arguing that the social enterprise answer to the corporate social responsibility debate may be one that both libertarians and progressive corporate law proponents may find palpable).

112. J. Robert Brown, Jr., *Discrimination, Managerial Discretion and the Corporate Contract*, 26 WAKE FOREST L. REV. 541, 542 (1991) (stating that contractarians favor freedom of contract and take "the position that managers and owners should have complete freedom to negotiate over all terms of the corporate charter").

113. *See, e.g.*, Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 885 (1997) (reviewing PROGRESSIVE CORPORATE LAW (Lawrence E.

may help break the power of the shareholder wealth maximization norm, as it would be difficult for even the densest director to think his or her job is to maximize shareholder wealth when the entity itself is formed under a social enterprise statute and has a name like "benefit corporation" or "social purpose corporation."[114] The social enterprise statutes have already prompted intense attacks on the shareholder wealth maximization norm from the popular media, and the social enterprise movement has begun to change the tenor of education (though more in business schools than law schools, currently).[115] If the second alternative—a separate social

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Mitchell ed. 1995)) ("Here then is the essential conservative contractarian: one who seeks to reconcile conservative principle and economic theory by duplicating Russell Kirk's ability 'consistently to favor free markets, private property, competition, and at the same time to champion virtue.'"); Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, *supra* note 18, at 133 (praising "open and free competition" in the same article he disparages corporate social responsibility).

114. *See supra* Part I.D (discussing the power of the persistent common perception linked to the shareholder wealth maximization norm).

115. The media has been abuzz about the new social enterprise forms, spawning thousands of articles in various magazines, newspapers, and blogs over the past months. In June 2012 alone, there were 1,334 articles returned for a LexisNexis news search for the term "social enterprise." LEXISNEXIS, http://www.lexisnexis.com (follow "News & Business" hyperlink under "Search"; then follow "News" hyperlink and select "News, All" database; then use the "Terms and Connectors" search for "social enterprise") (search last performed June 7, 2012). *See* Kerr, *supra* note 55, at 630 & n.43 (discussing an increase in search results for the term "social entrepreneur"). Business and law schools have also caught social enterprise fever, adding significant social enterprise-focused offerings to their curriculum and hosting social enterprise symposia. *See, e.g.*, Stacey Blackman, *Social Entrepreneurship and the M.B.A.*, U.S. NEWS & WORLD REP. (Aug. 12, 2011), http://www.usnews.com/education/blogs/MBA-admissions-strictly-business/2011/08/12/social-entrepreneurship-and-the-mba; John A. Byrne, *Social Entrepreneurship: The Best Schools & Programs*, POETS & QUANTS (Aug. 13, 2010), http://poetsandquants.com/2010/08/13/social-entrepreneurship-the-best-schools-programs/ (discussing business school programs in social enterprise, including: the Duke University's Fuqua School of Business's Center for the Advancement of Social Entrepreneurship, Harvard Business School's Social Enterprise Initiative, Northwestern University Kellogg School of Management's Social Enterprise at Kellogg (SEEK) Program, Oxford Saïd Business School's Skoll Centre for Social Entrepreneurship, Stanford Graduate School of Business's Center for Social Innovation, Yale University's School of Management's Program on Social Enterprise). In addition, New York University is the home of The Catherine B. Reynolds Foundation Program in Social Entrepreneurship. *Catherine B. Reynolds Foundation Program for Social Entrepreneurship*, NEW YORK UNIV., http://www.nyu.edu/reynolds/index.flash.html (last visited Nov. 11, 2012). Emory University recently announced a research center called Social Enterprise @ Goizueta. Goizueta Newsroom, *Social Enterprise Announced as Research Center*, EMORY UNIV. GOIZUETA BUS. SCH. (Apr. 4, 2012), https://newsroom.goizueta.emory.edu/gnr/2012/04/04/social-enterprise-at-goizueta-now-a-research-center/. Law schools appear to be lagging behind the business schools a bit in the adoption of social enterprise-focused programs (perhaps because the law itself is lagging behind the business developments, or perhaps because many law professors are skeptical of the new social enterprise forms). Nonetheless, social enterprise has become a popular symposium topic at law schools over the past few years, and a few prominent schools have begun taking significant interest in social enterprise. For example, New York University School of Law funds a social entrepreneurship fellowship. *NYU Fellowships in Entrepreneurship, Social Entrepreneurship, and Innovation*, NEW YORK UNIV. L. SCH., http://www.law.nyu.edu/leadershipprogram/socialenterprise/index.htm (last visited

enterprise statute—is chosen, however, the law will have to address issues with the current statutes, discussed in Part III, for the social enterprise forms to be useful and sustainable.

III. SEEKING SUSTAINABILITY FOR SOCIAL ENTERPRISE

"Sustainability" is perhaps the most overused word in the social enterprise space, yet ironically, serious questions exist about the sustainability of the various social enterprise entity forms.[116] As discussed above, the two primary social enterprise entity forms in the United States are the benefit corporation and the L3C.[117] This Section focuses on the benefit corporation, as the author has addressed L3Cs in an earlier article, but many of the suggestions may be applicable across social enterprise forms, with some variations and exceptions.[118]

A. Board Guidance and Prioritizing Priorities

If you don't know where you're going, you might end up somewhere else.[119]

One of the primary problems with the current benefit corporation statutes is the lack of guidance the statutes provide for boards of directors. Directors of benefit corporations are told they *must* consider the effects of

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Nov. 11, 2012). The University of Washington School of Law now has a Social Entrepreneurship and Nonprofit Law Clinic and the Georgetown University Law Center will open a similar clinic in the fall of 2013. *ELC Social Entrepreneurs & Non-Profits*, UNIV. OF WASH. SCH. OF LAW, http://www.law.washington.edu/clinics/entrepreneurial/clients/nonProfit.aspx (last visited Nov. 11, 2012); *Social Enterprise and Nonprofit Clinic*, GEORGETOWN LAW, http://www.law.georgetown.edu/academics/academic-programs/clinical-programs/our-clinics/social-enterprise/index.cfm (last visited Nov. 11, 2012). In addition, a few law schools, including the author's own school, have very recently added a social enterprise course to the curriculum. Moreover, the social enterprise fellowship opportunities for recent law and business graduates have mushroomed in recent years. *See 50+ Fellowship Programs for Social Innovators*, INNOV8SOCIAL (Oct. 24, 2011), http://www.innov8social.com/2011/10/50-fellowship-programs-for-social.html.

116. *See* Brakman Reiser, *supra* note 107, at 593 ("[The] benefit corporation lacks robust mechanisms to enforce dual mission, which will ultimately undermine its ability to expand funding streams and create a strong brand for social enterprise as sustainable organizations."); Kleinberger, *A Myth Deconstructed*, *supra* note 104, at 881 ("The 'L3C' is an unnecessary and unwise contrivance."); Murray & Hwang, *supra* note 9, at 51–52.

117. *See supra* Part II.C.

118. *See generally* Murray & Hwang, *supra* note 9.

119. TOBY KEITH & BOBBY PINSON, SOMEWHERE ELSE (Show Dog–Universal Music 2011), *lyrics available at* http://www.cowboylyrics.com/lyrics/keith-toby/somewhere-else-30645.html (last visited Nov. 11, 2012). This line likely stems from the similar saying attributed to humorist and former professional baseball player and manager, Yogi Berra. *Yogi Berra, Sayings and Ripostes*, LINGUISTIC HUMOR, http://www.ling.upenn.edu/~beatrice/humor/yogi-berra.html (last visited Nov. 11, 2012) ("If you don't know where you're going, you might not get there.").

any action on such diverse groups as: (1) shareholders; (2) employees ("of the benefit corporation, its subsidiaries and its suppliers"); (3) customers; (4) community and society; (5) "the local and global environment"; (6) "the short and long term interests of the benefit corporation"; and (7) "the ability of the benefit corporation to accomplish its general public purpose and any specific public benefit purpose."[120] Since Biblical times, it has been well recognized that people cannot properly serve two masters, much less seven or more.[121]

Directors would benefit from having a primary master and a clear objective. One of the reasons the shareholder wealth maximization norm has been so widely followed by traditional corporations may be because it provides a clearer corporate objective than many of the argued-for alternatives.[122] Without clear guidance and without a clear master, many directors of benefit corporations and other social enterprises will likely default to seeking their own self-interest or their own objectives.[123] Professor Lynn Stout and others reject the need for a single metric and have argued that directors, like other human beings, balance the interest of various corporate stakeholders.[124] Among other examples of balancing by human beings, Professor Stout points to the ability of people to balance

120. *See, e.g.*, MODEL BENEFIT CORP. LEGIS. § 301(a); *see also* Murray, *supra* note 92 (showing the standard of conduct for directors adopted by the various states, which track, in most instances, the model legislation). The mandatory nature of this provision of the benefit corporation statutes differentiates benefit corporation statutes from most constituency statutes and from the flexible purpose and social purpose statutes. *See supra* Part II.C.

121. *Luke* 16:13 ("No one can serve two masters. Either you will hate the one and love the other, or you will be devoted to the one and despise the other. You cannot serve both God and money.").

122. Having shareholders as the focus of directorial attention may also make matters (relatively) easier for judges. Strine, *The Social Responsibility of Boards of Directors and Stockholders in Charge of Control Transactions*, *supra* note 24, at 1173 n.11 ("By permitting directors to justify their actions by reference to more diffuse concerns [than those of shareholders], the (already challenging) judicial task of adjudicating fiduciary compliance arguably becomes impossible."). This Article does not argue that the shareholder wealth maximization norm provides perfectly clear guidance for directors of traditional corporations, but merely that it provides better guidance than other proposed alternatives. For example, shareholders often have conflicting interests due to, among other things, varied investment time horizons. Bainbridge, *Director Primacy and Shareholder Disempowerment*, *supra* note 41, at 1745.

123. *See* Roe, *supra* note 33, at 2065 ("[A] stakeholder measure of managerial accountability could leave managers so much discretion that managers could easily pursue their own agenda."); Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1013 (1992) ("There is a very real possibility that unscrupulous directors will use nonshareholder interests to cloak their own self-interested behavior.").

124. STOUT, *supra* note 18, at 107–09 (arguing that the need for a single metric, championed by economist Michael Jenson in his article *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 12 BUS. ETHICS Q. 235, 238 (Apr. 2002), is overstated and "ignores the obvious human capacity to balance").

work and family.[125] This Article admits that directors do and should balance various stakeholder interests and does not argue for myopic focus on a *single* metric, but rather posits that clear corporate *priorities* can make that difficult balancing job easier.[126]

Using Professor Stout's work/family example of balancing can help illustrate the point. Clearly defined priorities can help an individual make difficult decisions in the constant work/family balance. If an individual prioritizes family over work, that obviously does not mean that every decision leads to direct, short-term benefits for the family. For example, on occasion, that family-primacy individual will rightly choose to stay late at work and miss dinner. While that individual decision may have seemed to prioritize work over family, viewed in the long-term, the family *may* benefit from the resultant career security. Even if the long-term benefits do not actually come to fruition, most would agree that the individual should not be judged for her well-intentioned decision.

The fact that humans certainly balance interests of various constituents, however, does not mean that priorities are unimportant. Priorities can help guide and can also provide weightings for the costs and benefits of any decision.[127] Also, priorities most clearly help in critical situations.[128] To continue with the work/family example, in a zero-sum game, how does one decide between work and family when the outcome of that decision is of critical importance to both?[129] If an individual has clearly stated that

125. *Id.* at 108 ("[S]hopkeepers balance the hope of making one more sale against the desire to get home in time for the family dinner."). Professor Stout admits that balancing, in both the corporate and personal context, is difficult. *Id.*

126. This Article does not defend the claim that shareholder wealth *maximization* should be the *sole* focus of directors of traditional corporations, but it is more sympathetic to the argument that *long-term* shareholder wealth *enhancement* should be the *primary* focus of traditional corporations. Of course, as the ALI Principles of Corporate Governance note, this priority cannot overcome the requirement to follow the law. AMERICAN LAW INSTITUTE, *supra* note 22, at § 2.01. Also, the *long-term* focus allows for many decisions that appear to benefit most directly stakeholders other than shareholders in the *short-term*. Virtually no companies can be successful for its shareholders in the *long-term* without considering other stakeholders.

127. In a zero-sum game, priorities will help determine which stakeholder should win, as the prioritized stakeholder's benefits and costs will be weighted more heavily.

128. In the corporate context, decisions involving potential takeovers, discussed in Parts I.C and III.B.3, are among the most critical decisions faced by directors. Decisions regarding takeovers also often most clearly pit various corporate stakeholders against one another. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981) (noting the serious conflicts between stakeholders that arise in the takeover context).

129. The most common critical decision in the work/family context is a career decision that requires a family move. Of course, in some cases, moving for a new job is in the best interest of the family, but on occasion, the decision to move has incredibly large costs for the family and equally large benefits for one's career. When the costs for two or more constituents are high, in opposite directions, priorities can be extremely helpful in resolving the issue.

family is a higher priority than work, this critical decision is more easily answered. Even if the priorities are not clearly stated, priorities will still drive the decision. Transparency as to the priorities makes things clearer to all involved and makes it less likely that the individual will drift from his or her true priorities.[130] Similarly, directors would benefit from a clear corporate objective that includes specific corporate priorities.[131]

Proponents of the benefit corporation statutes may argue that the clear benefit corporation objective is to increase "net stakeholder value."[132] This approach is already embedded in the model benefit corporation statute, which defines "general public benefit" as "[a] material positive impact on society and the environment, *taken as a whole*, assessed against a third-party standard, from the business and operations of a benefit corporation."[133] Current benefit corporation statutes do not allow directors to abandon the "general public benefit purpose" in favor of a more specific master or mandate.[134] Rather, the benefit corporation statutes require that any "specific public benefit purpose" be adopted *in addition* to the "general public benefit purpose." The "general public benefit purpose" concept, as used in the current benefit corporation statutes, is both too vague and too confining.

The mandate that a benefit corporation pursue a "general public benefit purpose" is too vague because it does not provide a practical way for directors to make decisions. Over forty years ago, Milton Friedman wrote that "[t]he discussions of the 'social responsibilities of business' are

130. Personally, the author has been greatly helped by documenting his priorities (in a Google document) and referring to them often. Even with the documentation, balancing is challenging and necessary. But clearly listing priorities, in order, aids in difficult decision-making and can act as a reminder to take time for the "important" things even if they are not "urgent." *See* STEPHEN R. COVEY, THE SEVEN HABITS OF HIGHLY EFFECTIVE PEOPLE: RESTORING THE CHARACTER ETHIC 151–82 (2004) (defining "Quadrant II activities"—activities that are not urgent, but are important—and discussing how most people do not spend enough time doing Quadrant II activities).

131. For example, if a corporation such as Patagonia lists the environment as a high (or primary) priority, the high ranking will likely inform the directors' decisions. *See* CHOUINARD, BUSINESSMAN, *supra* note 1, at 3. Patagonia's founder, Yvon Chouinard, admits that the corporation cannot avoid all environmental harm (and still operate as a sustainable corporation), so Patagonia attempts to "cause no *unnecessary* harm to the environment." CHOUINARD & STANLEY, *supra* note 1, at 3, 15 (emphasis added). The high prioritization of the environment has also led to a number of decisions, such as switching to organic cotton, even if the decisions were likely to harm corporate profitability. *Id.* at 48–52.

132. *See, e.g.*, *The New ABC's of California Corporations*, KAYE & MILLS, http://www.kayemills.com/articles/new-abcs-of-california-corporations.html (last visited Nov. 11, 2012) (stating that benefit corporation law shifts "the corporate purpose from maximizing shareholder value to maximizing stakeholder value").

133. MODEL BENEFIT CORP. LEGIS. § 102(a).

134. *Id.* § 201(b) ("The identification of a specific public benefit under this subsection does not limit the obligation of a benefit corporation under [the general public benefit purpose] subsection.").

notable for their analytical looseness and lack of rigor."[135] Recently, a number of organizations, like B Lab's Global Impact Investing Rating System ("GIIRS"), have begun attempting to apply some rigor to the measurement of social and environmental impact.[136] In addition, the Impact Reporting and Investment Standards ("IRIS") has been "developed to provide a common reporting language for impact-related terms and metrics" within the social enterprise space.[137]

Further, Social Return on Investment ("SROI") is a method of identifying stakeholder interests and helps measure a company's improvement in addressing those interests.[138] In short, SROI aspires to help develop and choose the indicators for individual companies, while IRIS attempts to help standardize definitions and indicators to facilitate comparison of companies.[139] In a project focused more on traditional U.S. public corporations, but which may still prove useful in some ways to social enterprises, the Sustainability Accounting Standards Board ("SASB") is "engaged in the creation and dissemination of sustainability

135. Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, *supra* note 18, at 133.

136. B Lab analogizes GIIRS "to Morningstar investment rankings and Capital IQ financial analytics." GLOBAL IMPACT INVESTING RATINGS SYSTEM, http://giirs.org/ (last visited Nov. 11, 2012). There are numerous organizations, other than B Lab, that are also trying to quantify social and environmental impact. *See Selecting a Third Party Standard: List of Standards*, *supra* note 88 (mentioning that there are over 100 raters of corporate sustainability and listing a dozen third-party standards, including B Impact Assessment, Global Reporting Initiative, Green Plus, Green Seal, Green America Business Network, ISO 26000, and Sustainability Quotient). As the social enterprise market matures, there is likely to be consolidation of these ratings systems, which will make the choosing of a third-party standard simpler for directors, but will also bring the specter of self-interested actions by the powerful rating companies similar to the problems posed by only three main credit rating agencies, Moody's, S&P, and Fitch. *See generally Wall Street and the Financial Crisis: The Role of Credit Rating Agencies: Hearing Before the Permanent Subcomm. on Investigations of the Comm. on Homeland Sec. & Gov't Affairs*, 111th Cong., (2010), *available at* http://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/042310Exhibits.pdf (containing 581 pages of information about the credit rating agencies' role in the most recent financial crisis, including the memorandum to the Members of the Permanent Subcommittee on Investigations, Exhibit No. 1a, which provides a helpful summary of the investigation); Patrick Kingsley, *How Credit Agencies Rule the World*, THE GUARDIAN (Feb. 15, 2012, 15:00 EST), http://www.guardian.co.uk/business/2012/feb/15/credit-ratings-agencies-moodys?INTCMP=SRCH (describing the tremendous power of the "Big Three" credit rating agencies).

137. *About IRIS*, IMPACT REPORTING & INVESTMENT STANDARDS, http://iris.thegiin.org/about-iris (last visited Nov. 11, 2012). IRIS was created by the Rockefeller Foundation, B Lab, Acumen Fund, and the Global Impact Investing Network ("GIIN"). *See History*, IMPACT REPORTING & INVESTMENT STANDARDS, http://iris.thegiin.org/history (last visited Nov. 11, 2012); *see also* BUGG-LEVINE & EMERSON, *supra* note 5, at 10–11.

138. *What is Social Return on Investment (SROI)?*, THE SROI NETWORK INT'L., http://www.thesroinetwork.org/what-is-sroi (last visited Nov. 11, 2012).

139. Attempting to standardize the measurement of various social and environmental outcomes is an ambitious and challenging project.

accounting standards."[140]

While there has been significant movement in the rigor of measuring social and environmental impact since the days of Milton Friedman, boards of directors still do not have a simple, yet adequate guide to help them pursue the "general public benefit" and the interests of all the various stakeholders listed in the benefit corporation statute. How should benefit corporation directors resolve an issue that requires harming some stakeholders, but benefiting others? For example, how should directors weigh harm to the environment against harm to employees? Of course, it would be wonderful if all decisions could simply benefit all stakeholders, but that is not possible with many decisions.[141] Even if directors are simply attempting to maximize net stakeholder value, the question of how to measure and compare stakeholder value remains largely unanswered.[142]

Ironically, "general public benefit" is not only too vague, but it could be argued that it is too confining as well. *Requiring* social enterprise directors to consider an unprioritized group of stakeholders while also requiring a corporate purpose that looks at societal and environmental impact *as a whole* is not only unworkable, but could also exclude corporations with a more specific mission.[143] A corporation with a focused and specific public

140. SUSTAINABILITY ACCOUNTING STANDARDS BOARD (SASB), http://www.sasb.org/ (last visited Nov. 11, 2012). Like the Financial Accounting Standards Board ("FASB") establishes financial accounting and reporting standards, SASB is attempting to establish recognized standards for sustainability accounting. *See* Alicia Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TENN. J. BUS. L. 221, 257 (2012).

141. Bainbridge, *Director Primacy*, *supra* note 20, at 600 n.261 (noting that "[e]ven if shareholder and nonshareholder interests are often congruent, it nevertheless remains the case that some situations present zero-sum games" whereby the directorial decision results in certain stakeholder winners and certain stakeholder losers).

142. The author recognizes that shareholder value may also be difficult to define, as different shareholders have different goals, but currently there is much more consensus on measuring shareholder value (for example, using a discounted cash flow model) than on measuring stakeholder value. STOUT, *supra* note 18, at 86–94 (noting the differing interests and investment horizons among various types of shareholders).

143. *See Benefit Corporation—Legal Provisions and FAQs*, B LAB, 2–3, http://www.bcorporation.net/resources/bcorp/documents/Benefit%20Corporation%20-%20Legal%20Provisions%20and%20FAQ.pdf (last visited Nov. 2, 2012) (stating that the statute prevents a company from adopting a narrow specific purpose and then ignoring "general public benefit"); *see also* J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, 2 AM. U. BUS. L. REV. 85 (2012). California's Corporate Flexibility Act, which allows the formation of "flexible purpose corporations" allows entrepreneurs the freedom to provide for a more specific corporate mission without the restrictive mandates of the benefit corporation statute. CAL. CORP. CODE § 2602(b); *see* Plerhoples, *supra* note 140, at 228 (noting the permissive nature of California's Corporate Flexibility Act). California does not currently have a constituency statute and the California Corporate Flexibility Act, which allows for the formation of flexible purpose corporations, appears to serve as a de facto opt-in constituency statute. *See generally* Dana Brakman Reiser, *The Next Big Thing: Flexible Purpose Corporations*, 2 AM. U. BUS. L. REV. 55 (2012).

purpose at its core is more likely to pursue that purpose because the objective is more easily identified by directors.[144] A more specific public purpose (or a prioritizing of certain stakeholders within a more general public purpose) would also provide a more workable system of board accountability.

B. Board Accountability

The benefit corporation statute is said to be an antidote to "greenwashing" and faux corporate social responsibility ("faux CSR").[145] But without at least some minimal level of board accountability, the benefit corporation statute could be an avenue to greenwashing and faux CSR rather than an antidote to them. In fact, if an appropriate accountability framework is not erected, benefit corporations could allow an unprecedented amount of rent-seeking and could allow greater management entrenchment than permitted in other entity forms.[146]

Benefit corporation statutes state that directors *must* consider multiple stakeholders in each and every decision they make.[147] As has been long recognized, if the law asks directors to serve multiple masters, it becomes difficult to hold the directors accountable *at all*.[148] In the same vein, early

144. A clear statement of priorities could also stem a flood of potential benefit corporation litigation because if priorities are identified from the beginning there is a greater chance that shareholders who choose to invest will have similar goals and interests. Courts could use well-settled rules of contract interpretation to interpret the statement of corporate objective, including the corporation's primary focus.

145. *Benefit Corporation—Legal Provisions and FAQs*, *supra* note 143, at 2 ("The 'general public benefit' purpose helps prevent abuse of this legislation by corporations interested in green-washing."). Jay Westerveld, an American environmentalist, is credited with coining the term "greenwashing" in 1986, and the term generally refers to companies making exaggerated or untrue statements about its environmentally friendly practices. Miriam A. Cherry & Judd F. Sneirson, Chevron, *Greenwashing and the Myth of "Green Oil Companies,"* 3 WASH. & LEE J. ENERGY, CLIMATE & ENV'T 133, 140–41 (2012) [hereinafter Cherry & Sneirson, Chevron, *Greenwashing and the Myth of "Green Oil Companies"*]. *See generally* Miriam A. Cherry & Judd F. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster*, 85 TUL. L. REV. 983, 1002–09 (2011) [hereinafter Cherry & Sneirson, *Beyond Profit*] (coining the term "faux CSR" and proposing reforms to address false or misleading claims by a company about corporate social responsibility).

146. The rent-seeking in benefit corporations may rise to unprecedented levels because benefit corporations have the ability to be as profitable as traditional corporations, yet managers have a new set of excuses for selfish behavior, namely the various constituents that the statute *mandates* they consider. *Cf.* Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI.-KENT L. REV. 681, 688 n.38 (1989) (describing constituency statutes, which the benefit corporation statutes resemble in some respects, as "rent-seeking statutes").

147. *See* MODEL BENEFIT CORP. LEGIS. § 301. Obviously, merely "considering" various stakeholders is not very demanding of benefit corporation directors, but the mandatory nature of the command makes it more onerous than permissive constituency statutes.

148. *See* Berle, *For Whom Corporate Managers Are Trustees*, *supra* note 15, at 1367 ("When the fiduciary obligation of the corporate management and 'control' to stockholders is weakened or eliminated, the management and 'control' become for all

commentators on social enterprise have noted that the imposition of multiple masters makes it difficult to hold directors accountable and may permit directors to seek their own self-interest by using one of the many masters as pretext.[149] Chancellor Strine colorfully criticized benefit corporation statutes as existing in a:

> [F]ictional land where you can take other people's money, use it as you wish, and ignore the best interests of those with the only right to vote. In this fictional land, I suppose a fictional accountability mechanism will exist whereby the fiduciaries, if they are a controlling interest, will be held accountable for responsibly balancing all these interests. Of course, a very distinguished mind of the political left, Adolph Berle, believed that when corporate fiduciaries were allowed to consider all interests without legally binding constraints, they were freed of accountability to any.[150]

As suggested in the previous Section, directors should be given clear guidance by either the statute or the benefit corporation's governing documents to allow for a workable governance system that includes at least some minimal level of board accountability.[151]

Once the issue of clear guidance is addressed, an enforcement mechanism, or at least the potential for enforcement, can aid in corralling the natural selfish urges of directors and can also aid in creating a norm that directors may follow. Humans are, by their very nature, self-seeking.[152] A rule that attempts to curb the self-seeking nature of directors will not be

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practical purposes absolute."); William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and* The Modern Corporation, 34 J. CORP. L. 99, 129 (2008) ("The key insight that Berle attributed to these corporate lawyers is that a management-coordinated, multiple constituency system simply would not work."); EASTERBROOK & FISCHEL, *supra* note 18, at 38 ("[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.").

149. *See, e.g.*, John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 142–44 (2010) (noting the problems associated with multiple masters, but asserting that "[t]here is but one master in the L3C-charitable, exempt purposes"); Brakman Reiser, *supra* note 107, at 599–600 ("The broad discretion benefit corporation statutes accord to directors can likewise be faulted for giving directors unbridled discretion, with which they might pursue social good or might pursue foolish or self-serving practices."); Murray & Hwang, *supra* note 9, at 39–41 (suggesting a clear ordering of priorities for L3Cs).

150. Strine, *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, *supra* note 24, at 150 (citing A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365, 1367 (1932)).

151. *See supra* Part III.A.

152. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 3 (6th ed. 2003) ("[M]an is a rational maximizer of his ends in life, his satisfactions—what we shall call his 'self-interest.'"). *But see* STOUT, *supra* note 18, at 96–99 (arguing that most people are not "psychopaths" and challenging "[c]onventional shareholder value thinking [that] presumes that investors . . . care only about their own material circumstances").

very effective without some potential consequences.[153] Most benefit corporation statutes currently state that a "benefit enforcement proceeding" is the only way to enforce the above directorial mandate.[154] The benefit enforcement proceeding cannot result in monetary damages.[155] As a default, only a shareholder, a director, or the holder of five percent or more of the benefit corporation's parent can bring a benefit enforcement proceeding.[156] This enforcement structure can be improved, but is actually not as far removed from the enforcement structure of traditional corporate law as it may seem because, as a practical matter, traditional corporate law provides more in the way of guidance than accountability.[157] As described below, an improved structure would require a clear statement of the corporation's objective and allow for dissenters' rights when the objective is changed or the corporation ceases to be a benefit corporation. Further, an improved benefit corporation statute would provide for the ability to opt-into monetary liability for directors.[158] The corporate governance

153. As discussed above, some of these consequences may be legal consequences and some may be social consequences stemming from the violation of established norms. While a norm can be quite powerful, a legal rule without *any* real consequences seems unlikely to spawn a strong norm. *See supra* Part II.D.

154. *See* MODEL BENEFIT CORP. LEGIS. §§ 303–305.

155. *Id.* §§ 301, 305.

156. *Id.* § 305. Other persons may be given standing to bring a benefit enforcement proceeding in the articles or bylaws of the benefit corporation. *Id.* In the most recent version of the Model Benefit Corporation Legislation, a two percent ownership threshold was set for shareholder standing. MODEL BENEFIT CORP. LEGIS. § 305(b)(2)(i). This change stemmed, in part, from a conversation between the author and the drafter of the Model Benefit Corporation Legislation, Bill Clark, about the fear of potential frivolous lawsuits against the directors of a benefit corporation by shareholders with extremely small financial stakes in the corporation, but a strong interest in one or more of the various stakeholders listed in the statute. E-mail from William H. Clark, Jr., *supra* note 98. At a recent symposium hosted by the University of California Hastings College of Law on October 19, 2012, the author suggested to the audience, including Bill Clark, that the ownership threshold should be a sliding scale that decreases as the size of the company increases. Amassing two percent of the outstanding stock in a large company, or organizing a group of investors who do, could be a significant hurdle. Alternatively, the statutes could provide a set dollar threshold, such as the ownership of $2,000 or more in stock in the benefit corporation.

157. *See supra* Part I.B-C (describing some of the extremely rare cases where the shareholder wealth maximization norm has been enforced). For a recent example of guidance, without accountability, see also *In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 450–52 (Del. Ch. 2012), where Chancellor Strine strongly criticized the actions of the officers and directors of El Paso, yet denied the plaintiffs' request to preliminarily enjoin the proposed merger. *See also* Lyman Johnson, *Counter-Narrative in Corporate Law: Saints and Sinners, Apostles and Epistles*, 2009 MICH. ST. L. REV. 847, 860–64 (2009) (describing the serious scolding of the directors in *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) despite no holding of liability); Julian Velasco, *The Role of Aspiration in Corporate Fiduciary Duties*, 54 WM. & MARY L. REV. (forthcoming 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1995734 (noting the "pervasive divergence between standards of conduct and standards of review" in corporate law).

158. Allowing the ability to opt-into monetary liability for directors would both maximize freedom on the issue of liability and default to the option most likely to be

structure of benefit corporations should use much of traditional corporate law framework, albeit with a different primary objective than increasing shareholder value.

1. Dissenters' Rights

Currently, the California benefit corporation statute is the only statute that expressly provides for dissenters' rights when a corporation transitions to and from benefit corporation status.[159] B Lab has not promoted dissenters' rights because a transition to or from benefit corporation status is not a liquidation event, and thus corporations may not have the available capital to pay dissenters.[160] If states do not recognize dissenters' rights, benefit corporations are likely to face lawsuits from shareholders who object to the altering of the fundamental nature of their investment.[161] Virginia has addressed this problem by requiring 100% shareholder approval (as opposed to the more typical two-thirds vote)[162] for the transition from traditional corporation to benefit corporation.[163] While the Virginia solution eliminates the dissenting shareholder problem, the solution is suboptimal because it also makes it nearly impossible for a larger corporation to make the switch to a benefit corporation, even if the vast majority of its shareholders are in favor of such a move.[164]

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agreed upon if there were no transaction costs. *Cf.* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH AND HAPPINESS 4–6 (2008) (explaining the idea of "libertarian paternalism," which appreciates freedom to choose and sets defaults carefully). While this Article was in the editing process, and after a draft of the Article was posted on SSRN, this suggestion was adopted by the most recent draft of the Model Benefit Corporation Legislation. MODEL BENEFIT CORP. LEGIS. § 301(c). The drafter of the legislation, Bill Clark, credited a draft of this Article as a source of the change. E-mail from William H. Clark, Jr., *supra* note 98.

159. CAL. CORP. CODE §§ 14603–14604. During the editing of this Article, Massachusetts passed its benefit corporation statute, which includes appraisal rights similar to California's dissenters' rights. MASS. GEN. LAWS ANN. ch. 156E, §§ 5, 8 (West 2012). The Massachusetts statute, however, only expressly provides for appraisal rights when a company adopts benefit corporation status and is silent on rights that may arise when a company terminates its benefit corporation status. *Id. See* J. Haskell Murray, *Massachusetts Benefit Corporation Statute*, SOCENT LAW (Dec. 1, 2012), http://socentlaw.com/2012/12/massachusetts-benefit-corporation-statute/.

160. *See* Clark & Vranka, *supra* note 54.

161. VA. CODE ANN. §§ 13.1-785 to -786 (2012).

162. *See, e.g.*, CAL. CORP. CODE § 14603-04; HAW. REV. STAT. ANN. §§ 420D-3 to -4 (LexisNexis 2011); MD. CODE ANN., CORPS. & ASS'NS §§ 5-6C-03 to -04; N.J. STAT. ANN. §§ 14A:18-3(a) to (4)(a) (West 2011); S.C. CODE ANN. § 33-38-230 (West 2012); VT. STAT. ANN. tit. 11A, §§ 21.05 to 06.

163. VA. CODE ANN. § 13.1-785.

164. *Cf.* Guhan Subramanian et al., *Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988–2008*, 65 BUS. LAW. 685, 716 (2010) (finding that, between 1990 and 2008, no hostile bidder was able to obtain the tender of 85% or more of the outstanding shares through a tender offer). Professor Subramanian's study is relevant here because it shows the logistical difficulty of getting more than 85% of shareholders, not to mention 100%, to vote for anything, even if it is clear that the proposal is in the best interest of the shareholders.

Each benefit corporation statute should expressly provide for dissenters' rights to protect shareholders from a fundamental change to the company in which they invested. To prevent abuse, the dissenters' rights should only be available to shareholders who notify the corporation in a timely fashion regarding their objection and agree to accept the amount the court determines to be "fair value" for the shares.[165] These requirements lessen the chance that shareholders would object for improper motives, as there would be a chance that the shareholders will get less than they believe the corporation is worth.

2. *Duties of Care and Loyalty in Benefit Corporations*

While academics have often noted that multiple masters lead to no accountability, in practice, the benefit corporation statutes may already provide for similar amounts of accountability, though not as much guidance, as traditional corporate law.[166] Duty of loyalty lawsuits are generally the only type of corporate governance lawsuits with any real teeth, in terms of liability, in traditional corporate law.[167] These types of duty of loyalty lawsuits appear to be available to plaintiffs in the benefit corporation context, though case law has yet to provide guidance.[168] After *Stone v. Ritter*, Delaware law became clearer that the duty of loyalty addressed not only the self-interested actions of directors, but that the duty of loyalty also required directors to act "in good faith to advance the best interests of the corporation."[169] In the nonprofit context, some states recognize a duty of obedience, which is "sometimes referred to as a way of describing the board's obligation to remain faithful to the organization's

165. Delaware has a detailed statute and rich body of case law dealing with valuing shares in the merger context that might be helpful for courts to reference in determining "fair value" in the social enterprise dissenters context. *See* DEL. CODE ANN. tit. 8, § 262. *See generally* Lawrence A. Hamermesh & Michael L. Wachter, *The Fair Value of Cornfields in Delaware Appraisal Law*, 31 J. CORP. L. 119 (2005).

166. *See supra* notes 148 & 149.

167. *See* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 367 (2007) ("Whether or not the board exercised reasonable care is irrelevant" under traditional corporate law because of the business judgment rule.); *see also* Murray, *Latchkey Corporations, supra* note 70, at 584 ("[T]he business judgment rule and the exculpatory charter provisions, such as those authorized by the Delaware General Corporation Law section 102(b)(7), have taken most of the bite out of the duty of care.").

168. While managers of benefit corporations may have more ways to mask their self-interested decisions, the courts could presumably still hold managers liable for blatant actions that appear to be taken to benefit the manager individually as opposed to the corporation. More subtle selfishness, however, will be easier for a manager to hide if the benefit corporation is not forced to make its priorities clear.

169. Leo E. Strine, Jr. et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L.J. 629, 629–30 (2010); *accord* Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006).

purpose and mission."[170] But Delaware's broad conception of the duty of loyalty would be sufficient to encompass claims against benefit corporation directors who allegedly failed to pursue or create a general or specific public benefit and claims against directors who abuse their positions to harm the benefit corporation through their selfish actions. On the other hand, legal actions alleging a duty of care violation rarely lead to liability, on that claim, under traditional corporate law.[171] In reaction to the rare finding of liability in *Smith v. Van Gorkom*,[172] the Delaware legislature passed Delaware General Corporation Law Section 102(b)(7), which allowed the elimination of monetary liability for breaches of the duty of care.[173]

Benefit corporation statutes eliminate the possibility of monetary liability for both the directors and the benefit corporation for failure to pursue the general or specific public purpose of the benefit corporation.[174] The statutes contain no provisions allowing a benefit corporation to opt-into monetary liability if it so chooses.[175] There seems to be no good reason to prevent benefit corporations from opting into a regime where directors can be liable for monetary damages. The Delaware General Corporation Law Section 102(b)(7) requires corporations to include a provision in their certificates of incorporation that eliminates monetary liability for certain types of claims.[176] The vast majority of Delaware corporations have Section 102(b)(7) clauses in their certificates of incorporation, suggesting that the default should be elimination of monetary liability for duty of care claims.[177] While traditional Delaware

170. Thomas Lee Hazen & Liza Love Hazen, *Punctilios and Nonprofit Corporate Governance—A Comprehensive Look at Nonprofit Directors' Fiduciary Duties*, 14 U. PA. J. BUS. L. 347, 356 (2012).

171. David A. Hoffman, *Self-Handicapping and Managers' Duty of Care*, 42 WAKE FOREST L. REV. 803, 805 n.7 (2007) (noting the "toothless maw" of the duty of care).

172. 488 A.2d 858, 893 (Del. 1985) (reversing the Delaware Court of Chancery and holding that the directors breached their fiduciary duties to the stockholders by failing to adequately inform themselves and failing to fully disclose all material information).

173. DEL. CODE ANN. tit. 8, § 102(b)(7).

174. *See* MODEL BENEFIT CORP. LEGIS. §§ 301, 305.

175. *See* E-mail from William H. Clark, Jr., *supra* note 98 (noting that the Model Benefit Corporation Legislation has been modified to incorporate this suggested change due, at least in part, to a draft of this Article).

176. DEL. CODE ANN. tit. 8, § 102(b)(7).

177. *See, e.g.*, *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 752 (Del. Ch. 2005) ("The vast majority of Delaware corporations have a provision in their certificate of incorporation that permits exculpation to the extent provided for by section 102(b)(7)."); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983) (stating that default terms should be created by asking, "What arrangements would most bargainers prefer?"); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 700 (1982) ("[T]he legal system should supply rules that mimic the *ex ante* agreements shareholders would reach if they could bargain for and enforce their agreements costlessly.").

law may not provide the correct default, at least it allows private ordering regarding potential liability for breaches of the duty of care. Benefit corporation statutes should allow that choice as well, but with a default of exculpating liability because the majority of corporations will likely opt to do so if one assumes no transaction costs.

Benefit corporation statutes do allow shareholders to request injunctive relief if directors fail to pursue or create a general public benefit or the corporation's specific public benefit purpose.[178] As a practical matter, however, these injunctive claims may be rarely brought unless an action for injunctive (non-monetary) relief is made worthwhile for plaintiff attorneys, or they may be brought too frequently if the awarding of attorneys' fees is too generous or made too often.[179] The California benefit corporation statute, for example, expressly states that courts should award attorneys' fees to successful plaintiffs, but only if the court finds that the defendants' failure to comply with the statute was "without justification."[180] This is quite a high standard, as it probably should be, but again, the statute should allow for private ordering and allow a lower standard for liability and fee awards, such as "success on the merits," if desired by a benefit corporation.

3. *Takeovers and Takeover Defenses in Benefit Corporations*

Takeovers, in the "market for corporate control," are often considered one way to discipline managers and keep them accountable.[181] Some may argue that benefit corporation statutes destroy this path to accountability as well. However, takeovers could still discipline management in the benefit corporation context. Courts that apply a *Unocal*-like intermediate scrutiny to corporate takeover defenses could still apply the same two-pronged

178. *See generally* MODEL BENEFIT CORP. LEGIS. §§ 301–305. One can rightly wonder how courts will address these requests for injunctive relief. Already overburdened courts will not likely warm to the idea of policing the pursuit of general or specific public benefit purpose.

179. *See* John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 670 (1986) (noting the importance of legal rules establishing "the fee arrangements under which these plaintiff's attorneys are compensated" and stating that "these rules create an incentive structure that either encourages or chills private enforcement of law").

180. CAL. CORP. CODE § 14623(d).

181. *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 112–19 (1965); *see also* Easterbrook & Fischel, *supra* note 177, at 698 ("Transactions in corporate control often produce gains for the corporation. Substitution of one set of managers for another, for example, often produces gains because assets increase in value under better management."); Henry G. Manne, *The "Higher Criticism" of the Modern Corporation*, 62 COLUM. L. REV. 399, 411 (1962) ("[O]utsiders are attracted to the potential gain they may make by buying the shares *and* managing the company efficiently.") (emphasis in original). Constituency statutes, in the states that have adopted them, already provide significant, though not absolute protection, for directors of traditional corporations.

test—(1) there must be a reasonable ground to believe a threat to corporate policy and effectiveness and (2) the defensive measure must be reasonable in relation to the threat posed by the hostile bid—but the threat and reasonableness would simply be evaluated through the lens of a corporate objective different than pursuing shareholder value, namely the benefit corporation's specified objective.[182] For companies like craigslist, in the 2010 case of *eBay v. Newmark*, described above, the advent of benefit corporations could be a godsend.[183] Currently, Delaware does not have a benefit corporation statute, but had craigslist been incorporated as a benefit corporation, in a different state, the outcome of the case would have likely been different, even if that different state followed *Unocal* in the application of its traditional corporate law.[184] Moreover, the Delaware courts require even more of a shareholder focus in the *Revlon* context, where a break-up of the business has become inevitable or directors have initiated an active bidding process to sell the corporation, than they do under the *Unocal* standard.[185]

The benefit corporation statute may provide a better platform than traditional corporate law for erecting defensive measures to protect a corporation's pursuit of a non-shareholder focused objective. Successful social enterprises, including benefit corporations, may be prime hostile takeover targets because of the ability for acquirers to easily cut costs (those social and environmental programs that are not profitable) and make sizeable short-term profits.[186] Benefit corporation law, and social enterprise law in general, should protect vulnerable social enterprises from takeover threats, but the protection should not be absolute, as absolute

182. Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 955–56 (Del. 1985). *Unocal* scrutiny, though enhanced from that applied to day-to-day decisions, still provides directors with great discretion, and Delaware courts only consider whether the directors' actions were within a "range of reasonableness." *See, e.g.*, Paramount Commc'ns, Inc. v. QVC Network, Inc., 637 A.2d 34, 48 n.18 (Del. 1994). Shareholders of benefit corporations would have little, if any, room to complain, if the specified objective was made clear in the benefit corporation's articles of incorporation prior to the shareholders' investment.

183. *See* eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34–36 (Del. Ch. 2010). The defensive measures erected by craigslist appear reasonable in relation to the threat to craigslist's apparent corporate objectives, which included providing valuable services to the community.

184. *See supra* Part I.C.

185. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); *see also* Paramount, Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150 (Del. 1989); Lisa M. Fairfax, *Achieving the Double Bottom Line: A Framework for Corporations Seeking To Deliver Profits and Public Services*, 9 STAN. J.L. BUS. & FIN. 199, 219 (2004) (stating that only in the limited context of *Revlon* "do courts require directors to focus solely on profit maximization"). This required focus on profit maximization is a requirement that social entrepreneurs fear, and while the situations, where the rules in *Revlon* apply, as modified by its progeny, are admittedly limited, those situations can be of critical importance to various corporate stakeholders.

186. *See* Plerhoples, *supra* note 140, at 233–36.

protection would allow for complete director entrenchment.[187] If the defensive measures are not reasonable in relation to the threat to the specified objective of the benefit corporation, then the appropriate court should invalidate the defensive measures.

4. The Purpose Judgment Rule

Despite the need for some potential accountability, corporate law places and should place directors at the helm.[188] To protect the authority of directors, most directorial decisions receive the protection of the business judgment rule.[189] Something similar to the business judgment rule should exist in the benefit corporation context for many of the reasons the rule exists in the traditional corporation context.[190] Perhaps the rule, in the benefit corporation context, would be better termed the "purpose judgment rule," as directors would be determining how to best pursue the stated objective of the corporation.[191] With the protection of this rule, only if a director of a benefit corporation consciously failed to carry out her duties in good faith, knowingly violated the law, or prioritized her own self-interest, would the real possibility of liability exist. This aspect of the corporate governance framework for benefit corporations would mirror, in many ways, the corporate governance framework of traditional corporations, albeit with different objectives envisioned by the two types of abstention

187. In a forthcoming article, the author will further explore benefit corporations in the mergers and acquisitions context. J. Haskell Murray, *Defending Patagonia: Mergers & Acquisitions with Benefit Corporations*, 9 HASTINGS BUS. L. J. (forthcoming 2013) (invited symposium article) (on file with the author).

188. *See supra* notes 40 & 41 and accompanying text. *Cf.* Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 836–44 (advocating for increasing shareholders' role in corporate governance, but acknowledging that "[t]he basic and longstanding principle of U.S. corporate law is that the power to manage the corporation is conferred on the board of directors").

189. *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) ("[Delaware] law presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'" (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))); Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, *supra* note 20, at 109 ("[T]he business judgment rule is justified precisely because judicial review threatens the board's authority."); *see id.* at 108–09 (citing Nobel laureate economist Kenneth Arrow for the proposition that "the power to hold to account is ultimately the power to decide").

190. *See* Murray, *Latchkey Corporations*, *supra* note 70, at 615–16 ("[C]ourts employ the business judgment rule because: (1) it encourages board service; (2) it encourages risk taking; (3) courts recognize that directors are generally better situated to make business decisions than judges; (4) courts recognize that the statutory regime provides responsibility for managing the corporation to directors, not shareholders; and (5) courts recognize that unhappy shareholders can always vote the directors out of office.") (internal citations and quotations omitted).

191. The name "purpose judgment rule" sprung from a conversation with Professor Joseph Leahy of South Texas College of Law at the Southeastern Law Scholars Conference hosted by the Charleston School of Law on October 29, 2011.

doctrines. As discussed below, additional and more onerous accountability could be added by those providing private branding, but enforcement provided by the courts should be extremely limited, as to respect the authority of the board of directors of the benefit corporations.[192]

C. Transaction and Uncertainty Costs in Social Enterprise

One purpose of social enterprise statutes could be to minimize transaction costs for social entrepreneurs by setting default rules. Currently, however, benefit corporation statutes mostly increase, not decrease, transaction costs for social entrepreneurs. First, each benefit corporation must prepare and make available an annual benefit report.[193] The statutes do not provide much guidance regarding the required details of these annual benefit reports, but the benefit reports have the potential of being burdensome for small social enterprises and some state statutes expressly require that the reports be provided at no cost to the shareholders.[194] Second, a number of the benefit corporation statutes require the appointment of a benefit director who is required to draft an opinion each year regarding the benefit corporation's pursuit (or non-pursuit) of its general and any specific public benefit.[195] Third, the C-corporation law, upon which the benefit corporation statute is based, is often thought of as less friendly to small business than LLC law (or S- or close corporation law).[196] Maryland is the only state to have adopted a benefit LLC statute.[197] Some may argue that LLC law does not need additional sections addressing social enterprise because the current statutes are heavily contract-based and are flexible enough for social entrepreneurs to set up a socially-focused LLC. Both the benefit LLC and the benefit corporation statute, however, could help social entrepreneurs by setting "off-the-rack" defaults to accommodate entrepreneurs who do not have the

192. *See infra* Part III.D.2.

193. *See* MODEL BENEFIT CORP. LEGIS. § 401.

194. *See, e.g.*, N.J. STAT. ANN. § 14A:18-7(a); *see also* MODEL BENEFIT CORP. LEGIS. § 302.

195. *See, e.g.*, N.J. STAT. ANN. § 14A:18-7(a), (c). Of course, an existing director can be appointed the benefit director, but the additional responsibilities (such as overseeing the drafting of the benefit report and opining on the pursuit of the general and any specific public benefit purpose) may lead the director to demand higher compensation.

196. *See, e.g.*, Howard M. Friedman, *The Silent LLC Revolution—The Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 43–44 (2004) (describing the mandatory rules in corporate law that are often ill-suited for smaller businesses and describing the default rules present in LLC statutes that decrease transaction costs); *see also* Geoffrey Christopher Rapp, *Preserving LLC Veil Piercing: A Response to Bainbridge*, 31 J. CORP. L. 1063, 1090 (2006) (stating that LLCs "have become dominant" in the small business context).

197. MD. CODE ANN., CORPS & ASS'NS §§ 4A-1101 to -1108.

resources to create nuanced governance documents.[198] The increasing automation of organizational documents will also help cut down on transaction costs associated with forming a social enterprise.[199] The drafting of model organization documents has been done for the L3C form,[200] and the increased automation of these types of documents could be helpful in lowering transaction costs for the many small social enterprises.[201]

In addition, the legal changes introduced by social enterprise statutes may carry with it large uncertainty costs.[202] Professor Van Alstine explains that "[n]egative uncertainty costs . . . reflect the loss of the accumulated experience with a legal regime over time. Positive costs, on the other hand, reflect the uncertainty created by doubts over the precise meaning of, and simple lack of familiarity with, a new body of law."[203] The negative uncertainty costs will remain until sufficient case law emerges regarding aspects of the benefit corporation statutes that are currently far from clear, including: the fiduciary duties of a benefit corporation director, the details of the benefit report requirements, and which "third-party standards" will

198. Professor Ribstein writes that the lower contracting cost "can make a critical difference for smaller firms that may have higher drafting, planning and litigation costs per dollar of capitalization than do larger ones." RIBSTEIN, *supra* note 82, at 26–27 (discussing the reasons for business association statutes, including reducing contracting costs and filling gaps in contracts); *see* THALER & SUNSTEIN, *supra* note 158, at 8 (noting the power of inertia and arguing that default rules should be carefully chosen to help improve society). Perhaps, for example, the benefit report and benefit director requirements could be waived for small benefit corporations for the first few years of the corporation's existence. The drafters of social enterprise legislation might benefit from referring to the state statutes on "close corporations," which were adopted, in part, to help decrease transaction costs for small corporations with relatively few shareholders.

199. *See, e.g.*, *Why Koncision?*, KONCISION CONTRACT AUTOMATION, http://www.koncision.com/why-koncision/ (last visited Aug. 31, 2012) (describing Koncision Contract Automation, a company that employs technology to make the contract drafting process more efficient). Professors Larry Ribstein and Richard Susskind have written at more length on how technology can be utilized to decrease legal transaction costs. *See* Larry E. Ribstein, *The Death of Big Law*, 2010 WIS. L. REV. 749, 780–81 (2010); RICHARD SUSSKIND, THE END OF LAWYERS? RETHINKING THE NATURE OF LEGAL SERVICES 29–32 (2008). Of course, the increased automation of legal documents is not without risks.

200. *Model L3C Articles of Organization and Model Operating Agreement*, AMS. FOR COMMUNITY DEV., http://www.americansforcommunitydevelopment.org/downloads/ModelL3CArt.ofOrg.&Oper.Agree.-VermontCompliant.pdf (last visited Nov. 11, 2012).

201. Clark & Vranka, *supra* note 54, at 27 (stating that most businesses interested in benefit corporation legislation are "private, small, and growing ('cash poor')"); Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2451 (2009) (noting that most social enterprises are small businesses). Admittedly, it may be difficult to automate organizational documents for social enterprises, which will likely have a wide variety of objectives.

202. *See* Michael P. Van Alstine, *The Costs of Legal Change*, 49 UCLA L. REV. 789, 822–36 (2002) (discussing the uncertainty costs arising from legal change).

203. *Id.* at 823.

be acceptable to the courts. In addition, positive uncertainty costs will stem from the planning costs undertaken to deal with the risk stemming from the current lack of clarity in and the current lack of familiarity with this new area of law.[204] A way to quickly lessen these uncertainty costs is to provide more clarity in the benefit corporation statutes, but the vague areas of the statutes (like fiduciary duties) may be purposefully vague and may be better addressed by case law that will develop over time.

D. Branding: Community, Customers, and Investors

1. Benefits of Branding

One of the most talked about benefits that social enterprise offers to its owners is branding. The benefits of a social enterprise brand have the potential to be significant. If the brand is more than mere greenwashing and actually provides some assurance that the company is attempting to improve society and the environment, then the social enterprise community, customers, and investors will likely respond more favorably.

Social enterprise communities are already springing up around the various social enterprise brands. Most notable are the communities involving Certified B Corporations, benefit corporations, and L3Cs.[205] Social enterprise communities often provide their members with significant discounts, access to service providers, and a sense of identity.[206] A solid social enterprise brand gives companies the ability to quickly identify other companies with similar ultimate goals and these similarly minded companies can lend helping hands to one another.

Branding is also beneficial because it can help customers and investors quickly identify socially and environmentally responsible companies. Customers are already tiring of greenwashing, and a social enterprise brand with a backbone should be welcome.[207] Likewise, while some investors

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204. *Id.* at 829.

205. *B Corp. Community*, B LAB, http://www.bcorporation.net/community (last visited Nov. 30, 2012); *Latest L3C Tally*, *supra* note 7. As explained below, there is a difference between private and public branding. The Certified B Corporation community is a result of private branding, while the benefit corporation and L3C communities spring from a public brand. *See infra* Part III.D.2.

206. *See* Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1314 (2011) ("The identity theory of nonprofits also offers insight into [social enterprise]."); *id.* at 1318 ("Clearly individuals can derive some identity or warm-glow benefits from financial transactions and are willing to sacrifice financial gain to do so."); *Save Money and Access Services*, B LAB, http://www.bcorporation.net/become-a-b-corp/why-become-a-b-corp/save-money-and-access-services (last visited Nov. 30, 2012) ("Through access to over 80 service partnerships, B Corps have enjoyed more than $5 Million in savings and accessed technology, talent, and expertise for their businesses.").

207. *See, e.g.*, Jeffrey J. Minneti, *Is It Too Easy Being Green? A Behavioral Economics Approach to Determining Whether to Regulate Environmental Marketing Claims*, 55 LOY. L. REV. 653, 653–57 (2009) (noting the proliferation of

may want to invest in socially and environmentally friendly companies, they remain wary of unsupported claims.

2. Private Branding v. Public Branding

There are two possible types of branding of social enterprises: private branding and public branding. Part II.B noted the basic differences between the B Corp certification given by B Lab (private branding) and the benefit corporation status achieved by incorporating under one of the available state statutes (public branding).

In only four years (2008 to 2012), we already have five different types of social enterprise statutes in the United States alone (L3C, benefit corporation, FPC, SPC, and BLLC).[208] If the state competition focuses solely on building newer, shinier brands, the proliferation of statutes could continue, creating an unnecessarily tangled web of corporate law.[209] If, however, the competition simply focuses on providing the best solution to social entrepreneurs, competition between the states could lead to an improved and more useful entity form.[210]

A flexible corporate code, coupled with a meaningful private brand (such as, perhaps, B Lab's B Corp certification), could meet and exceed the stated goals of the benefit corporation statute.[211] Private organizations are better equipped than state governments to build nuanced brands and to police them.[212] Ideas about what constitutes a "good" company vary significantly, and there is room for various privately created social

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greenwashing).

208. *See supra* Introduction.

209. While corporations, LLCs, and LLPs may have all developed their own brands, in one sense of the word, the primary purposes of statutes allowing for those brands extend beyond simply creating a new brand.

210. RIBSTEIN, *supra* note 82, at 28 (noting the success of the limited liability company and suggesting that "experimentation through interjurisdictional competition" may be the best way to determine the optimal number of business forms).

211. *See* Clark & Vranka, *supra* note 54, at 15 (noting the main goals of the benefit corporation legislation are addressing the corporate purpose debate, increasing accountability, and improving transparency). If the corporate code of a state expressly allowed for a society- or environment-focused objective, the accountability and transparency could be handled by private organizations with the threat of removing the company's certification for non-compliance.

212. *Cf.* Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the Twenty-First Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 494 (2010) (noting that state attorney generals have little time to monitor charities due to constraints on the attorney generals' time and resources). The benefit corporation proponents may argue that the super-majority shareholder vote to terminate benefit corporation status is a statutory protection not found in private branding. For example, directors of companies that are only certified privately and not formed under a social enterprise statute may simply decide to stop applying for certification one year. This problem, however, is easily solved by a contractual provision in the company's organizing documents requiring a super-majority shareholder vote prior to any decision to cease applying for the private branding.

enterprise brands that focus on the interests of different groups. While courts could police the most obvious violations—such as fraud and self-interested decisions—the more rigorous accountability could come from the private organizations and their members, which may have the motivation and the resources to build and maintain a valuable brand.[213]

E. Capital Raising and Financial Sustainability

For social enterprises to be more than a passing fad, they will have to be able to raise money.[214] Currently, many think social enterprises occupy a no man's land, between for-profit entities and nonprofit entities.[215] The sections below briefly discuss potential avenues for social enterprise capital raising and routes to financial sustainability.

1. Tax Advantages

Tax advantages could give potential investors reason to invest in social enterprises. The City of Philadelphia has recently provided a tax credit for a few sustainable businesses, but it is an extremely limited credit and, in this economic environment, most other cities and states are unlikely to follow suit.[216] In any event, if tax breaks for social enterprise became more

213. *See, e.g.*, *Make it Official*, B LAB, http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/120 (last visited Nov. 30, 2012) (stating that B Lab conducts an on-site review of ten percent of the Certified B Corporations each year.) Potentially, private branding organizations, or even the benefit corporation statutes, could also require corporate giving similar to the giving that Patagonia already does (the greater of 1% of revenues and 10% of profits) to provide some backbone to that social enterprise community. CHOUINARD, BUSINESSMAN, *supra* note 1, at 73. Few things speak louder on the issues of corporate priorities than how corporations allocate their resources.

214. *See* Brakman Reiser, *supra* note 107, at 609–10 (arguing that obtaining access to sufficient capital from third parties is a practical obstacle for social entrepreneurs); Laura Burke, *Is the Social Enterprise Bubble About to Burst?*, GOOD (Feb. 2, 2012, 5:30 AM), http://www.good.is/post/is-the-social-enterprise-bubble-about-to-burst/ (suggesting that one of the reasons for the rise in social enterprises popularity is the disenchantment with traditional for-profit companies that were at the center of the most recent economic downturn).

215. *See* Brakman Reiser, *supra* note 107, at 610 (questioning whether sufficient capital will exist for dual mission enterprises); Murray & Hwang, *supra* note 9, at 42–43 (2011) (arguing that most traditional investors will hesitate to invest in L3Cs); Callison & Vestal, *supra* note 81, at 279–85, 291–93 (2010) (discussing flaws in the L3C form, which attempts to satisfy both traditional investors and foundations); Bishop, *supra* note 104, at 243–44 (calling capital formation, while attempting to serve two masters, "particularly difficult"); Kleinberger, *A Myth Deconstructed*, *supra* note 104, at 891–94 (explaining the difficulty of raising money for an L3C).

216. *Philadelphia First City to Offer Green Biz Tax Incentives*, SUSTAINABLEBUSINESS.COM (Dec. 4, 2009, 9:56 AM), http://www.sustainablebusiness.com/index.cfm/go/news.display/id/19350 ("For tax years 2012 through 2017, twenty-five eligible businesses will receive a tax credit of $4,000 to be used against the gross receipts portion of the Business Privilege Tax. Companies can be classified as certified sustainable businesses once they are certified as B Corporations . . . .").

widespread, traditional businesses may argue that those tax breaks facilitate unfair competition from social enterprises that are merely thinly disguised for-profit entities. Without tax breaks (and if projected monetary returns for social enterprise lag behind traditional companies), social enterprises will have to raise capital from investors who value—and believe the enterprise will provide—positive social and environmental outcomes to compensate for the potentially less favorable monetary returns.[217]

2. *Foundations and Impact Investors*

> *How selfish so ever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.*[218]

Not all investors are driven by profit alone. Foundations and an emerging class of social investors (also known as "impact investors") seem willing to sacrifice some profit if a company can further social and/or environmental goals.[219] Foundations represent a tremendous potential source of capital for social enterprises with approximately $600 billion in assets in the United States alone.[220] Proponents of the L3C form have attempted to tap into this treasure chest to receive easier access to PRIs from foundations, but to date the IRS has not agreed to treat L3Cs any differently than traditional for-profit forms.[221]

Estimates of the size of the socially responsible investment market vary wildly, depending, in large part, on how broadly "socially responsible" is defined. The Forum for Sustainable and Responsible Investment, using a broad definition, estimates that Sustainable and Responsible Investing

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217. Yasemin Saltuk et al., *Insight into the Impact Investment Market: An In-Depth Analysis of Investor Perspectives and Over 2,200 Transactions*, J.P. MORGAN SOCIAL FINANCE RESEARCH, 3 (Dec. 14, 2011), *available at* http://www.jpmorganchase.com/corporate/socialfinance/document/Insight_into_the_Impact_Investment_Market.pdf. Sixty-two percent of investors stated that they would sacrifice financial return for positive societal impact. All of the respondents that would not sacrifice returns, and two-thirds of those who would, stated that they believed one must sacrifice profits in order to make a positive impact. *Id.*

218. ADAM SMITH, THE THEORY OF MORAL SENTIMENTS 1 (D.D. Raphael & A.L. Macfie eds., Oxford Univ. Press 1976) (1759).

219. *See generally* CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET, AND OTHER ECONOMIC LEADERS (Michael Kinsley ed., Simon & Schuster Paperbacks 2008); *see also* Timothy Smith, *Institutional Investors Find Common Ground with Social Investors,* 1622 PLI CORP. 283, 289 (2007) (stating that socially motivated investors consider not just profits, but also consider the company's social and environmental impact).

220. Philanthropy News Digest, *Foundations Increasingly Use Investment Assets to Achieve Their Missions, Report Finds*, FOUND. CTR. (Oct. 26, 2011), http://foundationcenter.org/pnd/news/story.jhtml?id=359000002.

221. *See* Callison & Vestal, *supra* note 81, at 273–74 (stating that Congress has not enacted the tax legislation lobbied for by L3C proponents).

("SRI") accounts for "$3.07 trillion out of $25.2 trillion in the U.S. investment marketplace."[222] "Impact investing" funds, which tend to use a more narrow definition and are made up of "investments intended to generate positive [social and/or environmental] impact alongside financial return," have begun entering the scene at an increasing pace.[223] Even some of the most prestigious and traditional of investment banks are sticking their toes into the "impact investing" pool.[224] In December of 2011, J.P. Morgan and the Global Impact Investing Network ("GIIN") produced a thirty-page document analyzing the state of the "impact investing market."[225] They defined impact investment as an "[i]nvestment intended to create positive impact alongside financial return" and analyzed 2,200 investments, totaling over $4 billion.[226] Ninety-four percent of the survey of random institutional or high net worth clients said that impact investing was either "in its infancy and growing (75%) or about to take off (19%)."[227] The United Kingdom's government created Big Society Capital, which will potentially invest hundreds of millions of British pounds, to serve as a cornerstone impact investor and to leverage additional private capital.[228] In the United States, "the Overseas Private Investment Corporation committed [$285 million] to catalyze [$875 million] of investment into six impact investment funds in emerging markets," and the U.S. Small Business Administration has pledged $1 billion "over five years to support domestic

222. *See Sustainable and Responsible Investing Facts*, THE FORUM FOR SUSTAINABLE & RESPONSIBLE INV., http://ussif.org/resources/sriguide/srifacts.cfm (last visited Nov. 30, 2012) (stating that "one or more of the three core sustainable and responsible investing strategies-screening, shareholder advocacy, and community investing" had to be used to qualify as SRI).

223. *See J.P. Morgan Social Finance*, J.P. MORGAN CHASE & CO., http://www.jpmorganchase.com/corporate/socialfinance/social-finance.htm (last visited Nov. 30, 2012) (describing J.P. Morgan Social Finance, which "was launched in 2007 to service the growing market for impact investments"); *see also* Rahim Kanani, *The State and Future of Impact Investing*, FORBES (Feb. 23, 2012, 9:36 AM), http://www.forbes.com/sites/rahimkanani/2012/02/23/the-state-and-future-of-impact-investing/ (stating that some of the largest banks in North America and Europe have created "impact investing" products). *See generally Investing for Impact*, CREDIT SUISSE (Jan. 2012), *available at* https://infocus.credit-suisse.com/data/_product_documents/_shop/336096/investing_for_impact.pdf.

224. *See supra* note 223 and accompanying text (showing that J.P. Morgan, Credit Suisse, and other large banks have entered the social finance or "impact investing" space).

225. *See generally* Saltuk et al., *supra* note 217 (updating a 2010 research study).

226. *Id.* at 2–3.

227. *Id.* at 5. Within ten years, the respondents thought that impact investments would constitute five percent of institutional investment and approximately ten percent of high net worth clients' portfolios. *Id.* at 5–6.

228. *See id.* at 7; *see also Big Society Capital: How We Are Funded*, BIG SOC'Y CAP., http://www.bigsocietycapital.com/how-we-are-funded/ (last visited Nov. 30, 2012) (stating that the "Merlin banks"—such as Barclays, HSBC, Lloyds Banking Group, and RBS—have each agreed to invest £50 million into Big Society Capital and the transfers from the English share of dormant accounts could reach £400 million).

businesses operating in underserved communities."[229] Moreover, GIIN's global online database of impact investment funds (ImpactBase) lists over 200 funds after less than two years of the database being online.[230]

Foundations and impact investors serve as potential sources of capital for social enterprises, but both will likely be concerned with many of the issues discussed above, such as board accountability and objectively measuring the societal and environmental benefit created.

3. Crowdfunding

Crowdfunding, defined as the use of the Internet to raise money through small contributions from a large number of investors,[231] could be a useful tool for social entrepreneurs.[232] Some social enterprises might attempt to focus their crowdfunding efforts outside of the scope of federal securities regulation, like the microloan provider Kiva and the funding platform Kickstarter, by making clear that there is no profit potential for those contributing.[233] The recent Jumpstart Our Business Startups Act ("JOBS Act") created a federal securities exemption for certain types of crowdfunding.[234] The SEC has yet to enact rules regarding this exemption,

229. Saltuk et al., *supra* note 217, at 7; *see* OVERSEAS PRIVATE INVESTMENT CORP., http://www.opic.gov/ (last visited Nov. 30, 2012) (declaring that the OPIC is "the U.S. Government's development finance institution").

230. Saltuk et al., *supra* note 217, at 8. *See generally* IMPACTBASE, http://www.impactbase.org/ (last visited Nov. 30, 2012) (showing 203 active funds as of Oct. 29, 2012).

231. C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10 (2012); *see* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 880–82 (2011) (describing the various definitions of the term crowdfunding).

232. *See generally* Murray & Hwang, *supra* note 9 (proposing crowdfunding from social investors to fill the gap left by traditional investors in the capital structure of L3Cs).

233. *About Us*, KIVA, http://www.kiva.org/about (last visited Sept. 17, 2012) (Kiva has provided more than $368 million in loans through 167 microfinance field partners as of October 29, 2012. No interest is charged on Kiva loans.); *FAQ*, KICKSTARTER, http://www.kickstarter.com/help/faq/kickstarter%20basics?ref=nav (last visited Nov. 30, 2012) (Since Kickstarter's launch on April 28, 2009, "over $350 million has been pledged by more than 2.5 million people, funding more than 30,000 creative projects"; backers do not get ownership in the projects and "Kickstarter cannot be used to offer financial returns or equity, or to solicit loans.").

234. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106 §§ 301–305, 126 Stat. 306, 315–23 (2012); *see also* Oan Salisbury, *The SmartMoney Report: Green Light for Hedge-Fund Ads Means Caution on Main Street*, WALL ST. J., Apr.17, 2012, at C10. Eliot Spitzer referred to the JOBS Act as the "Bring Fraud Back to Wall Street Act." Susanne Craig & Ben Protess, *Wall Street Examines Fine Print in a Bill for Start-Ups*, N.Y. TIMES DEALBOOK (Apr. 4, 2012, 8:43 PM), http://dealbook.nytimes.com/2012/04/04/wall-st-examines-fine-print-in-a-new-jobs-bill/. Evaluating the merits of the JOBS Act is beyond the scope of this Article. For scholarly analysis of the crowdfunding exemption, mostly prior to the passing of the JOBS Act, see generally Bradford, *supra* note 231 (noting that registration of crowdfunding is prohibitively expensive in most situations and proposing that an

and, before that time, it is unlawful for issuers to purport to rely on the crowfunding exemption to the federal securities laws.[235] Even after crowdfunding rules are enacted, some social enterprises may simply wish to avoid the hurdles erected by the JOBS Act altogether and crowdfund using a Kiva or Kickstarter model. Other social enterprises, however, may wish to offer investors the potential to profit and may find the crowdfunding exemption works well for their business models. The potential blended value return offered by social enterprises, which may often be a below-market *financial* return, may be more appealing to a large number of people who only have to part with small amounts of money than it would be to a few people investing very large amounts of money. Additionally, in many instances a social enterprise will be a local endeavor. Raising $1 million from a few high net worth individuals living across the country might be difficult, but a social entrepreneur may be able to raise the same $1 million spread out over many local residents, all of whom have a personal connection to the social enterprise's community.[236] At least one website specifically dedicated to assisting social enterprises crowdfund has already been erected.[237]

4. Social Impact Bonds

A Social Impact Bond generally involves a contingent contract between a government and a private organization.[238] Under these contingent contracts, the private organization earns all or most of its payment from the

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exemption similar to the one contained in the Entrepreneur Access to Capital Act); Heminway & Hoffman, *supra* note 231, at 880 (noting that many small businesses struggle or fail to receive adequate financing because of the significant costs associated with complying with securities laws and regulations); Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why Any Specially Tailored Exemption Should be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735 (2012) (arguing against proposals for a crowdfunding exemption from the Securities Act of 1933 that do not include significant investor protection measures).

235. *Information Regarding the Use of the Crowdfunding Exemption in the JOBS Act*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/spotlight/jobsact/crowdfundingexemption.htm.

236. *Cf. Discover Projects,* KICKSTARTER, http://www.kickstarter.com/discover/most-funded?ref=sidebar (last visited Nov. 30, 2012) (showing examples of multiple online raises over $1 million without even promising any equity in the company).

237. *See* Anne Field, *New Crowdfunding Site for Social Enterprises to Tap the JOBS Act*, FORBES (May 11, 2012, 12:04 PM), http://www.forbes.com/sites/annefield/2012/05/11/new-crowdfunding-site-for-social-enterprises-to-tap-the-jobs-act/ (describing the business of Impact Trader, which was created by John Jordan and Josh Hibben to facilitate crowdfunding for social enterprises); *see also* IMPACT TRADER, http://www.impacttrader.com/ (last visited Nov. 30, 2012).

238. *Let's Hear Those Ideas*, ECONOMIST, Aug. 12, 2010, http://www.economist.com/node/16789766; *Social Impact Bonds*, SOC. FIN., http://www.socialfinance.org.uk/work/sibs (last visited Feb. 12, 2012).

government by achieving certain performance targets, which usually include the provision of social services and resultant public sector savings.[239] Social Impact Bonds, sometimes referred to as "Pay for Success Bonds," shift some of the risk inherent in a given social services project from the government to the market.[240] Under the Social Impact Bond model, also called a "contingent return model," inefficiencies in social service projects should be reduced by subjecting the projects to market forces.[241] Investors in Social Impact Bonds only get paid if the social service project is successful, and even if the project is successful, investors are usually only entitled to a portion of the overall governmental savings.[242]

In September 2010, Social Finance, an organization in the United Kingdom that focuses on social business, issued its first Social Impact Bond, called the "One* SIB."[243] One* SIB's objective is to "reduce re-offending amongst male prisoners leaving HMP Peterborough [a prison in England] who have served a sentence of less than 12 months."[244] Payment to the One* SIB investors is contingent on the project achieving at least a 7.5% reduction in the re-offending rate and certain bonuses are paid for exceeding that threshold.[245] In the United States, Vermont has begun following the United Kingdom's lead and has recently introduced legislation to "create a social impact bonds study committee to determine whether opportunities exist for the use of social impact bonds in Vermont."[246] Additionally, President Obama's 2012 budget proposed setting $100 million aside for pilot programs involving "Pay for Success Bonds."[247]

These Social Impact or Pay for Success Bonds could be part of the social enterprise capital raising solution. These bonds, like social enterprise, address hybrid solutions and attempt to harness the power of the market for

239. *See supra* note 238.

240. David Leonhardt, *For Federal Programs, A Taste of Market Discipline*, N.Y. TIMES, Feb. 9, 2011, at B1 (noting that Social Impact Bonds are sometimes referred to as "Pay for Success" Bonds).

241. Arthur Wood, *New Legal Structures to Address the Social Capital Famine*, 35 VT. L. REV. 45, 48 (2010) (referring to the Social Impact Bond model as a "contingent return model").

242. *Criminal Justice*, SOC. FIN., http://www.socialfinance.org.uk/work/sibs/criminaljustice (last visited Sept. 17, 2012) (stating that investors in One* SIB will receive a "share of the long term savings").

243. *Social Impact Bonds*, *supra* note 238; Wood, *supra* note 241, at 48.

244. *Criminal Justice*, *supra* note 242.

245. *Id.*

246. H.B. No. 625, 2011–12 Leg., Reg. Sess. (Vt. 2012) (unenacted).

247. *Who Succeeds Gets Paid: Barack Obama Imports a Big Idea From Britain*, ECONOMIST (Feb. 17, 2011), http://www.economist.com/node/18180436?story_id=18180436; *see* Leonhardt, *supra* note 240.

positive societal change.

5. Labor Costs

Finally, while not directly related to capital-raising, loan forgiveness programs and the intangible benefits that employees may receive from working at a social enterprise may allow these companies to pay lower salaries and thus have less demanding capital needs. Beginning with its 2009 class, the Yale School of Management expanded its loan forgiveness program to include graduates employed by Certified B Corporations.[248] In addition, New York University's Stern School of Business has a loan assistance program directed at graduates who pursue a career in social enterprise, and a few other schools are considering similar programs.[249] Currently, these benefits are provided by a very limited number of schools, but as programs such as these multiply, the benefits could have a significant impact on attracting talent to social enterprises. Further, even without loan repayment, prospective employees may be willing to accept a somewhat lower salary if they believe the company is socially and environmentally responsible.[250]

CONCLUSION

The beauty of social enterprise lies in the fact that managers and investors can choose which side of the well-worn shareholder wealth maximization argument they favor through their choice of entity or choice of corporate objective. They can choose their own master. They can choose their preferred paradigm. This Article recognizes that the traditional legal framework under corporate law already provides social entrepreneurs with most of the flexibility they seek, but posits that the social enterprise statutes might help combat the persistent shareholder wealth maximization norm. As an alternative to a new social enterprise statute, the Article suggests that states (that have not already done so) could consider amending their corporate code to expressly allow for a societal- or

248. *Loan Forgiveness*, YALE SCHOOL OF MANAGEMENT, http://mba.yale.edu /MBA/admissions/financial_aid/loan_forgiveness.shtml (last visited Nov. 30, 2012).

249. *NYU Stern Loan Assistance Program*, NYU STERN, http://www.stern.nyu.edu /portal-partners/financial-aid/loan-repayment/loan-assistance-program/index.htm (last visited Nov. 30, 2012) ("[Social enterprise] careers often have smaller compensation packages than traditional MBA tracks. The Loan Assistance Program supports the School's mission to develop leaders who create value for business and society.").

250. Harvard Business Review, *New MBAs Would Sacrifice Pay for Ethics*, THE DAILY STAT (May 17, 2011), http://web.hbr.org/email/archive /dailystat.php?date=051711 (Survey information shows that "88.3% of graduating MBA students say they'd take a pay cut to work for firms that have ethical business practices." The average amount the students stated that they would sacrifice was $8,087.).

environmental-focused objective in a corporation's charter. If a benefit corporation statute, or other social enterprise statute, is passed, the Article argues that the statute should require companies to choose a primary master.

The question remains, however, whether significant numbers of investors will invest in a corporation that chooses as its primary master something other than shareholder wealth maximization. Ultimately, the market will decide whether these social enterprise business forms will flourish or whether they will languish on the books with relatively little use.[251]

251. *See generally* RIBSTEIN, *supra* note 82.

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THE NEXT BIG THING: FLEXIBLE PURPOSE CORPORATIONS

DANA BRAKMAN REISER*

TABLE OF CONTENTS

INTRODUCTION

Over the past few years, jurisdictions across the country have enacted specialized organizational forms to house social enterprises. Social enterprises are entities dedicated to a blended mission of earning profits for owners and promoting social good. They are neither typical businesses, concentrated on the bottom line of profit, nor traditional charities, geared toward achieving some mission of

* Professor of Law, *Brooklyn Law School.* I greatly appreciate the support of Brooklyn Law School's summer research stipend program, the research assistance of Rachel Seelig, and the comments of Biff Campbell, William Callison, Walter Effross, Claire Kelly, Benjamin Leff, J. Haskell Murray, and Robert Wexler. I am also grateful for the input and suggestions I received from the participants at the *American University Business Law Review* Symposium on "Profits Plus Philanthropy: The Emerging Law of 'Social Enterprises'" and the 2012 Program of the Association of American Law Schools Section on Agency, Partnerships, LLC's, and Unincorporated Business Associations. Any remaining errors are, of course, my own.

good for society. Their founders instead see value in blending both goals. They believe their social enterprises will be superior to traditional businesses by considering and internalizing the social costs they produce.[1] They believe social enterprises more efficiently produce social goods than traditional charities by applying business methods to this important work.[2] Yet, these social entrepreneurs worry traditional organizational forms designed for either businesses or charities will constrain their ability to achieve the gains they see in blended mission enterprises.[3] Legislatures have obviously been convinced. Since 2008, lawmakers in nearly one-third of U.S. jurisdictions have enacted enabling legislation providing one or more specialized forms designed to house social enterprises.[4] Thus far, these specialized forms have taken three distinct types, the latest of which is the subject of this Article: the flexible purpose corporation.

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1. *See, e.g.*, Julie Battilana et al., *In Search of the Hybrid Ideal*, STAN. SOC. INNOVATION REV., Summer 2012, at 51, 52 (describing the desire of social entrepreneurs to exploit the positive externalities of linking social value and revenue creation).

2. *See, e.g.*, Kyle Westaway, *New Legal Structures for 'Social Entrepreneurs,'* WALL ST. J. (Dec. 12, 2011, 12:42 PM), http://online.wsj.com/article/SB10001424052970203413304577088604063391944.html ("Social entrepreneurs believe a business can be part of the solution to some of the world's greatest challenges."); *see also* DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 35–127 (2008) (arguing that greater social good would be gained by allowing charities to follow a range of practices typically identified with for-profit enterprises); Charles R. Bronfman & Jeffrey R. Solomon, *Should Philanthropies Operate Like Businesses? Yes: Good Intentions Aren't Enough*, WALL ST. J., Nov. 28, 2011, at R1, R4 ("Adhering to sound business principles makes a nonprofit more likely to accomplish its mission, not less."). *But see* Garry W. Jenkins, *Who's Afraid of Philanthrocapitalism?*, 61 CASE W. RES. L. REV. 753 (2011) (challenging the benefit of applying business methods and techniques in philanthropy and traditional nonprofits).

3. Battilana et al., *supra* note 1, at 52 (describing the "confusing dilemma" facing social entrepreneurs confronted with only pure for-profit and nonprofit organizational forms); Heerad Sabeti, *The For-Benefit Enterprise*, HARV. BUS. REV. (Nov. 2011), http://hbr.org/2011/11/the-for-benefit-enterprise/ar/1 (lamenting that "socially minded entrepreneurs end up shoehorning their vision into one structure or the other and accepting burdensome trade-offs in the process"); Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 363–64 (2009).

I am sympathetic to the view that corporate law would not prevent adopters of a standard for-profit corporation from pursuing both business and non-business goals. *See, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH 25–31 (2012); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 738–47 (2005). This, however, clearly is not the perception from which social enterprise form creators and enthusiasts are working.

4. *See generally Laws*, AMS. FOR CMTY. DEV. (last visited Nov. 25, 2012), http://americansforcommunitydevelopment.org/laws.html (listing nine states and two Native American tribes with L3C statutes); *State by State Legislative Status—Benefit Corporation*, B LAB, http://www.benefitcorp.net/state-by-state-legislative-status (last visited Nov. 25, 2012) (listing twelve states with benefit corporation statutes, three of which also have L3C legislation); CAL. CORP. CODE §§ 2500–3503 (West 2012).

Part I places the flexible purpose corporation ("FPC") in the broader context of other specialized legal forms established to house social enterprise. Part II explores the FPC in greater depth. After explaining the genesis of its enabling legislation, this Part details and critiques its major provisions. These components segregate the FPC form from traditional for-profit and nonprofit corporations. The statutes structure FPCs' operations, guide their fiduciaries, and empower their shareholders with enforcement rights. Part III summarizes my evaluation of these attributes and compares them with relevant aspects of other specialized forms for social enterprise. Part IV briefly concludes.

I. THE FPC IN CONTEXT

The flexible purpose corporation became available under the California Corporate Flexibility Act of 2011 (the "FPC statute").[5] It joined its (only slightly) older colleagues: the low-profit limited liability company ("L3C") inaugurated by Vermont in 2008[6] and the benefit corporation first adopted by Maryland in 2010.[7] Since their initial adoption, these forms have each been adopted by several other jurisdictions and proposed in still others.[8] These later adoptions are not identical to the originals, though sufficient overlap exists to examine the L3C and benefit corporation as archetypes. Shortly after California adopted its FPC statute, Washington approved legislation enabling a Social Purpose Corporation form, which shares some, though by no means all, of the elements of the FPC.[9] Other

5. *See* S.B. 201, 2011–2012 Legis. Sess. (Cal. 2011) (approved by Governor Jerry Brown on Oct. 9, 2011); *see also* Stephanie Strom, *A Quest for Hybrid Companies That Profit, But Can Tap Charity*, N.Y. TIMES, Oct. 13, 2011, at B1, B2 (reporting that "California is the latest state to adopt a statute permitting what is called a flexible-purpose corporation, new companies that are part social benefit and part low-profit entities" and comparing that statute with low-profit limited liability company ("L3C") and benefit corporation law adoptions in other jurisdictions).

6. *See* VT. STAT. ANN. tit. 11 § 3001(27) (2012); *see also Low-Profit Limited Liability Company*, VT. SECRETARY ST. CORP. DIVISION, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Nov. 16, 2012) ("A low-profit LLC is a new type of company, called an 'L3C.' Vermont is the first state to enact this new type of company.").

7. MD. CODE ANN., CORPS. & ASS'NS §§ 5-6C-01 to -08 (LexisNexis 2012).

8. For current listings of L3C and benefit corporation enabling legislation enactments, see *Laws*, *supra* note 4 and *State by State Legislative Status*, *supra* note 4 respectively. *See also* Carter G. Bishop, *Fifty State Series: L3C & B Corporation Legislation Table* (Suffolk Univ. Law Sch. Research Paper, No. 10-11, 2012), *available at* http://ssrn.com/abstract=1561783 (analyzing the contents of legislation); J. Haskell Murray, *Benefit Corporations—State Statute Comparison Chart* (Regent Univ. Sch. of Law, 2011) (unpublished chart), *available at* http://ssrn.com/abstract=1988556 (analyzing the contents of benefit corporation statutes).

9. *See generally* H.B. 2239, 2011–12 Leg., 2012 Reg. Sess. (Wash. 2012).

state legislatures have considered new forms that share features with the FPC,[10] and other countries have implemented yet further models.[11] To situate the FPC form in context, without overwhelming the reader with details on too many jurisdiction-specific enactments, this Part will discuss the major features of the L3C and benefit corporation in brief.

The low-profit limited liability company operates like a standard limited liability company ("LLC") with only a handful of deviations. All of these changes address the specialized purposes adopting entities must pursue. Specifically, L3Cs must "significantly further[] the accomplishment of one or more charitable or educational purposes within the meaning of" the Internal Revenue Code sections defining charitable contributions,[12] and "no significant purpose of the company is the production of income or property."[13] That said, an L3C that actually produces significant income or capital appreciation will not be disqualified from this status by virtue of those facts alone.[14]

Other than these adaptations of the L3Cs' purposes, the statutes typically subject them to ordinary for-profit LLC law. Their governance structures are highly flexible, subject to private ordering by an operating agreement. In contrast to the benefit corporation and the FPC to be described below, L3Cs have no special disclosure obligations, no expressly modified fiduciary duties,[15] and no

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10. *E.g.*, S.B. 62, 117th Gen. Assemb., Reg. Sess. (Ind. 2012); H.F. 697, 87th Leg., Reg. Sess. (Minn. 2011).

11. *See, e.g.*, Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 630–36 (2010) [hereinafter Brakman Reiser, *Governing and Financing*] (discussing the United Kingdom's community interest company ("CIC")); Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 306–16 (2010) (describing the CIC in the U.K and the Belgian Société à Finalité Sociale).

12. VT. STAT. ANN. tit. 11 § 3001(27)(A).

13. *Id.* § 3001(27)(B).

14. *See id.* In addition, L3Cs may not be formed to "accomplish one or more political or legislative purposes," again as defined by the tax code. *Id.* § 3001(27)(C).

15. Some commentators argue adapted duties for L3C fiduciaries are created by statutory implication. *See, e.g.*, 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, 39–40 (2011); John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 141 (2010). Others, including myself, argue that L3C statutes leave fiduciary obligations dangerously uncertain. *See* Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 109–11 (2010) [hereinafter Brakman Reiser, *Blended Enterprise*]; Brakman Reiser, *Governing and Financing*, *supra* note 11, at 623–30; Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, EMORY L.J. (forthcoming 2012) (manuscript at 18–19) [hereinafter Brakman Reiser, *Theorizing Forms*]; J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit*

limitations on change of status. In fact, an L3C ceases to exist as such, and transforms immediately into an ordinary LLC, if at any time it no longer meets the special purpose requirements.[16] This transformation occurs by operation of law. The entity need not file any documents indicating the change, managers and members have no official input, and no regulator is involved.[17]

When compared to the L3C, the statutory framework establishing the benefit corporation is both more extensive and more rigid. This is due, in part, to the fact that benefit corporations borrow the for-profit corporate form as a starting point. The signature innovation of the benefit corporation form, however, is its reliance upon "third-party standards."[18] These standards play a powerful role, as benefit corporations must: (1) frame their required public benefit purposes with reference to them, and (2) issue reports to shareholders and the public evaluating their achievements according to them. Benefit corporation statutes differ in the level of detail at which they define the content of such standards. For example, California's statute defines a third-party standard as "a comprehensive assessment of the impact of the business and the business's operations upon" a broad range of stakeholder groups.[19] In contrast, Maryland's legislation requires only a generic "standard for defining, reporting, and addressing best practices in corporate social and environmental performance."[20] All benefit corporation statutes demand that third-party standards be developed by transparent, independent entities.[21]

Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment In Entrepreneurial Ventures, 35 VT. L. REV. 273, 286–89 (2010).

16. *See, e.g.*, VT. STAT. ANN. tit. 11 § 3001(27)(D).

17. A more detailed account and critique of the L3C form can be found in Brakman Reiser, *Governing and Financing*, *supra* note 11, at 620–30.

18. *See* Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 592, 600–03 (2011) [hereinafter Brakman Reiser, *Benefit Corporations*]; J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 21 (2012) [hereinafter Murray, *Choose Your Own Master*]; J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, 2 AM. U. BUS. L. REV. 85, 90–91, 94 (2012) [hereinafter Callison, *Procrustean Bed*].

19. *See, e.g.*, CAL. CORP. CODE § 14601(g). References in this Article will cite legislation as adopted by various jurisdictions as examples, rather than the model statute drafted by benefit corporation proponents. This model statute can be consulted at MODEL BENEFIT CORP. LEGIS. (B Lab 2012), *available at* http://benefitcorp.org/storage/Model_Legislation.pdf. For a thorough description and evaluation of the benefit corporation form, see generally Brakman Reiser, *Benefit Corporations*, *supra* note 18.

20. MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01(e).

21. *See, e.g.*, *id.*; N.J. STAT. ANN. § 14A:18-1 (West 2012); VA. CODE ANN. § 13.1-782 (Supp. 2012).

Benefit corporation statutes also make several important revisions to standard for-profit corporate governance arrangements. Benefit corporation directors must consider a very broad range of non-shareholder stakeholder interests when making decisions.[22] Benefit corporations must report to shareholders and the public on their pursuit and achievement of their public benefit purposes.[23] With this information in hand, benefit corporation shareholders can sue fiduciaries to hold them to their expanded duties, sometimes using new enforcement actions created under the statutes.[24] Shareholders also must approve adoption or abandonment of benefit corporation status by a supermajority vote.[25]

The L3C and the benefit corporation represent poles on a spectrum of flexibility. On the one hand, the L3C allows almost complete contractual freedom to order a social enterprise as founders might desire. The statutory scheme imposes no new obligations on fiduciaries and no disclosure requirements. It is a status that may be taken on and thrown off with ease, merely by changing the purposes the entity pursues. On the other hand, the benefit corporation provides a comprehensive set of "off-the-rack" governance arrangements, many of which cannot be varied by adopters. It enlists the assistance of third-party standard setters to develop metrics to gauge the public benefit bona fides of adopting entities. It also varies fiduciary duties, creates reporting obligations, and empowers shareholders with voting and litigation rights. As the next Part will describe, the FPC sits somewhere between these two poles, offering significant flexibility and discretion for founders and directors, but paired with expansive rights, powers, and protections for shareholder investors.[26]

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22. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07 (requiring directors to consider impact of their decisions on employees, customers, the community, society, and the local and global environment); VT. STAT. ANN. tit. 11A, § 21.09 (similar).

23. *See, e.g.*, VA. CODE ANN. § 13.1-791; HAW. REV. STAT. ANN. § 420D-11 (2011).

24. *See, e.g.*, N.J. STAT. ANN. § 14A:18-10; LA. REV. STAT. ANN. § 1825 (2012).

25. *See, e.g.*, N.Y. BUS. CORP. LAW § 1705 (McKinney 2012); A277, 119th Gen. Assemb., Reg. Sess. (S.C. 2012) (to be codified at S.C. CODE ANN. § 33-38-230).

26. For analyses of the FPC comparing it with other forms, see Eric Talley, *Corporate Form and Social Entrepreneurship: A Status Report from California (and Beyond)* (U.C. Berkeley Pub. Law Research Paper No. 2144567), *available at* http://ssrn.com/abstract=2144567; Robert T. Esposito, *The Social Enterprise Revolution in Corporate Law: A Primer on Hybrid Corporate Entities in Europe and the United States and the Case for the Benefit Corporation*, WM. & MARY L. REV. (forthcoming 2013) (manuscript at 54–57), *available at* http://ssrn.com/abstract=2134022.

II. THE FPC IN DEPTH

The history of the FPC actually begins not with the L3C or benefit corporation, but rather with the 2008 proposal of a constituency statute for California.[27] Constituency statutes permit for-profit corporate directors to consider the interests of non-shareholder stakeholders when making decisions, dislodging any real or perceived legal requirement to maximize shareholder value.[28] Some constituency statutes limit this broadened directorial discretion to the takeover context, but others apply it more comprehensively to directorial action.[29] Over thirty U.S. jurisdictions now have constituency statutes of one type or another.[30] California does not. In 2008, State Senator Mark Leno and others sought to change that. He sponsored a bill granting for-profit corporate directors the option to consider the interests of various stakeholder groups, along with the long- and short-term interests of shareholders in both ordinary and change of control situations.[31] In the view of the bill's proponents, a constituency statute was pivotal to attract and maintain socially-responsible businesses in California.[32]

Important representatives of the business community opposed the bill. For example, both the state bar's Business Section and the California Chamber of Commerce argued it was unnecessary and threatened to undermine directors' accountability.[33] Although the bill passed both houses of the state legislature without their support, then-Governor Schwarzenegger ultimately vetoed it. His veto

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27. This Part will discuss the California FPC. If the experiences of the L3C and benefit corporation are any guide, the California approach will be considered and may be adopted, with small or significant variations, by other jurisdictions. If they do, future work can examine these emendations. At this early stage, the California statute is the appropriate model.

28. *See* Lisa Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 460–61 (2002); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14, 27–29 (1992); Tyler, *supra* note 15, at 132.

29. *See* Tyler, *supra* note 15, at 133; *see also* Orts, *supra* note 28, at 30–31.

30. *See* Tyler, *supra* note 15, at 132; *see also* Fairfax, *supra* note 28, at 460–61 (placing the count at thirty-two in an earlier work).

31. *See* CAL. S. JUDICIARY COMM., AB 2944 BILL ANALYSIS (2008), *available at* http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_2901-2950/ab_2944_cfa_20080611_123248_sen_comm.html.

32. *See id.* ("California has the highest concentration of corporations trying to practice business responsibly, but the lack of a constituency statute is an impediment to these corporations as they grow and seek investment capital, threatening California's leadership position.").

33. *See id.* (quoting comments by the bar association and chamber of commerce in discussing the views of the bill's opponents).

message grounded his action in the need for caution in the "serious matter" of corporate governance, but "urge[d] the Legislature to consider and study new styles of corporate governance that can offer alternatives to the current model, but that maintain the vital shareholder protections that have helped turn California into the economic powerhouse of the world."[34]

The bill lacked sufficient support to obtain a legislative override, but its significant success and the governor's message buoyed a group of California lawyers to try to create a specialized legal form to house social enterprises.[35] They formed a working group of ten and together engaged in an extensive drafting process to develop the bill that became the Corporate Flexibility Act, sponsored by State Senator Mark DeSaulnier and passed unanimously by the Senate and in substantially similar form by a large majority in the Assembly.[36] Governor Jerry Brown signed it into law and it took effect, enabling entities to register as FPCs, beginning January 1, 2012.[37]

The FPC uses the California corporate form as its foundation.[38] But, like all specialized forms recently developed to house social

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34. Arnold Schwarzenegger, *AB 2994 Veto Message*, OFFICIAL CAL. LEGIS. INFO. (Sept. 30, 2008), http://www.leginfo.ca.gov/pub/07-08/bill/asm/ab_2901-2950/ab_2944_vt_20080930.html.

35. W. Derrick Britt, R. Todd Johnson & Susan H. MacCormac, *Proposed Amendments to the California Corporations Code for a New Corporate Form: The Flexible Purpose Corporation and Senate Bill 201—Frequently Asked Questions*, BUS. FOR GOOD (Feb. 23, 2011), http://businessforgood.blogspot.com/2011/03/frequently-asked-questions-proposed.html.

36. The Working Group members are W. Derrick Britt (Co-chair), Partner, Doty, Barlow, Britt, and Thomas, LLP; R. Todd Johnson (Co-chair), Partner, Jones Day; Susan H. MacCormac (Co-chair), Partner, Morrison Foerster; Keith Paul Bishop, Partner, Allen Matkins Leck Gamble & Mallory LLP; Edward A. Deibert, Director, Howard Rice Nemerovski Canady Falk & Rabkin; William P. Fitzpatrick, General Counsel, Omidyar Network; Steven K. Hazen, Retired, Former Vice-Chair for Legislation of the State Bar of California Business Law Section; David M. Hernand, Partner, Gibson, Dunn & Crutcher LLP; Jay A. Mitchell, Director, Organizations and Transactions Clinic, Stanford Law School and former chief corporate counsel of Levi Strauss & Co.; and Robert A. Wexler, Partner, Adler & Colvin. *See id.*

37. The registration process utilized by the Secretary of State makes it difficult to obtain a precise count of current FPCs. *See* E-mail from Business Filings, California Secretary of State, to Rachel Seelig (Feb. 22, 2012, 7:58 P.M.) (on file with author) (providing a list of the fifteen entities who had filed to form or change status to either FPC or benefit corporation status: The Ideal World; Prometheus Civic Technologies, FPC; Strozzi Institute; Great Pacific Iron Works; Lost Arrow Corporation; Patagonia, Inc.; Opticos Design, Inc.; Give Something Back, Inc.; JP & Sun, Inc.; Thinkshift; Dopehut; The University of the Brain; Farm From a Box, Inc.; Search Inside Yourself Leadership Initiative Inc.; and Patagonia Provisions Inc.). *See also* Talley, *supra* note 26, at 6–7 fig. 1 & 12 n.15 (reporting results of the only empirical study to date whereby data collected with the help of the California Commissioner of Corporations showed fifteen entities had registered as FPCs between January and August 2012).

38. *See* CAL. CORP. CODE § 2501.

enterprises, the FPC builds on its original model. Its additions work to segregate the new form from existing ones, guide the conduct of entities operating as FPCs, and provide channels for enforcement.

A. Segregating FPCs

Only entities adopting FPC status may access its permission to brazenly pursue both profit and social good, and founders and shareholders together guard admission to it. To become an FPC, a corporation must include the term "flexible purpose corporation" or an abbreviation in its name, and it must identify its particular special purpose or purposes in its articles of incorporation.[39] The breadth of FPCs' permitted purposes is striking. The statute not only expressly allows FPCs to pursue charitable purposes like those of traditional nonprofits,[40] but also permits adopting entities to choose to pursue the interests of the broadest range of non-shareholder stakeholders.[41] These include employers, suppliers, customers, creditors, the community, society, and the environment.[42] This broad vision of the social "good" FPCs might pursue places the definition of that contested term, and the discretion over what type of purpose their entities will pursue, precisely and exclusively in the hands of the founders.[43]

At the very beginning of an FPC's life cycle, however, we see too its reliance on disclosure to shareholders. The flexible-purpose quality of an adopting corporation must be broadcast in its very name. Investors need look no further than an FPC's foundational documents to learn toward precisely what other kinds of ends its leaders might sacrifice returns. Neither shareholders nor any member of the public should mistake an FPC for a traditional for-profit corporation, or a nonprofit one for that matter.

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39. *Id.* § 2602.

40. *See id.* § 2602(b)(2)(A) (permitting an FPC to cite among its special purposes "[o]ne or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out").

41. *See id.* § 2602(b)(2)(B) (allowing an FPC to adopt a special "purpose of promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of" its activities on "employees, suppliers, customers, and creditors, [t]he community and society, [or] . . . [t]he environment").

42. *See id.*

43. Unlike benefit corporation statutes, the FPC framework does not require adopting entities to apply a third-party standard to evaluate their pursuit of social good. *Compare id.* § 2602(b), *with* VA. CODE ANN. § 13.1-782 (requiring benefit corporations to pursue a general public benefit, defined as "a material positive impact on society and the environment taken as a whole, as measured by a third-party standard, from the business and operations of a benefit corporation").

Once an FPC has been created, changing this status also requires both prompting by its leaders and substantial buy-in from shareholders. If directors propose any amendment to the articles that would "materially alter any special purpose of the flexible purpose corporation," two-thirds of the outstanding shares of each class of shareholders must approve it.[44] Indeed, this heightened threshold applies even if article amendments would result in a corporation still qualifying as an FPC, but pursuing a different special purpose or purposes than before.[45] It likewise requires shareholder consensus when a corporate transaction would affect a change in the purpose or flexible purpose status.[46]

The breadth of special purposes the statute permits suggests that changes in purpose within the FPC umbrella are quite possible. Consider Edify FPC, a hypothetical FPC formed to pursue profits and social good by providing low-cost educational services to children of the working poor. Its directors could propose an article amendment to transform the entity's purposes to the pursuit of profits and the promotion of the long-term positive effects of its activities on its employees by offering its educational services at higher prices to children of more affluent parents. Greater revenues would offset investments in professional development and higher wages for employees. The new emphasis on benefitting employees is a special purpose clearly permitted by the FPC statute, but is a considerable change of focus from its former mission of educating needy kids. The FPC statute takes no position on the relative merits of these different purposes,[47] but requires shareholders to approve such a change by a large majority.

Shareholders are given additional protections against loss of economic value in FPC conversions. The ultimate protection is afforded to shareholders opposing an FPC's conversion to a nonprofit entity. Here, the statute demands that shareholders unanimously approve the transaction before adopting nonprofit status, which would terminate their rights to distributions.[48] Thus, a

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44. CAL. CORP. CODE § 3000(b).

45. *Id.*

46. *See id.* §§ 3100, 3201.

47. *See* Britt, Johnson & MacCormac, *supra* note 35 ("The Working Group believes strongly, and unanimously, that the proposed approach provides the best manner for permitting what is now prohibited, in a manner that does not include the intellectual and technical complexity of defining 'what is good' . . . .").

48. *See* CAL. CORP. CODE § 3001 (requiring that such transactions "shall be approved by *all* of the outstanding shares of all classes") (emphasis added).

single dissenting shareholder can stop an FPC from transforming into nonprofit entity.

The statute erects less daunting, but still considerable, barriers to conversions between FPC and ordinary for-profit status. At least two-thirds of each class of voting shares must approve any conversion by an ordinary for-profit corporation into an FPC or vice versa.[49] These supermajority voting rights ensure significant shareholder consensus will stand behind any shift into or out of FPC status, providing substantial protection to even sufficiently large minority shareholder groups. Moreover, even if an approving supermajority shareholder vote is secured, dissenters may opt to have their shares purchased by the corporation for "[t]he fair market value . . . determined as of the day before the first announcement of the terms of the proposed [transaction]."[50]

This appraisal-type remedy appears better designed to protect dissenters in transactions converting entities into FPC form than away from it. Appraisal rights in a conversion from for-profit to FPC status can be seen as conventional protection for the economic rights of minorities.[51] If shareholders invest in a traditional corporation and dissent from its conversion to an FPC to pursue special purposes along with profit, we can assume their concerns are financial—they fear their investment will lose economic value when it becomes a stake in an FPC rather than a traditional business entity. If we put aside the typically substantial costs of an appraisal proceeding, dissenters' financial interests should be protected by requiring the converting corporation to cash them out at a price reflecting the value of the entity as a standard profit-centered business. This right to be cashed out by the corporation is particularly important to protect shareholders' financial interests when there is no ready market for the dissenting investors' shares.

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49. *Id.* §§ 1152(d)(1), 3002, 3301.

50. *Id.* § 1300(a); *id.* § 1152(d)(2) (providing dissenting shareholders rights under Section 1300 in transactions converting traditional business entities into FPCs); *id.* § 3305 (providing dissenters rights under Section 1300 in transactions converting an FPC into another type of business entity).

51. *See* JAMES D. COX & THOMAS LEE HAZEN, BUS. ORGS. L. 636 (2011) ("in theory the ostensible purpose of the statutory appraisal remedy is to protect the minority and offer them a way out in case of fundamental changes . . . ."); *see also* Hideki Kanda & Saul Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 UCLA L. REV. 429, 434 (1985) (describing the conventional rationale for appraisal as allowing dissenters to decamp from a corporation about to undergo a fundamental change with which they disagree). Modern authors critique this conventional view, however, due to the delay and expense involved in appraisal litigation. This issue will be addressed *infra*. *See infra* notes 54 & 55 and accompanying text.

The rationale for the statute's dissenters' rights as financial protection for shareholders opposed to conversion of FPCs to for-profits is considerably weaker. These shareholders could oppose an FPC to for-profit conversion purely on economic grounds. Perhaps they view social enterprises as more sustainable and therefore ultimately able to outperform solely profit-focused ones even on economic terms. At least in the short term, however, following a conversion from FPC to standard corporate status, one would expect former FPCs to cut costs and achieve greater profits. If so, dissenting shareholders could achieve financial protection by remaining invested through the conversion, after which they would gain from the pure for-profit's greater economic value. The problem, as is frequently the case in appraisal, is the likely lack of a market.[52] For dissenting shareholders to protect their financial investment this way, they need to be able to realize the entity's value by accessing a market for post-conversion sale of their shares.[53] They can then use the funds they obtain through sale to make substitute investments. When the converted corporation does not have a market for its shares, however, an appraisal remedy could conceivably remain useful financial protection (again, setting aside its likely costs).

Its utility ultimately depends on whether courts can define and apply the fair market value concept to avoid undercompensating dissenters in FPC conversions. Imagine LocalCorp, a manufacturing concern founded as an FPC with a special purpose to pursue the long-term interests of its local community. LocalCorp's board of directors proposes a transaction that would lead to the abandonment of this special purpose. Although more than two-thirds of LocalCorp shareholders approve the transaction, ten percent vote against it. Consider a dissenting LocalCorp shareholder, Sarah, who purchased a share of the FPC for $100. Sarah invested $100 in LocalCorp because she valued the financial return she expected LocalCorp to produce for her at $80, and she valued its commitment to further local community interests at $20. Once freed of its obligation to pursue these local interests, LocalCorp could earn greater economic returns. For simplicity, we can assume its value as a pure for-profit

52. *See* Britt, Johnson & MacCormac, *supra* note 35 ("Dissenter's rights seemed particularly important in achieving the [FPC Working Group's] goal of ensuring that a change in form should cause no harm to shareholders or investors, particularly where the company involved is a private company with no liquidity for shareholders.").

53. Appraisal rights statutes often recognize the differing positions of dissenting shareholders by excepting those with marketable shares from their protections. *See* COX & HAZEN, *supra* note 51, at 640; *see also* Kanda & Levmore, *supra* note 51, at 432.

is $100 per share. Perhaps LocalCorp would achieve these greater returns by more cheaply sourcing components outside its community or by transferring human or physical resources to a less costly location. Sarah does not want the company to move in this direction, but she has been outvoted. She fears there will not be a market for the converted entity's shares, and so she pursues her dissenters' rights.

Under the FPC statute, Sarah is entitled to the fair market value of her shares, valuing LocalCorp prior to the conversion's announcement. The question is: How will fair market value be defined? If appraisal provides Sarah $100, it will go a long way toward protecting her financial interests. She might reinvest the $100 in another locally-focused social enterprise. Alternatively, she might invest $80 in a pure for-profit and invest in or donate $20 to a community-focused entity. Assuming substitutes exist, she might engage in any number transactions to achieve her desired mix of profit and social good. On the other hand, if appraisal provides Sarah only $80, valuing only the entity's purely economic returns pre-transaction, dissenting shareholders like Sarah are underprotected. They will have insufficient funds to avail themselves of substitutes for their FPC investment that has ceased to exist.

A court using the fair market value concept will need to be very nimble to avoid this outcome. It must not only determine the FPC's economic value, but also some price for the utility of the social good it generates, or at least the economic value foregone in generating that social good. Attempting to include appreciation in fair market value will add further complications. Valuations of appraisal rights in pure for-profits are already notoriously tricky.[54] Applying the concept in a transaction converting an FPC into a for-profit will be even more difficult.

Moreover, and perhaps most importantly, the appraisal tool can only offer cash as its remedy for lost social good production. But, there are some things money simply cannot buy. For FPC shareholders, the significant risks of a conversion transaction are non-financial; they fear the abandonment of the entity's special purpose. It seems far more likely that Sarah opposes LocalCorp's

54. *See* COX & HAZEN, *supra* note 51, at 641 ("The most difficult task in obtaining relief under appraisal statutes is establishing the fair value of the dissenting shares . . . . Legislatures and the courts have not been able to establish any definite measure or standard of value.").

conversion out of concern that it will abandon the local community, than out of fear that her financial investment will deteriorate. A remedy offering Sarah and other dissenters fair market value for their shares, valued at the moment before the conversion's announcement, may just be inapposite to these concerns.

Finally, any realistic assessment of the FPC dissenters' rights provisions must take into account the serious costs and delays associated with appraisal-type remedies. When these costs are factored back into the equation, it is highly unlikely that dissenters' rights will provide any shareholder with even purely financial protection. Perhaps this remedy should instead be understood as a means to review transactions without blocking them, possibly discovering fiduciary wrongdoing along the way.[55]

Currently, FPC dissenters' rights look frustratingly like empty promises. A more aggressive appraisal-based remedy would set the cash out price after the transaction's announcement or completion, either by default or at the option of the dissenting shareholder. Alternatively, the statute could have provided novel, specialized remedies for shareholders frustrated by the loss of a converting FPC's devotion to its special purpose. It might have locked all or some portion of an FPC's assets into pursuing its special purpose for a period of time or indefinitely. The statute could have forced FPCs to pay some penalty on exit from FPC status. The drafters declined to take these steps or any other specialized remedial course, perhaps because locking in social mission in this way would make FPCs look and operate much more like nonprofits.

In realizing its goal of segregating FPCs from traditional corporate forms, the FPC statute enlists both organizational leaders and shareholders in key roles. Founders can select from a broad range of charitable or other purposes. Yet, they must make their chosen special purposes abundantly clear to the public, and especially to shareholders. Founders or fiduciaries can propose the adoption or renunciation of FPC form. Shareholders, however, will temper their ability to act unilaterally through supermajority voting requirements and express, though imperfect, dissenters' rights.

B. Operating FPCs

This same pattern—discretion for fiduciaries with disclosure to shareholders tasked with enforcement—reappears in the statute's

55. *See id.* at 635–36; *see also* Kanda & Levmore, *supra* note 51, at 443–45. A more detailed discussion of fiduciary challenges appears *infra* Part II.C.2.

provisions regarding FPC operations. We can start with director discretion. The statute provides that:

> In discharging his or her duties, a director may consider those factors, and give weight to those factors, as the director deems relevant, including the short-term and long-term prospects of the flexible purpose corporation, the best interests of the flexible purpose corporation and its shareholders, and the purposes of the flexible purpose corporation as set forth in its articles.[56]

This language was intended to make clear that FPC directors may pursue purposes beyond, and even in conflict with, shareholder value maximization.[57] The FPC statute codifies protection from liability when directors carry out their duties within the confines of this additional discretion.[58] In addition, individual FPCs may limit or eliminate their directors' exposure to monetary damages by adopting exculpatory charter amendments.[59] Finally, the statute expressly disclaims any grant of standing to non-shareholder stakeholders to challenge directorial action.[60] FPC directors are permitted to consider their articulated purposes, but shareholders alone may challenge their operational decisions.[61]

Considering the FPC's origins, it is not surprising that constituency statutes share many of these attributes. Constituency statutes also broaden directors' permissible considerations beyond the perceived strictures of the shareholder value maximization norm.[62] Constituency statutes, however, are also subject to a powerful, unintended consequences critique. By expanding directorial discretion so widely, they may allow directors to mask mismanagement and even malfeasance.[63] If the sweep of a

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56. CAL. CORP. CODE § 2700(c).

57. Britt, Johnson & MacCormac, *supra* note 35.

58. *See* CAL. CORP. CODE § 2700(d).

59. *Id.*

60. *See id.* § 2700(f).

61. Although the statute expressly renounces any negation of the Attorney General's power to police charitable trusts, it states "a flexible purpose corporation shall not be deemed to hold any of its assets for the benefit of any party other than its shareholders" and does not contemplate creating any new supervisory role for existing regulators. *See id.* § 2700(e).

62. *See supra* notes 29 & 30 and accompanying text.

63. *See* Rutherford B. Campbell, Jr., *Corporate Fiduciary Principles for the Post-Contractarian Era*, 23 FLA. ST. U. L. REV. 561, 621–23 (1996) (making this criticism and noting the wider debate); Brett H. McDonnell, *Corporate Constituency Statutes and Employee Governance*, 30 WM. MITCHELL L. REV. 1227, 1231–36 (2004) (reviewing the literature on constituency statutes).

constituency statute is so broad that a director can claim almost any decision was made with the intent to better the lot of some non-shareholder stakeholder group, fiduciary obligations lose their teeth of potential monetary liability, or even the reputational impact of a serious public challenge. Paradoxically, this critique argues, constituency statutes leave directorial decisions essentially unconstrained.

The terms of constituency statutes vary considerably across jurisdictions, but in terms of this threat of unbridled discretion, the FPC statute's grant of discretion is narrow when compared with many of them. Even without a constituency statute, directors of a standard for-profit corporation would also have the discretion to consider its short- and long-term prospects. They are certainly and generally required to act "in the best interest of the corporation and its shareholders."[64] The FPC statute's grant of additional discretion is thus only its permission to consider the special purpose or purposes stated in an FPC's articles of incorporation. An FPC's directors may not seek shelter in the statute's grant of discretion by claiming to have pursued any non-shareholder interest referenced in the statute. Directors of an individual FPC receive only the additional latitude to pursue the particular special purpose stated in its charter.[65] This mutes somewhat the reservation that FPC directors' discretion will be unbounded and impossible to police.

In this respect, the FPC statute's grant of directorial discretion also compares favorably with that provided to directors of benefit corporations by many statutes enabling that form. For example, directors of benefit corporations in New Jersey must consider:

> [T]he employees and workforce of the benefit corporation and its subsidiaries and suppliers, the interests of customers as beneficiaries of the general or specific public benefit purposes of the benefit corporation; community and societal considerations, including those of any

64. *See, e.g.*, MODEL BUS. CORP. ACT. § 8.30(a) (2002) (requiring directors to "act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best interests of the corporation"). Numerous Delaware cases cite directors' duty to pursue the best interests of the corporation and its shareholders. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) ("[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a . . . controlling shareholder . . . ."); *see also* Unocal Corp. v. Mesa Petrol. Co., 493 A.2d 946, 954 (Del. 1985) ("When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders . . . .").

65. *See* CAL. CORP. CODE § 2700(c).

> community in which offices or facilities of the benefit corporation or its subsidiaries or suppliers are located; the local and global environment; and the short-term and long-term interests of the benefit corporation, including benefits that may accrue to the benefit corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the benefit corporation.[66]

These benefit corporation directors may also consider "any other pertinent factors or the interests of any other group that they deem appropriate."[67] There are three important points of comparison here. First, FPC directors are *permitted* to consider non-shareholder interests, while benefit corporation directors are *required* to consider them. Second, the non-shareholder interests FPC directors may choose to consider are limited to those special purposes stated in the FPC's charter and thus on which their shareholders are particularly on notice. In contrast, benefit corporation directors are required to consider a range of non-shareholder interests as long as one's proverbial arm, and there is no particular requirement to apprise their shareholders of which interests directors will prioritize. Third, benefit corporation directors are further authorized to consider *anything else* ***they*** deem relevant.

Commentators have noted the benefit corporation's laundry list of mandatory considerations offers little guidance to directors and will hinder attempts to hold them accountable.[68] The greater specificity of purpose in an FPC softens, but does not entirely counteract, this critique. FPCs will always be formed for at least two purposes, to pursue a business and its special purpose. They may be formed for multiple purposes, if more than one special purpose is selected and disclosed. The statute does not require prioritization among any of these purposes. Thus, when an FPC's various purposes come into conflict, it will be easy for its fiduciaries to defend their actions and difficult for shareholders to challenge them.

C. Policing FPCs

Indeed, it is shareholders who will engage in any challenges to an FPC's operations. Their power to monitor and enforce is exclusive. The statute enables this policing by imposing disclosure

66. N.J. STAT. ANN. § 14A:18-6(a).

67. *Id.* § 14A:18-6(b).

68. *See* Brakman Reiser, *Benefit Corporations*, *supra* note 18, at 599–600; Callison, *Procrustean Bed*, *supra* note 18, at 106–08; Murray, *Choose Your Own Master*, *supra* note 18, at 27–34.

requirements on FPCs and empowering their shareholders with voting and litigation rights.

1. Disclosure

Under the statute, an FPC must engage in extensive reporting, beyond what would be required for a generic California for-profit corporation. Like in a standard for-profit, the FPC board must provide an annual report to shareholders, containing a balance sheet, income statement, and statement of cash flows.[69] An FPC's board must also include in its annual report to shareholders, however, "a management discussion and analysis (special purpose MD&A) concerning the flexible purpose corporation's stated purpose or purposes as set forth in its articles."[70] The board must also make the special purpose MD&A available on the FPC's website.[71]

The statute goes into considerable detail regarding the required contents of the special purpose MD&A. These reports will begin by "[i]dentif[ying] and discuss[ing] . . . the short-term and long-term objectives of the flexible purpose corporation relating to its special purpose or purposes" as well as changes in them over the past year.[72] FPCs might respond to this requirement by stating vague ideals and platitudes, but the remaining items they must discuss demand greater specification. An FPC annual report must identify its recent and planned future "material actions" to pursue its special purpose objectives, including the intended impact of these actions.[73] For material actions taken during the relevant fiscal year, the report must also identify and discuss "the causal relationships between the actions and the reported outcomes, and the extent to which those actions achieved the special purpose objectives for the fiscal year."[74] Furthermore, the annual report must include substantial information

69. *See* CAL. CORP. CODE § 3500(a) (imposing these requirements on FPCs and mandating that these documents be "accompanied by any report thereon of independent accountants or, if there is no report, the certificate of an authorized officer of the flexible purpose corporation that the statements were prepared without audit from the books and records of the corporation"); *id.* § 1501(a)(1) (mandating similar reporting by for-profits).

70. *Id.* § 3500(b).

71. *Id.* The statute allows a board to redact or otherwise manage the public posting of its special purpose MD&A to avoid confidentiality breaches and leaves to each FPC the decision of precisely which electronic means it will use to give the public access to this document. *See id.*

72. *Id.* § 3500(b)(1).

73. *See id.* § 3500(b)(2)–(3).

74. *Id.* § 3500(b)(2).

about the FPC's recent and planned future expenditures.[75] Finally, the annual report must delve into "the process for selecting, and an identification and description of, the financial, operating, and other measures used by the flexible purpose corporation during the fiscal year for evaluating its performance in achieving its special purpose objectives."[76] It must explain why it chose the measures it did, and give the reasons for any changes it has made to the measures it used in the relevant period.[77]

In addition to these robust annual reports, an FPC must also make a "special purpose current report" to shareholders and the public no later than forty-five days after any of several key events.[78] A current report must address any expenditure that arises without inclusion in a current annual report and that "has or is likely to have a material adverse impact on the flexible purpose corporation's results of operations or financial condition for a quarterly or annual fiscal period."[79] The board must also issue a current report if capital or operating expenditures (other than officer or director compensation) are made in a way not contemplated by its most recent annual disclosure.[80] Finally, the FPC must issue a current report if it deems one of its stated special purposes to be satisfied or decides not to pursue it any longer.[81] These reports will keep diligent shareholders and the public up to date on material changes in the FPC's operations and activities between annual reports.

FPC shareholders seeking to exercise their enforcement prerogatives should find this rigorous level of disclosure helpful, but it may prove daunting for social entrepreneurs considering the form. The disclosure requirements not only outpace reporting required for traditional for-profits but also reporting demanded from alternative specialized forms. L3C statutes do not impose any specialized reporting obligations on adopting entities. Benefit corporation statutes vary somewhat in their reporting requirements, but even the most onerous are not as thorough and frequent as the FPC's.[82]

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75. *Id.* § 3500(b)(5) (requiring identification of current "material operating and capital expenditures . . . in furtherance of achieving the special purpose objectives" and a "good faith estimate" of future ones).

76. *Id.* § 3500(b)(4).

77. *See id.*

78. *See id.* § 3501.

79. *Id.* § 3501(b).

80. *See id.* § 3501(c)(1).

81. *Id.* § 3501(c)(2).

82. *See, e.g.*, N.J. STAT. ANN. § 14A:18-11.

The FPC statute, however, offers several components that may assuage founders' compliance concerns. First, the statute expressly states that its reporting standards do not require disclosure of every FPC purchase or plan.[83] Second, the consequences of failures to produce the required reports are limited. A fiduciary who causes reports to include false or misleading statements may be held liable,[84] but officers and directors are immunized against claims based on forward-looking statements made in good faith.[85] Even wholesale failure to produce reports typically triggers only a mandate to generate them, though if the failure to report is found "without justification," shareholders can recoup expenses incurred in challenging the failure, including attorney's fees.[86] Third, the statute establishes a presumption that all information required to be presented in a special purpose MD&A or current report has been provided if an FPC uses "best practices" to provide it.[87] The statute does not define these best practices, but instead leaves them to "emerge" over time.[88] Finally, any FPC with fewer than 100 shareholders can be relieved entirely of its obligation to produce special purpose MD&A and current reports if it obtains waivers from two-thirds of its outstanding shares.[89] At least in small and closely-held FPCs in which directors and shareholders overlap, one can expect waivers to be granted as a matter of course. Whether waivers will be easy to obtain in other types of FPCs will likely depend on the relative appetite of shareholders for disclosure as compared with their desire to limit compliance costs.

2. Enforcement Tools

Relying on information gleaned from the mandatory reports detailed above, shareholders alone will police FPCs' compliance with their blended missions and that of their fiduciaries. In this enforcement role, they have both legal and practical tools at their disposal. As shareholders, they are entitled to vote for directors and on certain major transactions and to bring derivative actions against FPC fiduciaries. In addition, the market could play an important

83. *See* CAL. CORP. CODE § 3502(a).
84. *See id.* § 3503.
85. *Id.* § 3502(d).
86. *See id.* § 3502(b).
87. *Id.*
88. *Id.*
89. *See id.* § 3502(h). This section parallels waiver provisions for for-profit corporations with fewer than 100 shareholders. *See id.* § 1501(a)(1).

enforcement role, as investors will buy or sell their shares depending on their confidence in the ability of an FPC investment to return both economic and social value.

As shareholders in other corporate settings, FPC shareholders can use their voting rights to enforce their preferences. Standard California corporate law applies to authorize FPC shareholders to elect and remove directors[90] and approve bylaws by a majority vote.[91] FPC shareholders, however, have special and uniquely strong voting rights when an FPC wishes to remove its dedication to special purposes. Whether this result will be achieved through article amendment,[92] merger,[93] or other transaction,[94] shareholders must consent by a two-thirds majority. Standard California for-profit corporations can often pursue these fundamental transactions with lesser investor consensus.[95] Thus, when it comes to protecting the blended mission legacy of an FPC from the ultimate threat of its abandonment, shareholders guard the gate. The information FPC shareholders obtain from annual and current reports, as well as transaction-specific disclosures, will help them to decide how to vote in these end-game scenarios.

Information about FPC operations will also assist shareholders in deciding whether to challenge the more everyday efforts and actions of their fiduciaries. They may do so through voting rights in director elections or through litigation. FPC shareholders may bring direct suits alleging individual harms, such as the FPC's failure to provide required access to information or to hold mandated votes.[96] In addition, the statute authorizes shareholders—and only shareholders[97]—to bring suit derivatively on behalf of the FPC. These litigation rights are checked somewhat by the typical procedural steps shareholders must complete before derivative suits may be heard.[98] Still, at least nominally, derivative suit rights afford

90. *See id.* §§ 301(a), 303, 304.

91. *See id.* §§ 152, 211.

92. *See id.* § 3000(b).

93. *See id.* § 3201.

94. *See id.* §§ 3100, 3301(a)(2).

95. *See id.* §§ 1201, 181, 152 (requiring only the "affirmative vote of a majority of the outstanding shares entitled to vote" for a reorganization outside the FPC context).

96. FPC shareholders' rights here track those of ordinary shareholders. See COX & HAZEN, *supra* note 51, at 443–49 (describing the distinction between direct and derivative suits).

97. *See* CAL. CORP. CODE § 2900(b) ("No action may be instituted or maintained in right of any domestic or foreign flexible purpose corporation under this section by any party other than a shareholder of the flexible purpose corporation.").

98. *See, e.g., id.* § 2900(c)(2), (d) (requiring that the plaintiff first inform the board

FPC shareholders authority to challenge directors' and officers' operations of their entities by challenging their fiduciary compliance.

Shareholders might claim fiduciary lapse when confronted with reports detailing their FPC's less than stellar achievements of special purposes or its undesirable expenditures. But, let us unpack this potential enforcement avenue a bit more carefully. Like in other corporate forms,[99] FPC shareholders will have little success in achieving redress through litigation unless the disappointing results or expenditures stem from a breach of loyalty. With loyalty breaches, a fiduciary has placed her own interest ahead of her corporation's interest, engaging in some transaction or activity that treats the corporation unfairly.[100] If an FPC shareholder makes allegations like these, she is likely to clear the procedural hurdles of derivative litigation, and a court should make a searching review of the activity or transaction to determine what the fiduciary gained and what the FPC may have lost.

FPC shareholders may, however, be unhappy with the management of a corporation even if no fiduciaries are being enriched at its expense. They may believe directors are trading off too much profit in order to pursue its special purposes, or that they are sacrificing too little profit in their pursuit. They may believe directors have made foolish, but not avaricious, business decisions. These poor choices cost the FPC resources it could have used to pursue either profit or social good. If generated and distributed to shareholders and the public, the voluminous and detailed special purpose MD&A and current reports might well reveal facts supporting such beliefs. But, FPC shareholders will not likely have financial incentives to bring legal claims for relief, as damage awards are unlikely and would be paid to the corporation. Further, it is hard to imagine the plaintiffs' bar taking up such cases. Even putting these practical impediments aside, shareholder derivative claims

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of the impending lawsuit and furnish a bond, respectively).

99. *See* Geoffrey P. Miller, *A Modest Proposal For Fixing Delaware's Broken Duty of Care*, 2010 COLUM. BUS. L. REV. 319, 322–25 (2010) (setting forth various reasons why "the threat of money damages [for breach of a for-profit director's duty of care] has little or no force in Delaware"); Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1440–42 (1998) (bemoaning the law's propensity to focus on breaches of care rather than of loyalty, as "courts seem more willing to listen to duty-of-care complaints if the transaction is tainted by duty-of-loyalty implications").

100. *See* COX & HAZEN, *supra* note 51, at 220–23 (describing directors' duties of loyalty); Brakman Reiser, *Theorizing Forms*, *supra* note 15, at 15.

alleging breaches of the duty of care based on these actions will almost invariably fail.[101]

If FPC directors make decisions with reasonable inquiry and information, without conflict of interest, and in good faith, courts will review their substance in a quite cursory fashion. The FPC statute imports language verbatim from California's codified business judgment rule, which protects directors from monetary liability for simple negligence.[102] As in a standard for-profit, an individual FPC may adopt exculpatory charter amendments to further limit or eliminate its directors' exposure to monetary damages.[103] Further, FPC directors may use the state's common law business judgment rule to further "insulate from court intervention management decisions which are made by directors in good faith in what the directors believe is the organization's best interest" even in suits seeking injunctive relief.[104]

Duty of care claims by FPC shareholders, however, face obstacles beyond those experienced by ordinary for-profit shareholders. These obstacles inhere in an FPC's blended mission and are exacerbated by the statute's director protections. Again, an example is instructive. Recall LocalCorp, our manufacturing concern founded as an FPC with a special purpose of pursuing the long-term interests of its local community along with profit for shareholders. Imagine its special purpose MD&A reveals that it declined to renew its largest contract with a local supplier in order to obtain an input more cheaply from an out-of-state vendor. This type of action would not trigger any voting rights for LocalCorp's shareholders, but the FPC appropriately disclosed the decision in a current report to shareholders. A group of LocalCorp shareholders might read this

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101. For a discussion of how courts might apply good faith analysis or a revived fiduciary duty of obedience to consider such challenges across social enterprises, see Brakman Reiser, *Theorizing Forms, supra* note 15, at 17–18. Such a reading of FPC fiduciary duty would require interpretive enterprise by the courts, as suggestions of either route are entirely absent from the statute. Thus, they are beyond the scope of the current article.

102. *Compare* CAL. CORP. CODE § 309, *with id.* § 2700 (eliminating "liability based upon any alleged failure to discharge the person's obligations as a director" when a director performs her duties "in good faith, in a manner the director believes to be in the best interests of the [flexible purpose] corporation and its shareholders, and with that care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances") (bracketed language in FPC statute only). A recent federal case held that this California provision affords business judgment protection only to directors, and not to officers. *See* FDIC v. Perry, No. CV 11-5561, ODW (MRWx) 2012 WL 589569, at *1, *4 (C.D. Cal. Feb. 21, 2012).

103. *See* CAL. CORP. CODE § 2700(d).

104. *See* Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 897 (Ct. App. 2009).

report, disapprove of the action, and bring a fiduciary duty challenge. Assuming the decision posed no conflicts of interest for fiduciaries, this claim seems most easily styled as a breach of the duty of care.[105] Perhaps shareholders would seek only injunctive relief, and we can assume arguendo that their claim would not be blocked by the demand requirement or stymied by the business judgment rule. Still, challenged directors could simply defend on grounds that in this decision they decided to pursue greater profit and would continue to pursue the FPC's special purposes in other ways. Essentially, the same scenario would play out if the decision ran in precisely the opposite direction, with the FPC throwing over a dependable out-of-state vendor for an upstart local one.

FPC directors' discretion to consider multiple non-prioritized purposes will frustrate shareholders' efforts to hold them accountable under the duty of care. Of course, this may be sensible, as courts' lack of expertise in business matters and the need to encourage responsible risk-taking by fiduciaries may justify deference to non-conflicted FPC decisions just as to those of for-profit directors. Moreover, there may be little impact from weaker review of FPC directorial decisions because standard corporate law limits this review so markedly already. But, at least wholly irrational decisions are theoretically the basis for potential scrutiny and liability in an ordinary for-profit. This "two masters" problem[106] makes even this minimal level of review more challenging for an FPC, though admittedly not as challenging as the virtually unlimited "masters" in a benefit corporation.[107]

A shareholder, of course, may pursue one other option if she feels her FPC is not pursuing profit and social good in accordance with her preferences—exit. Rather than vote out the board or bring derivative litigation, our disgruntled LocalCorp shareholder may well prefer to

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105. *See* Brakman Reiser, *Theorizing Forms*, *supra* note 15, at 15–17.

106. This shorthand has been used by virtually every author writing on specialized entities for social enterprise, including myself. *See* Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment By Proxy Or Perversion?*, 63 ARK. L. REV. 243, 243 (2010); Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks—Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TENN. J. BUS. L. 221, 223 (2012); Callison & Vestal, *supra* note 15, at 288; Murray & Hwang, *supra* note 15, at 39–40; Brakman Reiser, *Blended Enterprise*, *supra* note 15, at 105; Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 7 (2010); Tyler, *supra* note 15 *passim*.

107. *See* Brakman Reiser, *Benefit Corporations*, *supra* note 18, at 599–600; Callison, *Procrustean Bed*, *supra* note 18, at 106–08; Murray, *Choose Your Own Master*, *supra* note 18, at 27–34.

sell her shares, end her involvement with LocalCorp, and seek out substitutes. Further, the fear of shareholders' divestiture may motivate fiduciaries to follow shareholder preferences. Yet, exit is effective to protect shareholders' interests and incentivize fiduciaries to align their actions with those interests only in the shadow of a market for FPC shares. Importantly, the reverse is also true. If no realistic market exists for FPC shares, directors will be less motivated to align their actions with shareholders' desires, and shareholders will have only the limited tools of voting or litigation to express their critiques of FPC management.[108] As a vibrant market for FPC shares is unlikely, at least for some time, the value of exit in enforcement is limited.

The exit rights of FPC shareholders bring to light one final important limitation on the statute's framework for monitoring these new entities. As noted earlier, when it comes to monitoring and enforcing the obligations of FPCs and their fiduciaries, shareholders stand alone.[109] Although the public may view posted annual reports and special purpose MD&As, the statute does not provide anyone but shareholders with legal tools for enforcement. Even members of classes particularly singled out for consideration in an FPC's articles of incorporation lack voting authority or standing to challenge the actions of its leaders.[110]

There can be good reasons to avoid general rights of participation or grants of standing to the public or even beneficiary classes in organizations formed to promote social good. In the somewhat analogous case of charities, public standing is rejected because litigious individuals opposed to the charitable mission of a particular entity might otherwise be motivated to bring damaging nuisance suits against it.[111] Such suits would drain charitable resources.[112]

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108. *See* Plerhoples, *supra* note 106, at 257–58 (describing the potential accountability gap for directors in FPC control transactions).

109. *See supra* Part II.C.2.

110. Alicia Plerhoples describes this aspect of the FPC statute as embracing "shareholder primacy," but a shareholder primacy norm uniquely sensitive to the combined profit and social good preferences FPC shareholders are assumed to hold. *See* Plerhoples, *supra* note 106, at 256 ("To the extent that investors in the flexible purpose corporation have non-economic interests, then those interests must be advanced along with the shareholders' financial interests in order to uphold shareholder primacy.").

111. *See* MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 333 (2004) (explaining that limits on standing are needed to "permit fiduciaries to function without unwarranted abuse and harassment").

112. *See* Mary Grace Blasko et al., *Standing to Sue in the Charitable Sector*, 28 U.S.F. L. REV. 37, 42 (1993).

Moreover, the possibility of such litigation could exacerbate the difficulty charities already experience in attracting and retaining qualified directors and officers.[113] These concerns have some resonance for social enterprises, and FPCs have the ready solution of shareholder standing to appear to solve the enforcement problem.

Whether exclusive shareholder enforcement is a satisfactory solution depends upon one's view of the interests an FPC should serve. At least at the outset, FPC shareholders should have preferences regarding its special purpose aligned with those expressed by the entity's founders and stated in its articles.[114] Over time, however, shareholders' views on the desirability of the entity's special purpose, including their preference for its pursuit over profit, may change. If an FPC should be operated for the benefit of its shareholders, as their preferences change, the entity's course should change as well. On this view, exclusive shareholder monitoring is effective. In contrast, if one views a social enterprise as one imbued with an obligation to interests beyond its shareholders, exclusive monitoring by shareholders will not necessarily be effective to address special purpose failures.

Consider once again Edify FPC, formed to pursue profits and provide low-cost educational services to children of the working poor, the directors of which propose amending its articles to transform the entity's purposes to pursue profits and the long-term positive effects of its activities on its employees. The directors disclose to shareholders that this change of purpose will result in offering its educational services at higher prices to offset investments in professional development and higher wages for its employees. Shareholders, by more than a two-thirds majority, approve the change. Representatives of the children Edify FPC serves, the local educational community, or the public at large will have no role to play in this decision. If an FPC should be operated solely in the interest of its shareholders and their preferences regarding pursuit of its special purposes, this is proper. If creating an FPC, however, should create some ongoing obligation to consider the interests identified in its special purposes, as those interests or related stakeholders would view them, exclusive shareholder enforcement is insufficient.

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113. *See* FREMONT-SMITH, *supra* note 111, at 325 ("[I]t would be impossible to manage charitable funds, *or even to find individuals to take on the task*, if the fiduciaries were to be constantly subject to harassing litigation.") (emphasis added).

114. *See* Plerhoples, *supra* note 106, at 252–54.

Shareholders have an important legal role to play in enforcement of FPC obligations, especially in an end-game situation where change of status is contemplated. Unless strong consensus among shareholders approves a change, the FPC must retain its special purpose character. As far as enforcing the blended mission mandate against more ordinary hazards, though, shareholders remain the only enforcer and their legal tools are weak. Shareholders may contest an FPC's compliance with its special purpose obligations, and that of its directors, but will face many obstacles in securing monetary liability or even injunctive relief. Further, depending on one's view of the ultimate purpose of FPCs, policing by shareholders alone may be insufficiently protective of special purposes.

3. Summary

The FPC statute follows a market-driven approach to monitoring and enforcement. It demands that FPC founders state their mission clearly and disclose their actions comprehensively. Then, it authorizes shareholders alone to enforce, with relatively strong legal tools in end-game scenarios and relatively limp ones in ordinary situations. It remains uncertain whether incentives will be sufficient for FPC shareholders to digest and utilize the information they receive, and how effectively they will employ the legal and practical tools at their disposal to police FPCs' blended missions.

III. EVALUATING FPCS

The FPC provides an organizational form enabling founders to clearly articulate both profit and social goals. Its structures for segregating, operating, and policing FPCs, however, differ importantly from the prior L3C and benefit corporation forms. In all of these respects, the FPC statute relies on directors to act within broad discretion and shareholders to enforce based on extensive disclosures.

In segregating FPCs from other corporate forms, the FPC statute relies on founders' own specification of a special purpose or purposes in organizational documents, without recourse to or use of any third-party standard. The FPC's special purposes may be drawn from a broad range of potential interests and stakeholder groups, but they must be clearly identified and disclosed to shareholders and the public. Viewers of these disclosures can then make their own decisions about whether to involve themselves with a given FPC, through consumption of its products or services, employment or business dealings, or—most importantly—investment. Once created,

supermajority voting provisions create greater lock-in for an FPC's special purpose than would be found in an L3C form, through provisions similar to those imposed by benefit corporation statutes. FPC shareholders also possess dissenters' rights, a concept rarely found in other specialized forms,[115] though one of potentially less value than may initially appear.

The FPC statute provides a substantial architecture for operating FPCs, which relies on an express grant of discretion to directors. These clear instructions on structure and decision-making contrast sharply with the L3C form. L3C adopters must design their governance arrangements individually by contract and will find no guidance in the statute on managing fiduciary obligations in a dual or multiple mission entity. The benefit corporation, as an incorporated form, provides an "off-the-rack" set of operating structures quite similar to the FPC. Its grant of discretion to directors is, however, importantly distinct. FPC directors may choose to consider the special purposes articulated in its articles, along with the interests of shareholders, in making decisions. Benefit corporation directors are required to consider a laundry list of divergent interests in making their decisions and are thereby given virtually absolute discretion.

To police FPCs, the statute relies exclusively on shareholders. To boost their effectiveness, shareholders are afforded uniquely comprehensive disclosures. Although the FPC statute takes several steps to reduce the burden of its disclosure requirements, they remain considerably more extensive than those demanded of benefit corporations and, again, involve no third-party standards. Few L3C statutes impose any disclosure requirements at all.

Armed with detailed information about FPC operations and achievements, shareholders are empowered to enforce the obligations of FPCs and their fiduciaries through voting and litigation rights. These enforcement tools far surpass those of L3C investors. They are similar to the enforcement rights of benefit corporation shareholders, though not identical. Both forms require supermajority shareholder approval for change of status, but their litigation mechanisms can differ. FPC shareholders may pursue fiduciary

115. The California and South Carolina benefit corporation statutes do provide dissenters' rights. Those under the California statute are identical to the dissenters' rights under the FPC statute. *See* CAL. CORP. CODE § 14604. The South Carolina statute provides its appraisal-type remedy only for shareholders of for-profits who dissent from a conversion to a benefit corporation. *See* A277, 119th Gen. Assemb., Reg. Sess. (S.C. 2012) (to be codified at S.C. CODE ANN. § 33-38-230). The Washington Social Purpose Corporation statute also contains an appraisal provision. *See* WASH. REV. CODE ANN. § 23B.25.120 (2012).

claims through typical derivative actions but are not granted access to a special enforcement process like the benefit enforcement proceeding.

CONCLUSION

We do not yet know if the FPC, or any other specialized form for social enterprise, will break out of the pack and become "the next big thing." All of these forms are novel, and it will be some time before many of their provisions are interpreted and their usefulness is determined. Despite the early stage of their development and the variation in the details of their structures, they all face a common struggle. They all allow social entrepreneurs to articulate a blended mission to pursue profit and social good, but none offers a clear path to enforcement.[116] To become a brand that attracts the capital social entrepreneurs desire, a specialized form will need to meet this serious enforcement challenge.[117] For the FPC, experience will need to prove that exclusive policing by shareholders will—or even can—be effective in enforcing blended mission.

116. In the L3C, enforcement concerns arise because fiduciary duty is unclear and the entity can be effortlessly transformed into a standard LLC. *See* Brakman Reiser, *Blended Enterprise*, *supra* note 15, at 108–11; Brakman Reiser, *Governing and Financing*, *supra* note 11, at 650; Brakman Reiser, *Theorizing Forms, supra* note 15, at 18–19; Callison & Vestal, *supra* note 15, at 286–88. *But see* Murray & Hwang, *supra* note 15, at 39–40; Tyler, *supra* note 15, at 141 (viewing the L3C's enforcement prospects more favorably). The benefit corporation grants virtually unbridled discretion to directors, shares the FPC's problematic dependence on shareholder enforcement, and its reliance on third-party standards may set the stage for greenwashing. *See* Brakman Reiser, *Benefit Corporations*, *supra* note 18, at 611–17; Brakman Reiser, *Theorizing Forms, supra* note 15, at 20–28, 38–39; Callison, *Procrustean Bed*, *supra* note 18, at 94–97, 106–11; Murray, *Choose Your Own Master*, *supra* note 18, at 27–36.

117. *See* Brakman Reiser, *Theorizing Forms*, *supra* note 15, at 40.

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PUTTING NEW SHEETS ON A PROCRUSTEAN BED: HOW BENEFIT CORPORATIONS ADDRESS FIDUCIARY DUTIES, THE DANGERS CREATED, AND SUGGESTIONS FOR CHANGE

J. WILLIAM CALLISON*

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* Partner, Faegre Baker Daniels LLP, Denver, Colorado. I dedicate this Article to an extraordinary group of Colorado corporate law practitioners and academics, who have wrestled with benefit corporation concepts and legislation for the last three years and from whom I have learned much over the last several decades. They include Bob Keatinge, Tony van Westrum, Cathy Krendl, Professor Mark Loewenstein, Mike Sabian, Allen Sparkman, Herrick Lidstone, John DeBruyn, Beat Steiner, and Sarah Steinbeck. I also thank the participants in the *American University Business Law Review*'s Symposium, "Profits Plus Philanthropy: The Emerging Law of 'Social Enterprises,'" for their comments on an earlier version of this Article.

INTRODUCTION

In Greek myth, Procrustes, a bandit son of Poseidon, had a one-size-fits-all iron bed on which he invited passers-by to spend the night.[1] Once his guests were asleep, he used his ironsmith's hammer to stretch them to fit the bed. If a guest proved too tall, Procrustes would use shears to amputate the excess in order that the body would fit the bed. Ultimately, Theseus, who killed the Minotaur and escaped the Maze using Ariadne's thread, killed Procrustes by compelling him to fit his own body to his bed.

In current parlance, a procrustean bed is an arbitrary standard to which exact conformity is enforced; that which does not fit the standard is either ignored or stretched and cut until compliant. A procrustean law is canonical, formal, rigid, hard, and fast, from which there can be no deviation. Procrustean laws have their place, and where uniformity is necessary or desired, Procrustes should rear his head. However, procrustean laws have costs as well, since individual circumstances, choice, and liberty are neglected at the expense of uniformity.

A fundamental and long-standing corporate law issue is whether, and the extent to which, a procrustean bed of unalterable rules should apply to business corporations, or whether shareholders should be able to select the bed of their own choosing when joining together in a business relationship in corporate form.[2] For example, one of corporate law's central mantras

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1. *See Procrustes*, THE ENCYLOPEDIA BRITANNICA, http://www.britannica.com/EBchecked/topic/477822/Procrustes.

2. Frank Easterbrook and Daniel Fischel have noted that the tension between the shareholder profit maximization norm and shareholder choice have "plagued" corporate law scholars for many years:

> [W]hat is the goal of the corporation? Is it profit, and for whom? Social welfare more broadly defined? . . . Our response to such questions is: who cares? If the New York Times is formed to publish a newspaper first and make a profit second, no one should be allowed to object. Those who came in at the beginning consented, and those who came later bought stock the price of which reflected the corporation's tempered commitment to a profit objective. If a corporation is started with a promise to pay half the profits to the employees rather than the equity investors, that too is simply a term of the contract.

See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 35–36 (1991). Easterbrook and Fischel respect freedom of contract and believe shareholders should be free to create corporations that respect their choices and values. Others express similar contractarian views. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 577–83 (2003) (arguing that the shareholder wealth maximization norm should be a default rule because parties would choose this rule in a hypothetical bargain, but leaving room for contracting away from the default rule); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1752 (2006) (observing that flexibility to engage in "private ordering" is a goal in Delaware corporate law); Jonathan R. Macey, *A Close Read of an Excellent*

reflects a norm that American business corporations have the purpose of creating financial benefit for their shareholders.[3] In *Dodge v. Ford Motor Co.*, the Michigan Supreme Court stated:

> A business corporation is organized and carried on primarily for the benefit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among shareholders in order to devote them to other purposes.[4]

In procrustean terms, this view of corporate essence would mean, first, that corporations do not have purposes and goals that do not involve shareholder profit-maximization and, second, that corporate agents, including directors, who pursue other purposes and goals, can be liable to the corporation and its shareholders for breach of their fiduciary duty and for waste of corporate assets. Although modern corporate law may be more nuanced than that expressed in 1919 by *Dodge*,[5] shareholder profit-

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Commentary on Dodge v. Ford, 3 VA. L. & BUS. REV. 177, 179 (2008) (arguing that shareholder profit maximization is only a default rule that shareholders can vary by agreement).

3. *See* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2073 (2001) (stating that norms "emphasize the value, appropriateness, and indeed the justice of maximizing shareholder wealth"); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 290 (1997) (arguing that the effect of the wealth maximization norm is overstated); *see also* Richard H. McAdams, *The Origin, Development and Regulation of Norms*, 96 MICH. L. REV. 338, 340 (1997) ("[Norms are] informal social regularities that individuals feel obligated to follow because of an internalized sense of duty, because of a fear of external non-legal sanctions, or both.").

4. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919). Of course, the question of what "primarily" means is left dangling. *See generally* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163 (2008) (arguing that *Dodge* promotes a constipated view of corporate purposes). Some promoters of benefit corporation legislation argue that *Dodge* is "good law" and state that "many still maintain" that *Dodge*'s wealth maximization principles have been widely accepted by courts over an extended period of time. *See* William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 825–26 (2012).

5. For example, under the business judgment rule, courts almost always defer to the directors' business judgment. If a course of action may lead to some potential shareholder benefit, board decisions generally survive judicial review. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("[The business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."). Corporations generally can claim that their socially or environmentally beneficial activities help them achieve short- or long-term financial goals. Issues arise on the fringes, where the social activities are so significantly extreme that they connect to no financial purpose or where there are *Revlon* duties to maximize the shareholders' immediate return when a break-up is inevitable or shareholders are selling controlling interests. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) ("A board may have regard for

maximization principles have been expressed in more recent cases and writings.[6] Thus, corporate directors arguably continue to have a fiduciary duty requiring that they be motivated by their desire to increase the corporation's value for the shareholders' benefit.

Even if the legal effect of the shareholder profit-maximization norm might be overstated, the widely-held perception that corporations exist to maximize shareholder profit can operate on a prophylactic level to discourage directors from considering non-shareholder interests when making significant corporate decisions. For example, Ben & Jerry's was once a poster child for social enterprise and social entrepreneurship, pursuing a "dual-mission"[7] by seeking to advance its founders' progressive social goals while yielding an acceptable financial return to its

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various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. However, such concern for non-stockholder interests is inappropriate when an auction among active bidders is in progress, and the object is no longer to protect or maintain the corporate enterprise, but to sell it to the highest bidder."); *see also* Unocal v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (a board considering a hostile takeover bid may consider the bid's effect on the corporate enterprise, including "constituencies other than shareholders," such as creditors, customers, employees, and perhaps even the community generally); Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. 1968) (stating that corporate directors could consider the effect of lights and night-time baseball games at Wrigley Field on surrounding property values, and "the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating"); Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1386 (2008) (noting theoretical uncertainty on fundamental questions of corporate governance, including questions concerning for whose benefit corporations are run and corporate law's relationship to the achievement of social good). *See generally* Melvin A. Eisenberg, *Corporate Conduct That Does Not Maximize Shareholder Gain: Legal Conduct, Ethical Conduct, The Penumbra Effect, Reciprocity, The Prisoner's Dilemma, Sheep's Clothing, Social Conduct, and Disclosure*, 28 STETSON L. REV. 1 (1998); Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533 (2006).

6. *See, e.g.*, eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34–35 (Del. Ch. 2010) ("Directors of a for-profit Delaware corporation cannot deploy a [corporate policy] . . . to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law. . . . Having chosen a for-profit corporation form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form [including] acting to promote the value of the corporation for the benefit of its stockholders."); Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders . . . ."). *See generally* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993); Leo E. Strine, *Our Continuing Struggle With the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135 (2012) [hereinafter Strine, *Our Continuing Struggle*]; David A. Wishnick, Comment, *Corporate Purposes in a Free Enterprise System: A Comment on* eBay v. Newmark, 121 YALE L.J. 2405 (2012).

7. Robert A. Katz & Anthony Page, *Is Social Enterprise the New Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1355, 1357 (2011).

shareholders.[8] In 2000, however, Ben & Jerry's was acquired by Unilever, an international conglomerate that may, over time, have a different focus from the Ben & Jerry's founders. Paradise lost, at least according to one storyline. Some have argued that corporate law compelled the Ben & Jerry's-Unilever transaction by presenting the Ben & Jerry's board with two options when Unilever made its takeover bid: accept the offer with its rich rewards to existing shareholders (including the founders), or attempt to thwart it by using anti-takeover measures and other protective devices with the potential for fiduciary breach claims by shareholders who were deprived of maximum financial benefit.[9] In Ben & Jerry's case, such anti-takeover devices had been put in place well before the Unilever bid, but the board chose not to deploy them due, perhaps, to personal sensitivity to liability risk.[10] Instead, the profit-maximization route was taken and Ben & Jerry's became something else.[11]

The "social enterprise" movement has reacted to this perceived procrustean bed of corporate profit-maximization in several ways.[12] First,

8. For a well-reasoned analysis of the Ben & Jerry's takeover that takes a more complex and nuanced approach, see generally Anthony Page & Robert Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211 (2010) (noting commentary, including from Ben Cohen and Jerry Greenfield, to the effect that corporate law required the board to take an offer that well exceeded the stock trading price despite the fact that they did not want to sell the company; noting that corporate law did not mandate the sale and therefore concluding that profit-maximization principles were a handy scapegoat; arguing that certain pro-social attributes of Ben & Jerry's continued unabated after its acquisition; and concluding that corporate law is sufficiently flexible to enable a double bottom-line approach and that social enterprises need to consider structures that make the founders' initial social benefit preferences more robust and less malleable over time). The Ben & Jerry's case may point out the danger of reliance on special founders, who can espouse negative social views, change their minds and seek profit, or "cash out" and admit minority shareholders who limit the founders' ability to maintain a personal vision after having taken other peoples' money. My observation on a recent failed attempt to pass benefit corporation legislation in the 2012 Colorado legislative session is that it was significantly motivated by one founder's attempt to incorporate her social motivations into her corporation, so that she could then sell shares to third parties and cash out of some or all her investment.

9. *Id.* at 228–29.

10. *Id.* at 234–42.

11. *Id.* at 242–48 (discussing post-acquisition changes to Ben & Jerry's).

12. *See* Robert Katz & Anthony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 86 (2010) [hereinafter Katz & Page, *Social Enterprise*] (defining "social enterprise" as an entity having profit-making goals while also embracing the duty to sometimes make decisions that will not maximize profit and sharing some of the social aims of a public benefit nonprofit corporation). *See generally* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337 (2009).

B Lab Corporation also operates a certification program through which qualifying entities, including corporations, limited liability companies, cooperatives, and others, can license a "B Corp" trademark in order to hold themselves out as a "B corporation" to investors and the public. This certification program and the "B Corp" mark are sometimes confused with the benefit corporation movement. They are very

some promoters have pushed the concept of low-profit limited liability companies ("L3Cs"), and several state legislatures have adopted this limited liability company deviation. Proponents of L3Cs have argued that they help solve fiduciary duty problems by establishing that social benefit goals prevail over, or at least are balanced against, profit-maximization objectives when managerial authority is exercised.[13] Allan Vestal and I, and others, have been critical of L3Cs, in part because we view existing limited liability company law as highly malleable and, therefore, L3Cs as irrelevant to fiduciary and other issues.[14] I will not repeat those arguments in this Article.

Second, others, led by B Lab Corporation ("Blabs"), have encouraged state legislatures to adopt so-called "benefit corporation" legislation in order to "redefine the purpose of business organizations."[15] It is argued that this redefinition is necessitated by existing obstacles to articulating and enforcing dual public good/private benefit concepts if corporations adopt traditional nonprofit or for-profit organizational forms.[16] Nonprofit corporations do not allow profit distributions to members and therefore cannot attract investment capital, while, as discussed above, for-profit corporations arguably are required to favor private benefit over public good. The promoters of benefit corporations state that distinctive features of such benefit corporations are: (1) in addition to for-profit objectives, they have a corporate purpose to create a material positive impact on

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different, as the "B Corp" license involves branding only, and "benefit corporation" involves changes to state corporation laws. At present, "B Corp" does not need to be a "benefit corporation," and a "benefit corporation" does not need to license the "B Corp" label. I have heard anecdotally that B Lab Corporation has stated it will not license its "B Corp" mark to Washington social purpose corporations and, if this is true, one is left wondering about the future of the mark.

13. *See, e.g.*, John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117 (2010); Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 105 (2010) [hereinafter Brakman Reiser, *Blended Enterprise*] (discussing the "two masters" problem).

14. *See* J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 286–88 (2010). *See generally* Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879 (2010) (criticizing the L3C form).

15. *See generally* Clark & Babson, *supra* note 4. As of December 20, 2012, twelve states have adopted benefit corporation legislation that adheres generally to the Blabs model discussed below. *State by State Legislative Status,* BENEFIT CORP. INFO. CTR., http://www.benefitcorp.net/state-by-state-legislative-status (last visited Dec. 20, 2012). In addition to benefit corporation legislation, California also adopted a flexible benefit corporation statute. Washington has adopted a social purposes corporation statute.

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

society and the environment; (2) their directors' duties are expanded to require consideration of public interests in addition to the shareholders' financial interests; and (3) they are required to report annually on overall social and environmental performance using an appropriate third-party standard.[17] Assuming that the shareholder profit-maximization principles create a procrustean bed that cannot be varied by private agreement, the proponents of benefit corporations can be thought of as attempting by statute to allow at least some American corporations to choose to arise from that bed and smell the free-trade coffee of social and environmental good, thereby pleasing consumers, employees, investors, and society.

In this Article, I make three overarching assumptions, each of which is highly contestable. First, I assume that American corporate law presently includes a shareholder profit-maximization principle to which all for-profit corporations must adhere and which allows insufficient deviation by shareholder agreement or otherwise. Second, I assume that corporate fiduciary duty law requires more-or-less uncompromising director and officer adherence to the profit-maximization principle in connection with their management of the corporation, both in establishing corporate policy and in corporate operations. In this regard, I also assume that there are settings in which the pursuit of public good is outside the parameters of the business judgment rule.[18] Third, I assume that shareholders should be allowed to choose a different regime in which social and environmental goals are given their due, and in which corporate directors and officers are required to consider public goods in addition to private, monetary good when exercising their discretion in managing corporate affairs. In short, I assume, without significant reflection or analytical development of the myriad issues behind these assumptions, that we have arrived at the starting point to consider entities like benefit corporations. These assumptions allow a pragmatic focus on how benefit corporations should work, and the remainder of this Article considers the structure of benefit corporations, primarily by considering Blabs' "Model Benefit Corporation Act" (the "Model").[19] It argues that the current model of benefit corporations as expressed by Blabs is itself too rigid and uncompromising, indeed that it fits all benefit corporations onto the Blabs promoters' own procrustean

17. Clark & Babson, *supra* note 4, at 818–19.

18. *See supra* note 5 and accompanying text.

19. J. William Callison, *Pragmatic Reform: Lessons from the South African Experiment*, 91 KY. L.J. 841, 843 (2002–2003) ("[B]usiness organization law should not be a matter of orthodox ideology imbedded in an unchanging set of principles, but instead, like a coral reef, should grow by accretion over time and should be hospitable to living things.").

bed.[20] It asserts that the Blabs Model will ultimately discourage corporations from becoming benefit corporations and will discourage outside investment in benefit corporations and consumer validation of the benefit corporation status. It concludes with an examination of alternative structures, including an alternative to the orthodox benefit corporation structure, that operate under the same fundamental assumptions as those that guide the benefit corporation movement, that help resolve the problems with Blabs' Model, and that would be more hospitable for American business corporations that seek to promote values beyond shareholder profit-maximization. In short, this Article attempts to create a comfortable bed that fits all, rather than a device that chops arms and legs to fit the bed to passers-by who seek respite.[21]

I. OVERVIEW OF BENEFIT CORPORATION LEGISLATION

The states that have enacted benefit corporation legislation have modestly different variations on the theme.[22] Rather than examine any particular state benefit corporation statute, this Article considers Blabs' Model, which at present is the foundation for all existing benefit corporation statutes.[23] Under the Model:

1. A "benefit corporation" is a business corporation, formed pursuant to the state's general business corporation law, which has elected to subject

20. My views and comments concerning benefit corporations have been influenced by an approximately two-and-a-half year discussion of the benefit corporation structure, which has played out twice in the Colorado legislature. At least to me, it has become apparent that the proponents of the Blabs structure seek orthodoxy to the model statute such that those who adhere to a rigid law can proclaim themselves as benefit corporations and capture whatever economic benefit can be derived therefrom. Others, principally lawyers who have labored over Colorado business entity statutes for many decades, seek a more open-ended approach whereby all corporations that seek to include socially and/or environmentally beneficial purposes, as defined by the shareholders, can obtain benefit corporation status without undue cost. Thus, the two positions share the end of allowing deviation from the wealth-maximization norm, but differ on the question of whether the statutory benefit should be exclusively held by a few or available to many. I also note that the supporters of benefit corporation legislation appear to be, like me, from the progressive political left. This leads me to wonder whether the same support would be there for a statute that could or would be used by others who do not share the same outlooks. In my view, benefit corporation legislation should be drafted so that it is conducive to all who seek social good, however they define it.

21. *See generally* Brakman Reiser, *Blended Enterprise*, *supra* note 13 (encouraging experimentation with hybrid forms); Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 U. COLO. L. REV. 947 (1995) (stating the authors' early argument that excessive, externally-imposed, uniformity can be inefficient and is costly since it halts statutory evolution).

22. *See* Brakman Reiser, *Benefit Corporations*, *supra* note 16 (discussing some of the variations).

23. MODEL BENEFIT CORP. LEGIS. (B Lab 2012), *available at* http://benefitcorp.net/storage/Model_Legislation.pdf.

itself to the benefit corporation provisions of the Model.[24] The corporation's articles of incorporation must state that it is a "benefit corporation," thereby placing potential investors, creditors, and others who inspect organizational documents on notice of the corporation's status.[25] There are no name requirements, either in the positive sense, where benefit corporations must designate themselves as such, or in the negative sense, where corporations that are not benefit corporations cannot use a name implying benefit corporation status.

2. If an existing corporation seeks to become a benefit corporation, or if an existing corporation seeks to merge into a benefit corporation, shareholders owning at least two-thirds of the interests must approve the election.[26] Similarly, a two-thirds shareholder vote is needed to terminate benefit corporation status.[27] Notably, the Model does not presently contain dissenters' rights or other provisions to protect the interests of non-controlling shareholders who invested in what they believed to be a profit-maximizing business.[28]

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24. *Id.* § 101(c) ("Except as otherwise provided . . . [the business corporation law] shall be generally applicable to all benefit corporations."); *id.* § 103 (noting a requirement for formation of benefit corporation); *id.* § 104 (requiring an election of benefit corporation status).

25. *Id.* § 103.

26. *Id.* § 104 (requiring "minimum status vote" to change the status of a corporation); *id.* § 102 (defining same as a two-thirds vote). Here, I note that Section 101(d) states that the articles of incorporation or bylaws may not relax, be inconsistent with, or supersede, any other benefit corporation provisions. Thus, if the legislature adopts a two-thirds vote requirement, unlike other shareholder vote items, the election cannot be reduced to, for example, majority vote or increased to, for example, unanimous vote. In addition, a "minimum status vote" requires the vote of two-thirds of the shareholders of every class or series, irrespective of their other voting powers.

27. *Id.* § 105(a). Further, Section 105(b) requires that "sales, leases . . . or other dispositions of all or substantially all" of the benefit corporation's assets that are not in the ordinary course of business "shall not be effective" unless approved by at least a two-thirds vote. This two-thirds vote requirement cannot be reduced by the corporation's articles of incorporation or bylaws. *Id.* § 101(d). In some situations, this requirement may create business-planning difficulties and these difficulties may be exacerbated by the fact that a two-thirds vote is required from the shareholders of each class or series of shares, irrespective of their participation in control of other corporate actions.

28. The benefit corporation proponents' position on the dissenters' rights issue is unclear. Although the California benefit corporation statute and the Blabs-sponsored Colorado bill included dissenters' rights provisions, Blabs generally has not promoted dissenters' rights because electing corporations may not have liquid capital to pay dissenters and because any payment would deprive the corporation of operating capital for its business and social good. *See* William H. Clark et al., *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form that Best Addresses the Needs of Social Entrepreneurs, Investors, and Ultimately, the Public*, 1, 26–27 (Jan. 26, 2012) (white paper), *available at* http://benefitcorp.net/storage/documents/The_Need_and_Rationale_for_Benefit_Corporations_April_2012.pdf. Notwithstanding these liquidity issues, state legislatures should include, and some have included, dissenter's rights provisions in their benefit corporation legislation. Alternatively, the election of benefit corporation status should require unanimous shareholder consent. However, this may

3. A benefit corporation *must have* the purpose of "creating [a] general public benefit."[29] In addition to, but not instead of, a general public benefit, the articles of incorporation may identify specific public benefits "that it is the purpose of the benefit corporation to create."[30] "Identification of a specific public benefit . . . does not limit the obligation of a benefit corporation [to create a general public benefit]."[31] Thus, general public purpose is superior, and specificity is a subcategory of the general and is thereby rendered somewhat superfluous.

4. "General public benefit," to be pursued by all benefit corporations, is defined *very broadly* as "a material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation."[32] There is no clarification about the hierarchy of benefit purposes served by the corporation. The Model's comments state, "[b]y requiring that the impact of a business on society and the environment be looked at 'as a whole,' the concept of general public benefit requires consideration of all the effects of the business on society and the environment."

A "third-party standard" is a "recognized standard for defining, reporting and assessing corporate social and environmental performance."[33] A third-party standard is also credible, transparent, and developed by an independent organization.[34] The Model spills much ink attempting to define each of these characteristics, but it does not prescribe any content for the standards, and it fails to state how standards are applied or by whom. Neither the government nor the standard-setter is given any enforcement powers. Thus, it is conceivable that some third-party standard-setters will establish very low, but transparent, standards for benefit corporations and the whole concept of public good will go down the greenwash drain. There is also no indication in the Model concerning fees that can be charged by

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make adoption of benefit corporation status impossible in many situations, and adoption of dissenters' rights provisions seems more palatable. At a minimum, the lack of dissenters' rights demonstrates that the Model is either badly drafted or unduly authoritarian in nature.

29. MODEL BENEFIT CORP. LEGIS. § 201(a). The use of the word "creating" seems odd and may exclude non-creative aspects such as "sustaining."

30. *Id.* § 201(b).

31. *Id.*

32. *Id.* § 102.

33. *Id.* Note that the Model does not refer only to business operations, but requires the consideration of existential questions like the nature of the corporation's business itself. Some corporations will likely shy away from benefit corporation status due to an ongoing need to consider whether, for example, making salad dressing or running a ski resort or brewing beer or manufacturing high-fat ice cream has a material positive impact on society and the environment, taken as a whole.

34. *Id.*

standard-setters for making their presumably useful and possibly valuable standards available.

5. The creation of general public benefit and any specific public benefit "is in the best interests of the benefit corporation."[35]

> [Directors] *shall* (i.e., must), in discharging their duties and in considering the corporation's best interests, consider the effects of any action or inaction on (i) shareholders; (ii) the employees and workforce of the benefit corporation, its subsidiaries and its suppliers; (iii) the interests of customers as beneficiaries of the general public benefit; (iv) community and societal factors (including those of all communities in which the corporation, its subsidiaries and its suppliers have offices or facilities); (v) the local and global environment; (vi) the corporation's short-term and long-term interests, including benefits that may accrue from long-term plans and the possibility that those interests may be best served by the corporation's continued independence;[36] and (vii) the corporation's ability to accomplish its general public benefit purpose and any specific public benefit purpose . . . .[37]

There is no hierarchy to or prioritization of the interests that directors must consider.[38] In addition, under the Model, directors *may* consider "other pertinent factors or the interests of any other group that they deem appropriate."[39] Further, the Model provides that directors are not personally liable for monetary damages for any action taken as a director or the failure of the benefit corporation to create public benefit,[40] and that directors are not liable to beneficiaries of the corporation's general public benefit purpose or specific public benefit purpose arising from the person's

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35. *Id.* § 201(c).

36. The breadth of this factor likely allows many forms of anti-takeover provisions based on the directors' perception of the corporation's long-term interests. It thereby may gut the shareholder protections contained in much recent corporate case law.

37. MODEL BENEFIT CORP. LEGIS. § 301(a)(1) (emphasis and commentary added).

38. *Id.* § 301(a)(3) ("[Directors] need not give priority to the interests of a particular person or group . . . over the interests of any other person or group, unless the benefit corporation has stated in its articles its intention to give priority to certain interests related to its accomplishment of its general public benefit purpose or of [any] specific public benefit purpose."). It appears that a benefit corporation cannot indicate a priority for shareholder interests.

39. *Id.* § 301(a)(2).

40. *Id.* § 301(c). Bill Clark and Elizabeth Babson state that the elimination of director monetary liability was "driven by twin desires to (1) eliminate such concern in the face of a lack of court precedent by which such liability could be quantified and (2) to focus courts on the exclusive remedy of awarding injunctive relief wherein the benefit corporation would be required to simply live up to the commitments it voluntarily undertook." Clark & Babson, *supra* note 4, at 848–49. Enforcement problems are discussed later in this Article.

status as a beneficiary.[41]

The standards of conduct set forth for directors establish, and are intended to establish, director fiduciary duties. They affect the essential nature of a benefit corporation in two ways. First, directors who consider the enumerated factors are insulated from shareholder claims that they breached their fiduciary duties by not acting to maximize shareholder benefit. Second, they establish positive rules for director action. The first aspect is contained in the Model's provision that the consideration of the enumerated interests and factors does not constitute a violation of fiduciary standards[42] and that directors are not monetarily liable for damages. The second aspect is emphasized through the Model's creation of "benefit enforcement proceedings" against directors and officers who do not march to the benefit corporation tune.[43]

6. "Benefit enforcement proceedings" may be brought directly by the benefit corporation or derivatively by (a) a shareholder or shareholders that own at least 2% of the shares on the date the proceeding commences, (b) a director, (c) a person or group owning 5% or more of equity interests in a benefit corporation's parent corporation (subsidiaries/parent corporations are defined using a 50% ownership standard), or (d) other persons specified in the corporation's articles of incorporation or bylaws.[44] Unless otherwise provided in articles or bylaws, benefit corporation directors do not have duties to mere beneficiaries of the public purpose who are not listed above.[45] Thus, for example, customers, employees of suppliers, and representatives of impacted communities or the environment cannot sue.[46]

A "benefit enforcement proceeding" is a claim or action for failure of a benefit corporation to *pursue or create* general public benefit (or a specific public benefit set forth in its articles), or for violation of any statutory obligation, duty, or standard.[47] Thus, it is the clear intent of the Model to

41. MODEL BENEFIT CORP. LEGIS. § 301(d).

42. *Id.* § 301(b)(1) (consideration of general and specific public benefit interests does not constitute a violation of corporation laws concerning director fiduciary duties).

43. *Id.* § 305(a)(1).

44. *Id.* § 305(b).

45. *Id.* § 301(d).

46. This clearly tilts the playing field in favor of the set of interests represented by those who own (by issuance or acquisition) corporate stock and away from those representing other interests. *See* discussion of enforcement issues, *infra.*

47. *Id.* § 305(b). The proceeding is direct when brought by the corporation and derivative when brought by directors or shareholders. Presumably all procedural aspects of derivative litigation, including a demand for corporate action and the potential for a special litigation committee to consider whether pursuing the litigation is in the corporation's best interests, will be applicable. In my view, the derivative litigation issues will likely be complex, and thereby weaken the benefit corporation concept.

enable fiduciary duty litigation not only against directors who fail to meet their obligation to consider the effects of their action in the statutorily-listed ways, but also against directors whose actions fail to create general public benefit. Other than in a benefit enforcement proceeding, no person can assert a claim against the benefit corporation and its directors for failure to pursue or create benefit or for a violation of a standard of conduct under the Model.[48]

7. The board of directors of a benefit corporation that is publicly traded must include an independent "benefit director," and the board of other corporations may include a benefit director.[49] The benefit director must prepare an annual opinion concerning (a) whether the benefit corporation acted, in all material respects, in accordance with its general public benefit purpose and any specific public benefit purpose; (b) whether directors and officers complied with their obligations to consider the best interests listed in the Model; and (c) a description of any ways in which the corporation or its directors or officers failed to comply.[50]

8. Benefit corporations must prepare an "annual benefit report" meeting numerous requirements, including a narrative description of the ways the benefit corporation pursued general public benefit during the year and the extent to which it was created, circumstances hindering the creation of public benefit, and the process and rationale for choosing or changing the third-party standard used.[51] The narrative must also include an assessment of the corporation's overall social and environmental performance against a third-party standard, the name and address of any benefit director, the compensation paid to each director, the name of each five percent shareholder (including known beneficial shareholders), any benefit director's opinion, and a statement of certain relationships with the third-party standard provider.[52] The Model does not state how the benefit report should assess corporate performance, and one might expect some benefit corporations to provide very general, even minimalist, reports. The report (along with any benefit director opinion) must be provided to each shareholder, posted on the "public portion" of its Internet website (or made available to any person requesting it), and filed with the state's secretary of state or other filing official.[53]

48. *Id.* § 305(a).

49. *Id.* § 302(a). "Independent" is defined in Section 102.

50. *Id.* § 302(c).

51. *Id.* § 401(a)(1).

52. *Id.* § 401(a)(2)–(7).

53. *Id.* § 401(c)–(e). Director compensation and proprietary information can be eliminated from public reports. One wonders whether almost all information will be proprietary information. In Colorado, the Secretary of State balked at the public filing

9. Various similar rules apply to officers.

It should be clear from the foregoing that benefit corporation status involves a large and complex superstructure that cannot be diminished by agreement among the shareholders or otherwise. Assuming that there are benefits to benefit corporation status, they come with large structural and other costs.

II. PROBLEMS AND DANGERS OF BENEFIT CORPORATION STATUS

In this Section, I identify and discuss several large issues with the current, orthodox benefit corporation Model. I refer to these as the "Illiberalism Problem," the "Bipolarity Problem," the "Fiduciary Uncabining Problem," and the "Greenwash/Greenmail Enforcement Problem." It should be noted that these criticisms focus solely on the orthodox Blabs Model legislation and therefore on state benefit corporation statutes derived from the Blabs Model. As noted throughout this Article, I generally support the concept of allowing corporate shareholders to elect deviation from the profit-maximization norm, and I generally support a modified, flexible, elegant, and convergent benefit corporation statute to enable corporations to do so.[54] In essence, the remainder of this Article represents one perspective on an intellectual debate about how benefit corporation legislation should work, not whether benefit corporations should exist in some form.

A. The Illiberalism Problem of General Public Benefit

Benefit corporations, as exemplified by the Model, deprive benefit corporations of choice, and instead attempt to fit all electing corporations to broad, state-authorized conceptions of the "good" as measured against a third-party standard. Thus, benefit corporations are illiberal and conformity-inducing.

Although there are many variations of liberal political theory, liberalism's common theme is the paramount value of autonomy and freedom. Liberal theorists agree that a central goal of political society is to establish conditions for individuals, each of whom has a free and independent will that should not be dominated by others, to flourish. Therefore, liberalism historically has focused on rights and choice.[55]

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requirement, and it was eliminated from the proposed legislation.

54. *See infra* Section III.B of this Article.

55. *See, e.g.*, THOMAS HOBBES, LEVIATHAN, ch. 21 (G.A.J. Rogers & Karl Schuhmann ed., Thoemmes Continuum 2003) ("Liberty, or [f]reedom [is] . . . the absence of opposition (by [o]pposition I mean external [i]mpediments of motion)."). Hobbes recognized both the existence of individual autonomy and the fact that equally autonomous individuals are vulnerable to interference by other persons' pursuit of their

The concepts of "positive" and "negative" liberty form the mainstay of contemporary liberal political theory. Although the distinction is ancient[56] and recurring,[57] it received more modern treatment by Isaiah Berlin.[58] Berlin stated that positive liberty "derives from the wish on the part of the individual to be his own master," to exercise one's capacities to achieve one's own ends.[59] Negative liberty, on the other hand, is measured by "the area within which the subject—a person or group of persons—is or should be left to do or be what he is able to do or be, without interference by other persons."[60]

In liberalism's positive aspect, people exercise their free wills to advance their individual goals. Positive liberty is the freedom to be, and to do, anything the actor might wish to be or do.[61] In a liberal state, law's role is to facilitate individual choices and to ensure that each person, and group of persons, has as much freedom as possible to pursue goals of his or her own choosing, rather than to dictate how people should exercise choice or whether they succeed or fail upon exercising choice. Liberalism can thus be viewed to include the avoidance of unnecessary procrustean laws.

This positive liberty is limited by others' freedom to pursue their own goals, and liberal theory recognizes a need to protect individual boundaries so that each person's enjoyment of freedom does not unduly restrict others' abilities to exercise their freedom. In this sense, liberalism has a "negative aspect" in that it involves restrictions protecting people from external

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own ends. His solution to the "war of all against all" was based on individual autonomy and contract; people choose to surrender some of their autonomy to the state in order to maintain their ability to establish and pursue individual goals while restricting others from interfering with those pursuits.

56. *See* ARISTOTLE, POLITICS, *reprinted in* BASIC WORKS OF ARISTOTLE 1127, 1265–66 (Richard McKeon ed., 1941).

57. *See* BENJAMIN CONSTANT, THE LIBERTY OF THE ANCIENTS COMPARED WITH THAT OF THE MODERNS (1819), *reprinted in* LEADING AND LEADERSHIP 110 (Timothy Fuller ed., 2000).

58. *See* ISAIAH BERLIN, TWO CONCEPTS OF LIBERTY (1958), *reprinted in* FOUR ESSAYS ON LIBERTY 118 (1969).

59. *Id.* at 131 ("The 'positive' sense of the word 'liberty' derives from the wish on the part of the individual to be his own master. I wish my life and decisions to depend on myself, not on external forces of whatever kind. I wish to be the instrument of my own, not of other men's, acts of will.").

60. *Id.* at 121–22 ("Political liberty in this sense is simply the area within which a man can act unobstructed by others. If I am prevented by others from doing what I could otherwise do, I am to that degree unfree; and if this area is contracted by other men beyond a certain minimum, I can be described as being coerced, or, it may be, enslaved.").

61. Berlin also notes risks of positive liberty; including that "the real self may be conceived of as something wider than the individual, as a social 'whole' of which the individual is an element or aspect . . . . [An] entity [that] is then identified as being the 'true' self which, by imposing its collective, or 'organic' single will upon its recalcitrant 'members,' achieves its own, and therefore their, 'higher' freedom." *Id.*

coercion or restraint.[62] The negative aspect considers freedom to include the absence of, or limitations on, governmental regulation. There are several strands to negative liberal theories based on where the theory is located on a continuum defining the frontier between private life and public authority, and thus the permissible scope of governmental power. First, at one extreme, there are those who believe that government's sole role is to protect personal and property rights.[63] Second, there are those who argue that government should not only protect personal and property rights, but that it should also remedy collective action problems left unresolved by the free market, but no more.[64] Third, there are those who argue that government should be restrained from limiting individual actions that do not harm others, but that governmental action is appropriate when individual actions cause harm to others.[65] Finally, there are those who allow a broader conception of the state's police power, including the power to enact legislation relating to the general public welfare.[66]

Some have referred to liberalism's "voluntarist conception of freedom" as having a core thesis and three corresponding elements.[67] The core thesis is that "society, being composed of a plurality of persons having their own aims, interests and conceptions of the good, is best arranged when it is governed by principles that do not themselves presuppose any particular conception of the good."[68] The corresponding elements are: first, state power to coerce individuals should be limited to those situations where collective action to implement collective norms can be justified, otherwise individuals should be free to pursue their private objectives; second, the scope of the market and other contract-based institutions should be correspondingly maximized; and, third, the state should maintain neutrality as among different conceptions of the good out of respect to individuals'

62. *See id.* at 122.

63. *See* ROBERT NOZICK, ANARCHY, STATE AND UTOPIA 26 (1974) [hereinafter NOZICK, ANARCHY, STATE AND UTOPIA] ("[T]he appropriate role of the state is limited to the functions of protecting all its citizens against violence, theft, and fraud, and to the enforcement of contracts."). Nozick later characterized this position as "seriously inadequate." ROBERT NOZICK, THE EXAMINED LIFE 286–87 (1989).

64. *See* RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 367–86 (4th ed. 1992); *see also* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 25 (1962).

65. *See* JOHN STUART MILL, ON LIBERTY 28 (Gertrude Himmelfarb ed., Penguin Books 1859) ("The sole end for which mankind are warranted, individually or collectively, in interfering with the liberty of any of their number, is self-protection. That the only purpose for which power can be rightfully exercised over any member of a civilized community, against his will, is to prevent harm to others. His own good, either physical or moral, is not a sufficient warrant.").

66. *See generally* JOHN RAWLS, A THEORY OF JUSTICE 1 (Rev. ed. 1999).

67. *See generally* MICHAEL J. SANDEL, LIBERALISM AND THE LIMITS OF JUSTICE 1 (2d. ed. 1998).

68. *Id.* (emphasis omitted).

freedom and autonomy to choose their own ends.[69]

The "communitarian" critique of liberalism begins with this notion of voluntarism, and focuses on the philosophical difficulty inherent in the liberal conception of persons as "freely choosing, independent selves, unencumbered by moral or civic ties" existing prior to their choice.[70] In the communitarian view, "the liberal vision cannot account for a wide range of commonly recognized moral and political obligations," and liberalism's failure rests with its inability to recognize that we can "be claimed by ends we have not chosen," such as those given by our identities as members of families, cultures, traditions, and society. Communitarian theorists note that when the political world brackets morality too completely, it generates disenchantment.[71] The resulting yearning for a public life of larger meaning ultimately finds expression in some form, much of it negative and undesirable.[72] Similarly, communitarian analysis notes that the triumph of the voluntarist conception of freedom has coincided with a growing sense of disempowerment, in which the freely choosing, independent self confronts a "world governed by impersonal power structures that defy individual understanding and control."[73]

Benefit corporations can be seen as a communitarian reaction to what some perceive to be an illiberal corporation law structure that is perceived to create little or no meaning beyond financial enhancement of individual shareholders, who then participate, if at all, in social life as individuals. Thus, the benefit corporation movement can be viewed as having both liberal and communitarian aspects. The liberal aspect emphasizes choice—corporate shareholders should be allowed to exercise their own free will to choose ends to be sought by the corporation. The communitarian aspect considers corporations, which harbor enormous power and in which much of the nation's economic life takes place, to remain insufficiently encumbered by non-wealth maximizing societal, moral, and environmental obligations.[74] By electing benefit corporation status, shareholders allow their corporations to become responsible to a "general public purpose," an idea mildly redolent of "general will" concepts in Rousseau's social contract.[75] In a sense, since benefit corporation legislation implies an

69. *See* NOZICK, ANARCHY, STATE AND UTOPIA, *supra* note 63, at 30–33.

70. MICHAEL SANDEL, DEMOCRACY'S DISCONTENT: AMERICA IN SEARCH OF A PUBLIC PHILOSOPHY 322 (1996).

71. *Id.*

72. *Id.*

73. *Id.* at 323.

74. This all begs questions concerning the nature of corporations, beginning with aggregate-entity questions. *See* David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201 (1990). This Article does not discuss this critical question.

75. *See* JEAN JACQUES ROUSSEAU, THE SOCIAL CONTRACT, OR PRINCIPLES OF

aggregate conception of corporations in which shareholders select the nature of the entity, the shareholders also become personally responsible to a general purpose.[76]

Whether or not one accepts the notion that a corporation is a "person," some corporations are personal and associational in nature; that is, they are formed and owned by a single individual or by people who have decided to act in concert to undertake a trade or business.[77] It is likely that most "associational corporations" are closely-held, and it is likely that corporations that embrace conceptions of public benefit beyond shareholder profit-maximization will come largely from this group of "associational corporations." It seems relatively unlikely that larger corporations, in which shareholders do not share familial or personal connection, will comprise a large proportion of the corporations seeking to enable values other than shareholder profit-maximization. This is due in part to an inability to have widely dispersed and heterogeneous shareholders reach agreements on the pursuit of public good and in part to various other costs of benefit corporation status. However, allowing limited, special public values to be adopted might also permit shareholders

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POLITICAL RIGHT (G. D. H. Cole, trans. 1782) (1762), *available at* http://www.constitution.org/jjr/socon.htm. Rousseau argued that each individual may have a particular will which is different from the people's general will. The individual's particular will, moreover, may be forced to submit to the general will because of the obligations that have been defined for all individuals by the terms of the social contract. The general will is not some combination of individual wills, but is concerned with the public interest rather than private interests. Rousseau also argued that the general will may not always be able to choose correctly between what is advantageous or disadvantageous for the public interest because it may be influenced by groups of individuals who are concerned with promoting their private interests. Thus, the general will may need to be guided by the judgment of a person who is concerned only with the public interest. This "legislateur" (law-giver) is a person whose enlightened judgment can determine the justice principles and common good requirements that are best suited to society.

At a superficial level, benefit corporation legislation seems Rousseauvian. However, a significant distinction that prevents implication of Rousseau's social contract theory in the benefit corporation arena is that Rousseau's concept of the general will applies to all persons in society, and not just to those who exercise their particular will and elect in.

76. The social enterprise movement also allows for a feeling of community with like-feeling believers and provides a sense not only of doing the right thing, but also moving in the direction of history. This explains the feeling of sadness and betrayal expressed by L3C supporters when the Colorado legislature voted against L3C legislation and the "true believer" approach of some benefit corporation supporters. The individual is placed at the center of not only a historical project, but a collective process. *See* Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1314–18 (2011) (discussing identity theory of nonprofit organizations and noting linkage to social enterprise); *see also* TONY JUDT, THINKING THE TWENTIETH CENTURY 97–98 (2012) (describing the story of the Soviet Union for those who had faith in it).

77. For example, partnerships are defined as associations of one or more persons to carry on as co-owners of a business for profit. UNIF. P'SHIP ACT § 101(6) (1997).

in more widely held corporations to agree to sacrifice some profit for some public benefit.

Focusing on closely-held corporations, as noted above, the existing benefit corporation conception is insufficiently liberal. It starts down the right path by facilitating choice and allowing people who associate together in business corporation form to agree to pursue a good other than profit-maximization. In this sense, benefit corporations are creatures of positive liberty and allow an escape from one procrustean bed. However, the cost of such escape is being strapped into yet another procrustean bed. Rather than allowing shareholders the autonomy and freedom to pursue their own, self-defined ends and their own conception of the good, the Model forces all electing corporations to adhere to broad communitarian conceptions of "good" assessed against an independent organization's third-party standard which has been legislatively endorsed.[78] Thus, the positive liberty of the election is stunted, and the negative liberty of avoiding external constraints is not obtained. In my opinion, there are insufficient reasons for applying external constraints, particularly since the state is not providing any particular benefit to corporations that elect benefit corporation status.[79] If shareholders desire that the corporation they own benefit a particular low-income community or a particular river watershed, they may do so only by also adhering to a broader general public benefit purpose of having a "material positive impact on society and the environment, taken as a whole."[80] Not only must low-income jobs be created or a sustainable watershed maintained, but beneficial employee health benefits, effects of corporate actions and inactions on the communities in which suppliers reside, and effects of actions and inactions on global warming (or perhaps even the benefits of global warming if all views are taken into account) must be considered. A "general public purpose" and third-party standards

78. In addition, the violation of negative liberty conceptions is increased by forum electing benefit corporations who incur the cost of benefit directors, annual benefit reports, and other constraints that have little to do with the public benefit choice.

79. Berlin notes that drawing the line between private life and public authority is a "matter of argument, indeed of haggling." BERLIN, *supra* note 58, at 124. My argument is that when government does not provide benefit to the business entity, such as limited liability, but only facilitates owner choice, government should not impose limitations on choice or costs for choice. *See* J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. CORP. L. 951, 980–81 (2001) (noting that legislative extension of limited liability protection could have come with related costs); Allan W. Vestal & Thomas E. Rutledge, *Disappointing Diogenes: The LLC Debate That Never Was*, 51 ST. LOUIS U. L.J. 53 (2006) (discussing legislative adoption of limited liability protection without discussion of costs and trade-offs). Benefit corporation status changes the private character of the electing corporation and affects the directors' actions with respect to the corporation, and there is no role for government to limit the shareholders' ability to choose or to impose costs on the choice.

80. MODEL BENEFIT CORP. LEGIS. § 102.

become the uncontrolled, impersonal moral force that is balanced against the uncontrolled, impersonal power structure of the contemporary corporation.[81]

Further, by mandating assessment of public good against a recognized third-party standard, certain points of view may be excluded. For example, if the shareholders wish for their corporation to act in a manner consistent with tenets of Trotskyism, certain Austrian economists, Herbert Spencer's "Social Statistics," or any number of belief structures, whether on the left or on the right, it may be difficult for them to find an enabling "third-party standard" promulgated by some credible independent organization under whose umbrella public good is to be measured. One man's global warming is another's agricultural crop enhancement—who is to say where "public benefit" definitively lies? Since liberalism is inherently nonpartisan, and equally maintains that everyone benefits from everyone's freedom and that society has no way to evaluate opinions other than by letting everyone freely express them and try them out, any third-party imposed limitations on "public good" are undesirable.[82]

B. The Bipolarity Problem and Negative Inferences

The illiberalism problem that prevents shareholders from choosing their own corporate ends is compounded by the legislative inference that

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81. A prominent supporter of benefit corporations makes this attribute clear:

> One of the main purposes of benefit corporation legislation is to create a voluntary new corporate form that has the corporate purpose to create benefits for society and the environment generally, as well as for the shareholders. The entrepreneurs, investors, consumers, and policymakers interested in new corporate form legislation are not interested in, for example, reducing waste while increasing carbon emissions, or reducing both while remaining indifferent to the creation of economic opportunity for low-income individuals or underserved communities. They are interested in creating a new corporate form that gives entrepreneurs and investors the flexibility and protection to pursue all of these or other public benefit purposes. The best way to give them what they need is to create a corporate form with a general public benefit purpose. A company may also designate a specific public benefit, in addition to its general public benefit purpose. This ensures that a benefit corporation can pursue any specific mission, but that the company as a whole is also working toward general public benefit.

Clark & Babson, *supra* note 4, at 841. One might note the use of "they"—benefit corporations are not designed for use by corporations that might actually find the form useful to their business, but rather for some "they" who happens to be interested in a particular corporate ethos.

82. *See* FRIEDRICH HAYEK, THE CONSTITUTION OF LIBERTY 30 (1960) ("[A]ll institutions of freedom are adaptations to this fundamental fact of ignorance, adapted to deal with chances and probabilities, not certainty. Certainty we cannot achieve in human affairs . . . .").

corporations that are not benefit corporations can act only in ways that maximize shareholder profit.[83] This bipolarity problem has two aspects—the broad and the narrow. Viewed from a broad corporate governance perspective, the benefit corporation's primary rationale is based on the premise that existing law prevents corporate directors from considering the social and environmental impact of corporate decisions.[84] One might argue that this view perpetuates the misconception that current corporate law requires directors to focus solely on immediate profit and share price maximization, and thereby undermines the promotion of socially responsible decision-making by corporate boards. However, even under the restraints of current corporate law, for most corporate decisions there are no legal restrictions on the directors' ability to take non-shareholder interests into account, and there is little or no case law where directors have been held liable for considering such interests. Therefore, the benefit corporation movement arguably harms the broader interests of 21st century corporate governance by creating a bipolar world of regular corporations that maximize private profits and other corporations that consider social and environmental sustainability and other public goods.[85] Benefit corporation legislation, particularly in the Model form proposed by Blabs, overstates the limitations of existing law on corporate decision-making and might have unintended consequences in future judicial decisions that consider the scope of directors' fiduciary duties. This problem could be exacerbated by intemperate language, such as that contained in the New York State Senate memorandum introducing benefit corporations: "[The bill] removes legal impediments preventing businesses and investors from making their own decisions to use sustainability and social innovation as a competitive advantage."[86] Loose lips sink ships, and one might be excused for thinking that the business judgment rule eliminates this issue, at least when "competitive advantage" is involved.

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83. Although the MODEL BENEFIT CORP. LEGIS. § 101(b) provides that "[t]he existence of a provision of this [statute] shall not of itself create an implication that a contrary or different rule of law is applicable to a business corporation that is not a benefit corporation," this does not change the existential question of whether a legislature's adoption of a benefit corporation statute entails recognition of the profit maximization norm as a starting place for all corporations.

84. *See* Clark and Babson, *supra* note 4, at 825–38.

85. Mark A. Underberg, *Benefit Corporations vs. "Regular" Corporations: A Harmful Dichotomy*, HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (May 13, 2012, 8:31 AM), http://blogs.law.harvard.edu/corpgov/2012/05/13/benefit-corporations-vs-regular-corporations-a-harmful-dichotomy/.

86. S. MEMORANDUM, S79A-2011 (N.Y. 2011), *available at* http://open.nysenate.gov/legislation/bill/S79A-2011; *Promote Corporate Responsibility Through Benefit Corporation Statutes*, AM. SUSTAINABLE BUS. COUNCIL, http://asbcouncil.org/campaigns/promote-corporate-responsibility-through-benefit-corporation-statutes (last visited Nov. 21, 2012).

Notwithstanding the broad argument, which indicates a need to limit some of the rhetoric of the benefit corporation movement, benefit corporation status does allow directors to consider public goods that are completely unrelated to corporate business purposes and are essentially personal to the corporation's shareholders, thereby moving them beyond the business judgment rule's protections. In my view, this is where benefit corporations may add value. However, under the orthodox Blabs Model, this is available only for corporations that elect to pursue "general public benefit," and not corporations that, while pursuing public benefit, want a more limited scope of public benefit. To the extent that benefit corporation legislation implies that directors cannot implement shareholders' narrower public benefit goals, or that they have liability if they do so, the orthodox Model is harmful.

For example, assume that all shareholders of "Peachblossom Orchard," a close corporation that manufactures and sells clothing items from Delta, Colorado, recognize the connection of their corporation and themselves to the Delta community, and they desire that their corporation shall invest in and otherwise diminish private profit by providing benefit to the community. Assume that the shareholders do not wish to subscribe to more general standards of "material positive impact" on society and environment, do not wish to assess their corporation against a third-party standard, see no need in their closely-held corporation for benefit directors, do not want the risk of benefit enforcement proceedings, and do not want the expense and privacy loss of annual benefit reporting—they only seek to invest in their community. Thus, Peachblossom Orchard should not become a "benefit corporation," at least as defined in the orthodox Model. Assume that the directors substantially reduce potential profit from their very successful clothing business by creating benefit to the Delta community, just as the shareholders want. A shareholder dies and her son inherits the stock. The son notes the "waste" of corporate assets on non-pecuniary, community-enhancing activities, demands that the waste stop, and sues the directors for breach of their fiduciary duty to act in the corporation's best interests. The directors refer to the shareholders' wishes for Delta, Colorado.

A likely response would be that the legislature enacted benefit corporation legislation as a response to the shareholder wealth-maximization principle, that providing mandatory general and precatory specific public benefit is in the "best interests" only of electing benefit corporations, and that directors of benefit corporations alone may consider the effects of their actions on public good. However, it is likely that Peachblossom Orchard would not be considered a benefit corporation, and therefore its directors cannot consider public good in making their

decisions, rendering corporate expenditures on the community excessive and beyond those that can be made under the penumbra of the business judgment rule. Thus, potential liability (and certainly risk and settlement fodder) for corporate waste and a breach of fiduciary duty follows, as well as a likely forward-looking director's focus on profit and not on Delta. If one accepts the premise that shareholders should be allowed to choose corporate ends beyond profit maximization, this is an unfortunate result. Benefit corporations should be enabling, not disabling. They should not be used to draw lines between corporations that pursue good whose directors are protected and corporations who pursue good whose directors are unprotected. Further, they should not be used in a way that implies director liability for public good-seeking corporations that do not wish to toe an undesirable and expensive orthodox Blabs line.

C. The Fiduciary Uncabining Problem and the Loss of Fiduciary Restraints

Two leading approaches to fiduciary duty have emerged—contractarian and fiduciarian—and benefit corporations satisfy neither.[87] In each case, there is recognition that the internal structures of business entities create relationships of power and dependency, and that the law has attempted to provide a principled set of rules to ensure that those with power are accountable to those that depend on its appropriate exercise. The question becomes the foundation of (and limitations on) the power and dependency relationship.

Contractarians argue that fiduciary duties should be confined to relationships involving the contractual delegation of broad and open-ended power over one's property.[88] Thus, the existence of fiduciary duties (specifically, duties of care and loyalty) depends on the structure of the parties' relationship, as expressed by their actual or implied contract. Contractarians further argue that fiduciary duties are a response to the impossibility of writing contracts that completely specify the parties' obligations.[89] Thus, contractarians conclude that the "fiduciary" relationship is a contract gap-filler, characterized by high costs of specification and monitoring, in which the courts prescribe the actions that the parties, presumed to be rational and benefit-maximizing persons, would

87. *See* J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice*, 1 J. BUS. & TECH. L. 431, 444–49 (2007).

88. *See* Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 427 (1993).

89. *Id.*

have preferred if bargaining were cheap and promises fully enforced.[90]

Fiduciarian legal scholars consider fiduciary duties through a different, morally-based lens, and begin by contemplating thick state-imposed restrictions that substantially hamper the freedom to act of a person whose performance involves the risk of injury to others.[91] Fiduciarians accept that values other than wealth-maximization, including trust values, are served by the visions of human relationships underlying fiduciary concepts and that the fiduciary relationship serves functions not addressed by mere contract.

From either perspective, orthodox Blabs benefit corporations permit directors and officers to take an enormous number of interests and factors into account, many of which are unspecified by the shareholders who adopt the benefit corporation posture. General public benefit is a mish-mash and directors, all of whom have personal interests and some of whom may have personal agendas, are simply tossed into the middle of the mess. For example, if directors conclude that electric car promotion is a social good, Teslas can be acquired for all corporate executives. If directors think that polar bear preservation is good, the corporation can spend large fortunes to maintain ice in Greenland. From the contractarian perspective, further specification of fiduciary duties by contract is not contemplated and the gap-fillers are not sufficiently robust. From the fiduciarian perspective, there are fundamentally no restrictions that hamper the freedom of directors whose actions involve the risk of injury to others. Benefit corporations open the door for irresponsible directors to justify their actions (including self-interested actions) by pointing to some public benefit justification (or alternatively when public benefit is involved, to some private shareholder benefit justification). Managerial accountability has proven difficult in for-profit enterprises,[92] and it is difficult to conceptualize accountability in a hybrid entity with both broad general public purposes and narrow private purposes.[93]

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90. *Id.*

91. *See* Melvin A. Eisenberg, *The Duty of Care of Corporate Officers and Directors*, 51 U. PITT. L. REV. 945, 945–48 (1990); Victor A. Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 597–98 (1997).

92. It is likely that the shareholder wealth maximization norm has become more salient because it provides clearer corporate objectives than other alternatives, giving guidance to directors and allowing sharper judicial focus on directorial actions. *See* Leo E. Strine, Jr., *The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. CAL. L. REV. 1169, 1173 n.11 (2002) (arguing that by permitting directors to justify their actions by reference to more "diffuse" concerns than those of shareholders, the judicial job of judging fiduciary compliance becomes impossible).

93. *See* Adolf A. Berle, Jr., Note, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1365, 1367 (1932) ("When the fiduciary obligation of the corporate management and 'control' to shareholders is weakened or eliminated, the management

On the other hand, it is arguable that, despite the rhetoric of public benefit contained in the orthodox benefit corporation Model, the directors of a benefit corporation will follow the power—they are elected by shareholders—and will ultimately serve the private interests of the shareholders rather than some broad social good. When faced with a conflict between shareholder interests and social goods, directors will likely align with the shareholders, since only the shareholders vote for directors. Thus, the social aspects of benefit corporation legislation may be illusory whenever they conflict with private interests.[94] In addition, it seems difficult to coordinate benefit corporation status with director fiduciary obligations to creditors in insolvency settings.[95]

D. The Greenwash/Greenmail Enforcement Problem

1. Greenwash Possibilities

To the extent a "benefit corporation" election is intended to confer special branding status in the marketplace, the unregulated nature of the election, and the possibility of greenwashing for-profit activities under the benefit corporation label, is a significant problem.[96] All that is necessary

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and 'control' become for all practical purposes absolute."). Berle was not against a regime in which corporate managers could consider non-shareholder interests, but argued that until a sensible system emerges to constrain managers who consider broader interests, the status quo should remain. *Id.* ("Unchecked by present legal balances, a social-economic absolutism of corporate administrators, even if benevolent, might be unsafe; and in any case it hardly affords the soundest base on which to construct the economic commonwealth which industrialism seems to require. Meanwhile, as lawyers, we had best be protecting the interests we know, being no less swift to provide for the new interests as they successively appear."); *see also* Bainbridge, *supra* note 6, at 1445 (arguing that displacing the wealth maximization norm would create the "very real risk that some corporate directors and officers will use nonshareholder interests as a cloak for actions to advance their own interests").

94. *See* Strine, *Our Continuing Struggle*, *supra* note 6, at 150–51 ("Equally unrealistic is the idea that corporations authorized to consider other interests will be able to do so at the expense of stockholder profits if voting control of the corporation remains in the stock market. Just how long will hedge funds and mutual funds subordinate their desire for returns to a desire of a founder to do good?"). I think the problem goes beyond publicly held stock to all situations in which directors are elected by shareholders that they do not control.

95. This uncertainty may impede the ability of benefit corporations to borrow money or otherwise operate on credit and, at a minimum, should require complex covenant restrictions on benefit corporations that borrow money. Without such restrictions, creditors could watch corporate assets disappear into the public realm and would run the risk of director irresponsibility.

96. Bill Clark and Elizabeth Babson give considerable attention to the market demand for benefit corporations by consumers and investors. Clark & Babson, *supra* note 4, at 819–22 ("For-profit social entrepreneurship, social investing and the sustainable business movement have reached critical mass and are now at an inflection point. Accelerating consumer and investor demand has resulted in a substantial marketplace for companies that are using the power of business to solve social problems.").

for a corporation to be a benefit corporation is for the corporation, at the formation or through shareholder election, to elect the status and include two words in its articles of incorporation. A benefit corporation then assesses its "material positive impact on society and the environment" against some third-party standard, has a benefit director, and prepares (or does not, who's to say) annual benefit reports. Other than potential, derivative benefit enforcement proceedings, in which standing is limited to shareholders and directors and in which damages are not a remedy, there is no enforcement mechanism to ensure that corporations which fail to seek general public benefit do not latch on to the benefit corporation moniker and the developing marketplace for social enterprises. In addition, the benefit corporation legislation contains no naming requirements, keeping traditional for-profit corporations from calling themselves benefit corporations, or forcing nonconforming corporations to stop designating themselves as benefit corporations and obtaining branding benefits.

For example, assume a dog kennel business (dog lovers being a socially and environmentally conscious breed) wants to distinguish itself from its competitors and capture greater market share. Its sole shareholder elects benefit corporation status, amends the articles of incorporation to state that "Dudley Dooright Kennels" is a benefit corporation, and changes the corporate name to "Dudley Dooright Kennels Benefit Corporation." The corporation now "shall have a purpose of creating general public benefit," but unless a specific public benefit purpose is also elected, the articles do not need to say anything about benefit purpose, only that the corporation is a benefit corporation. Dudley Dooright, originally the sole director and still the sole shareholder, elects an "independent" benefit director. "Independent" is defined in the Blabs Model as a person "having no material relationship with a benefit corporation," and states that employees, immediate family members, and five percent owners are conclusively presumed not independent.[97] Not knowing what an "immediate family member" is (and not really caring), Dudley appoints his brother as the independent director and pays him an annual stipend for his services.[98] Dudley then advertises and otherwise holds the corporation out as a benefit corporation and, since dog boarders board dogs and do not investigate truth-in-marketing, the corporation captures market share and does exceedingly well. Dudley never gives any consideration to social or environmental factors when making board decisions, just profit. At year

97. MODEL BENEFIT CORP. LEGIS. § 102.

98. If the brother does not pan out, for example, by being too independent or by threatening benefit enforcement proceedings, he can be removed and replaced by Dudley, the sole shareholder.

end, the corporation is supposed to prepare an annual benefit report, deliver it to Dudley, and either post it on the public portion of its Internet website or provide a copy to any person requesting a copy. The Model also requires that the corporation deliver a copy of the benefit report to the Secretary of State for filing, but assuming that the state statute maintains this requirement (and the resulting governmental cost), there is no review component. If Dudley's benefit corporation fails to prepare an annual benefit report, there is no enforcement mechanism. Similarly, Dudley's corporation can comply in a pro forma manner with the report requirements and state certain ways the general public benefit was pursued and the extent to which it was created, the process and rationale for selecting or changing the third-party standard, an assessment of performance against the third-party standard, and other required matters. The report can be sketchy, forward-looking, vague, non-analytical or fabricated, and no one will know the difference.

2. *Greenmail*

As noted above, benefit corporation shareholders and directors can bring "benefit enforcement proceedings," and thereby allege that the benefit corporation failed to adequately pursue a general public benefit. For example, if a benefit corporation produces widgets but could theoretically do so with less social or environmental harm (or with some greater social or environmental benefit), shareholders and directors can sue for the harm (or for the failure to benefit). A court, presumably, would determine whether the directors failed to adequately consider the harm when deciding to produce widgets in an efficient and cost effective manner. At one level, this empowers shareholders and directors as eternal nags and reduces the efficiency of corporate boards (and increases the cost of obtaining board members), which face litigation whenever some portion of the company is unhappy with its direction.[99] At a higher extreme, it fosters a greenmail scenario where shareholders can seek to be bought off through higher profit distributions or through adherence to their idiosyncratic conception of the good. In any case, the enabling of open-ended shareholder litigation without focus is an obvious problem of the current Model.

III. WHAT CAN BE DONE?

A. Forget Corporations and Use Limited Liability Companies

One possible solution to the hybrid entity conundrum is to allow

99. Consideration needs to be given to the availability and extent of director and officer ("D&O") insurance in the benefit corporation context.

corporations to be corporations, with attendant possible shareholder wealth maximization norms intact, and to encourage "social enterprise entities" to organize as limited liability companies, which permit contractually tailored for-profit and nonprofit purposes.[100] Although this might simplify choice of entity decisions and reduce information costs to investors and others who transact business with business entities, since they would know what "Inc." signifies, in my view, this is an insufficient basis for shifting the focus from benefit corporations to limited liability companies. First, the fact that some newly formed business enterprises choose the benefit corporation form indicates that, at least in some cases, there is perceived tax or business benefit to the corporate form. Second, with respect to existing corporations, the conversion into limited liability company form could be costly and difficult.[101] Third, because investors and others undertake (or should undertake) due diligence prior to investment, the information cost rationale may not withstand scrutiny since it would not be costly for investors to learn of nonprofit maximizing purposes prior to investing in a corporation. Such purposes would, in the case of benefit corporations, be set forth in the articles of incorporation. Finally, a move to an LLC regime is intellectually unappetizing because it fails to attempt a resolution of the historical tension over what it means to incorporate—intractable wealth maximization, default rules, or something else. Thus, in my view, the fact that LLCs offer a generally acceptable alternative to benefit corporations does not mean that there should not be benefit corporations or that we should not attempt to get benefit corporation legislation right.

In my view, the "illiberalism problem," the "bipolarity problem," the

100. For example, the Delaware Limited Liability Company Act allows LLCs to have nonprofit purposes. *See* DEL. CODE ANN. tit. 6, § 18-106(a) (2005) ("A limited liability company may carry on any lawful business, purpose or activity, whether or not for profit."). A number of other state LLC statutes contain similar language. Further, the whole concept and history of LLCs demonstrates that they are predominately contractual entities, in which statutory and common law provisions and arrangements can be varied by the members' operating agreement. *See* Ann E. Conaway, *The Global Use of the Delaware Limited Liability Company for Socially-Driven Purposes*, 38 WM. MITCHELL L. REV. 772, 780, 802 (2012) ("[P]resently, the Delaware LLC provides global investors maximum internal efficiency, as well as asset protection at decreased agency cost, for businesses operating solely within or outside the United States for socially-driven enterprises . . . [while benefit corporations create unnecessary] legal nightmare[s]."). One of the arguments against L3Cs has been that a statutory nonprofit scheme is unnecessary since LLCs already can be contractually structured with nonprofit purposes in mind. *See* Callison & Vestal, *supra* note 14, at 286–88. The same argument applies to "benefit LLCs" as enacted in Maryland.

101. At a minimum, the change would entail drafting an operating agreement setting forth numerous provisions that are otherwise presumed by corporate law. Second, although tax costs of conversion could be alleviated by using an LLC that elects to be taxed as a corporation and then using a tax-free reorganization, the conversion of a corporation into an LLC is not without risk of significant tax cost.

"fiduciary uncabining problem," and the "greenwash/greenmail enforcement problem" are obvious drawbacks to the orthodox benefit corporation legislation. Assuming that corporations, other than single shareholder corporations that are dictatorial by nature, want to enable public-good-enhancing activities, in my view, rational shareholders will not adopt the benefit corporation form, thereby creating greater risk and cost when choosing to forego personal profit. The equation is wrong. Further, in my view, this is tragic, since there is presently a focus on legislative responses to the profit maximization norm and since creation of an unworkable statute is a wasted opportunity for corporate law reform. In the next Section, I discuss alternative methods for success.

B. Adopt a Much Simpler, Contract-Based Structure for Benefit Corporations

Another approach to benefit corporation legislation would be to accept the primacy of shareholder choice and allow shareholders to specify the general or specific public benefits they want their corporation to seek. Thus, the shareholders of my hypothetical, "Peachblossom Orchard," could specify that their corporation's public purpose is to benefit the Delta, Colorado community, in general or specific fashion. Further, the shareholders could elect whether they want accoutrements of the orthodox Model, such as benefit directors and annual public reporting. If they seek a third-party brand, the third-party may insist on these things, but otherwise the shareholders' agreement should govern. Adoption of this flexible approach would allow public-good-providing corporations the externality benefits of the "benefit corporation" brand, while avoiding the negative effects of the orthodox Model. First, since shareholder choice would be available, the liberalism problem would be avoided. Second, since narrower purposes than a vague "general public benefit" could be chosen, there would not be a separation of benefit-providing corporations into different categories, and the bipolarity problem would be avoided. Third, since shareholders would be able to establish boundaries, director fiduciary duties would be fenced within those boundaries and directors would not be free to choose general public benefits that suit them. Finally, although enforcement problems may still exist and need to be addressed, their scope would be significantly reduced. Benefit corporations arise from shareholder choice concepts, and expansive shareholder choice may make them work.

CONCLUSION

Benefit corporation legislation can be useful for corporations in which the shareholders want to encourage public good activities beyond shareholder profit maximization, and such legislation should be embraced. However, the Model proposed by Blabs and adopted in several states is fraught with conceptual and practical hazards that likely will sub-optimally limit the use of benefit corporations to single shareholder corporations and the ill-advised. Although limited liability companies presently allow most or all of the desired features of benefit corporations, there seems to be a significant desire to allow public benefit considerations to play out in corporate form. Thus, to solve the problems of the orthodox benefit corporation Model, it is necessary to look to corporate law. Fortunately, the problems can be readily solved by building flexibility and shareholder choice into the Model. This would make benefit corporation status potentially useful for many corporations, rather than the relatively few corporations that easily fit the orthodox Model. If it is desired that the shareholder profit-maximization sheets on the existing procrustean bed of corporate law be turned down, then contractual flexibility should be sought and new procrustean laws should be avoided.

L3CS: AN INNOVATIVE CHOICE FOR URBAN ENTREPRENEURS AND URBAN REVITALIZATION

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INTRODUCTION

Social enterprises offer fresh ways of addressing seemingly intractable social problems, such as high levels of unemployment and poverty in economically distressed urban areas in the United States. Indeed, although social enterprises have deep and longstanding roots, the recent iteration of the social enterprise movement is gaining momentum in the United States and globally.[1] Though there is not a singularly accepted legal definition of social enterprises, they are popularly known as businesses that use for-profit business practices, principles, and discipline to accomplish socially beneficial goals.[2] Social entrepreneurs, those who operate social enterprises, eschew a traditional notion of charity, which primarily relies on charitable donations to eliminate societal ills and instead employ market-oriented strategies to achieve social good.[3] Social entrepreneurs are not just focused on the bottom line and seeking financial returns but seek to obtain double-bottom line (financial and social) or triple-bottom line (financial, social, and environmental) objectives.[4] The Grameen Bank is an example of an early social enterprise. The bank was established in 1976 by Muhammad Yunus to combat poverty in rural villages in Bangladesh by extending small loans to rural village women to allow them to establish businesses and provide them with self-employment opportunities.[5]

Social enterprises blur the lines among the nonprofit, for-profit, and government sectors, and given their innovative and distinct characteristics,

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1. *See* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 338 (2009); Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 292 (2010); Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2012).

2. *See* MARC LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS 1 (2011); Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 59 (2010); Rosemary Fei, *A Guide to Social Enterprise Vehicles*, TAX'N OF EXEMPTS, Jan.-Feb. 2011, at 37; Janelle A. Kerlin, *Social Enterprise in the United States and Europe: Understanding and Learning from the Differences*, VOLUNTAS, Sept. 28, 2006, at 248; J. Gregory Dees, *The Meaning of "Social Entrepreneurship"* 1 (Ctr. for the Advancement of Soc. Entrepreneurship, 2001), *available at* http://www.caseatduke.org/documents/dees_sedef.pdf; *The Case for Social Enterprise Alliance*, SOCIAL ENTERPRISE ALLIANCE, https://www.se-alliance.org/why#whatsasocialenterprise (last visited Sept. 16, 2012) (describing the Social Enterprise Alliance as the membership organization for social enterprises in North America that defines social enterprises as businesses whose primary purpose is the common good and that "use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas").

3. *See* Kelley, *supra* note 1, at 339.

4. *Id.*

5. *See A Short History of Grameen Bank*, GRAMEEN BANK, http://www.grameen-info.org/index.php?option=com_content&task=view&id=19&Itemid=114 (last visited Sept. 1, 2012) (providing a short history of how Grameen Bank was established).

require new legal entities to meet their needs.[6] New legal entity forms, such as the low-profit limited liability company ("L3C"), the benefit corporation, and the flexible purpose corporation, were created in response to the needs of social entrepreneurs for new legal entities, other than traditional for-profit and nonprofit entities, that can attract the necessary funding for their ventures while also achieving their social missions.[7] Many social entrepreneurs, their lawyers, and others, who work with and support social entrepreneurs, support the creation of new hybrid legal entities, which better reflect the socially beneficial pursuits and financial concerns of social entrepreneurs.[8]

As with other social entrepreneurs, minority urban entrepreneurs determined to use their businesses to make a profit and provide positive social outcomes in economically distressed urban areas also need innovative legal entities to attract funding and fulfill their social missions. The L3C, though needing changes to enhance its effectiveness, holds promise for minority-owned small businesses in urban areas with socially beneficial goals that are in need of capital to establish and operate their businesses.

It is important to establish viable minority-owned social enterprises in urban areas because many urban areas in the United States face substantial challenges, such as high levels of poverty and unemployment.[9] Despite

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6. *See* Kelley, *supra* note 1, at 341 (discussing both the problems with existing complex legal entities that practitioners create for hybrid ventures and demands by social entrepreneurs for lawyers and lawmakers to develop new laws and new legal entities to facilitate double- and triple-bottom line goals); 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, 6–8 (2011) (discussing social entrepreneurship as being a part of the Fourth Sector, an entirely new organizational sector that blends social purposes with business methods and is distinct from the three traditional sectors of private, public, and nonprofit organizations); *see also* Heerad Sabeti et al., FOURTH SECTOR NETWORK ET AL., THE EMERGING FOURTH SECTOR: A NEW SECTOR OF ORGANIZATIONS AT THE INTERSECTION OF THE PUBLIC, PRIVATE, AND SOCIAL SECTORS 4–6, *available at* http://www.fourthsector.net/attachments/39/original/The_Emerging_Fourth_Sector_-_Exec_Summary.pdf?1253667714 (describing how most Fourth Sector organizations are structured as hybrids of nonprofit and for-profit forms and asserting that new legal forms may need to be created to facilitate the creation of Fourth Sector enterprises).

7. *See* Katz & Page, *supra* note 2, at 62–63. *See generally* Susan H. Mac Cormac, *The Emergence of New Corporate Forms: The Need for Alternative Corporate Designs Integrating Financial and Social Missions*, *in* SUMMIT ON THE FUTURE OF THE CORPORATION, PAPER SERIES ON CORPORATE DESIGN (Allen White & Marjorie Kelly eds., 2007), *available at* http://www.jussemper.org/Resources/corp2020SummitPapers.pdf (discussing the need to develop new entities to facilitate the work of social enterprises, including a discussion of L3Cs, the B corporation, and the Minnesota Socially Responsible Corporation).

8. *See* Kelley, *supra* note 1, at 341. *See generally* LANE, *supra* note 2, at 31–52 (discussing the hybrid organizations developed for social enterprises).

9. *See* Christiana McFarland, *State of America's Cities Survey on Jobs and the Economy*, NAT'L LEAGUE OF CITIES RES. BRIEF ON AM.'S CITIES, May 2010, at 1–2, *available at* http://www.nlc.org/Documents/Find%20City%20Solutions/

these problems, urban areas in the United States are significant to the national economy and are valuable underutilized resources that need innovative and strategic solutions[10] to address their problems and help the United States become even more competitive in the global market. Social enterprises in these areas, particularly those owned by people of color, could play a role in revitalizing these financially troubled urban areas by providing much needed jobs to residents and much needed revenues, products, and services to these areas. Organizations, such as Greyston Bakery in New York and Sweet Beginnings, LLC in Chicago, provide compelling examples of for-profit urban social enterprises that have developed successful businesses while also providing jobs in their respective urban areas to individuals with considerable barriers to employment.[11] But many minority-owned small businesses in urban areas, including social enterprises, confront a number of challenges that hinder their development and growth, including lack of access to capital. Current entity forms available to these businesses are inadequate in allowing them to accomplish their socially beneficial goals and attract the necessary

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Research%20Innovation/Economic%20Development/state-of-americas-cities-survey-jobs-economy-rpt-may10.pdf; *see also* Teresa Lynch & Lois Rho, *Capital Availability in Inner Cities: What Role for Federal Policy?* 2 (Initiative for a Competitive Inner City, 2011), *available at* http://www.icic.org/ee_uploads/publications/Capital_Policy_Paper_November_2011.pdf.

10. *See, e.g.*, Michael E. Porter, *The Competitive Advantage of the Inner City*, HARV. BUS. REV., May–June 1995, at 55–62 (explaining the need to move from social models to economic models to revitalize inner cities and asserting that the competitive advantages of the inner city are: 1) its strategic location; 2) the local market demand; 3) its integration with regional clusters; and 4) the access to human resources); *see also* Jay Williams, Ric Geyer, and Peter Benkendorf, *Rumors of Our Death Have Been Greatly Exaggerated*, FORBES (Sept. 3, 2009, 8:42 PM), http://www.forbes.com/2009/09/03/dying-cities-youngstown-ohio-opinions-contributors-21-century-cities-09-williams-geyer-benkendorf.html ("[C]ities and urban counties represent 80 percent of the American population. They hold a concentration of wealth and the intellectual resources associated with technology, higher education, and research institutions. Cities are convenient, making a reduction in fuel consumption and green living within reach. And lastly, urban living provides access to arts and culture as well as other amenities and reflects a growing trend in this country."); Gregory B. Fairchild, *In Your Own Backyard: Investment Opportunities in Emerging Domestic Markets* 3–4 (Batten Inst. Res. Paper No. 1440486, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1440486.

11. *See The Greyston Bakery's Guiding Principles*, http://www.greystonbakery.com/wp-content/uploads/pdf/greyston-bakery-guiding-principles.pdf (last visited Dec. 20, 2012) (describing Greyston Bakery's double-bottom line mission to strive to be a model for inner-city business development by providing jobs and fair wages to inner-city residents and making a profit by creating a sustainable organization); *see also Greyston Bakery Our Story*, http://www.greystonbakery.com/the-bakery/our-story/ (last visited Dec. 20, 2012) (discussing Greyston Bakery's innovative social mission, its high quality baked goods and brownies, and how it is the producer of brownies for Ben & Jerry's products); *About Us*, http://www.sweetbeginningsllc.com/about-us (last visited Dec. 20, 2012) (explaining that Sweet Beginnings, LLC offers full-time employment to formerly incarcerated individuals and others with extreme challenges to employment, while producing all natural urban honey skin care products).

financing to successfully establish viable ventures.

Consider the following example:

The city of Metropolis is a large, industrial metropolitan city suffering from high levels of poverty and unemployment due, in part, to the decline of its major manufacturing industry, the loss of a great number of manufacturing jobs, a lack of diverse business industries, and a massive decline in its middle class population. Recognizing the need for establishments to provide fresh, organic home-style meals in a casual yet elegant setting and for jobs for residents in Metropolis, Ann and Carl, both people of color and residents of Metropolis, decide to open a restaurant called the Good People, Good Food Company ("GPGFC"). They would also like the company to offer a delivery service to distribute their meals to different neighborhoods in Metropolis with limited access to fresh foods.

Metropolis has a burgeoning urban farming movement. There are large swaths of vacant land in Metropolis as a result of large numbers of people leaving the city in search of jobs and better housing in the suburban areas surrounding the city and outside of the state. People interested in repurposing these vacant urban lands are creating urban farms, which produce a wide variety of food items, including fruits, vegetables, honey, and even small farm animals, such as chickens. GPGFC will offer fresh, quality meals by obtaining as much food as possible from these Metropolis urban farms. Ann and Carl are committed to operating a high quality restaurant and delivery service with delicious and healthy locally-sourced foods and excellent customer service. They are also committed to paying fair wages and hiring a large percentage of the workers from a Metropolis nonprofit program that mentors and trains at-risk young people, most of whom are unemployed or underemployed people of color from low-income Metropolis neighborhoods, who are looking for opportunities to better their lives. Ann and Carl intend to make a profit and a living from the establishment and hope that if GPGFC is successful, they will be able to expand to other locations around the city and to other urban areas in the state and throughout the country. They would like to earn a salary and share in the potential upside of GPGFC's financial returns. They also hope that by being able to make a profit, they will be able to attract a wide range of financing sources to invest in their enterprise, including socially conscious investors and small business lenders, which will allow them to establish a more sustainable business.

Ann has years of experience working in the restaurant industry, and she previously owned a small catering company. At Ann's previous catering company, she hired Carl as a chef. Carl is committed to the socially beneficial mission of the restaurant and believes there is a demand for a restaurant and delivery service offering fresh and tasty food. They have a

small amount of money saved to invest in the business but need to attract additional investors and financing to meet the numerous costs necessary to start up and operate a restaurant. They have family and friends who think the restaurant is a great idea but do not have more than a nominal amount of money to invest in the company. Ann and Carl both own homes in Metropolis, but due to the economic downturn, the large number of foreclosures in Metropolis, and the overall poor economic state of the metropolitan area surrounding Metropolis, they owe more on their homes than the value of the homes. Consequently, they are unable to tap into the equity of their homes to finance the company.

As they explore the legal options they have to form their business, they determine they can establish the business as a for-profit entity, such as a limited liability company or a corporation, a nonprofit Internal Revenue Code ("IRC") Section 501(c)(3) tax exempt organization, or the recently established L3C entity form for social enterprises. So what are the advantages and disadvantages of each of these entities given Ann and Carl's social mission and their desire to make a profit and finance their establishment? In addition, why may a L3C provide an advantage over a for-profit entity and a nonprofit organization?

This Article answers these questions by examining the for-profit, nonprofit, and L3C entities available to establish GPGFC and the advantages and disadvantages of each of these entities. This Article focuses on the L3C entity, rather than exploring other hybrid entities, such as the benefit corporation, because the L3C was specifically created to address social entrepreneurs' capital needs. This Article further considers whether the L3C should be another tool used to develop GPGFC and other socially motivated small businesses owned by people of color living in financially challenged urban areas. Part I examines minority small business owners in financially distressed urban areas and why these businesses play an important role in urban revitalization. It addresses their challenges and unique difficulties accessing capital and briefly discusses the various programs created to support minority urban entrepreneurs and their need for additional funding sources. Part II discusses the for-profit and nonprofit entities available to Ann and Carl and other urban minority-owned social enterprises and the advantages and disadvantages of using these entities for social entrepreneurial efforts. Part III discusses the development of the L3C and its advantages and disadvantages, including a discussion of the concerns with the L3C's ability to attract private foundation funding. Part IV offers recommendations on how to improve the L3C structure. This Article concludes by asserting that the L3C could be another tool used to support urban minority-owned small businesses with social missions if certain measures are implemented to improve the L3C legislation.

I. MINORITY-OWNED SMALL BUSINESSES IN URBAN AREAS

Small businesses are a critical part of a healthy economy.[12] They play a vital role in the United States' economic system by creating the most net new jobs, by bringing innovative products and services to the market, and by providing much needed tax revenues to local and state municipalities.[13] In the United States, small businesses, defined by the U.S. Small Business Administration as businesses with fewer than 500 employees, create 60–80% of net new jobs annually[14] and they represent approximately 43% of private payroll.[15] As these small businesses become successful and transition into larger businesses, they create more jobs and drive economic growth.[16] As with the national economy, small businesses play an important role in the economic development of inner cities.[17] Ninety-nine percent of all businesses in inner cities are small businesses and 80% of total inner-city employment comes from small businesses.[18]

For decades, urban areas in the United States have been plagued by high levels of unemployment and poverty. While the national unemployment rate fluctuated between 7.8% and 8.3%[19] in 2012, the unemployment rates of African Americans and Hispanics were well above the national rate.[20]

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12. *See* JAMES R. BARTH ET AL., BARRIERS TO ENTREPRENEURSHIP IN EMERGING DOMESTIC MARKETS: ANALYSIS AND RECOMMENDATIONS 1–2 (Milken Inst. 2006), *available at* http://www.milkeninstitute.org/pdf/entrepreneurship.pdf.

13. *See* U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 1 (2010), *available at* http://www.sba.gov/sites/default/files/sb_econ2010.pdf; *see also* Tim Lohrentz, *Inclusive Business Practices*, *in* BUILDING HEALTHY COMMUNITIES: A GUIDE TO COMMUNITY ECONOMIC DEVELOPMENT FOR ADVOCATES, LAWYERS AND POLICYMAKERS 358–59 (Roger A. Clay, Jr. & Susan R. Jones eds., 2009) [hereinafter BUILDING HEALTHY COMMUNITIES].

14. BARTH ET AL., *supra* note 12, at 1.

15. U.S. SMALL BUS. ADMIN., OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS ABOUT SMALL BUSINESS 1 (Sept. 2012), http://www.sba.gov/sites/default/files/FINAL%20FAQ%202012%20Sept%202012%20web.pdf.

16. *See* BARTH ET AL., *supra* note 12, at 1.

17. *See* INITIATIVE FOR A COMPETITIVE INNER CITY BOSTON, MA., STATE OF THE INNER CITY ECONOMIES: SMALL BUSINESSES IN THE INNER CITY 1 (2005) [hereinafter ICIC], *available at* http://www.sba.gov/advo/research/rs260tot.pdf. The ICIC defines inner cities as "core urban areas that are economically distressed." *Id.* at 3

18. *Id.* at 1.

19. *See Unemployment in the United States*, GOOGLE PUBLIC DATA, http://www.google.com/publicdata/explore?ds=z1ebjpgk2654c1_&met_y=unemployment_rate&idim=country:US&fdim_y=seasonality:S&dl=en&hl=en&q=unemployment+rate (last visited Nov. 13, 2012); BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, http://www.bls.gov/ (last visited Nov. 13, 2012).

20. *See Economic News Release: Employment Situation Summary*, BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR (Nov. 2, 2012) (stating that the unemployment rate for African Americans in October 2012 was 14.3% and for Hispanics was 10%, while the rate for Whites in October 2012 was 7%); Algernon Austin, *Uneven Pain: Unemployment by Metropolitan Area and Race*, ECON. POL'Y INST. ISSUE BRIEF, No. 278 (June 8, 2010), *available at* http://www.epi.org/page/-/ib278/ib278.pdf (examining the unemployment rates across the fifty largest metropolitan areas in the United States and the higher rates of unemployment among

Since an estimated 82% of the inner-city population are people of color,[21] these high levels of unemployment among African Americans and other people of color have an adverse impact on the growth and development of inner cities. Yet, inner cities hold great potential and are valuable, untapped domestic markets that, if developed, could contribute to the success and health of the national economy and produce businesses that "spur the next growth engine of the U.S. economy."[22]

A strategy to revitalize economically distressed urban areas and decrease their high levels of unemployment is to create and grow viable small businesses in these areas.[23] Although it is important to establish viable small businesses owned by people of any race in urban areas to drive economic development, it is particularly important to establish viable small businesses owned by minority urban entrepreneurs in these areas.[24]

It is essential to develop urban small businesses owned by people of color for several reasons. First, small businesses owned by people of color operating in economically depressed urban areas tend to employ more people of color and residents living in these areas than White-owned

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people of color in these areas); *see also Unemployment Rates by Race and Ethnicity, 2010*, BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR (Oct. 5, 2011), http://www.bls.gov/opub/ted/2011/ted_20111005.htm.

21. Fairchild, *supra* note 10, at 3.

22. *See id.* at 2–4 (discussing the encouraging social and economic indicators of emerging domestic markets (defined either by ethnic minorities or inner-city neighborhoods), which include decreasing inner-city poverty, raising educational attainment of racial and ethnic minorities, growing minority purchasing power, and migrating back into previously unattractive urban neighborhoods in all major U.S. cities by young, single, college-educated professionals).

23. *See* Alicia M. Robb & Robert W. Fairlie, *Access to Financial Capital Among U.S. Businesses: The Case of African American Firms*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 47, 48–49 (2007) ("Stimulating minority business creation in sectors with high growth potential (e.g., construction, wholesale trade, and business services) may also represent an effective public policy for promoting economic development and job creation in poor neighborhoods."); *see also* Lohrentz, *supra* note 13, at 358.

24. I use minority small business owner, small business owner of color, minority entrepreneur, and urban entrepreneur interchangeably in this Article. There is no common definition of urban entrepreneur, but when I use it in this Article, I use it to mean minority small business owners, small business owners of color, entrepreneurs of color, or minority entrepreneurs. *See* Susan Jones, *Current Issues in Community Economic Development: Supporting Urban Entrepreneurs: Law, Policy, and the Role of Lawyers in Small Business Development*, 30 W. NEW ENG. L. REV. 71, 72–73 (2007) (defining urban entrepreneurs as not having one definition but sometimes meaning minority entrepreneurship and other times meaning small businesses established in or serving economically depressed areas). Although not specifically discussing urban entrepreneurs, the legal scholar W. Sherman Rogers offers a compelling historical study on African American entrepreneurship and asserts the need for African Americans to become entrepreneurs. He states that "[t]he statistics suggest that the families of entrepreneurial African Americans fare better than those who assimilate into the job structure of the dominant culture. Additionally, persons who experience difficulty finding jobs have the option of establishing a business." W. SHERMAN ROGERS, THE AFRICAN AMERICAN ENTREPRENEUR THEN AND NOW 20 (2010).

businesses.[25] A recent study of the urban development potential of Black-owned businesses found that due to social networks, small White-owned firms in urban areas most often employ Whites, while small Black-owned firms hire more minority workers.[26] Given this dynamic, more Black-owned small businesses and small businesses owned by people of color must be established in urban areas.

In addition, there are growing numbers of people of color in the United States and in urban areas. For example, between now and 2050, more than eighty-five percent of the estimated population growth will come from minority groups.[27] This means that in the near future, people of color will no longer be the minority population in the United States but will be a plurality of the population. This increasing ethnic population should play an important role in the economic growth of the United States and could fulfill this role, in part, by establishing viable entrepreneurial ventures in urban areas.

Furthermore, urban small businesses owned by people of color may bring wealth to the business owners and income to people of color living in these areas.[28] Also, these business owners often help to improve the social capital and civic engagement in urban neighborhoods.[29] Establishing successful minority-owned small businesses in economically distressed urban areas is essential to urban community economic development, in part, because these businesses help to stabilize neighborhoods.[30] Moreover, small businesses owned by urban entrepreneurs living in economically distressed urban areas have a unique understanding of the local issues of the area, which enhances the survival prospects of the businesses.[31] Finally, these owners often use their businesses to make a living and to provide social benefits to their communities.[32]

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25. Timothy Bates, *The Urban Development Potential of Black-Owned Businesses*, J. AM. PLAN. ASS'N, Spring 2006, at 227; Robb & Fairlie, *supra* note 23, at 49.

26. *See* Bates, *supra* note 25, at 229 ("Even among the businesses physically located within minority communities, the majority of the workers in the nonminority small firms are White. Black-owned businesses, in contrast, rely largely on minority workers, even when their firms are located outside of minority neighborhoods.") (internal citation omitted).

27. BARTH ET AL., *supra* note 12, at 2.

28. Lohrentz, *supra* note 13, at 359; Robb & Fairlie, *supra* note 23, at 48–49.

29. Lohrentz, *supra* note 13, at 359; *see* Dana Thompson, *The Role of Nonprofits in CED*, *in* BUILDING HEALTHY COMMUNITIES 74–75 (noting that social capital is an important concept in the community economic development field and has been defined as the "networks, norms and trust . . . that enable participants to act together more effectively to pursue shared objectives").

30. *Id.* at 358.

31. *See* Jeffrey Robinson, *Current Urban Entrepreneurship: Patterns and Policy*, 30 W. NEW ENG. L. REV. 103, 107 (2007).

32. *See* Candida Brush et al., *Building Ventures Through Civic Capitalism*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 155, 168 (2007) (discussing a research study

Minority small business owners operating in various industries in inner cities confront many of the same challenges that other small business owners face, including the lack of access to capital and the increased market share of large, publicly-held corporations, which makes it difficult for small businesses to attain profit margins similar to those attained by large, publicly-held corporations.[33] But the access to capital issues minority entrepreneurs face are more extreme for a number of reasons. One reason is because certain businesses that start in urban areas, such as small grocery stores, bakeries, clothing stores, and retail businesses that provide necessary products and services to their communities, may not be as attractive to investors and are not high growth businesses; therefore, these businesses are not likely to attract venture capital funding.[34]

Venture capital financing is a significant source of revenue for emerging businesses that has spawned the development of innovative industries in the United States.[35] Venture capitalists typically invest in companies with technologies "that have the potential to disrupt product markets and generate enormous returns."[36] Venture capitalists typically seek to invest in businesses that are able to grow in size quickly and generate large rates of return in four to six years.[37] These large rates of return are necessary so that the venture capitalists may realize certain rates of returns expected by their investors.

There are an increasing number of minority-owned urban businesses started by well-educated and experienced individuals, who are establishing businesses in higher growth industries, such as finance, business, and professional services.[38] Although they may be attractive to certain minority venture capitalists, many of these businesses are not attractive to traditional venture capital firms because they are not in the high-tech or other sectors that offer the potential for great returns.[39]

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evaluating the growth of smaller urban and minority businesses, asserting that many of these businesses blended business and community improvement goals in creative ways, and labeling these entrepreneurs as "civic capitalists" and their ventures as "civic enterprises").

33. *See* Lohrentz, *supra* note 13, at 360; Robb & Fairlie, *supra* note 23, at 67.

34. Victor Fleisher, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 95 (2007).

35. Mike Green, *Venture Capitalists Aren't Investing in Black Entrepreneurs*, HUFFINGTON POST (Apr. 5, 2011, 9:20 PM), http://www.huffingtonpost.com/mike-green/uplifting-black-america-v_b_844738.html.

36. *Id.*

37. ROGERS, *supra* note 24, at 241.

38. *See* Bates, *supra* note 25, at 230 (discussing the nature of the modern Black business community and its focus on offering skill-intensive services as opposed to traditional Black businesses in the twentieth century that typically consisted of "mom-and-pop food stores, small restaurants, barbershops, and beauty parlors").

39. Timothy Bates & William Bradford, *Traits and Performance of the Minority Venture-Capital Industry*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 95, 101 (2007)

Another reason access to capital issues are more extreme for minority entrepreneurs is that equity investors other than venture capital firms, such as private equity investors, tend not to invest in viable, minority-owned businesses located in urban areas because of, among other reasons, their unfamiliarity with these businesses and their perceptions that these businesses are small, undercapitalized, and subsistence in nature.[40] Moreover, many of these businesses face discrimination from both equity investors and lenders.[41] Research studies show that African American businesses are more likely than White-owned businesses to be denied credit, pay higher interest rates, and avoid borrowing from banks because they believe they will not be approved for financing.[42] Finally, African Americans have lower levels of wealth than Whites.[43] Given these lower levels of wealth, African Americans tend to invest less start-up capital in their businesses, which restricts the ability of these businesses to develop and prosper.[44] Thus, minority-owned businesses have access to fewer capital resources than other small businesses. A minority-owned urban social enterprise confronts greater obstacles accessing capital because of its blended profit and socially beneficial purposes and the traditional investor's reluctance to invest in these types of ventures.

In addition to financing issues, a higher percentage of inner-city minority small business owners face problems not experienced by other small business owners.[45] Due, in part, to these challenges and inaccurate perceptions of minority-owned businesses, many investors view urban minority-owned small businesses as riskier ventures than other kinds of

(discussing how mainstream venture capital firms primarily invest in high-tech sectors while minority venture capitalists invest in high-tech fields, like communications, as well as low-tech fields, like wholesale and retail trade).

40. *See* Fairchild, *supra* note 10, at 13.

41. *See* Bates & Bradford, *supra* note 39, at 106–07 ("[T]he existence of discrimination . . . can result in distaste for minority persons, spilling into distaste for investing in minority businesses. To the extent that general partners prefer not to work with ethnic minorities and are willing to forego economic profits in order to avoid transacting with minority owners, then fund entrance will be (self-) restricted.").

42. *See* Robb & Fairlie, *supra* note 23, at 66–67 (asserting the existence of lending discrimination against Black-owned businesses and claiming that lending discrimination directly effects the success of these businesses because it restricts access to loans that help the businesses sustain themselves through challenging times or limits their ability to offer new products or expand into new markets); *see also* BARTH ET AL., *supra* note 12, at 5 (noting studies that find lending discrimination against African American small businesses).

43. *See* Robb & Fairlie, *supra* note 23, at 67.

44. *Id.*

45. *See* Lohrentz, *supra* note 13, at 361 (citing problems that minority small business owners encounter, including lack of education, experience, and access to the growth sectors of the economy, and numerous regulatory and licensing burdens); Jones, *supra* note 24, at 78–79 (addressing inaccessibility to social, financial, and human capital as one of the many issues faced by urban entrepreneurs).

businesses and avoid making investments into these businesses because of the perceived risks.[46] Consequently, minority small business owners in urban areas need supplementary support and resources to ensure their success.

Gains have been made in the development of minority entrepreneurship, partially owing to numerous federal, state, and local programs designed to revitalize urban areas and spur entrepreneurship.[47] Despite the existence of these programs and advances made by urban entrepreneurs of color, additional resources, particularly financial resources, are needed to establish and develop these entrepreneurs. Urban areas continue to be plagued by high levels of unemployment and poverty, and viable urban small businesses may help combat these issues.[48] Indeed, social enterprises owned by minority urban entrepreneurs that are committed to using their businesses to make a positive impact on their urban communities are also likely to confront the same challenges faced by urban minority small business owners and also need additional sources of financing and technical support to establish viable businesses and accomplish their social missions.

II. FOR-PROFIT AND NONPROFIT FORMS AVAILABLE TO ANN AND CARL

The social enterprise movement could play a larger role in positively impacting economically distressed urban areas, though the traditional for-profit and nonprofit legal structures available to minority urban social entrepreneurs, like Ann and Carl, do not adequately complement their goals and financing needs.[49] This Part revisits the charitable restaurant and

46. *See* Fairchild, *supra* note 10, at 13 (contending that many investors are not interested in making investments in Emerging Domestic Market firms (firms either owned by ethnic minorities or operated in inner-city neighborhoods) for the following five reasons: "1) limited experience with investments in this asset class; 2) the perception that these investments are for social purposes rather than economic opportunities; 3) the mixed past performance of government-sponsored programs; 4) an outdated perception of minority-owned businesses; and 5) a public policy agenda that has been focused outside of business development").

47. *See* ROGERS, *supra* note 24, at 112–14 (describing federal programs assisting small businesses and minority-owned small businesses, including the Small Business Administration Programs (which include the 8(a) Program, Section 7(a) Loan Guaranty Program, Microloan Program and the Section 504 Certified Development Company Program, Economic Opportunity Loans, and Specialized Small Business Investment Company Loans), Empowerment Zones and Enterprise Community Programs, HUD's Renewal Communities Program and Community Development Block Grant Program, the New Markets Tax Credit Program, and the Community Reinvestment Act); *see also* Robinson, *supra* note 31, at 110–12 (discussing the various government programs designed to develop minority-owned businesses).

48. *See* McFarland, *supra* note 9, at 1; Lynch & Rho, *supra* note 9, at 2.

49. *See* Kelley, *supra* note 1, at 340. *See generally* Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233, 236–44 (discussing how for-profit and nonprofit legal structures are unable to meet the goals of social

delivery service Ann and Carl would like to establish and explores the for-profit corporation, the limited liability company, and the nonprofit, Section 501(c)(3) tax-exempt organization, entities traditionally available to Ann and Carl to establish GPGFC, and the advantages and disadvantages of these entities.

A. For-Profit Entities

The for-profit entities Ann and Carl could consider for their business that have typically been used for social enterprises are the corporation and the limited liability company.[50] These entities are designed to attract capital from outside investors and limit the liability of the owners, but the for-profit corporation is primarily focused on maximizing profits for its owners.

1. Corporation

The for-profit corporation is one of the most commonly used business entities in the United States. The corporation is formed principally to generate a profit for its owners.[51] It is a preferred entity for raising capital from investors because investors are familiar with the corporate form, the interests in the corporation are freely transferable, and the investors' liability in the entity is limited.[52] The corporation is an entity formed under state law and is legally separate from its owners, who are known as shareholders or stockholders.[53] Due to this separate identity, the shareholders of a corporation enjoy limited liability, subject to certain limitations.[54] Limited liability means that the shareholders are generally not liable for the debts and obligations of the corporation beyond the assets

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entrepreneurs).

50. There are other for-profit entities available to Ann and Carl, including the general and limited partnerships and the business trust. Those entities are not often used for social enterprises and will not be discussed further in this Article.

51. Indeed, the influential twentieth century economist Milton Friedman contended that the sole purpose of the corporation is to make a profit, and he stated that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits." Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 133. However, there is a debate among legal scholars concerning the claim of the primacy of shareholder profit maximization as opposed to the corporation having a responsibility to other stakeholders, including its employees and consumers. *See generally* Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1351 (2011).

52. *See* F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCS, LAW AND PRACTICE § 2.4, at 2-24 (3d ed. 2004).

53. *Id.* § 1.10, at 1-42.

54. Owners are subject to personal liability if they personally guarantee a debt or obligation of the corporation, and if they negligently perform their responsibilities. Richard A. Mann et al., *Starting From Scratch: A Lawyer's Guide To Representing A Start-Up Company*, 56 ARK. L. REV. 773, 791 (2003–2004).

they have contributed to the corporation.[55] For example, if the corporation is sued by a third-party for breach of contract, subject to certain exceptions, the third-party will only be able to reach the assets of the corporation to remedy the breach of contract claim and is not legally permitted to access the personal assets of the individual shareholders that are not invested in the corporation. Thus, the shareholder's sole assets at risk are the assets the shareholder has actually invested into the corporation.

The corporation has a very well-developed and accepted body of law established by each state. It is subject to certain statutory requirements, such as having a board of directors who manages the affairs of the company, having certain officers, such as a president, secretary, and treasurer, who carry out the day-to-day responsibilities of the corporation, and having regular meetings.[56] The corporation's directors, officers, and other managers have heightened legal duties, known as fiduciary duties, when acting on behalf of the corporation and its shareholders.[57] Furthermore, the directors are legally required to maximize the profits of the owners, although they may consider other issues, such as the impact of the company's activities on employees and the environment when making decisions.[58] If the directors fail to fulfill these fiduciary duties, they may be subject to personal liability to the corporation and its shareholders.[59]

For federal income tax purposes, a corporation may be taxed as a C corporation or an S corporation.[60] A corporation taxed under Subchapter C of the IRC is subject to double taxation.[61] The C corporation is first taxed on its business income, and if the corporation distributes the business income to the shareholders in the form of dividends, the shareholders pay

55. O'NEAL & THOMPSON, *supra* note 52, § 1.10, at 1-43.

56. Mann et al., *supra* note 54, at 799.

57. *See* MODEL BUS. CORP. ACT § 8.30 (2011).

58. *See* Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 747–48 (2009–2010) (comparing the "canonical account," which requires directors to further shareholder interests and maximize profits, with the "corporate social responsibility" model); *see also* Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board's Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 636–37 (2007–2008) (discussing how the business judgment rule protects a manager's decision to consider other stakeholder's interests and issues other than maximizing profits).

59. *See* Robert Rosenberg, *Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations*, ILL GLOBAL, 2 (June 2003), http://www.iiiglobal.org/component/jdownloads/viewdownload/393/1422.html; Charles M. Nathan, *Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations*, AMERICAN BAR ASSOCIATION THE SECTION OF BUSINESS LAW ESOURCE (Aug. 2002), *available at* http://www.abanet.org/buslaw/newsletter/0003/materials/tip3.pdf.

60. O'NEAL & THOMPSON, *supra* note 52, § 1.5, at 1-17.

61. LEE R. PETILLON, ROBERT JOE HULL & MARK T. HIRAIDE, REPRESENTING START-UP COMPANIES § 2.6, at 2-13 (2011).

tax on the dividends.[62] A corporation that elects to be taxed under Subchapter S of the IRC is a pass-through entity.[63] This means that a Subchapter S corporation is not subject to tax on its income. Instead, the corporation's income and losses are passed through to the shareholders and are considered their income and losses.[64]

a. Advantages of the Corporation

There are a number of advantages of the corporation that may make it a useful form for Ann and Carl to operate their restaurant and delivery service as a social enterprise. One advantage is the ability to attract equity and debt investments from a number of different sources. Because Ann and Carl need capital to establish the restaurant, have limited money to invest in the company, and are unlikely to be able to obtain capital from family and friends, the corporation allows them to seek funding from socially conscious angel and venture capital investors, private foundations, and other investors who will get a return on their investment. In addition, Ann and Carl want to earn a profit from the company, and the corporation allows them to distribute income earned from the corporation to themselves and other investors. Furthermore, since the corporation has a well-developed governance structure, they can set up the entity with relative ease.

b. Disadvantages of the Corporation

A significant disadvantage of forming Ann and Carl's socially beneficial restaurant and delivery service as a corporation is the corporation's profit-driven focus. This focus conflicts with a fundamental aspect of Ann and Carl's vision of GPGFC, which is to use the restaurant and delivery service as a means to employ and provide job training to the unemployed and underemployed of Metropolis and to provide fresh food to the underserved in this community, in addition to making a profit. As mentioned earlier, a corporation is a vehicle primarily used to make profits for its shareholders; however, as will be discussed further below, for-profit corporations are increasingly taking into account and engaging in socially beneficial pursuits.

One of the key roles of the corporation's directors is to ensure that the corporation increases shareholder value and maximizes the corporate returns for the shareholders.[65] Directors owe fiduciary duties to the

62. *Id.*

63. *See generally* O'NEAL & THOMPSON, *supra* note 52, § 2.6, at 2-44.

64. *Id.*

65. GREGORY V. VARALLO ET AL., FUNDAMENTALS OF CORPORATE GOVERNANCE: A GUIDE FOR DIRECTORS AND CORPORATE COUNSEL 7 (2d ed. 2009) (citing to Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)) (explaining

corporation and its shareholders.[66] These duties are known as the duty of loyalty and the duty of care.[67] The duty of loyalty imposes on the directors, and those who manage the corporation, an undivided duty of loyalty to the corporation and its shareholders, and they must act in a way they reasonably believe is in the best interests of both the corporation and the shareholders.[68] This generally means that the directors, officers, and managers may not use corporate property to further their interests to the detriment of the corporation. The duty of care requires directors and officers to use care when making decisions on behalf of the corporation.[69] This means that when the directors and officers act on behalf of the corporation, they must do so on an informed basis.[70] If they are relying on information from employees, consultants, or other third parties, the reliance must be reasonable and in good faith.[71]

Related to these fiduciary duties, the courts have developed the business judgment rule, which creates a rebuttable presumption that recognizes that when the directors, officers, and managers are making business decisions, they are doing so in good faith and on an informed basis.[72] This presumption may be rebutted if one can prove the directors', officers', or managers' actions did not have a rational business purpose, or they were acting fraudulently, illegally, or in conflict of interest with the corporation.[73] This rule encourages individuals to serve on corporate boards, make corporate decisions without unnecessary judicial interference, and take an appropriate level of risk.[74] It is well-settled that the business judgment rule allows directors to take account of other issues and interests, such as impacts on the environment and employees, in addition to maximizing the profits of the owners.[75]

c. Constituency Statutes and Corporate Social Responsibility

Constituency statutes and the corporate social responsibility movement

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that the board's discharging of its responsibilities must have rationally related benefits to stockholders).

66. *Id.* at 2.

67. *Id.* at 2.

68. *See* MODEL BUS. CORP. ACT § 8.30.

69. VARALLO ET AL., *supra* note 65, at 2.

70. *Id.*

71. MODEL BUS. CORP. ACT. § 8.30.

72. VARALLO ET AL., *supra* note 65, at 61.

73. *Id.*

74. Kerr, *supra* note 58, at 636–37.

75. *See id.* at 637 (discussing the court's opinion in Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968), in which the court ruled that the directors' decisions were covered by the business judgment rule and held that "the effect on the surrounding neighborhood might well be considered by a director").

offer examples of the increasing acceptance of for-profit corporations considering non-shareholder stakeholder interests as well as shareholder interests. Since the 1980s, many state legislatures in the United States have passed constituency statutes that allow corporate managers to consider the interests of non-shareholders, such as customers, employees, suppliers, communities, and others, when making corporate decisions and satisfying their fiduciary duties.[76] Constituency statutes further solidify the business judgment rule protections of corporate managers' decisions that take into account non-shareholder stakeholder interests that may conflict with maximizing shareholder profits.[77] Some commentators argue that these constituency statutes allow corporate managers to give preference to non-shareholder stakeholder interests over shareholders' interests.[78] Yet, the prevailing understanding of most constituency statutes is that, while they allow managers to consider non-shareholder interests, they are not legally mandated to consider these interests.[79] Furthermore, in most jurisdictions with constituency statutes, even if managers are permitted to consider non-shareholder interests, legal scholars assert that there are legal and practical arguments that any decisions managers make that involve non-shareholder interests must be tied to enhancing shareholder value.[80]

There is also a growing movement among the general public, consumers, social investors, corporate critics, and activists known as "corporate social responsibility" ("CSR"), which asserts that corporations should consider a set of constituencies broader than shareholders and profit maximization, including employees, governments, communities affected by corporate activities, and organizations promoting environmental and social interests.[81] Supporters of CSR argue that, given the power and influence of corporations, these organizations have a responsibility to do more than serve their owners' interests; they have a responsibility to also serve interests that benefit society as a whole.[82] Various jurisdictions in the United States have acknowledged the ability of corporations to consider

76. *Id.*; John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 132 (2010).

77. *Id.*

78. *Id.* at 134.

79. *Id.*

80. Only three states, Iowa, Indiana, and Pennsylvania, may allow directors in these states to give preference to non-shareholders' interests over shareholders' interests. *Id.* at 136.

81. Kelley, *supra* note 1, at 349 (discussing the CSR trend); *see* Page & Katz, *supra* note 51, at 1353 (providing a historical analysis of the CSR movement and arguing that social enterprise provides an alternative to CSR); Taylor, *supra* note 58, at 747–48.

82. Kelley, *supra* note 1, at 349.

these wider constituencies.[83] In addition to state constituency statutes and the CSR trend, there are for-profit companies, such as Google.org that are engaging in for-profit philanthropy and successfully using the for-profit corporation for socially beneficial purposes.[84]

Despite the development of state constituency statutes, CSR, and corporations, such as Google.org, many scholars and corporate law commentators still contend that for-profit corporations are established and operated chiefly to generate revenues for their shareholders.[85] There are debates among scholars about the dominance of this theory, but the predominate view is that corporate managers must primarily focus on maximizing shareholder profits and may consider other interests as long as they are tied to maximizing shareholder profits.[86] Although state constituency statutes permit managers to consider interests other than shareholders and their financial maximization, most of these statutes still do not require them to consider non-shareholder interests.[87] If a for-profit corporation's managers ultimately decide they do not want to pursue socially beneficial activities or consider non-shareholder interests in favor of generating shareholder profits, they are legally able to do so.[88] Those corporations who engage in CSR may consider and be aware of larger societal and environmental interests while engaging in their business operations but are not legally required to incorporate these interests into their decision-making processes. In fact, some advocates of CSR maintain that a reason to engage in more socially responsible practices is because it increases the bottom line.[89] Again, this illustrates the linkage between CSR and using good corporate practices to increase shareholder value.

Given that Ann and Carl's restaurant and delivery service is committed not only to making a profit but also to paying fair wages, employing and training unemployed and underemployed residents of Metropolis, and providing underserved community members with access to fresh and

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83. *Id.* at 350.

84. *Id.* at 344; Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2438 (2009) (discussing Google.org and how the for-profit company purposely chose the for-profit corporation rather than a nonprofit, tax-exempt corporation to further its philanthropic goals).

85. Tyler, *supra* note 76, at 126–27.

86. *Id.* at 127–28.

87. Of the thirty-one states that have enacted constituency statutes only Connecticut requires consideration of non-shareholder interests and then only for publicly traded corporations when there is a change of control. *Id.* at 132–33.

88. *Id.* at 135; *see* Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective*, (Perlman & Perlman (2008)), *available at* http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf.

89. Christopher Flavelle, *Responsibility is Still Good For Business*, WASH. POST, Feb. 15, 2009, at F1 (discussing a study of sustainable companies that outperformed the market and asserting that proponents of CSR claim that "good behavior is also good for the bottom line").

healthy food, the for-profit corporation would not be an ideal fit for their purposes. If Ann and Carl created the GPGFC as a for-profit corporation, various constituency statutes and CSR would allow their corporate managers to consider the interests of the workers and the community benefitted by their services. Yet, these corporate managers may subsequently decide that employing and training unemployed and underemployed residents of Metropolis may not be the most cost effective way to operate the business. If these managers decide to change who they employ in the company to maximize profits, they will legally be permitted to do so, and subsequent investors may argue that they are legally required to do so. Therefore, in order for Ann and Carl to fulfill their goals of creating a sustainable business that would allow them to make a profit and employ unemployed and underemployed citizens of Metropolis, the for-profit corporation is not likely to suit their needs.

2. Limited Liability Company

Since its inception in 1977 in Wyoming, the limited liability company ("LLC") has become the preferred business entity form used by for-profit organizations to conduct business.[90] In fact, the number of new LLCs formed in the United States in 2007 surpassed the number of new corporations by a margin of nearly two to one.[91] The LLC has become a popular business entity due, in part, to its limited liability characteristic, its flexible management and governance structure, its tax structure, and its respect for the LLC parties and their agreements, including agreements limiting or waiving fiduciary duties.[92] The LLC is a limited liability entity similar to a for-profit corporation but has some of the characteristics of a general partnership, such as the ability to be managed by the owners, who are known as members, and to be taxed by default as a partnership.[93] As discussed above, limited liability means that subject to certain exceptions, the LLC's owners' personal assets are not available to be used to pay the liabilities of the entity, and the owners are not personally liable for the debts and obligations of the entity.[94]

The LLC also possesses other features that make it an attractive business entity for numerous types of businesses.[95] For example, the LLC may be

90. *See* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES 1 (2d ed. 2012).

91. Rodney D. Chrisman, *LLCs are the New King of the Hill*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010).

92. *Id.* at 485.

93. PETILLON ET AL., *supra* note 61, § 2.8, at 2-16.

94. *Id.* § 2.3, at 2-9.

95. *Id.* § 2.8, at 2-16 to 2-17 (discussing other favorable aspects of the LLC, including: 1) few statutorily required administrative requirements, such as holding regular meetings and keeping meeting minutes; 2) no restrictions on the number of

owned by individuals or any type of business entity, such as a for-profit corporation, a nonprofit corporation, a trust, and a partnership.[96] This feature makes the LLC attractive to a wide variety of investors.[97] Unless it elects to be taxed as a corporation, a multi-member LLC is taxed as a partnership under the federal tax laws and is a pass-through entity.[98] As a pass-through entity, the LLC itself is not subject to taxation, but the individual owners must pay tax on the LLC's income at their individual tax rates.[99]

a. Advantages of the LLC

As with the corporation, the LLC structure offers Ann and Carl the ability to attract both equity and debt financing for GPGFC. Ann and Carl could offer angel investors, corporations, and individuals membership interests in the company. They could also seek program-related investments ("PRI") from private foundations to finance the company. Further, as a startup company, they are not likely to qualify for traditional bank financing, but could seek other debt financing, such as convertible debt financing, microfinance loans, and Small Business Administration guaranteed loans. It is highly unlikely that they would attract venture financing for two reasons. First, they are not the type of high growth company with the potential for high returns in which venture capitalists typically invest. Second, venture capitalists tend not to invest in pass-through entities, such as LLCs, because of unfavorable tax treatment on their investments. Venture capital firms receive investments from a variety of entities, including charitable organizations, educational endowments, government and corporate pension funds, large corporations, banks, professional institutional investors, funds of funds, high-net-worth individuals, and insurance companies.[100] The tax-exempt entities investing in venture firms prefer to invest in entities that minimize or eliminate unrelated business taxable income ("UBTI").[101] Generally, a tax-exempt entity does not pay any unrelated business income tax ("UBIT") on dividends from corporations.[102] However, if the tax-exempt investor is a

shareholders; and 3) the ability to divide profits and losses of the entity among the members in any manner upon which they agree as long as the substantial economic effect rules are satisfied).

96. EMERGING COMPANIES GUIDE: A RESOURCE FOR PROFESSIONALS AND ENTREPRENEURS 72 (Robert L. Brown & Alan S. Gutterman eds., 2011).

97. *Id.*

98. PETILLON ET AL., *supra* note 61, § 2.8, at 2-16 to 2-18.

99. Mann et al., *supra* note 54, at 800.

100. BRAD FELD & JASON MENDELSON, VENTURE DEALS: BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST 101 (2011).

101. UBTI and UBIT will be discussed in greater detail *infra* Part II.A.3.

102. BRUCE HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 696 (10th ed.

member of an LLC taxed as a partnership and the LLC's business is an unrelated trade or business with respect to the tax-exempt investor's organization, the tax-exempt investor must pay unrelated business income tax on its share of the gross income of the LLC.[103]

Other advantages of the LLC are that the LLC may be established easily and can give Ann and Carl a limited liability vehicle that allows them to manage the establishment or hire other individuals to manage it. In addition, if GPGFC initially generates losses, which is likely for this type of business, then subject to certain limitations, the LLC taxed as a partnership allows Ann and Carl and other investors to deduct these losses from their personal taxable incomes.[104] Moreover, if they establish the LLC in a jurisdiction that permits an LLC to be formed for any purpose, given the LLC's freedom of contract feature, they could restrict the purposes of the LLC in the articles of organization and the operating agreement to include only providing fair wages, employing the unemployed and underemployed, and providing fresh food to the underserved. They could also contractually impose fiduciary duties on the GPGFC's managers to ensure that the managers take LLC actions consistent with the company's charitable purposes as well as for profit-making purposes.

b. Disadvantages of the LLC

The inherent flexibility of the LLC is both one of the greatest benefits and liabilities for Ann and Carl and others considering the LLC for social enterprises.[105] Though Ann and Carl could form the LLC for their charitable purposes in a jurisdiction that enables an LLC to be formed for any purpose, creating an operating agreement, the document that dictates how the LLC is governed and managed, would be time consuming and could potentially overlook crucial provisions, impacting their ability to accomplish their social goals.[106] As mentioned above, the operating agreement could be drafted to provide for Ann and Carl's charitable and profit-making purposes and to impose fiduciary duties on the managers,

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2011).

103. *Id.* at 718.

104. RIBSTEIN & KEATINGE, *supra* note 90, at 48–49.

105. *See* Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 586 (2009) ("[T]he flexibility of LLCs is both a blessing and curse. Like a very sharp knife, properly used, an LLC is an effective tool to accomplish exactly what the craftsperson using it wishes. On the other hand, used carelessly, it can cause severe and unanticipated damage.").

106. *See id.* (asserting that it is not clear whether the LLC's flexibility is a good or bad thing for nonprofits and claiming that "careless organization or inappropriate actions by the LLC or its constituents can defeat the nonprofit purposes of the LLC, result in adverse tax consequences, and possibly lead to acrimonious litigation or regulatory action").

mandating their fidelity to the charitable mission while also making a profit. In addition to these provisions, they would need to state in their operating agreement the authority that would enforce the charitable purposes of the organization.[107] In the nonprofit corporation context, the enforcement body is typically a jurisdiction's attorney general's office.[108] Ann and Carl would need to decide whether it makes sense to include an outside enforcement agency to enforce GPGFC's charitable mission or to instill in the members or some other third-party the rights to enforce the charitable purpose.[109] They should also consider adding a provision that limits the personal liability of LLC managers, except in the case of self-dealing.[110] They should also provide a mechanism for dealing with disputes concerning the legitimacy of the LLC's actions.[111] In order to ensure that these provisions are not easily modified, they need to address how the operating agreement can be amended and make it difficult to amend the operating agreement and subvert the charitable purpose of the LLC.[112]

There is also a compelling legal argument that given the LLC's flexibility and the ability for the parties to the LLC agreement to waive their fiduciary duties, the LLC form is not best suited to accomplish hybrid charitable and profit purposes because it is easier for the parties to the LLC to freely change their purpose without notice to the public or other public consequences.[113] Indeed, although the parties may contractually agree to a charitable and profit making purpose, if Ann, Carl, or some of their other investors eventually decide they would rather not pursue charitable purposes, they may amend their agreement accordingly without informing the public.[114]

In addition to the uncertainty of locking in the charitable purpose of an entity organized as an LLC, it could be more difficult for Ann and Carl to effectively brand GPGFC as a social enterprise if operating a limited liability company that has no obvious social enterprise, charitable, or social purpose designation, such as an L3C or a nonprofit organization. Creating a brand as a social enterprise has the potential for attracting socially conscious investors and consumers interested in investing in social enterprises. Socially conscious investors and consumers may be opposed

107. *See id.* at 583–85 (discussing the provisions that should be addressed when establishing a nonprofit or hybrid LLC).

108. Murray & Hwang, *supra* note 6, at 38.

109. Keatinge, *supra* note 105, at 584.

110. *Id.*

111. *See id.* at 585.

112. *See id.*

113. *See* Tyler, *supra* note 76, at 146.

114. *Id.*

to a for-profit entity engaging in socially responsible practices that they perceive are ultimately designed to increase the entity's profits.[115] In light of these disadvantages, a limited liability company is not the ideal entity to operate GPGFC.

3. Nonprofit, Tax-Exempt Organization

A nonprofit, tax-exempt organization is an entity governed by both state and federal law[116] and is typically formed as a corporation under a state's nonprofit corporation statute. In order for a nonprofit to be recognized as being exempt from federal income taxation under the IRC, it must submit an application to the Internal Revenue Service ("IRS").[117] A nonprofit, tax-exempt organization may earn profits.[118] In fact, in order for most nonprofit organizations to be sustainable and effectively carry out their missions, they must make more earnings than their expenses and earn profits. However, a nonprofit, tax-exempt organization may not distribute its profits to its directors, officers, or other individuals, except in the form of reasonable compensation.[119]

The type of nonprofit, tax-exempt organization Ann and Carl would most likely consider creating is a charitable organization. A charitable organization is a nonprofit, tax-exempt organization formed for charitable, educational, or some exempt purposes set forth in Section 501(c)(3) of the IRC.[120] For an organization to qualify as a tax-exempt charity, it must be organized and operated exclusively for IRC Section 501(c)(3) purposes; the organization will not qualify as charitable if it is not operated exclusively for these purposes.[121] To satisfy the "organized" requirement in IRC

115. *See* Kelley, *supra* note 1, at 361 (discussing the importance of branding for social enterprises to attract investors and customers).

116. *See* HOPKINS, *supra* note 102, at 3 (discussing the large number of federal laws, including tax exemption, charitable giving, antitrust, education and labor, and state laws, including formation of corporations, trusts, and charitable solicitation laws, applicable to nonprofit, tax-exempt organizations).

117. *See id.* at 46 (describing how Congress, and not the IRS, grants tax-exemption, how certain organizations, such as religious organizations, are automatically exempt from federal income taxes, and how other organizations must by law submit an application to the IRS to be recognized by the IRS as a business that qualifies for tax-exemption).

118. Tyler, *supra* note 76, at 160.

119. HOPKINS, *supra* note 102, at 508.

120. The IRC states that the following organizations qualify as charitable organizations: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals . . . ." *See* Treas. Reg. § 1.501(c)(3) (2012).

121. *See generally id.* § 1.501(c)(3)-1 (describing the organizational and the operational tests).

Section 501(c)(3), also known as the organizational test, an organization must be organized as a corporation, trust, unincorporated association, or an LLC. It must also include language in its organizing or creating document, usually the articles of incorporation for a nonprofit corporation, which sets forth the purpose or purposes of the organization that must be aligned with IRC Section 501(c)(3) purposes. The articles must also state that the organization will not engage in private inurement nor will it be used to impermissibly benefit the interests of the organization's founders, insiders, or other third parties.[122] The articles must also limit the organization's lobbying activities and forbid the organization's involvement in any political campaign on behalf of any candidate for public office.[123] Finally, the articles must state that the assets of the organization will be permanently dedicated to charitable purposes, and if the organization is dissolved, the organization's assets will either be distributed for a charitable purpose, distributed to a government to be used for public purposes, or provided to a court to distribute in accordance with the exempt purposes of the organization.[124] The organization must also have bylaws or other governance documents that are consistent with the articles, which set forth the governance structure of the organization.[125]

To satisfy the "operated" language in the IRC and the operational test, an organization must establish that its activities are "operated exclusively" for exempt purposes.[126] The Treasury Regulations interpret "operate exclusively" to mean that the organization must engage "primarily" in activities that accomplish one or more exempt purposes, and if more than an insubstantial part of the activities are not in furtherance of the exempt purposes, the organization will not qualify for the exemption.[127] An organization will not meet the operational test if "its net earnings inure in whole or in part to the benefit of private shareholders or individuals."[128]

A nonprofit, tax-exempt organization may operate a trade or a business as a substantial part of its activities as long as such activities further its tax-exempt purposes.[129] If the trade or business does not further its tax-exempt purposes, the income from the trade or business is considered UBTI and the tax-exempt organization will pay unrelated business income tax on the

122. Section 501(c)(3) forbids charitable organizations from engaging in private interests and states in relevant part that "no part of the net earnings which inures to the benefit of any private shareholder or individual." *Id.*

123. *See id.* § 1.501(c)(3)-1, 3(i)-(iii).

124. *See* Treas. Reg. § 1.501(c)(3)-1(4) (as amended in 2008).

125. *See* HOPKINS, *supra* note 102, at 64.

126. *Id.* at 77.

127. *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008).

128. *See id.* § 1.501(c)(3)-1(c)(2).

129. *See* HOPKINS, *supra* note 102, at 78.

income at normal corporate tax rates.[130] If the trade or business is a substantial part of the organization's activities and does not further an IRC Section 501(c)(3) purpose, then the organization may not obtain tax-exemption or may even have its tax-exemption revoked.[131] The central focus is on the actual purpose of the organization and not the nature of the organization's activities.[132] If the organization's primary purpose is to revitalize an economically distressed community by providing fair wages and jobs to the community's unemployed or underemployed and fresh food to underserved neighborhoods, and if the organization accomplishes this purpose by operating a for-profit business, the activity of operating the business does not violate the operational test. If a tax-exempt organization is operating a commercial business to accomplish primarily an exempt purpose under IRC Section 501(c)(3), the IRS and courts will examine a number of factors to determine whether the primary purpose is nonexempt. Those factors include: 1) the particular manner that the organization's activities are conducted; 2) the commercial hue of the activities; and 3) the existence and amount of annual or accumulated profits of the organization.[133]

a. Advantages of Nonprofit, Tax-Exempt Organizations

If Ann and Carl formed the GPGFC as a nonprofit, IRC Section 501(c)(3) tax-exempt organization, the organization would enjoy a number of advantages. First, assuming the organization satisfies both the organizational and operational tests, it would not be required to pay federal income tax on the income it earns from the business. The organization could also be exempt from state taxes and may be able to get exemption from property, sales, and use taxes. Second, as a charitable organization, Ann and Carl could attract charitable donations from individuals and the general public by offering a charitable contribution deduction for federal and state income taxes. Third, the organization could obtain government, private foundation, and other grants available only to IRC Section 501(c)(3) organizations. Other advantages include: 1) the organization would not have to pay certain employment taxes; 2) volunteers of the organization would not have to comply with the Fair Labor Standards Act; 3) the organization could qualify for an exemption from federal and state securities laws; 4) the organization and any volunteers would be immune from certain types of tort liability arising out of the organization's charitable activities; and 5) the organization could get preferential postage

130. *Id.*
131. *See id.*
132. *Id.*
133. *Id.* at 79.

rates.[134]

b. Disadvantages of Nonprofit, Tax-Exempt Organizations

Ann and Carl would not be able to qualify for IRC Section 501(c)(3) tax-exemption because they want to be able to receive profits from the establishment. Although an essential part of their mission is to revitalize Metropolis by providing fair wages and jobs to the unemployed and underemployed and to provide fresh food to the underserved citizens of Metropolis, the fact that they want to distribute profits to themselves and their investors violates the operational test. Even if GPGFC fulfilled the operational test, it could not raise money from private investors because of its inability to distribute its earnings to investors, also referred to as the nondistribution constraint.[135] A significant disadvantage of the nondistribution constraint is that it limits a nonprofit corporation's ability to raise capital from outside investors who are seeking a return on their investment in the form of a financial profit.[136] Furthermore, many nonprofit organizations trying to obtain a loan to finance their organizations find that loans are more costly and less flexible than equity, and traditional lenders may not be as likely to make competitive loans to them because of concerns about the nonprofits' ability to repay the loan.[137] Other disadvantages include: the time-consuming administrative requirements with which the organization must comply to obtain recognition of and maintain its tax-exempt status, the restrictions on lobbying and prohibitions on engaging in political campaigns, and the need to comply with each state's attorney general and fundraising rules.[138]

A possible solution to the private inurement prohibition for Ann and Carl is that they could establish the restaurant as a for-profit subsidiary of a nonprofit, tax-exempt organization. However, this structure is not likely to work because while Ann and Carl will offer fair wages and jobs to the unemployed and underemployed of Metropolis and fresh food to the underserved, they will not offer specific job training programs or other charitable programs separate from the restaurant and delivery service. The primary function of the nonprofit organization would be to operate the for-profit subsidiary. Moreover, a nonprofit, tax-exempt organization with a for-profit subsidiary requires greater administrative effort and expense to establish and operate because it is necessary to create and maintain two

134. *Id.* at 48–50; *see* Brewer, *supra* note 1, at 692–93.

135. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

136. *See* Kelley, *supra* note 1, at 353.

137. *Id.* at 354.

138. HOPKINS, *supra* note 102, at 55–56; Brewer, *supra* note 1, at 694–95.

entities. A nonprofit, tax-exempt organization that creates a for-profit subsidiary must carefully comply with IRS rules when operating the subsidiary.[139] For these reasons, the nonprofit, tax-exempt organization is not the ideal entity to serve Ann and Carl's purposes.

The analysis of the for-profit corporation, the LLC, and the nonprofit, tax-exempt organization illustrates that these entities are inadequate to meet Ann and Carl's financing and mission-driven purposes. This Article now turns to the L3C to evaluate its development, advantages, disadvantages and whether it could serve Ann and Carl's capital and charitable purposes.

III. L3Cs

The L3C is one of a number of hybrid legal entities recently established to satisfy the social entrepreneur's need for a business entity more legally suitable to operate a social enterprise.[140] The architects of the L3C created the entity to address the social entrepreneur's capital concerns, and it was originally envisioned as a vehicle to attract PRIs from private foundations, as well as other forms of private investment, as further discussed below.[141]

The L3C is a type of LLC that consists of both for-profit and nonprofit characteristics.[142] It is designed to enable its owners to accomplish charitable or educational goals while earning and distributing profits to its owners.[143] The L3C is gaining momentum as an accepted hybrid organization,[144] as evidenced by the increasing number of jurisdictions

139. Bromberger, *supra* note 88, at 7 (discussing the rules with which charitable organizations must comply to operate joint ventures).

140. A complete discussion of the other entities recently created to facilitate social enterprises is beyond the scope of this Article, but these other entities include the benefit corporation, flexible purpose corporation, and the United Kingdom's Community Interest Company. There is also the nonprofit corporation, B Lab, which certifies various business entities as "B Corporations" if these entities meet B Lab's certification standards. *See generally* Katz & Page, *supra* note 2, at 62–63; Fei, *supra* note 2, at 37–42; Thomas J. Billitteri, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH?, http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf (last visited Aug. 20, 2012).

141. ROBERT M. LANG, JR., THE L3C: THE NEW WAY TO ORGANIZE SOCIALLY RESPONSIBLE AND MISSION DRIVEN ORGANIZATIONS, ALI-ABA COURSE OF STUDY MATERIALS: TAX-EXEMPT CHARITABLE ORGANIZATIONS 2 (2007).

142. Robert Lang & Elizabeth Carrott Minnigh, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship: The L3C, History, Basic Construct & Legal Framework*, 35 VT. L. REV. 15, 17 (2010); Doeringer, *supra* note 1, at 315 (discussing the development of social enterprise in the United States and Europe and the development of the L3C).

143. Lang & Minnigh, *supra* note 142, at 17.

144. *See* Kelley, *supra* note 1, at 341 (discussing hybrid ventures); *see also* Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 620 (2010) (discussing various hybrid forms including the L3C).

adopting L3C legislation[145] and the growing number of social enterprises forming as L3Cs.[146]

The L3C is a type of LLC, which means that it is a for-profit entity that offers the limited liability and flexible ownership and management structure of the LLC. As with the LLC, the L3C offers its owners: 1) fewer administrative requirements than a corporation and the ability to freely structure the LLC; 2) pass-through taxation; 3) the flexibility to allocate its profits and losses; and 4) the opportunity to attract a variety of investors, among other characteristics of the LLC. The primary difference between the LLC and the L3C is the purpose of the L3C. As mentioned earlier, some jurisdictions require the LLC to be formed for business purposes, but some allow the LLC to be formed for any purpose, including a nonprofit purpose. Conversely, the L3C is required to "significantly further the accomplishment of one or more charitable or educational purposes."[147] Additionally, no "significant purpose of the company is the production of income or the appreciation of property . . . ."[148] These purpose requirements mandate that the L3C be guided chiefly by its charitable aims and secondarily by making a profit.

A. Advantages of the L3C

A key advantage of the L3C is that it offers Ann and Carl and other urban social entrepreneurs the opportunity to pursue their social missions while also attracting investment from a variety of investors, including private foundations, socially conscious angel investors and other private investors, and crowdfunding investors, as well as attracting debt financing. The L3C facilitates private investment because of its ability to distribute profits to investors.

The ability to attract investors is an advantage the L3C has over the nonprofit, tax-exempt organization, which cannot obtain investor capital because the nonprofit cannot distribute its excess profits to any individual,

145. Currently, nine states and two federal jurisdictions have adopted L3C legislation, and the L3C is currently being considered in some form in twenty-six jurisdictions and has been introduced in fourteen states. *See Laws*, AMS. FOR CMTY. DEV., http://www.americansforcommunitydevelopment.org/laws.html (last visited Oct. 31, 2012); *see also Considering Legislation in Your State?*, AMS. FOR CMTY. DEV., http://www.americansforcommunitydevelopment.org/ considering.html (last visited Oct. 31, 2012).

146. As of December 13, 2012, there were 696 L3Cs organized in various jurisdictions in the United States. *See Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, L3C, http://www.intersectorl3c.com/l3c_tally.html (last visited Dec. 13, 2012).

147. VT. STAT. ANN. tit. 11 § 3001(27)(a) (2012). Other state L3C statutes, such as Michigan and Illinois, reflect substantially similar language.

148. *Id.* § 3001(27)(b).

except in the form of reasonable compensation.[149] L3Cs maintain an advantage over LLCs because the L3C's charitable purpose may not be waived, and its managers are required to fulfill their fiduciary duties to pursue the organization's charitable purposes.[150] The language of the L3C statutory provisions expressly requires that the L3C significantly accomplish charitable or educational purposes.[151] Because of these stated purposes, as a matter of law (as opposed a contractual requirement for an LLC), the L3C must satisfy this requirement, and the L3C's managers have fiduciary duties to ensure the L3C pursues these purposes.[152] As a result, unlike the LLC, it is not possible to waive the charitable purpose of the L3C.[153]

The L3C's statutory language directs the L3C to operate first for charitable or educational purposes, and its managers must engage in actions on behalf of the L3C to fulfill its fiduciary duties and ensure the L3C's fundamental commitment to these purposes.[154] If the managers of GFGPC are presented with a choice between engaging in activities that permit them to revitalize their community by paying fair wages, employing the unemployed and underemployed, and delivering fresh food to the underserved, or pursuing a primarily profit-driven structure, the managers are required to favor the charitable pursuits. If the L3C no longer significantly furthers its charitable and educational purposes, the L3C will convert to an LLC.[155]

Due to the LLC's much touted flexibility, the parties to the LLC may initially decide to incorporate a charitable purpose into the LLC's structure and require the LLC's managers to maintain fiduciary duties that satisfy this purpose. Yet, if the parties to the LLC subsequently decide they no longer want to pursue charitable purposes, they may amend the operating agreement and remove these charitable purposes and fiduciary duties. Moreover, they do not have to provide public notice of these fundamental changes. Accordingly, due to the conversion feature in the L3C statute and the ability to more easily waive requirements in the LLC context, the L3C's managers, owners, investors, employees, and the general public can be more certain that the L3C will remain committed to its charitable purposes.

149. HOPKINS, *supra* note 102, at 513.

150. Tyler, *supra* note 76, at 146–47.

151. VT. STAT. ANN. tit. 11, § 3001(27).

152. Tyler, *supra* note 76, at 146–47 (2010).

153. *Id.* at 146.

154. *Id.*

155. Murray & Hwang, *supra* note 6, at 31. Although the L3C converts to an LLC if it no longer significantly furthers a charitable or educational purpose, there is no adequate monitoring of the L3C by a third-party enforcement agency to ensure that the L3C will actually convert, if it is no longer primarily charitable. This issue will be discussed further in Part III.B below.

Another advantage of the L3C for Ann and Carl is the branding effect of the L3C designation on their venture. The L3C is developing a brand as a for-profit business that is committed to pursuing socially impactful goals. This brand enables investors interested in making investments in social enterprises to identify these types of companies more easily. There is a growing segment of investors evaluating opportunities to invest in businesses with a specifically stated social purpose that also offers financial returns.[156] The brand also signals to socially conscious consumers that the business is engaged in a charitable venture that uses its profits toward socially beneficial ends. This taps into the growing consumer sentiment for businesses to be engaged in pursuits with a broader positive community and environmental impact than the traditional for-profit corporation's bottom line focus.[157]

One of the benefits of the nonprofit, tax-exempt organization form over the for-profit form for those engaged in socially beneficial activities is the recognition of the nonprofit brand's dedication to the public good and helping the disadvantaged.[158] This brand facilitates the charitable donations the nonprofit receives from the general public, the government and foundations, and promotes the general support these organizations receive for their charitable programs. The L3C is developing a similar brand to that of the nonprofit, but is unique as a brand because the L3C blends a for-profit and nonprofit identity while using innovative practices to affect change that are unavailable to traditional for-profits and nonprofits.[159] This branding is important for urban social enterprises that need to attract investors and explicitly illustrate their commitment to social goals. Ann and Carl could use this brand to draw in a variety of customers to the establishment along with investors interested in revitalizing urban areas.

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156. JP Morgan recently published a report entitled *Impact Investments: An Emerging Asset Class* discussing the growing asset class of impact investment and stated in the report, "[W]e believe that impact investing will reveal itself to be one of the most powerful changes within the asset management industry in years to come." Nick O'Donohoe et al., *Impact Investments: An Emerging Asset Class*, J.P. MORGAN GLOBAL RESEARCH, Nov. 29, 2010, at 13, *available at* http://www.jpmorgan.com/cm/BlobServer/impact_investments_nov2010.pdf?blobkey=id&blobwhere=1158611333228&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs.

157. James Epstein-Reeves, *Consumers Overwhelmingly Want CSR*, FORBES: THE CSR BLOG (Dec. 15, 2010, 9:58 AM), http://www.forbes.com/sites/csr/2010/12/15/new-study-consumers-demand-companies-implement-csr-programs/ (discussing the highlights of two public opinion surveys that reveal that eighty-eight percent of consumers want companies to achieve their business goals while improving society and the environment).

158. *See* Murray & Hwang, *supra* note 6, at 13 (contending that the public views nonprofits as more trustworthy because nonprofits "have less incentive to profit at the expense of consumers than do [for-profits]").

159. *Id.* at 23.

Other advantages of the L3C include the advantages offered by the LLC entity structure, including its limited liability feature and flexibility in governance and management. In addition, an advantage of the L3C over the nonprofit, tax-exempt organization is that the L3C does not have to engage in the time-consuming and expensive process of applying for recognition as a tax-exempt organization.

B. Disadvantages of the L3C

Although the L3C offers advantages to Ann and Carl, there are a number of issues with the L3C that must be addressed before it can most effectively serve their purposes.[160] First, although there are an increasing number of private foundations making PRIs, most private foundations, except for large organizations such as the Gates Foundation, still continue to favor making grants rather than PRIs.[161] Although L3Cs were established to attract more easily PRI dollars, private foundations continue to be reluctant about making PRI investments to L3Cs or any other for-profit or nonprofit entity.[162] The next Section will provide some background on private foundations and PRIs and explain why private foundations are hesitant to make PRIs.[163]

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160. There are a number of L3C critics who contend that L3Cs are unnecessary because LLCs can be used to accomplish the same purposes as L3Cs. Further, critics contend that L3Cs are dangerous because they may mislead private foundations to think it is easier to make PRIs to L3Cs due to the L3C form. *See generally* Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 244–45 (2010) (asserting that the L3C's utility depends on revising federal tax laws regarding PRIs to recognize that investments made to L3Cs are PRIs and not jeopardizing investments and that tranche investments advocated by L3C proponents require more federal tax oversight); David S. Chernoff, *L3Cs: Less There Than Meets The Eye*, TAX'N EXEMPTS, May–June 2010 at 3, 4–5 (stating a number of myths asserted about PRIs, including those asserted by L3C proponents); J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 274 (2010) (contending that the L3C form has little or no value without revising federal PRI rules); Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 881 (2010) (claiming that the L3C is "unwise" and "misleading," that "current L3C legislation is nonsensical and useless," and that giving L3C special status under the IRC contradicts the policies of its relevant Sections).

161. *See* Brewer, *supra* note 1, at 685; Luther M. Ragin, Jr., *Transcript: Program-Related Investments in Practice*, 35 VT. L. REV. 53, 57 (2010) (discussing the increasing number of PRIs being made).

162. *See* Brewer, *supra* note 1, at 685.

163. One of the criticisms of the L3C is that the L3C founders advocated using PRIs to engage in tranche investing, which could lead to impermissible private inurement. Founders of the L3C envisioned the entity having three different equity investment levels or tranches. The first tranche is intended for foundation investors making PRIs into the entity. The foundation would receive a below market rate of return but their investment in the entity would encourage socially conscious and market rate investments. The second tranche is designed to attract socially motivated investors who receive a higher rate of return than foundations but less than a market rate of

Private foundations are nonprofit, IRC Section 501(c)(3) tax-exempt organizations, usually funded from one source (such as an individual or a corporation), whose primary activity involves grant making to accomplish their exempt purposes.[164] Unlike public charities, private foundations are subject to a number of punitive excise taxes if they fail to follow the federal rules governing private foundations.[165] For example, private foundations are obligated to distribute at least five percent of their net asset value annually or they will be subject to a tax on their undistributed income.[166] Private foundations are able to satisfy this five percent payout rule by making grants and PRIs.[167] Under the Tax Reform Act of 1969, private foundations are prohibited from making jeopardizing investments.[168] Jeopardizing investments are investments in which private foundation managers fail to meet the prudent investment standard.[169] PRIs are not considered jeopardizing investments, but instead are investments by private foundations that further their exempt purposes and whose investments are made to nonprofit or for-profit organizations.[170]

The language of the L3C legislation in various jurisdictions tracks the Treasury Regulation's definition of a PRI. A PRI is an investment made by a private foundation to a nonprofit or for-profit entity that complies with the three following requirements: 1) the primary purpose of the investment

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return. The third tranche attracts market rate investors who take the lowest risk and receive a competitive market rate of return. This may be a problematic investing strategy for L3Cs and is not recommended. However, this investment strategy is not central to the existence of the L3C and without implementing it, the other advantages of the L3C outlined in this Article illustrate the importance of the L3C to social entrepreneurs, including those working to achieve urban revitalization. For a discussion of tranche investing, see Steve Davis and Sue Woodrow, *The L3C: A New Business Model for Socially Responsible Investing*, FED. RES. BANK OF MINNEAPOLIS (Nov. 1, 2009), http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305; *see also* Bishop, *supra* note 160, at 245 (discussing the riskiness of the tranche investment plan).

164. *See* BRUCE R. HOPKINS & JODY BLAZEK, PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE, 6–14 (2d ed. 2003). Section 501(c)(3) organizations may be categorized as either public charities or private foundations. Public charities are more common than private foundations and generally receive funding from a wide variety of sources, including the general public, the government, and foundation grant funding sources. Private foundations typically receive funding from one or two sources, such as a corporation or a family, and are subject to numerous excise taxes and restrictions.

165. *Id.* at 1–5 (discussing excise taxes set forth in IRC §§ 4940–4948 imposed on private foundations for failure to adhere to the IRC).

166. I.R.C. § 4942 (2012).

167. *Id.* § 4942(g).

168. *Id.* § 4944(a)(1).

169. Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973).

170. I.R.C. § 4944(c); Treas. Reg. § 53.4944-3(a)(1) (1972). *See generally* David A. Levitt, *Investing in the Future: Mission-Related and Program-Related Investments for Private Foundations—When It Comes to Private Philanthropy, the Return on an Investment May Not Be Only Financial*, PRACTICAL TAX LAWYER, May 2011, at 33.

is to accomplish one or more charitable, educational, religious, or other exempt purposes under Section 170(c)(2)(B) of the IRC; 2) no significant purpose of the investment is the production of income or the appreciation of property; and 3) no purpose of the investment is to lobby, support or oppose candidates for public office, or to accomplish any other political purposes forbidden to private foundations by Section 170(c)(2)(D) of the IRC.[171] To satisfy the prudent investment standard and obtain more assurance that a PRI is not a jeopardizing investment, foundation managers often obtain, but are not required to obtain, legal opinions from tax counsel, private letter rulings from the IRS, or both, particularly for high dollar, complex, or unique PRIs.[172]

PRIs generally take the form of interest-free or below market rate loans, loan guarantees, equity investments in for-profit entities, purchases of promissory notes, and purchases of participation in loans.[173] If a private foundation makes a PRI to a for-profit entity, it is also required to comply with the expenditure responsibility rules of the Treasury Regulations.[174] Many private foundations, particularly small and medium sized foundations, avoid making PRIs in part because of the need to comply with the stringent requirements of the expenditure responsibility rules, their unfamiliarity with PRIs, and their unfamiliarity with the underwriting credit risk of PRIs.[175]

To facilitate the use of PRIs, L3C advocates drafted federal legislation that was recently introduced in the House. This legislation would allow entities seeking PRIs to receive IRS approval and voluntarily report on any PRI dollars they received.[176] Although this legislation may help to assist private foundations with satisfying their expenditure responsibility requirements and influence them to make PRIs, the bill has not moved beyond being introduced in the House Ways and Means Committee.

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171. Treas. Reg. § 53.4944-3(a)(1)(i)-(iii) (1972); *see* DAVID S. CHERNOFF, PROGRAM-RELATED INVESTMENTS: A USER-FRIENDLY GUIDE 2 (Community-Wealth 2005), http://www.community-wealth.org/_pdfs/tools/pris/tool-macarthur-pri.pdf (generally discussing program-related investments).

172. *See* Chernoff, *supra* note 160, at 4.

173. *See* CHERNOFF, *supra* note 171, at 2–3.

174. *See* Treas. Reg. §53.4945-5; *see also* HOPKINS & BLAZEK, *supra* note 164, at 323 (explaining the expenditure responsibility rules make the private foundation responsible for using reasonable efforts and establishing adequate procedures to 1) ensure that the grant is spent solely for the purpose it was made; 2) obtain full and complete reports from the grant recipient on how the funds were spent; and 3) make full and detailed reports about how the funds were spent to the IRS).

175. *See* Ragin, *supra* note 161, at 56–57; *see also* Chernoff, *supra* note 160, at 4 (stating that private foundations are not required to obtain a private letter ruling from the IRS nor obtain a tax opinion letter from counsel prior to making a PRI). In certain circumstances when dealing with a high dollar or unusually complex PRI, private foundations may obtain a private letter ruling or a tax opinion letter.

176. Philanthropic Facilitation Act of 2011, H.R. 3420, 112th Cong. (2011).

There is guidance in the Treasury Regulations and from the IRS that should give certainty to private foundations that PRIs made to urban social enterprises are not jeopardizing investments. The Treasury Regulations pertaining to PRIs provide a number of examples of private foundation investments to for-profit entities that constitute valid PRIs.[177] The first three examples in these Treasury Regulations involve a private foundation that makes PRIs to small businesses owned by members of an economically disadvantaged minority group operating their businesses in a deteriorated urban area.[178] The first two examples are of a private foundation that made a below market interest rate loan to a business because the business was not able to find conventional financing on reasonable terms.[179] The third example is of a private foundation that made an equity investment in the business so the business could attract conventional financing on reasonable terms.[180]

In all three examples, the private foundation made the PRIs to encourage the economic development of the economically disadvantaged minority groups.[181] Based on the facts, the Treasury Regulations recognized the private foundation's investments as PRIs because they were not intended to produce income or appreciate property. Furthermore, the private foundation would not have made the PRIs unless there was a connection between making the PRI and the private foundation's exempt purposes.[182]

In a 2006 private letter ruling, the IRS found that a private foundation's investment in a private investment fund structured as an LLC was a valid PRI.[183] The private investment fund was established to "enhance social welfare, support community improvement, eliminate prejudice and discrimination and promote economic self-sufficiency by serving or providing investment capital for, low-income communities or low-income persons."[184] The fund's operating agreement specifically stated the foregoing purposes. The fund accomplished these purposes by serving as

177. Treas. Reg. § 53.4944-(3)(b) (1972).

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.*

183. The IRS ruled that the capital contributions made to a fund by a private foundation with charitable programs helping individuals achieve economic independence by promoting educational achievement and entrepreneurial success qualified as a PRI. The fund invested in businesses in low-income communities owned or controlled by minorities or other disadvantaged groups unable to obtain conventional financing on reasonable terms. The foundation expected its capital contribution and its entrepreneurship initiatives to enhance investment in minority or disadvantaged businesses in low-income communities. I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006).

184. *Id.* at 2–3.

an angel investor and investing in certain types of minority-owned or otherwise disadvantaged businesses, providing these businesses with technical support and educating the other individual investors about angel investing and entrepreneurship.[185] The private foundation was the lead investor, and its mission was to help individuals achieve economic independence by advancing education and entrepreneurship.[186] The foundation's rate of return was predicted to be lower than similar investments and all of the LLC's members shared equally in the return and risk of the fund.[187] Other notable aspects of the ruling were that the operating agreement gave the foundation approval on the LLC investments, required reports and other oversight authority, and specifically prohibited the LLC from engaging in lobbying or political campaigning.[188] Given the foregoing facts, the IRS found that the foundation's investment was a PRI.[189]

The examples above illustrate that properly structured investments to for-profit entities in economically distressed urban areas are valid PRIs. If Ann and Carl are able to identify a private foundation with a purpose aligned with GFGPC's charitable purpose, show they are unable to obtain conventional financing, specifically provide the L3C statutory language that tracks the PRI language in their articles and operating agreement, and provide for oversight and control by the foundation in their operating agreement, an investment from the private foundation to GFGPC should be considered a PRI. Although the private foundation would still have to exercise expenditure responsibility over the PRI, the benefits of making a PRI, including making a more impactful direct investment to an organization and receiving a return on its investment and other tax benefits,[190] should make the PRI a more attractive option to the private foundation. If GFGPC is structured as an L3C, GFGPC's managers would be legally required to operate primarily for charitable purposes which should provide more assurance to private foundations with charitable purposes aligned with GFGPC that its investment would be a PRI. Despite this guidance, unless a critical mass of small- or medium-sized foundations take the lead on making PRIs to urban social enterprises (or to intermediary organizations that will fund these urban social enterprises), they will likely continue to be hesitant to make PRIs. So, Ann and Carl may not be able to obtain PRI funding for GFGPC.[191]

185. *Id.* at 3–4.
186. *Id.* at 3.
187. *Id.* at 5.
188. *Id.* at 5–6.
189. *Id.* at 14.
190. *See* CHERNOFF, *supra* note 171, at 8–9.
191. Even if a social enterprise, such as Ann and Carl's, is able to find a private

The L3C entity may also deter other types of investors from investing in Ann and Carl's venture. The "low-profit" designation and the statutory language that states "no significant purpose of the company is the production of income or the appreciation of property" may discourage certain types of socially conscious investors who are seeking a certain level of return. Concerns about the low-profit margins of the L3C could practically limit Ann and Carl's ability to attract a broad range of investors.

Another disadvantage of the L3C for Ann and Carl, their investors, and customers is that there is no regular mechanism for determining whether an L3C continues to principally pursue its charitable and educational purposes. Although the L3C statutes require an L3C that no longer meets the requirements of an L3C to convert to an LLC, there is no way to adequately monitor the L3C to ensure that it either meets the statutory requirements or has converted to an LLC.

For example, the Vermont statute provides that an L3C that fails to satisfy the requirements of an L3C will immediately cease to be an L3C, but will continue to exist as an LLC as long as it meets the requirements of the statute. The statute also requires the L3C to change its name to indicate it is no longer an L3C.[192] Under this statute, if a manager of GFGPC decides to reduce the number of unemployed and underemployed Metropolis citizens hired in order to hire other individuals who may require less training and potentially increase the profits to GFGPC, this could cause the L3C to cease to be an L3C. If GFGPC's articles are not amended to indicate it no longer is an L3C, there is no authority to ensure that the reporting requirement has been met to inform the public that the establishment is no longer an L3C. This could mislead the L3C's investors, customers, and the general public who may not be aware of the conversion and therefore decide to continue to invest in or patronize GFGPC despite the fact that it is no longer a social enterprise.

IV. RECOMMENDATIONS FOR THE L3C

Although the L3C is still in its early stages of development and has certain disadvantages for urban social entrepreneurs, such as Ann and Carl, the entity should be further developed to address the capital concerns and hybrid purposes of social enterprises. First, the statutory language of the L3C, which states that "no significant purpose of the company shall be the production of income or appreciation of property," should be changed to allow the company to have as an important purpose the production of

foundation interested in making a PRI to them, the private foundation would likely not make the PRI directly to the individual social enterprise but to an intermediary who would then distribute the PRI funds to the individual social enterprises.

192. *See* VT. STAT. ANN. tit. 11, §§ 3001(27), 3005(a), 3023(a).

income or appreciation of property, but should also not allow that purpose to outweigh the charitable or educational purpose of the company. Revising this provision should allay the fears of certain socially conscious investors who are concerned about not making a certain return on their investment.

Another recommendation is to amend the L3C provisions of the LLC statutes to require the L3C articles and operating agreement to specifically state the L3C's particular charitable or educational purposes, in addition to stating that the L3C will significantly further the accomplishment of those purposes. Similar to nonprofit, tax-exempt organizations, this will require L3Cs to clearly articulate their purposes and provides a prima facie case to foundations, investors, customers, and the general public that the L3C is organized to significantly further charitable or educational purposes. Another suggested revision to the L3C provisions in the LLC statutes is that L3Cs should be required to submit an annual report to the state that will be available to the public. The annual report should state that the L3C continues to significantly further the charitable or educational purpose set forth in its articles and operating agreement and provide a report discussing how its activities further that charitable or educational purpose. The L3C managers should also be required to issue a similar report to its investors every year. Although some L3Cs may have converted to LLCs in between the periods they are required to submit the annual report, the report should at least prompt those L3Cs that have converted during that period to change their names to indicate their current LLC status.

CONCLUSION

The L3C is a positive development for social enterprises, including for those minority-owned urban social enterprises working to improve conditions in economically deteriorated urban areas. Urban social enterprises owned by minority social entrepreneurs have a unique understanding of the issues impacting the urban areas in which they reside. These urban social enterprises are particularly poised to provide resources, such as jobs and entrepreneurship training to the disadvantaged citizens of these areas. Yet, these urban social entrepreneurs must be able to adequately finance their ventures to become sustainable, impactful companies. The L3C offers the possibility for minority-owned urban enterprises to gain access to a greater number of investors, but the L3C needs to be further developed to accomplish this goal. Indeed, although the LLC is currently the preferred entity form for businesses, the LLC was not widely accepted until there were changes in the federal income tax rules that provided significant tax advantages to operating as an LLC.[193]

193. RIBSTEIN & KEATINGE, *supra* note 90, at 1.

Likewise, it is necessary to consider changes to the federal income tax rules pertaining to PRIs and to the L3C statutes to facilitate the use of L3Cs for urban social enterprises.

As more socially conscious investors interested in making impact investments in urban areas become aware of the L3C's potential and the entity's commitment to accomplishing charitable purposes as well as making a profit, the investors should find that the L3C form is an attractive investment vehicle that ensures a dedication to double- and triple-bottom line goals. Just as the C corporation is a brand that high-tech companies use to attract venture capital financing,[194] the L3C should continue to develop its brand for urban social entrepreneurs to use to attract urban impact investments. The L3C must be further refined as set forth in this Article to enable urban social enterprises to more effectively amass the financial resources they need to become viable entities. These entities can help urban areas become places of opportunity, innovation, and economic success in the United States.

194. Mann et al., *supra* note 54, at 803–04.

ARTICLE

CAN'T SEE THE FOREST FOR THE TREES: WHERE DOES A PURCHASE OR SALE OF SECURITIES OCCUR?

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INTRODUCTION

Whether Justice Scalia chopped down the "judicial oak which ha[d] grown from little more than a legislative acorn"[1] or cleared an entire forest of "botanically distinct tree[s]"[2] when he created the transactional test in *Morrison v. National Australia Bank, Ltd.*, he undoubtedly changed the legal landscape for both international and antifraud securities laws. The transactional test—which the Supreme Court designed to act as a bright-line rule to supplant the older "conduct" and "effects" tests developed by the Second Circuit—gauges whether a U.S. court can hear an antifraud securities case containing extraterritorial elements.[3] In clearing away decades of federal extraterritorial jurisprudence, *Morrison* dictates that an American court may no longer hear an antifraud securities case under Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act")[4] and Rule 10b-5[5] unless the purchase or sale of securities occurred within the United States.[6]

Since its creation, the transactional test has gained both positive and negative attention from the international legal community.[7] But after the hundreds of securities class action cases adjudicated since the day of the decision,[8] the question remains: Does the transactional test clarify when an international securities antifraud claim falls within U.S. jurisdiction?

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1. Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2889 (2010) (Breyer, J., concurring in part) (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 737 (1975)).

2. *Id.* at 2880 n.4.

3. *See id.* at 2877–84 (explaining the history behind the "conducts" and "effects" tests and concluding that Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities").

4. 15 U.S.C. § 78j(b) (2006).

5. 17 C.F.R. § 240.10b-5 (2010).

6. *See Morrison*, 130 S. Ct. at 2888 (Stevens, J., concurring in part).

7. *Compare* Andreas Tilp et al., *AGORA* – Morrison v. National Australia Bank, 35 DAJV NEWSLET. 116, 119 (2010) (Ger.) ("Foreign companies who had been subject to actions for damages for having violated securities laws heaved a great sigh of relief."), *with* David Greene, *The US Ruling on Morrison v NAB Deals a Blow to the International Claims Culture*, THE GUARDIAN (June 28, 2010, 11:05 EDT), http://www.guardian.co.uk/law/2010/jun/28/supreme-court-morrison-national-australia-bank/print ("[T]he supreme court [sic] decision is a major step back for UK investors.").

8. *See* Luke Green, Morrison v. National Australia Bank - *The Dawn of a New Age?*, ISS (June 25, 2010, 5:54 PM), http://blog.issgovernance.com/slw/2010/06/morrison-v-national-australia-bank---the-dawn-of-a-new-age.html (noting that over a thousand class action securities cases were pending following the decision).

This Article will show that while Justice Scalia may have cut down the occasionally thorny "conduct" and "effects" tests, the seeds he planted with the transactional test may be just as difficult to care for and administer. Courts must now grapple with defining the "purchase" and "sale" of a securities transaction, and then determine whether such actions occurred within the United States. Within a complex global marketplace experiencing frequent cross-border activity, such terms are not easily defined and lead to contrary holdings on similar fact patterns.

Part I of this Article looks at how courts were able to avoid the terms "purchase" and "sale" prior to *Morrison*. Part II examines how *Morrison* used those terms in its decision. Part III analyzes how courts have thus far interpreted the *Morrison* transactional test and breaks down the various methods used in reaching their decisions. Finally, Part IV suggests a method for unifying the disparate methods of identifying whether a securities transaction is domestic or not.

I. EXTRATERRITORIAL APPLICATION OF "PURCHASE" OR "SALE" LANGUAGE PRIOR TO *MORRISON V. NATIONAL AUSTRALIA BANK, LTD.*

Although courts prior to the *Morrison* decision agreed that there should be an extraterritorial reach for antifraud provisions, there was little consensus as to how it should be applied.[9] Most private parties rely on Section 10(b) of the Exchange Act and Rule 10b-5 to bring a transnational securities fraud case within the United States.[10] The

9. *Morrison*, 130 S. Ct. at 2880 ("Although the circuits . . . seem to agree that there are some transnational situations to which the antifraud provisions of the securities laws are applicable, agreement appears to end at that point." (quoting Kauthar SDN BHD v. Sternberg, 149 F.3d 659, 665 (7th Cir. 1998))); *see* Hannah L. Buxbaum, *Remedies for Foreign Investors Under U.S. Federal Securities*, 75 LAW & CONTEMP. PROBS. 161, 161 (2012) (explaining that while public enforcement of securities law has become more efficient over the years due to improved cooperation between regulators worldwide, private enforcement has been much less unified).

10. Genevieve Beyea, Morrison v. National Australia Bank *and the Future of Extraterritorial Application of the U.S. Securities Laws*, 72 OHIO ST. L.J. 537, 540–41 n.11 (2011) ("The securities regulatory regime seeks to prevent and punish fraud via numerous provisions in both the Securities Act of 1933 and the Exchange Act. However, the most far-reaching of these provisions is Section 10(b) of the Exchange Act, and its accompanying Rule 10b-5 . . . ."). While Congress explicitly provided for a private cause of action under Sections 9 and 18 of the Exchange Act, they failed to do so under Section 10(b). However, courts have taken the position "that a right to be free from fraud implie[s] a remedy to make that right effective." STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: THE ESSENTIALS 107–08 (Vicki Been et al. eds., 2008).

broad language of both Section 10(b) and Rule 10b-5 was written to "close[] a loophole in the protections against fraud."[11] Thus, courts determined that Congress meant for Section 10(b) to protect investors regardless of whether they purchased or sold securities on U.S. markets.[12] To determine if there was a sufficient jurisdictional nexus between the conduct abroad and the investors Congress intended to protect, courts applied the "conduct" and "effects" tests.[13]

The "effects" test states that the United States has jurisdiction over claims arising out of fraudulent extraterritorial conduct that caused losses within the United States or harmed U.S. markets.[14] *Schoenbaum v. Firstbrook* first articulated this test in 1968.[15] The case involved the sale of treasury shares of a Canadian corporation, Banff Oil, Ltd., at a market price Banff and its directors knew would undervalue the shares.[16] The plaintiff was an American citizen and Banff common stock was traded on both the American Stock Exchange and the Toronto Stock Exchange.[17] Although the fraudulent transaction occurred in Canada, the court found that since Banff was listed on a U.S. stock exchange, it was required to comply with certain U.S. securities laws.[18] In particular, the court held that Section 10(b) had an extraterritorial reach if such fraudulent actions had a detrimental effect on U.S. investors.[19]

The "conduct" test looks to the actions taken by the allegedly fraudulent parties.[20] If such actions occurred within the United States, directly caused harm to investors, and were material to the alleged fraud, then U.S. courts had jurisdiction—regardless of whether the investors were U.S. citizens or whether the securities were bought or sold within the United States.[21] Judge Henry

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11. Exchange Act Release No. 34-3230, 1942 WL 34443 (May 21, 1942).

12. Beyea, *supra* note 10, at 541 (citing Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1336 (2d Cir. 1972)).

13. *Id.* at 542; Buxbaum, *supra* note 9, at 161.

14. Beyea, *supra* note 10, at 542; Buxbaum, *supra* note 9, at 161.

15. Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968); *see* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2879; Beyea, *supra* note 10, at 542.

16. *Schoenbaum*, 405 F.2d at 204.

17. *Id.*

18. *Id.* at 206.

19. *Id.*

20. *See* Beyea, *supra* note 10, at 543–44.

21. *See id.*

Friendly first laid out the test in the 1972 case *Leasco Data Processing Equipment Corp. v. Maxwell*.[22]

In *Leasco*, the plaintiffs, both U.S. and U.K. citizens, alleged that U.K. defendants fraudulently induced them to buy U.K. corporate stock at inflated prices.[23] Looking to Section 17 of the Restatement of Foreign Relations Law of the United States,[24] the court held that Section 10(b) could apply outside the United States so long as there was "significant conduct" related to the fraud.[25]

Judge Friendly further refined these two tests in *Bersch v. Drexel Firestone, Inc.*[26] As to the "conduct" test, Judge Friendly asserted that losses from securities sales to foreigners outside the United States would only fall under the jurisdiction of U.S. securities laws when the parties' conduct directly caused such losses.[27] However, losses occurring to Americans abroad would not have to meet such a high standard. Instead, such losses would fall under U.S. jurisdiction if the acts or omissions that occurred within the United States were of material importance.[28] For the "effects" test, Judge Friendly limited the test's scope to those actions that would injure "purchasers or sellers" of securities in whom the United States had an interest, excluding actions that had a general detrimental effect on the economy or U.S. investors.[29]

Until the Supreme Court overturned decades of precedent,[30] courts generally applied the principles found within the Restatement of

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22. 468 F.2d 1326 (2d Cir. 1972).

23. *Id.* at 1330.

24. RESTATEMENT (SECOND) OF FOREIGN RELATIONS LAW OF THE UNITED STATES § 17 (1965) ("A state has jurisdiction to prescribe a rule of law . . . relating to a thing located, or a status or other interest localized, in its territory.").

25. Conduct within the United States alone can be sufficient to allow a U.S. law to be applied extraterritorially, but courts need to interpret each statute to see if it is meant to be applied extraterritorially. Section 17(a) of the Securities Act of 1933, for example, explicitly applies to both foreign and domestic issuers and therefore can be applied extraterritorially. Since Section 10(b) was modeled after Section 17(a), it too can be applied extraterritorially so long as sufficient conduct occurs within the United States. *See Leasco*, 468 F.2d at 1334–35.

26. 519 F.2d 974 (2d Cir. 1975).

27. *See id.* at 993.

28. *Id.*

29. *Id.* at 989; *see* Richard B. Earls, Note, *Extraterritorial Application of Fraud Provisions of the Commodity Exchange Act*, 41 WASH. & LEE L. REV. 1215, 1222 n.51 (1984) (noting that the court held that a general deterioration of investor confidence resulting in a decline in securities prices is insufficient to trigger the "effects" test).

30. *See supra* notes 3 & 7 and accompanying text.

Foreign Relations Law to extraterritorial regulatory law.[31] Jurisdiction was based either on "conduct, that, wholly or in substantial part, takes place within its territory [the 'conduct' test] and conduct outside its territory that has or is intended to have substantial effect within its territory [the 'effects' test]."[32] While both of these tests mention the sale and purchase of securities, there was no need for courts to determine exactly where a purchase or sale of securities occurred.[33] Instead, courts focused on the parties, their actions, and the effects they had on either U.S. investors or U.S. markets. The broad scope of Section 10(b) and Rule 10b-5 allowed courts to assume congressional intent as to the extraterritorial reach of antifraud U.S. securities laws[34] and sidestep the issue of where a security was purchased or sold.[35]

II. THE LANGUAGE OF *MORRISON* AND WHAT "PURCHASE" OR "SALE" MEANS UNDER THE "TRANSACTIONAL TEST"

As an "F-cubed" case (foreign petitioners filing suit against foreign respondents over stocks sold on a foreign exchange), *Morrison* was the first Supreme Court case to address the

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31. Genevieve Beyea, *Transnational Securities Fraud and the Extraterritorial Application of U.S. Securities Laws: Challenges and Opportunities*, 1 GLOBAL BUS. L. REV. 139, 145 (2011); *see* SEC, STUDY ON THE CROSS-BORDER SCOPE OF THE PRIVATE RIGHT OF ACTION UNDER SECTION 10(B) OF THE SECURITIES EXCHANGE ACT OF 1934, 59 n.218 (2012), *available at* http://www.sec.gov/news/studies/2012/929y-study-cross-border-private-rights.pdf [hereinafter *Cross-Border Private Rights Study*] ("*The Restatement of Foreign Relations Law* is one of the leading secondary authorities on international and foreign-relations law, and is also generally viewed as a persuasive authority on questions of international comity such as those implicated by the potential extraterritorial extension of a Section 10(b) private cause of action.").

32. Beyea, *supra* note 31, at 145–46.

33. *Compare* Schoenbaum v. Firstbrook, 405 F.2d 200, 210 (2d Cir. 1968) (explaining that a foreign purchase or sale of securities is sufficient to trigger the "effects" test, and therefore Section 10(b) has extraterritorial reach), *with* Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d 1326, 1336–37 (2d Cir. 1972) (explaining that because Section 10(b) was intended to protect against fraudulent conduct in the purchase or sale of securities, it had extraterritorial reach so long as a sufficient amount of the fraudulent conduct occurred within the United States).

34. *See supra* notes 12 & 13 and accompanying text.

35. This is not to say that the "conduct" and "effects" tests were reliable tests in the U.S. judicial system. They often yielded fairly unpredictable results and the Second Circuit often did not give guidance as to what factors were determinative. *See* Morrison v. Nat'l Austl. Bank, Ltd. 130 S. Ct. 2869, 2879–80 (2010); Beyea, *supra* note 31, at 148; Joshua L. Boehm, Comment, *Private Securities Fraud Litigation after* Morrison v. National Australia Bank*: Reconsidering a Reliance-Based Approach to Extraterritoriality*, 53 HARV. INT'L L.J. 249, 254–55 (2012); Buxbaum, *supra* note 9, at 161–62.

extraterritorial reach of U.S. antifraud securities claims.[36] Petitioners were Australian nationals who had purchased common stock shares of respondent's Australian company, National Australia Bank, Ltd. ("National"), on the Australian Stock Exchange and other foreign stock exchanges.[37] HomeSide Lending, Inc., a Florida-based mortgage servicing company, was a wholly-owned subsidiary of National.[38] With National's knowledge, HomeSide manipulated its financial models to make it appear to be more profitable than it actually was.[39] National then included the company's inflated value in National's annual reports from 1998 through 2001 and touted its success.[40] In 2001, after National announced several write-downs related to the Florida-based company that amounted to over two billion dollars in losses, petitioners filed suit.[41] The district court dismissed petitioners' claims stating that they failed to provide sufficient evidence to create a jurisdictional nexus within the United States under either the "conduct" or "effects" tests.[42] A panel of five judges affirmed the holding on appeal.[43]

While the Supreme Court could have affirmed the lower courts' decisions, Justice Scalia instead decided to do away with both the "conduct" and "effects" tests. First, he pointed to the longstanding presumption against extraterritoriality in statutory law unless the language explicitly provided for one.[44] Then, after examining the history and application of the "conduct" and "effects" tests, the Court held that such tests were "judicial-speculation-made-law" and thus lead to incongruous results.[45] This analysis lead to *Morrison*'s main holding: Section 10(b) only applies to "transactions in securities listed on domestic exchanges, and domestic transactions in other securities."[46] The newly dubbed "transactional test" focuses on the

36. Beyea, *supra* note 10, at 550.

37. *In re* Nat'l Austl. Bank Secs. Litig., No. 03 Civ. 6537(BSJ), 2006 WL 3844465, at *1 (S.D.N.Y. Oct. 25, 2006).

38. *Id.*

39. *Id.* at *1–2.

40. *See id.* at *2.

41. *Id.*

42. *See id.* at *8 ("[I]t is the foreign acts—not any domestic ones—that 'directly caused' the alleged harm here.").

43. Morrison v. Nat'l Austl. Bank, Ltd., 547 F.3d 167, 177 (2d Cir. 2008).

44. Morrison v. Nat'l Austl. Bank, Ltd.,130 S. Ct. 2869, 2877 (2010).

45. *Id.* at 2881.

46. *Id.* at 2884.

strict textual reading of Section 10(b), creating a bright-line rule centered solely on where the purchase or sale occurred.

While the terms "purchase" and "sale" are contained within Section 10(b),[47] as well as defined within the Exchange Act,[48] the term "transaction" is not. Throughout the opinion, Justice Scalia refers to the application of Section 10(b) using the words "purchase," "sale," and "transaction" but only uses all three terms together in a single sentence once.[49] While Justice Breyer's concurrence is more explicit in equating a "transaction" to a "purchase" and "sale" of securities,[50] Justice Stevens's concurrence never mentions those terms together in a single sentence.[51]

One could take such rhetoric to mean that the Supreme Court meant to equate "purchase" and "sale" as a "transaction" in its test, but such a reading could force the test to be applied too expansively or too narrowly.[52] Under the Exchange Act, a "purchase" is defined as "any contract to buy," and a "sale" as "any contract to dispose of."[53] Black's Law Dictionary defines "transaction" as the "discharge of a contract."[54] Therefore, depending on which definition a court looks to, a transaction could either be held to be the solicitation, formation, and execution of purchase and sale contracts or solely the discharge of such contracts. Finally, since Section 10(b) reads "purchase *or* sale," rather than "purchase *and* sale," one can infer that the statute recognizes temporal and geographic differences between when and where a security is sold and bought, unlike the term "transaction," which makes no such distinction.[55]

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47. 15 U.S.C. § 78j(b) (2012).

48. *Id.* § 78c(a)(13)–(14).

49. *Morrison*, 130 S. Ct. at 2886 ("The transactional test we have adopted—whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange—meets that requirement.").

50. *Id.* at 2888 (Breyer, J., concurring in part) ("Section 10(b) of the [Exchange Act] applies to fraud 'in connection with' two categories of transactions: (1) 'the purchase or sale of any security registered on a national securities exchange' or (2) 'the purchase or sale of . . . any security not so registered.'").

51. *Id.* at 2888–95 (Stevens, J., concurring).

52. *See* 2 VED P. NANDA & DAVID K. PANSIUS, LITIGATION OF INTERNATIONAL DISPUTES IN U.S. COURTS § 8:36, 8-235 (2d ed. 2012).

53. 15 U.S.C. § 78c(a)(13)–(14).

54. BLACK'S LAW DICTIONARY 1635 (9th ed. 2009).

55. *See* 2 NANDA & PANSIUS, *supra* note 52, § 8:36, at 8-235 to 8-236 ("There is only one reasonable conclusion consistent with *Morrison*. If *either* the offer to purchase or the acceptance of the sale offer occurred in the United States, or, if *either* the offer to sell or the acceptance of the purchase offer occurred in the United States, then section 10(b) applies."). *But see id.* § 8:36, at 8-236 ("The argument could be

While the transactional test attempted to simplify the determination of whether U.S. securities laws have an extraterritorial reach, it created its own ambiguity in terms of where a "sale" or "purchase" of securities occurs. Part of this ambiguity is due to the language Justice Scalia used in *Morrison* to describe the transactional test.[56] In stating that Section 10(b) only applies to domestically listed securities and domestic transactions in other securities,[57] the Court left open questions on how to interpret transactional elements in an extraterritorial context.[58] For example: Does the purchase occur where the order is placed or where the security was offered? Or neither? Does the transaction occur where the security was cleared?[59] Does either party have to be an American citizen in order to gain protection under Section 10(b) for a securities transaction not listed on a U.S. exchange? As this Article discusses below, different courts have interpreted *Morrison* in varying, and sometimes contradictory, ways.

III. HOW COURTS HAVE DETERMINED WHEN AND WHERE A "PURCHASE" OR "SALE" HAS OCCURRED POST-*MORRISON*

In being forced to give up the "conduct" and "effects" tests, courts have had to apply an entirely different rubric when analyzing the jurisdictional requirements of an international antifraud case. The transactional test the Supreme Court created in *Morrison* applies in one of two situations: transactions for securities listed on a domestic exchange or transactions for securities not listed on an exchange but that are domestic.[60] While the test easily applies to f-cubed

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made that what the statute means is that the [Exchange Act] only applies to securities traded on U.S. exchanges, and securities that are not traded on any national . . . exchange so long as the purchase or sale occurs in the United States.").

56. *See id.* § 8:33, at 8-207 to 8-209 (pointing to three separate mentions of *Morrison*'s "transactional test" which could each presumably be interpreted differently).

57. Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2884 (2010).

58. By focusing on what Section 10(b) does not say and not clarifying what it does say, *Morrison* only definitively states that an "f-cubed" case does not have extraterritorial jurisdiction. Terms like "purchase," "sale," "transaction," and "settles" have multiple interpretations which will force courts to make a decision on what Justice Scalia meant in his transactional test. *See* 2 NANDA & PANSIUS, *supra* note 52, § 8:36, at 8-223.

59. BLACK'S LAW DICTIONARY 1554 (9th ed. 2009) (defining "stock clearing" as "the actual exchange of money and stock between buyer and seller . . . .").

60. *See* Beyea, *supra* note 10, at 562; Boehm, *supra* note 35, at 263; Buxbaum, *supra* note 9, at 162.

transactions, the complex nature of international financial instruments in the global marketplace makes it difficult to uniformly apply the transactional test to other instances.[61] In noting the disparity between courts in interpreting the two prongs of *Morrison*, it is clear that having a strict, textual-based reading of a law can lead to, at best, abnormal and, at worst, unjust results.[62]

A. Applying Morrison *to Securities Listed on Domestic Exchanges*

The first prong under the *Morrison* transactional test seems deceptively easy to parse. A "transaction[] in securities listed on [a] domestic exchange[]"[63] is a domestic transaction and thus a purchase or sale of securities within the United States. However, the global nature of the securities marketplace makes this phrase somewhat less than clear. Companies can have shares cross-listed on both a foreign exchange and an American exchange. While courts have rejected the idea that shares purchased on a foreign exchange are a domestic transaction because they are cross-listed, a strict textual reading of *Morrison* implies that such transactions are domestic.[64]

American Depositary Receipts ("ADRs")[65] also complicate a court's interpretation of whether a purchase or sale traded on an exchange is domestic or not. Most international companies trade their shares on U.S. exchanges as ADRs.[66] Each ADR can represent

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61. *See* Buxbaum, *supra* note 9, at 173.

62. *See, e.g.*, Boehm, *supra* note 35, at 262–63 (explaining that a large number of cases that courts have struggled to answer consistently due to the circumstance-dependent questions present in complex securities transactions); Buxbaum, *supra* note 9, at 164–73 (comparing how courts have interpreted transactions of securities listed on domestic exchanges, foreign exchanges, and transactions of American Depositary Receipts as well as comparing how courts have interpreted various over the counter securities transactions).

63. Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2884 (2010).

64. *In re* Vivendi Universal, S.A. Secs. Litig., 765 F. Supp. 2d 512, 530 (S.D.N.Y. 2011) (noting that all courts interpreting *Morrison* have rejected the idea that transactions that involve securities listed but not traded on a domestic exchange are domestic transactions. "Read in this context, perhaps Justice Scalia simply made a mistake. He stated the test as being whether the alleged fraud concerned the purchase or sale of a security 'listed on an American stock exchange,' . . . when he really meant to say a security 'listed and traded' on a domestic exchange.") (quoting *Morrison*, 130 S. Ct. at 2888).

65. *See generally Cross-Border Private Rights Study*, *supra* note 31, at A1–A4 (giving an in-depth description of how ADRs are created and the ADR market in the United States).

66. *International Investing*, U.S. SEC. & EXCH. COMM'N (last modified Aug. 14, 2012), http://www.sec.gov/investor/pubs/ininvest.htm [hereinafter *International Investing*].

a single share, multiple shares, or a fraction of a share of an international company's stock.[67] While the ADR corresponds to the price of the foreign stock on its home market, trades of ADRs clear and settle in U.S. dollars.[68] A depositary bank, which issues the ADRs, generally sends the ADR owner any dividends or cash payments in U.S. dollars and arranges to vote the owner's shares as per the owner's instructions.[69] Additionally, ADRs cannot be issued within the United States unless they are subject to the periodic reporting requirements under the Exchange Act[70] or are exempt from these reporting requirements under Rule 12g3-2(b).[71] Finally, possession of an ADR gives an owner the right to obtain the foreign stock if the owner so chooses.[72] It has been difficult for courts to decide whether purchasing an ADR on a U.S. exchange is a domestic transaction or merely a proxy for a foreign purchase. Since ADRs are purchased and sold on a U.S. exchange, one could argue that they meet the transactional test requirement. But since they are a contract for purchasing foreign securities listed on a foreign market, one could also argue that, under *Morrison*, ADRs fall outside the jurisdiction of U.S. antifraud securities law.

1. Purchases and Sales on Foreign Exchanges

One of the first cases to deal with deciding whether purchasing shares on foreign exchanges is a domestic transaction is *Stackhouse v. Toyota Motor Co.*[73] *Stackhouse* was a class action suit which arose over intentional misstatements by Toyota about the safety of eight of its vehicles.[74] Between 2004 and 2010, Toyota, which was listed on the Tokyo Stock Exchange and the New York Stock Exchange ("NYSE"), claimed that numerous accidents involving

67. *Id.*

68. *Id.*

69. *See id.* ("The depositary bank will convert any dividends or other cash payments into U.S. dollars before sending them to you.").

70. 15 U.S.C. § 78l(g) (2010).

71. *See* 17 C.F.R. § 240.12g3-2(b) (2010). *See generally* HAL S. SCOTT & ANNA GELPERN, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 115 (Robert C. Clark et al. eds., 18th ed. 2011) (explaining the registration and reporting requirements under the Securities Act of 1933 and the Securities and Exchange Act of 1934).

72. *See International Investing*, *supra* note 66.

73. No. 10-0922, 2010 WL 3377409 (C.D. Cal. July 16, 2010).

74. Complaint at *1–5, Stackhouse v. Toyota Motor Corp., No. 10-0922, 2010 WL 562034 (C.D. Cal. Feb. 8, 2010).

unintended acceleration were due to driver error or faulty placemats.[75] When Toyota finally revealed that it had known about the problem and issued a massive recall, its stock price fell sharply.[76] The plaintiffs in the class action were U.S. citizens "who purchased or otherwise acquired . . . securities of [Toyota], including [ADRs[77] traded on the NYSE]."[78] In determining who should be the lead plaintiffs in the class action suit, Judge Fischer dismissed the idea that buying or selling securities listed on a foreign exchange while residing in the United States constituted a domestic transaction.[79] Instead, Judge Fischer reasoned that purchasing or selling a security on a foreign exchange was akin to going to the exchange and completing the transaction through a foreign broker.[80] Domestic transactions, therefore, only occurred when the purchases and sales were explicitly solicited by the issuer within the United States.[81]

Cornwell v. Credit Suisse Group narrowed the definition of a domestic transaction from *Stackhouse* by rejecting all activity on a foreign exchange.[82] Plaintiffs were parties who had either bought Credit Suisse Group shares on the Swiss Stock Exchange or ADRs[83] on the NYSE.[84] Credit Suisse Group had allegedly made material misrepresentations or omissions about its risk practices and its stock price fell sharply due to the U.S. housing market crash.[85] The group that purchased shares on the Swiss Stock Exchange argued that the terms "purchase" and "sale" should be interpreted within the context of the choice of law provisions in the Restatement (First) of Conflict of Laws.[86] Judge Marrero rejected these arguments as merely trying

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75. *Id.* at *2–4.

76. *Id.* at *3–5.

77. The case actually discusses purchases of American Depositary Shares ("ADSs"). ADRs and ADSs are basically synonymous. *International Investing, supra* note 66 ("An ADR is actually the negotiable physical certificate that evidences ADSs, . . . and an ADS is the security that represents an ownership interest in the [foreign security].").

78. Complaint, *supra* note 74, at *7.

79. Stackhouse v. Toyota Motor Co., No. 10-0922, 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010).

80. *Id.*

81. *Id.*

82. *See* Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 625–26 (S.D.N.Y. 2010).

83. *See supra* note 77.

84. *Cornwell*, 729 F. Supp. 2d at 621.

85. *Id.* at 622.

86. *See id.* (reasoning that since the parties made the investment decision in the

to reinstate the "effects" test into the transactional test.[87] Instead, he looked to the corollary of the transactional test and held that trades executed on foreign exchange markets are never truly domestic transactions, even if some aspect of the transaction occurs within the United States.[88] Therefore, any transaction that occurs on a foreign exchange would be considered a purchase or sale that occurred outside the United States.

2. Purchases and Sales of Cross Listed Securities

Sgalambo v. McKenzie[89] and *In re Alstom SA Securities Litigation*[90] examined purchases and sales of securities on foreign exchanges when the shares were listed and sold on both domestic and foreign exchanges, rather than through ADRs. Both cases were class action suits brought against Canadian and French corporations, respectively, for material misstatements which violated Section 10(b) of the Exchange Act.[91] Each company was listed on an American exchange as well as a foreign exchange, but the plaintiffs purchased their shares off the foreign exchange.[92] While the parties in *Sgalambo* conceded that their purchases of securities were not made within the United States, and therefore did not meet the transactional test,[93] the plaintiffs in *Alstom* argued that because the purchases could have easily been made on the domestic exchange, they should be considered domestic purchases.[94] Further, the plaintiffs argued that their purchases of securities on a foreign exchange were "domestic" under *Morrison*, since those securities' ADRs were listed

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United States, accepted the shares into its U.S. account, and incurred the risks within the United States, it was a domestic transaction).

87. *Id.* at 625 ("This Court is not convinced that the Supreme Court designed *Morrison* to be squeezed, as in spandex, only into the factual strait jacket of its holding.").

88. *See id.* at 623–26 (finding that even if foreign transactions include American investors or if portions of the transaction occur within the United States, the exception pursued by the plaintiffs would not comply with the new rule due to the rare occasion that foreign transactions lack any connectivity to the United States).

89. 739 F. Supp. 2d 453 (S.D.N.Y. 2010).

90. 741 F. Supp. 2d 469 (S.D.N.Y. 2010).

91. *Id.* at 471; *Sgalambo*, 739 F. Supp. 2d at 463–68.

92. *See In re Alstom*, 741 F. Supp. 2d at 471 (noting that the corporation was listed on the French Stock Exchange); *Sgalambo*, 739 F. Supp. 2d at 487 (noting that the corporation was listed on the Toronto Stock Exchange).

93. *Sgalambo*, 739 F. Supp. 2d at 487.

94. *In re Alstom*, 741 F. Supp. 2d at 471–72.

on a U.S. exchange.[95] Judge Marrero, using *Cornwell*, held that purchases and sales on a foreign exchange cannot be considered domestic transactions and that, despite the wording in *Morrison* regarding listed securities, Section 10(b) focuses solely on purchases and sales.[96] Therefore, because the actual purchases and sales were made on a foreign exchange, they could not be considered domestic even though they were also listed on a domestic exchange.[97]

3. Purchases and Sales of ADRs

Courts have not yet come to a single consensus on how to classify purchases and sales of ADRs. Earlier court decisions like *Stackhouse* and *Cornwell* assumed that since ADRs were securities listed and traded on a domestic exchange, they would fall within the scope of the transactional test.[98] But later courts have instead tried to analyze the economic realities behind what ADRs represent, making it more difficult for companies to predict whether they will be held liable for securities fraud under U.S. law.[99]

Judge Berman looked to the economic underpinnings of ADRs in *In re Société Générale Securities Litigation*.[100] *Société Générale* involved a class action suit against French company Société Générale by two sets of parties: those who had purchased securities on the Euronext Paris Stock Exchange and those who had purchased ADRs on the New York over-the-counter market.[101] The court quickly dismissed the parties who purchased shares on the Euronext Paris Stock Exchange as well as the parties who had purchased ADRs, even though they were purchased and traded on a domestic market.[102] The court concluded that ADR transactions were "predominantly foreign securities transactions"[103] since they

95. *Id.* at 472 ("[A] crucial paragraph of *Morrison* concludes that 'it is in our view only transactions in securities listed on domestic exchanges . . . to which § 10(b) applies.'" (citing Morrison v. Nat'l Austl. Bank, Ltd. 130 S. Ct. 2869, 2884 (2010))).

96. *Id.* at 472–73.

97. *Id.*

98. Stackhouse v. Toyota Motor Co., No. 10–0922, 2010 WL 3377409, at *1–2 (C.D. Cal. July 16, 2010) (holding that the largest ADR holder should represent the class action securities fraud case under the *Morrison* decision).

99. *See, e.g.*, *In re* Société Générale Secs. Litig. No. 08 Civ. 2495, 2010 WL 3910286, *6 (S.D.N.Y Sept. 29, 2010); SEC v. Compania Internacional Financiera S.A., No. 11 Civ. 4904(DLC), 2011 WL 3251813, *6 (S.D.N.Y. July 29, 2011).

100. No. 08 Civ. 2495(RMB), 2010 WL 3910286, at *5 (S.D.N.Y Sept. 29, 2010).

101. *In re Société Générale*, 2010 WL 3910286, at *1.

102. *Id.* at *5–7.

103. *Id.* at *6 (quoting Copeland v. Fortis, 685 F. Supp. 2d 498, 506 (S.D.N.Y.

represent foreign shares of stock and are "traded in a less formal market with lower exposure to U.S.-resident buyers."[104] Thus, under *Société Générale*, purchases and sales of ADRs—even in a domestic market between American investors—are foreign purchases and sales, due to what they represent.

The economic analysis of ADRs and their financial equivalents, however, can cut both ways in international securities law. The United States Securities and Exchange Commission ("SEC") successfully argued that shares sold on the London Stock Exchange were domestic purchases and sales in *SEC v. Compania Internacional Financiera S.A.*[105] The case involved a Swiss company acquiring an American company for twelve percent above its listed price on the NYSE.[106] A money manager based in Geneva, using inside information, purchased contracts-for-difference ("CFDs")[107] on the London Stock Exchange, which mirrored the American company's stock.[108] When the SEC filed an action against the defendants, freezing their assets, the money manager claimed that his purchase of CFDs was outside U.S. jurisdiction since it occurred entirely on the London Stock Exchange.[109] The court, however, held that *Morrison* dealt specifically with fraudulent activity in connection with domestic purchases and sales of securities.[110] Since the central issue in this case was insider trading of domestic securities listed on the NYSE, the defendants' purchases of CDFs constituted a domestic transaction under *Morrison*.[111] Further, the court argued that such a narrow reading of *Morrison* would protect

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2010)).

104. *Id.*

105. No. 11 Civ. 4904(DLC), 2011 WL 3251813, at *6 (S.D.N.Y. July 29, 2011).

106. *Id.* at *1.

107. A CFD is a contract whose purpose is to match "the price movements of individual shares or bonds, stock market indices, or futures contracts." For each day that the contract is open, the purchaser will either pay or receive payment based on the movement of the stock or bond on which the CFD is based. *CFM13130 - Understanding Corporate Finance: Derivative Contracts: Types Of Derivative: Limits To The Regulatory Definitions*, HM REVENUE & CUSTOMS, http://www.hmrc.gov.uk/manuals/cfmmanual/cfm13130.htm (last visited Aug. 5, 2012). As an ADR allows a U.S. investor to purchase the rights to foreign stocks without purchasing them on a foreign market via a foreign brokerage account, a CDF allows foreign investors to purchase U.S. securities without opening a U.S. brokerage account. *Compania*, 2011 WL 3251813, at *3.

108. *Compania*, 2011 WL 3251813, at *2–3.

109. *Id.* at *5.

110. *Id.* at *6.

111. *Id.*

individuals involved in complex securities frauds via the transactional test so long as they personally did not trade in securities, contrary to the *Morrison* court's intent.[112]

But not all judges view the economic realities of ADRs in the same light. In the cases of *In re Royal Bank of Scotland Group PLC Securities Litigation*[113] and *In re Vivendi Universal, S.A. Securities Litigation*,[114] Judges Batts and Holwell, respectively, each held that purchases and sales of ADRs could be considered domestic transactions.[115] Each case involved class action suits where the defendant companies sold securities on a foreign exchange and ADRs on the NYSE.[116] Unlike the court in *Société Générale*, the courts did not similarly dismiss the claims of parties holding ADRs.

In *Royal Bank of Scotland*, defendants admitted that the purchase and sale of ADRs would be considered a domestic transaction under *Morrison*.[117] Because the plaintiffs had not actually purchased any ADRs, Judge Batts dismissed the Section 10(b) claims, but hinted that purchasers of ADRs would have had standing.[118]

In contrast, Judge Holwell gave a detailed description of how ADRs are purchased and sold. First, the court pointed out that when a foreign issuer decides to issue ADRs within the United States, it subjects itself to SEC reporting requirements and, therefore, may create a nexus within the United States sufficient to constitute a domestic purchase and sale.[119] Judge Holwell then noted that registering with the SEC and being listed on an exchange are not one and the same.[120] While all shares of a company would be registered with the SEC, only those backing up the ADRs would be listed on a

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112. *Id.* at *7.

113. 765 F. Supp. 2d 327 (S.D.N.Y. 2011).

114. 765 F. Supp. 2d 512 (S.D.N.Y. 2011).

115. *Royal Bank of Scot.*, 765 F. Supp. 2d at 337–38; *In re Vivendi*, 765 F. Supp. 2d at 529.

116. *See In re Vivendi*, 765 F. Supp. 2d at 521; *Royal Bank of Scot.*, 765 F. Supp. 2d at 329–31.

117. *Royal Bank of Scot.*, 765 F. Supp. 2d at 337.

118. *Id.* at 337–38 ("[C]ase law supports dismissal on these ADR claims *where Plaintiffs are not purchasers*. . . . Lead Plaintiffs . . . do not have standing *to bring domestic ADR claims* . . . .") (emphasis added).

119. *In re Vivendi*, 765 F. Supp. 2d at 529 (noting that the nexus created may be enough to subject a company to the antifraud provisions of the Exchange Act).

120. *Id.* (looking at a sample NYSE listing application, the court noted that only the number of ordinary shares needed to back up the amount of ADRs were listed and not all shares of the company).

U.S. exchange.[121] Since not every common share backs up a domestically listed ADR, one cannot simply argue that ownership of a foreign common share gives someone U.S. jurisdiction under *Morrison*. However, by owning an ADR, one would own a share that was listed and traded on the NYSE, and therefore would be within *Morrison*'s purview, meaning that a purchase or sale of an ADR could be considered a domestic transaction.[122]

While courts have solidified around the concept that purchases on foreign exchanges fail the *Morrison* transactional test and therefore fall outside U.S. jurisdiction,[123] they have not yet coalesced around whether purchases and sales of ADRs are domestic transactions. *Société Générale*, on one hand, holds that all purchases and sales of ADRs, regardless of where they are bought and sold, are international transactions and therefore fail *Morrison*'s transactional test.[124] Alternatively, *Royal Bank of Scotland* and *Vivendi* each state that ADRs can be considered a domestic purchase so long as they were bought and sold on a domestic exchange.[125] Such holdings are troubling to both domestic investors and foreign companies. Investors cannot be sure whether they will be protected by U.S. securities laws and foreign companies do not know if they will be held liable for their actions outside the United States, contravening the purpose for creating *Morrison*'s transactional test.[126]

B. Applying Morrison *to Securities Not Listed on an Exchange*

When a purchase or sale of a security is not listed on a domestic exchange—also known as an over-the-counter ("OTC") transaction

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121. *Id.*

122. *See id.* ("The ADRs were both listed and traded on the NYSE, and thereby fall within any reading of *Morrison*.").

123. *See, e.g.*, Stackhouse v. Toyota Motor Co., No. 10-0922, 2010 WL 3377409, at *1 (C.D. Cal. July 16, 2010); Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 623–26 (S.D.N.Y. 2010); *In re* Alstom SA Secs. Litig., 741 F. Supp.2d 469, 472–73 (S.D.N.Y. 2010); Sgalambo v. McKenzie, 739 F. Supp. 2d 453, 487 (S.D.N.Y. 2010).

124. *See In re* Société Générale Secs. Litig., No. 08 Civ. 2495, 2010 WL 3910286, at *5–7 (S.D.N.Y. Sept. 29, 2010).

125. *See Royal Bank of Scot.*, 765 F. Supp. 2d 327, 337–38 (S.D.N.Y. 2011) (stating so implicitly); *In re Vivendi*, 765 F. Supp. 2d at 529.

126. *See* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2885–86 (2010) ("[Various foreign nations] complain of the interference with foreign securities regulation that application of § 10(b) abroad would produce, and urge the adoption of a clear test that will avoid that consequence. The transactional test we have adopted—whether the purchase or sale is made in the United States, or involves a security listed on a domestic exchange—meets that requirement.").

—courts have had to look more at the actions taken by parties to determine whether a domestic purchase or sale has occurred. An OTC transaction of a security has many elements, including the citizenship of the parties, the solicitation, the offer, the decision to invest, and the transferring of title for the instrument.[127] Courts have had to determine at what point in the process the transaction occurred and which of these factors were merely conduct and thus separate from the transaction. So far, courts have developed three main methods to determine whether a purchase or sale is domestic: the economic realities method, the irrevocable liability method, and the transfer of title method.[128] Unfortunately, each method can result in a different outcome for a purchaser or seller, making it difficult for courts to give proper guidance to issuers and investors.

1. The Economic Realities Method

As financial instruments become increasingly complex, courts have had to examine transactions where the purchases or sales of securities are based on pools of other securities and assets[129] or pools of asset-backed securities.[130] For example, if one were to invest in a foreign hedge fund, which, in turn, invested in domestic securities, would the purchase be a domestic transaction under *Morrison*? In these instances, the courts look at the "economic realities" of the transaction to determine whether the purchase of a complex security falls under *Morrison*'s transactional test.

In re Banco Santander Securities-Optimal Litigation[131] was one of the first cases to deal with an OTC transaction. The case dealt with multiple foreign entities that had invested in several Bahamian investment funds.[132] These funds had, in turn, invested in funds run by Bernard L. Madoff's firm.[133] Plaintiffs claimed that the defendants, financial services institutions managing the Bahamian funds, failed to perform adequate due diligence on the Madoff-run

127. *See, e.g.*, Buxbaum, *supra* note 9, at 167–68 (noting the various ways plaintiffs have, post-*Morrison*, pointed to a variety of factors to prove that a transaction has occurred within the United States).

128. *See infra* Part IV.B.1–3.

129. *See generally* SCOTT & GELPERN, *supra* note 71, at 967–1030 (describing how mutual and hedge funds are formed and regulated).

130. *See generally id.* at 704–33 (describing how pools of assets are securitized, structured, and sold).

131. 732 F. Supp. 2d 1305 (S.D. Fla. 2010).

132. *Id.* at 1311.

133. *Id.*

funds and, therefore, asserted securities fraud claims under Rule 10b-5 when the funds became worthless after Madoff's Ponzi scheme came to light.[134] Plaintiffs argued that the Bahamian funds were purchased for the purpose of ultimately investing in U.S. funds through Madoff's firm.[135] Thus, plaintiffs claimed that their purchase was "in connection with" Madoff's investment funds and therefore a domestic transaction.[136] Judge Huck dismissed these arguments by holding that the phrase "in connection with" refers to the fraud alleged and not the actual purchase or sale of securities.[137] Even though the hedge fund was composed of domestic securities, the economic reality was that the securities were purchased in off-shore Bahamian investment fund.[138] Therefore, plaintiffs' fraud claims did not meet *Morrison*'s transactional test because the securities were purchased outside the United States and therefore governed by the laws of the Bahamas.[139]

Conversely, the court in *SEC v. Credit Bancorp, Ltd.* held that fraudulent activity outside the United States can fall within the scope of *Morrison*'s transactional test if the activity is in connection with purchases and sales of securities in the United States and is listed on a U.S. exchange.[140] The case involved defendant Credit Bancorp, a company based in Geneva, and Thomas Rittweger, an American citizen who was Credit Bancorp's managing director for North America.[141] Defendants solicited individuals to invest in its "Insured Credit Facility Program."[142] Using various assets as collateral, investors could borrow money at substantially lower rates than competing brokerage houses.[143] The assets would then earn interest and be paid back to the investors as a form of "dividend."[144] Despite promises to the contrary, defendants took the collateral assets and margined or sold them outright to fund a variety of different business

134. *See id.* at 1315–16.

135. *Id.* at 1317.

136. *Id.*

137. *Id.*

138. *Id.*

139. *Id.*

140. 738 F. Supp. 2d 376, 396–97 (S.D.N.Y. 2010).

141. *Id.* at 380; *see* Complaint in Intervention at *1, SEC v. Credit Bancorp Ltd., 738 F. Supp. 2d 376 (S.D.N.Y. 2010) (No. 99 Civ. 11395), 2003 WL 23671599, at *1.

142. *Credit Bancorp.*, F. Supp. 2d at 380.

143. *Id.*

144. *Id.*

investments and personal purchases within Europe.[145] Rittweger argued that since all the fraudulent activity had occurred in Europe, his conduct did not fall within the scope of *Morrison*.[146] Judge Sweet held that since Rittweger solicited American investors and received their stock certificates within the United States, his actions were a domestic transaction.[147] Rittweger also told domestic investors that their assets—some of which were stocks listed on U.S. exchanges—would be kept within the United States, further bolstering the SEC's assertion that Rittweger's fraudulent actions were in connection with a domestic securities transaction.[148] Therefore, despite the fraudulent purchases occurring outside the United States, the economic reality was that Rittweger's domestic actions were sufficient enough to fall under *Morrison*'s purview.

Interestingly, when the court in *Elliott Associates v. Porsche Automobil Holding SE*[149] applied the economic realities method to domestic hedge funds invested in domestic securities, it held that such transactions did not fall under *Morrison*'s transactional test. In *Elliott Associates*, plaintiffs were a collection of thirty-five hedge funds that were managed by nine investment managers in New York.[150] The funds entered into a security-based swap agreement which they created and carried out entirely within the United States to track the price of Volkswagen ("VW") shares traded in Germany.[151] The swap agreement was inversely proportional to the price of VW shares, so that if the price went up, the plaintiffs would generate losses.[152] The plaintiffs claimed that defendant, Porsche, made misleading statements about its desire to buy VW shares.[153] Later, when Porsche announced that it had accumulated a large portion of VW shares, causing a sharp price increase, the plaintiffs lost a considerable amount of money.[154] Plaintiffs argued that, while

145. *Id.* at 381.

146. *Id.* at 396.

147. *Id.* at 396–97.

148. *Id.* at 397 ("[T]he transactions for which Rittweger was prosecuted and sued satisfied both approaches to the application of § 10(b) under Morrison: they involved a securities transaction occurring domestically, and they involved the exchange of securities listed on domestic exchanges.").

149. 759 F. Supp. 2d 469, 476 (S.D.N.Y. 2010).

150. *Id.* at 471.

151. *Id.*

152. *Id.*

153. *Id.* at 473.

154. *Id.*

Porsche's actions were performed entirely outside of the United States, the purchases and sales of the domestic swap agreement were made entirely in the United States, falling within the scope of *Morrison*.[155] The court dismissed these arguments and instead compared the swap agreement to the plaintiffs actually going to Germany to purchase VW shares.[156] Under the economic realities method, the transactions were conducted on foreign exchanges and thus did not meet the *Morrison* transactional test.[157]

The divergent opinions of *Banco Santander*, *Credit Bancorp*, and *Elliot Associates* underlie the problems of applying the *Morrison* test to OTC transactions, as each decision must be interpreted on a case-by-case basis. While *Banco Santander* held that a foreign hedge fund invested with domestic securities did not meet the *Morrison* transactional test using the economic realities method[158] *Credit Bancorp* held that a domestic securities fund that made fraudulent foreign investments did.[159] *Elliott Associates* held, surprisingly, that domestic hedge funds invested in U.S. security swaps were not a domestic transaction.[160] Such disparate applications of the transactional test can lead to market inefficiency because neither the investors nor the managers of these securities have any certainty as to whether they may fall under U.S. jurisdiction.[161]

2. The Irrevocable Liability Method

Some courts have tried to solve the problem of determining where a "purchase" and "sale" occurs by first determining *when* it occurs. *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*,[162] *SEC v. Goldman Sachs & Co.* ("*Tourre*"),[163] and *Basis Yield*

155. *Elliott*, 759 F. Supp. 2d at 474.

156. *Id.* at 476.

157. *Id.*

158. *In re* Banco Santander Secs.-Optimal Litig., 732 F. Supp. 2d 1305, 1317 (S.D. Fla. 2010).

159. SEC v. Credit Bancorp, Ltd., 738 F. Supp. 2d 376, 397 (S.D.N.Y. 2010).

160. *Elliott*, 759 F. Supp. 2d at 476.

161. *Cf. Cross-Border Private Rights Study*, *supra* note 31, at v (noting that twenty-three comment letters were written to the SEC arguing against enacting the *Morrison* transactional test under the argument that, among other things, it would be more costly for U.S. investment funds to trade on foreign securities as they may be forced to trade ADRs or forego U.S. investor protection).

162. 735 F. Supp. 2d 166 (S.D.N.Y. 2010).

163. 790 F. Supp. 2d 147 (S.D.N.Y. 2011).

Alpha Fund (Master) v. Goldman Sachs Group, Inc.[164] each focused on the idea that "an individual [becomes] a 'purchaser' when he or she [incurs] an irrevocable liability to take and pay for the stock."[165]

The *Plumbers'* case involved a pension fund that purchased stocks on the Swiss stock exchange from defendant's company that allegedly made fraudulent statements about its earnings and accounting statements.[166] Plaintiffs argued that the transaction occurred within the United States because (1) they were a U.S. entity, (2) they made the decision to invest within the United States, (3) they placed their orders for stocks within the United States, (4) they suffered harm in the United States, and (5) the traders who executed plaintiffs' orders were within the United States.[167] Looking at these five elements, Judge Koeltl held that none of them were determinative in deciding whether a purchase was made within the United States.[168] The location of the purchaser at the time the order was placed was not determinative because it would not necessarily be the same place that the transaction was formed.[169] Neither would the location of the purchaser be determinative because whenever the decision to invest was made or the damages were subsequently incurred, the location of the actual transaction would change.[170] Since the plaintiffs had failed to assert that their order was irrevocable when it was placed and conceded that the purchase was made on a foreign exchange, the purchase could not be considered domestic under *Morrison*.[171]

Both *Tourre* and *Basis* involved defendants providing misleading information when selling synthetic collateralized debt obligations ("CDOs")[172] to a foreign party.[173] Both courts, drawing heavily on

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164. 798 F. Supp. 2d 533 (S.D.N.Y. 2011).

165. *Plumbers' Union*, 735 F. Supp. 2d at 177 (quoting Blau v. Ogsbury, 210 F.2d 426, 427 (2d Cir. 1954)).

166. *Id.* at 171–73.

167. *Id.* at 178.

168. *Id.* at 177–78; *see id.* at 178 ("There may be unique circumstances in which an issuer's conduct takes a sale or purchase outside this rule, but the mere act of electronically transmitting a purchase order from within the United States is not such a circumstance.").

169. *See id.* at 178.

170. *See id.*

171. *See id.*; *see also* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2869 (2010).

172. *See generally* SCOTT & GELPERN, *supra* note 71, at 717 (describing how CDOs are created).

173. *Basis*, 798 F. Supp. 2d at 535–36; *Tourre*, 790 F. Supp. 2d at 150–54.

the decision in *Plumbers'*, held that to prove that a purchase was made within the United States, a plaintiff must show that the defendants incurred "irrevocable liability."[174] In *Tourre*, Judge Jones was somewhat unclear in her decision that, in order to prove a domestic purchase, one has to prove that securities have to incur irrevocable liability within the United States. In doing so, Judge Jones seemingly combined the temporal aspect of *when* irrevocable liability occurs with *where* irrevocable liability occurs.[175] She attempted to clear up this distinction in *Basis* by explaining that once the plaintiff shows when a security has incurred irrevocable liability, he or she can then prove where the security was purchased.[176] However, she gave no indication as to what factors would allow a court to draw a reasonable inference that the purchase or sale occurred within the United States.

Judge Krieger cleared up some of the ambiguity left by Judge Jones in *Cascade Fund, LLP v. Absolute Capital Management Holdings Ltd.*[177] In *Cascade*, Cayman Island investment fund manager defendants solicited the plaintiff, a U.S. entity, to invest in their funds, which were made up of unregulated U.S. "penny stocks."[178] The plaintiff alleged that defendants had fraudulently failed to disclose material facts, causing it to sustain losses on its investments.[179] In arguing that its purchase of defendants' funds occurred in the United States, the plaintiff used factors similar to the plaintiffs in *Plumbers'*[180] but also pointed out that "the money for the

174. *Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 157–58.

175. *Tourre*, 790 F. Supp. 2d at 158–59 (looking at *Plumbers'*, Judge Jones held that the notion of *when* "irrevocable liability" occurs is the core of both purchase and sale, but then states that the SEC had failed to "demonstrate *where* any party to the [securities] purchases incurred 'irrevocable liability'") (quoting *Plumbers'*, 753 F. Supp. 2d at 177) (emphasis added).

176. *Basis*, 798 F. Supp. 2d at 537 ("Consequently, courts dealing with securities not traded on any exchange, like the CDO at issue here, have had to define *when* a purchase or sale occurs so that it can then determine *where* the transaction took place.") (emphasis in original).

177. No. 08-CV-01381-MSK-CBS, 2011 WL 1211511 (D. Colo. Mar. 31, 2011).

178. *Cascade*, 2011 WL 1211511, at *1; *see Important Information on Penny Stocks*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/schedule15g.htm (last visited Aug. 23, 2012) ("Penny stocks are low-priced shares of small companies.").

179. *Cascade*, 2011 WL 1211511, at *1.

180. *Id.* at *7 ("Cascade points to four facts . . . : (i) the Offering Memoranda and other investment materials were disseminated to [the plaintiff] in the United States; (ii) [the defendants] traveled to the United States to solicit American investors; (iii) [plaintiff] made its decision to invest while in the United States . . . .").

purchase was wired to a bank in New York."[181] After dismissing the other factors as non-determinative under *Morrison*, the court stated that the transaction did not have "irrevocable liability" at the moment the money transferred but rather when the defendants accepted the application to invest in the funds.[182] Therefore, since the defendants presumably accepted the application while in their Cayman Island offices, the purchase did not occur within the United States and fell outside the scope of *Morrison*'s transactional test.[183]

While courts have applied the irrevocable liability method uniformly, there is still a lot of uncertainty as to how a potential plaintiff may overcome the extraordinarily high burden the method puts in place. In *Plumbers'*, *Tourre*, and *Basis*, the burden of proof was on the plaintiff to prove that the transaction was irrevocably liable.[184] However, those courts failed to provide determinative factors as to whether a transaction was irrevocably liable. They only pointed to factors which were not determinative.[185] Further, *Cascade*—which utilized, but did not explicitly state it was using, the irrevocable liability method—only made an allusion as to how deciding when a transaction occurred would allow a court to determine where a transaction occurred.[186] But using this method alone would create a simple loophole for fraudulent actors to merely open a foreign office and make sure to accept applications to invest funds in that office, leading to possibly unjust applications of the *Morrison* transactional test.

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181. *Id.*

182. *See id.* (stating that the transfer of money "simply describes a step . . . to comply with [the] process for applying to invest in [defendant's] funds . . . . [The defendant] reserved the right to reject a request to invest for any reason, even if the purchase money had properly been wired to New York").

183. *Id.*

184. *Plumbers'*, 753 F. Supp. 2d at 178 ("The plaintiffs' construction would require a fact-bound, case-by-case inquiry into when exactly an investor's purchase order became irrevocable."); *Basis*, 798 F. Supp. 2d at 537 ("[T]o state a claim under Section 10(b), a plaintiff must allege that the parties incurred irrevocable liability to purchase or sell the security in the United States."); *Tourre*, 790 F. Supp. 2d at 159 ("[T]he [plaintiff] bears the burden of alleging the [defendant's securities] purchases were domestic transactions . . . . The Court need not address the [plaintiff]'s argument in view of the [plaintiff]'s failure to allege that *any* party to the [defendant's securities] purchases incurred 'irrevocable liability' in the United States.").

185. *Plumbers'*, 753 F. Supp. 2d at 178; *Basis*, 798 F. Supp. 2d at 537; *Tourre*, 790 F. Supp. 2d at 158.

186. *See Cascade*, 2011 WL 1211511, at *7.

3. The Transfer of Title Method

The transfer of title method is a way for courts to deal with more nuanced transactions without resorting to the confusing irrevocable liability method or bending the law to meet the economic realities method. For example, *Quail Cruise Ship Mgmt., Ltd. v. Agencia De Viagens CVC Tur Limitada* involved a Bahamian corporation who claimed that defendants, Brazilian and American entities, fraudulently induced it into buying a faulty cruise ship via a stock purchase from a Uruguayan corporation.[187] The plaintiff argued that the stock transfer was made pursuant to an agreement subject to Florida law and that the documentation required to transfer the stock was sent to Florida.[188] Therefore, the plaintiff argued, the purchase occurred within the United States since the parties intended the closing to occur in the Miami law office of one of the parties' counsel.[189] The district court held that the intent of the parties to close the sale is not dispositive of where a securities transaction occurs.[190] Instead, the location of the purchase or sale, not the closing, is determinative of where the securities transaction occurred.[191] Since the share purchase agreement was signed in Spain by Quail and in Uruguay by the Uruguayan corporation, the transaction did not occur within the United States and thus failed the *Morrison* transactional test.[192]

However, on appeal, the Eleventh Circuit remanded the district court's decision.[193] The court noted that Quail alleged that the transaction for the stock purchase closed by means of both parties submitting the stock transfer documents to the Miami law office.[194] In looking at the black letter definition of "closing" and "sale" in *Black's Law Dictionary* and the wording in the stock purchase agreement, the court held that the title to the shares was transferred to the plaintiff at the closing and that such a transfer constituted a

187. 732 F. Supp. 2d 1345, 1347 (S.D. Fla. 2010) *vacated*, 645 F.3d 1307 (11th Cir. 2011).

188. *Id.* at 1349.

189. *Id.*

190. *Id.* at 1350.

191. *Id.*

192. *Id.* at 1349–50.

193. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011).

194. *Id.* at 1309.

domestic sale.[195] Therefore, the plaintiff's purchase fell within the scope of *Morrison*'s transactional test since the transfer of title signified that the transaction had been completed.[196]

The most recent case to be decided concerning *Morrison*'s extraterritorial reach attempted to find harmony between the irrevocable liability and the transfer of title methods. In *Absolute Activist Value Master Fund Ltd. v. Ficeto*,[197] plaintiffs were nine Cayman Islands hedge funds who, like the plaintiffs in *Cascade*, were induced by defendants to purchase nearly valueless "penny stocks" issued by companies within the United States.[198] The defendants then traded the stocks between the funds to artificially increase the stocks' prices.[199] The district court employed the transactional test by examining the market on which penny-stocks are traded.[200] Even though the trades were being performed by U.S. companies, the funds were being traded solely among the Cayman Island funds.[201] Therefore, the district court held that the purchases and sales were not domestic and failed the *Morrison* transactional test.[202]

On appeal, Judge Katzmann drew from *Plumbers'*, *Tourre*, and *Quail* to argue that a sale of securities can either be understood when the purchaser incurred irrevocable liability or when the title is transferred.[203] In using both the irrevocable liability and transfer of title methods, the court listed the following types of evidence that may indicate a domestic transaction: "facts concerning the formation of the contracts, the placement of purchase orders, the passing of title, or the exchange of money."[204] However, since the plaintiffs had

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195. *Id.*

196. *Id.* at 1310–11.

197. 677 F.3d 60 (2d Cir. 2012), *aff'g in part, rev'g in part and remanding* Absolute Activist Value Master Fund Ltd. v. Homm, No. 09 CV 08862(GBD), 2010 WL 5415885 (S.D.N.Y. Dec. 22, 2010).

198. *Id.* at *62–63.

199. *Id.* at *63–64.

200. *Homm*, 2010 WL 5415885, at *5.

201. *Id.*

202. *Id.*

203. *Ficeto*, 677 F.3d at 68 ("Given that the point at which the parties become irrevocably bound is used to determine the timing of a purchase and sale, we similarly hold that the point of irrevocable liability can be used to determine the locus of a securities purchase or sale. . . . However, we do not believe this is the only way to locate a securities transaction . . . [A] sale of securities can be understood to take place at the location in which title is transferred.").

204. *Id.* at 70.

failed to give sufficient proof, Judge Katzmann held that their claims did not meet the transactional test of *Morrison*.[205]

The transfer of title method, therefore, allows for a more uniform application of the transactional test by various courts. Instead of arguing the economic realities of their securities transaction or providing evidence that the transaction was irrevocably liable within the United States, plaintiffs, like the ones in *Quail*, merely need to show that the transfer of title occurred within the United States in order to overcome the *Morrison* transactional test.[206] *Ficeto* encourages this view by stating that the transfer of title is a determinative factor in deciding whether or not a transaction is domestic.[207] However, the same loophole that could be used to circumvent the holding in *Cascade* is present here. Issuers could set up an offshore office to close a securities transaction and therefore avoid liability.

IV. HOW COURTS SHOULD INTERPRET *MORRISON* GOING FORWARD

Justice Scalia attempted in *Morrison* to replace the principles-based method of determining the extraterritorial reach of antifraud securities laws with a clear rules-based method. But with cross-listed securities being traded on a global scale and complex financial instruments being created and passed between various multinational institutions, strict, textual-based readings of a *Morrison* have created incongruous holdings. While there is not much courts can do to change the test, absent urging Congress or the Supreme Court to modify it, there are ways in which courts should approach an international antifraud case to minimize deviation between courts holdings while still adhering to the "spirit" of *Morrison*.

Despite the possibilities of allowing an investor to be taken advantage of by a fraudster on an international exchange, *Cornwell*'s holding that all "purchases" and "sales" made on a foreign exchange are outside the scope of *Morrison* should be adopted.[208] This bright-line rule would be easy and effective to manage by a court, and it would leave little room for parties to argue that their transactions

205. *Id.*

206. Quail Cruises Ship Mgmt. Ltd. v. Agencia de Viagens CVC Tur Limitada, 645 F.3d 1307, 1310 (11th Cir. 2011).

207. *Ficeto*, 677 F.3d at 70.

208. Cornwell v. Credit Suisse Grp., 729 F. Supp. 2d 620, 625–26 (S.D.N.Y. 2010).

were domestic. Further, this rule would fall within the spirit of *Morrison* of avoiding the possibility of "judicial-speculation-made-law"[209] as to whether a foreign investor solicited within the United States. However, it should *only* apply to direct purchases and shares on the foreign market, and it should not be extended to mutual or hedge funds, which invest on a majority of different markets. Those kinds of transactions should be viewed as OTC transactions and be analyzed by the second *Morrison* prong rather than the first.

As for ADRs, courts should follow Judge Holwell's reasoning in *Vivendi*. Judge Holwell's textual analysis, which differentiates between being registered and being listed on an exchange, avoids forcing the courts to walk the judicial line of determining whether or not an ADR is a "predominantly foreign securities transaction"[210] and therefore falling outside *Morrison*. While one could use the *Société Générale* method of assuming all ADRs are foreign transactions, it goes against the textual reading of *Morrison* and the Exchange Act since ADRs are specifically mentioned within the Act.[211]

To harmonize the holdings concerning OTC securities transactions, courts should reject the economic realities method in favor of the more succinct, but still flexible, combination of irrevocable liability and transfer of title tests. As witnessed in *Banco Santander*, *Credit Bancorp*, and *Elliott*, understanding the "economic realities" can be an unwieldy test to administer and lead to entirely opposite outcomes—the very same problems Justice Scalia tried to avoid when creating the transactional test. Rather than determining if a transaction was actually in another country or was merely akin to being in another country, the temporal and financial determinations laid out by the irrevocable liability and transfer of title tests allow for the flexibility necessary to catch more complex securities litigation while still being clear enough to administer uniformly. For example, if a foreign hedge fund were to purchase domestic securities and then defraud its investors, the economic realities test would require courts to decide whether the transaction was domestic (i.e., the economic reality is that the hedge fund investors essentially purchased the domestic stocks themselves) or extraterritorial (i.e., the economic

209. *See* Morrison v. Nat'l Austl. Bank, Ltd., 130 S. Ct. 2869, 2881 (2010).

210. *In re* Société Générale Secs. Litig. No. 08 Civ. 2495, 2010 WL 3910286, at *4 (S.D.N.Y Sept. 29, 2010) (citing Copeland v. Fortis, 685 F. Supp. 2d 498, 506 (S.D.N.Y. 2010) (quoting *In re* SCOR Holding (Switzerland) AG Litig., 537 F. Supp. 2d 556, 562 (S.D.N.Y. 2008)).

211. 17 C.F.R. § 240.12g3-2(b) (2010).

reality is that the investors purchased shares of a foreign hedge fund). Different courts could come to different conclusions. Under the combined irrevocable liability and transfer of title tests, the investors would know that they would be protected under U.S. securities laws so long as they could prove that the title to their shares of the hedge fund passed to them within the United States. However, this method alone has the potential to create legal loopholes. Foreign or domestic entities could attempt to set up offshore offices for the sole purpose of transferring title outside the United States while leading investors to believe that the transfer occurred within the United States. In this circumstance, the irrevocable liability test could close those loopholes by pinpointing the time the transaction occurred and then the location of the parties when the transaction occurred—thus giving more flexibility to courts in interpreting complex financial securities transactions while minimizing any incongruence between varying court decisions.

CONCLUSION

The Supreme Court's opinion in *Morrison v. National Australia Bank* represents an attempt to move away from principles-based securities law analysis and towards a more rule-based assessment. However, the Court failed to realize the reason courts came to adopt such an analysis. Section 10(b)'s broad language allowed it to easily adapt to today's securities markets, despite the growth of cross-border securities transactions and increasingly complex financial instruments. But by limiting Section 10(b) to a strict textual analysis, courts have had to go back and analyze each term within the legislation, causing confusion among investors and issuers as to what rights they are afforded within the United States. As Justice Stevens noted, "While the clarity and simplicity of the Court's test may have some salutary consequences, like all bright-line rules it also has drawbacks."[212] In doing away with the "conduct" and "effects" test, Justice Scalia inadvertently planted several new judicial saplings, which the lower courts have had to tend without much guidance. Hopefully, with a little pruning, they will grow together and form the unified tree the Supreme Court envisioned.

212. *Morrison*, 130 S. Ct. at 2895 (Stevens, J., concurring in part).

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COMMENT

IS JUDGE RAKOFF ASKING FOR TOO MUCH? THE NEW STANDARD FOR CONSENT JUDGMENT SETTLEMENTS WITH THE SEC

AMANDA S. NAOUFAL*

In SEC v. Citigroup Global Markets, Inc., *Judge Rakoff rejected a $285 million settlement between the Securities and Exchange Commission ("SEC" or "Commission") and Citigroup. The complaint alleged that Citigroup failed to disclose its role in the selection of assets for a billion dollar collaterized debt obligation. Judge Rakoff rejected the consent judgment, concluding it was neither fair, nor reasonable, nor adequate, nor in the public's interest. The critical issue in Judge Rakoff's decision was the validity of the SEC's "no admit/deny" policy, which is a policy that has long been accepted by courts. He objected to this policy because it required the court to employ its power without the parties providing him a factual basis, which constrained his ability to exercise his independent judgment. This decision has great implications for the SEC's enforcement program. The SEC relied on courts' longtime acceptance of a standard that produced an efficient and effective process with regards to consent judgments. This*

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Comment analyzes the differences between the traditional standard and the Rakoff standard by illustrating the differences that each standard has on the outcome of consent judgments. Finally, this Comment recommends that a combination of both standards be used for future consent judgments to ensure greater enforcement, accountability, and transparency.

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INTRODUCTION

The Securities and Exchange Commission ("SEC" or "Commission") is authorized to bring a civil injunction action as a form of enforcement against violators of securities laws.[1] When the SEC brings a civil action in federal district court, it often requests an injunction against future violations of federal securities laws.[2] A consent judgment, or consent decree, is a civil settlement incorporated within a judicial order[3] and is used in more than ninety percent of the SEC's civil actions.[4] Once a settlement is reached, the defendant consents to the entry of a judgment or order without admitting or denying the allegations.[5] A judge then evaluates the proposed consent judgment with a limited source of information and, therefore, the entry of the consent judgment is often ministerial.[6] Even though judicial inquiry is limited, the court is still required to exercise its independent judgment.[7]

The Supreme Court has long endorsed the use of consent judgments,[8] and courts recognize consent judgments as an effective and efficient means of dispute resolution.[9] The standard used to

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1. *See* Carmen Lawrence et al., *Seeing Beyond the Deal: The Collateral Consequences of SEC Settlements*, 1832 PRAC. LAW INST. 915, 917–18 (2010) (indicating that civil injunction actions are one of two basic enforcement actions that the SEC is authorized to bring against defendants).

2. *See id.* at 917 (explaining the differences between a civil injunctive action and an administrative proceeding, the two possible enforcement actions the SEC can seek when enforcing federal securities laws).

3. *See* Linda Chatman Thomsen, *The Expanding Role of Judges in Settlement and Beyond*, 1918 PRAC. LAW INST. 487, 490 (2011) (indicating that in consent judgments, the court has jurisdiction to enforce the agreement).

4. *See* SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (articulating that one of the reasons the SEC enters many consent judgments is because of the agency's limited resources).

5. *See generally* 17 C.F.R. § 202.5(e) (2012) (amending the Code of Federal Regulations due to the SEC's view that a refusal to admit an allegation is equivalent to a denial); Danne L. Johnson, *SEC Settlement: Agency Self-Interest or Public Interest*, 12 FORDHAM J. CORP. & FIN. L. 627, 650 (2007) (discussing the SEC's position that a refusal to admit an allegation is equal to a denial unless the defendant agrees to neither admit nor deny the allegations).

6. *See* Thomsen, *supra* note 3, at 490 (explaining that the only available sources of information are the complaint and the proposed order).

7. *See id.* at 491 (alluding to greater scrutiny because the consent judgment involves the judge's signature); *see also* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 331 (S.D.N.Y. 2011) (indicating that even though deference is given to a government agency, invoking a court's independent judgment is an "indispensible attribute of the federal judiciary").

8. *See* SEC v. Randolph, 736 F.2d 525, 528 (9th Cir. 1984) (citing Swift & Co. v. United States, 276 U.S. 311, 325–26 (1928)).

9. *See id.* (presenting the benefits of consent judgments, including avoiding the risk and cost of litigation).

evaluate a consent judgment is whether the court finds the decree fair, adequate, reasonable, and in the public interest.[10] A recent decision from the U.S. District Court for the Southern District of New York, however, used a different standard to evaluate consent judgments. The decision, if upheld, will likely have implications on the SEC's enforcement program.[11]

This critical decision was made on November 28, 2011, when Judge Jed Rakoff rejected a proposed $285 million settlement between the SEC and Citigroup Global Markets, Inc. ("Citigroup").[12] Contrary to the normal practice of a limited judicial role, Judge Rakoff expanded the role in reviewing consent judgments.[13] He also placed a greater burden on the SEC to present more facts to justify the terms of the decree.[14] Consequently, in *SEC v. Citigroup Global Markets, Inc.*, Judge Rakoff opened the door to a new set of questions regarding consent judgments with federal agencies, causing fear that this decision will result in a stricter standard for consent judgment settlements.[15]

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10. *See* SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 508 (S.D.N.Y. 2009) (stating that the court will review the proposed consent judgment to determine that it is within the bounds of "fairness, reasonableness, and adequacy and, in certain circumstances, whether it services the public interest").

11. *See* Yin Wilczek, *Court Throws Out Proposed $285M Deal Between SEC, Citigroup; Sets Case for Trial*, 43 SEC. REG. & L. REP. (BNA) 2395 (2011) (quoting the SEC Enforcement Director's response to Judge Rakoff's decision, in which the director indicated that the decision could hurt the SEC's enforcement program). *See generally* Bradley Bondi & Douglas Fischer, *Citigroup Ruling Has Serious Implications for SEC Settlements*, JURIST-SIDEBAR (Jan. 16, 2012), http://jurist.org/sidebar/2012/01/bondi-fischer-sec-citigroup.php (explaining the SEC's reluctance to now bring enforcement actions into court and the possibility of seeking other alternatives to consent decrees).

12. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 332 (S.D.N.Y. 2011) (holding that the proposed consent judgment was "neither fair, nor reasonable, nor adequate, nor in the public interest").

13. *See* Matthew Farrell, *A Role for the Judiciary in Reforming Executive Compensation: The Implications of* Securities and Exchange Commission v. Bank of America Corp., 96 CORNELL L. REV. 169, 191 (2010) (explaining that Judge Rakoff's approach is different than the approach of other judges in similar cases). *Compare Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 330 (stating that while the SEC is entitled to deference, the court must exercise its independent judgment in determining whether the consent decree serves the public interest), *with Randolph*, 736 F.2d at 529 (concluding that the lower court applied too strict a standard when evaluating the approval of a consent decree and should have deferred to the agency's decision).

14. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 335 (holding that a consent judgment that imposes penalties on the basis of unproven facts is neither fair nor reasonable).

15. *Cf.* SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 310 (S.D.N.Y. 2011) (granting a consent judgment while noting that the court reserves for the future "substantial questions of whether the Court can approve other settlements that involve the practice of 'neither admitting nor denying'" any wrongdoing).

This Comment argues that ambiguity exists in the law regarding the standard used to evaluate consent judgments. The ambiguity is a result of some courts applying a lenient standard while others apply a more stringent standard, specifically that of Judge Rakoff's. This Comment analyzes the standard previously used to grant consent judgments ("traditional standard") and compares it to the stricter standard applied in Judge Rakoff's court ("Rakoff standard"). Applying the Rakoff standard changes the meaning of what courts previously considered "fair, adequate, reasonable, and in the public's interest." To demonstrate that the application of each standard results in different outcomes, this Comment will apply each standard to a set of hypothetical facts involving a multibillion-dollar corporation, MG Global Corporation, that engaged in securities fraud and subsequently entered into a consent judgment with the SEC.

Part I of this Comment gives an overview of consent judgments and the adoption of such decrees in settlements with the SEC. Part I also discusses the interpretation of both the traditional standard and the Rakoff standard with an emphasis on three differences: (1) deference to federal agencies; (2) the "no admit/deny" provision in consent judgments; and (3) public knowledge of the underlying facts. Part II analyzes the two standards to show how each standard renders different outcomes when applied to the same set of hypothetical facts.

Part III recommends that courts adopt a combination of the traditional standard and the Rakoff standard in granting consent judgments to allow for greater transparency and ensure that consent decrees are meeting the standard of fair, reasonable, adequate, and in the public interest. Part IV concludes that there is ambiguity in the law regarding consent judgments and that a clear standard for granting consent judgments that is neither too stringent nor too lenient is needed.

I. CONSENT JUDGMENTS: BEFORE AND AFTER JUDGE RAKOFF

A. The Adoption of Consent Judgments and the Purpose of Consent Judgments in the SEC's Enforcement Program

The SEC's aim is to protect investors and maintain a fair and efficient market.[16] The SEC does this by investigating violations of

16. *See The Investor Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation*, U.S. SEC. & EXCH. COMM'N,

securities laws and deciding whether to settle with or litigate against the alleged violators.[17] The SEC favors settlements because of their effective and efficient enforcement and the low risks involved.[18] One type of settlement adopted by the SEC is the consent decree, a "judgment entered by consent of the parties whereby the defendant agrees to stop [the] alleged illegal activity without admitting guilt or wrongdoing."[19] The SEC adopted this standard long ago; however, it became concerned with defendants publicly denying wrongdoings following the entry of such judgments.[20] As a result, settlements with the SEC are entered by consent whereby the defendants agree to the entry of a judgment while neither admitting nor denying the allegations.[21] The validity of the "no admit/deny" provision had not been challenged until the *Citigroup* case.[22]

Consent judgments positively impact the SEC's enforcement of securities laws.[23] This is largely due to the fact that the SEC seeks, in its consent judgments, injunctive relief forbidding future violations.[24] Not only do SEC settlements affect market participants through these injunctions, they also serve as a means to create and accept new legal standards.[25] Consent judgments offer a sense of security by enforcing the terms of an agreement as well as reducing risks and costs of litigation.[26] Further, the SEC is able to save

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http://www.sec.gov/about/whatwedo.shtml (last visited Dec. 16, 2012) (stating the SEC's mission and how its enforcement authority is crucial to its effectiveness).

17. *See* Johnson, *supra* note 5, at 627–28.

18. *See* SEC Memorandum of Law in Response to Questions Posed by the Court Regarding Proposed Settlement at 3, SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11 Civ. 7387(JSR)), 2011 WL 5307417 [hereinafter SEC Mem. of Law] (noting that lower courts recognize the "importance of consent judgments to the SEC's effective and efficient enforcement of federal securities laws"); *id.* at 4 (stating that the Second Circuit has observed a "strong federal policy favoring the approval and enforcement of consent decrees").

19. *See id.* at 11.

20. *See id.* (explaining that defendants were not admitting to allegations but rather denying those allegations immediately after the consent judgment was entered).

21. *See id.* (explaining that the SEC amended its policy to prevent defendants from denying allegations in both the consent decree and elsewhere).

22. *See* Bondi & Fischer, *supra* note 11 (explaining that Judge Rakoff broke the tradition of granting "neither admit nor deny" settlements).

23. *See* SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (contending that there is a balance of advantages and disadvantages, which the court is reluctant to upset, when the SEC chooses injunction over litigation).

24. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 331 (S.D.N.Y. 2011) (stating that the injunctive relief sought in most consent judgment cases is an injunction forbidding future violations and a request to enforce future preventative measures).

25. *See* Johnson, *supra* note 5, at 653 (maintaining that a single enforcement action can cause developments of internal controls, compliance functions, and supervisory procedures in other companies).

resources for additional enforcement actions.[27] Consequently, courts often hesitate to deny consent judgments in fear that the balance of anticipated advantages and disadvantages will be destroyed.[28]

B. The Traditional Standard Used by Most Courts Involves a More Lenient Evaluation of Consent Judgments

Historically, courts have given great deference to what the SEC believes is in the public interest.[29] A consent decree should be granted unless a court finds the decree to be unfair, inadequate, or unreasonable.[30] Therefore, the decision of what is in the public interest should be left with the government agency negotiating the consent decree.[31] In evaluating a proposed consent judgment, the Second Circuit asserts that the parties to the settlement should be the ones to decide the terms of the consent judgment.[32]

The traditional standard is not whether the court would have agreed to the proposed consent judgment, but whether the proposed consent judgment is fair and reasonable.[33] The court is not to try and

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26. *See* SEC v. Randolph, 736 F.2d 525, 529–30 (9th Cir. 1984) (stating that a consent judgment offers more security than a settlement agreement because it can be enforced by judicial sanctions, whereas breaching a settlement agreement simply results in another lawsuit); *see also* Johnson, *supra* note 5, at 671–72 (explaining that the Commission is motivated to settle because uncertain results associated with litigation are avoidable through settlements).

27. *See Randolph*, 736 F.2d at 529–30 (explaining that the SEC was able to allocate resources saved through consent judgments towards investigations of other securities laws violations).

28. *See Clifton*, 700 F.2d at 748 (discussing the benefits of settlements for the SEC, such as the ability to conserve its own judicial resources while still informing potential investors that a company or person has violated securities laws in the past).

29. Farrell, *supra* note 13, at 188; *see Randolph*, 736 F.2d at 529 (stating that courts should give deference to the public agency negotiating the proposed judgment); FTC. v. Standard Fin. Mgmt. Corp., 830 F.2d 404, 408 (1st Cir. 1987) (recognizing that while courts should not blindly follow an agency's lead in entering a judgment, they should give substantial deference to the public agency entering into the negotiated consent decree).

30. *See Randolph*, 736 F.2d at 529 (applying the traditional standard because the lower court applied too strict a standard when it rejected the proposed consent judgment).

31. *See* SEC Mem. of Law, *supra* note 18, at 4 n.1 (explaining how the Ninth Circuit adopted the position that a court should defer to the agency's decision on whether a settlement is within the public interest).

32. *See In re* Sony Corp. SXRD, 448 F. App'x 85, 87 (2d Cir. 2011) (quoting City of Detroit v. Grinnell Corp., 495 F.2d 448, 462 (2d Cir. 1974)) (stating that the court should not evaluate a proposed consent judgment based on one that the court itself might have fashioned).

33. *See* United States v. Cannons Eng'g Corp., 899 F.2d 79, 84 (1st Cir. 1990) (stating that an agency's role deserves heightened respect in situations where sophisticated players with sharply conflicting interests negotiate an agreement at arm's length); *Randolph*, 736 F.2d at 529 ("Unless a consent decree is unfair, inadequate, or

resolve the facts of the case when evaluating a proposed consent judgment.[34] To do so would "emasculate the very purpose for which settlements are made."[35] After all, a government agency has put the time and resources into investigating the violations and negotiating the terms of the decree;[36] it is not the court's role to decide if the best possible settlement was reached.[37] Accordingly, when reviewing consent judgments, the courts should pay the parties deference.[38]

In granting a consent judgment, there is no resolution of the issues presented; instead, the parties enter into a consent decree with the understanding that the defendant immediately cease the alleged illegal activity without admitting or denying guilt.[39] With the "no admit/deny" provision, the Commission is able to resolve the matter and compensate the victims of the illegal act in a timely and reasonable manner.[40] In these consent judgments, the SEC enters the provision to preclude a defendant's subsequent denial of wrongdoing in order to avoid an assumption that the alleged conduct did not occur.[41] Courts understand that findings of fact are something the Commission must give up in order to enter a consent judgment,[42] and the SEC believes that without a defendant denying any wrongdoing, the Commission has essentially proven that the violations did in fact occur.[43] This policy, according to the SEC, is necessary to

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unreasonable, it ought to be approved.").

34. *See* United States v. Oregon, 913 F.2d 576, 582 (9th Cir. 1990) ("The reviewing court should not determine contested issues of fact that underlie the dispute.").

35. *See* City of Detroit v. Grinnell Corp., 495 F.2d 448, 462 (2d Cir. 1974) (explaining that the court is not to turn the evaluation of a settlement into a "rehearsal of the trial").

36. *See Randolph*, 736 F.2d at 529.

37. *See* United States v. Akzo Coatings of Am., Inc., 949 F.2d 1409, 1436 (6th Cir. 1991) (finding a settlement fair based on the "legal posture of the parties" and "the nature of the negotiation process that led to the decree").

38. SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y 2003); *see also Randolph*, 736 F.2d at 529 (concluding that the court's role is to ensure the consent judgment is reasonable).

39. *See* SEC Mem. of Law, *supra* note 18, at 11 (citing BLACK'S LAW DICTIONARY 410 (9th ed. 1990)) (defining consent judgments as judgments entered without admitting guilt).

40. *See id.* at 12–13 (explaining the advantages and disadvantages of including a "no admit/deny" provision in a consent judgment).

41. *See* 17 C.F.R. § 202.5(e) (stating that the refusal to admit wrongdoing is the same as a denial).

42. *See* SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (stating that the SEC gives up a number of advantages in order to enter a consent decree, such as findings of fact and court opinions that set forth reasons for a particular holding).

43. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011).

successfully resolve cases involving securities violations. [44] Otherwise, without the strategic wording in the "no admit/deny" provision, companies would refuse to settle and the SEC would be unable to carry the costs of litigation.[45] Several courts recognize the benefits of the SEC's "no admit/deny" policy and choose to grant consent decrees unless the consent judgments do not meet the standard of "fair, reasonable, and adequate."[46]

C. The Rakoff Standard Involves a More Stringent Evaluation of Consent Judgments

In *SEC v. Citigroup Global Markets, Inc.*, Judge Rakoff rejected a $285 million settlement between the SEC and Citigroup.[47] The SEC alleged that Citigroup's marketing materials were misleading because Citigroup failed to disclose its role in the selection of assets for a $1 billion collaterized debt obligation ("CDO") portfolio.[48] Citigroup's marketing materials for the CDO represented that an independent collateral manager would be selecting the portfolio of assets.[49] Citigroup, however, failed to disclose that it had a significant role and influence over the selection of the assets and even held a short position on those assets.[50] In the end, Citigroup

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44. *See* Dunstan Prial, *SEC 'Neither Admits Nor Deny Guilt' Policy Tests Investor Trust*, FOX BUSINESS (Jan. 20, 2012), http://www.foxbusiness.com/industries/2012/01/20/sec-neither-admit-nor-deny-guilt-policy-tests-investor-trust/ (describing the policy as a necessary tool for settlements with "deep-pocketed companies").

45. *See id.* (reporting that the SEC's limited resources places it at a disadvantage in the battle against the companies).

46. *See Clifton*, 700 F.2d at 748 (holding that the court is reluctant to "upset this balance" of advantages and disadvantages brought by consent decrees). *Cf.* SEC v. Randolph, 736 F.2d 525, 530 (9th Cir. 1984) (granting a consent judgment with "no admit/deny" provision); SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 310 (S.D.N.Y. 2011) (granting a consent judgment with "no admit/deny" policy even though the court had reservations about the policy); United States v. Microsoft Corp., 56 F.3d 1448, 1461 (D.C. Cir. 1995) (stating that criticism of a consent decree that does not include an admission is "unjustified").

47. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 332.

48. Complaint at 1–2, SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11 Civ. 7387(JSR)), 2011 WL 4965843; *see CDO Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/c/cdo.asp (last visited Apr. 28, 2012) (defining CDO as an "investment-grade security backed by a pool of bonds, loans and other assets").

49. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 329.

50. *See id.* at 329–30 (alleging that Citigroup knew in advance that selling the portfolio would be difficult if it disclosed its intention to get rid of the negatively projected assets).

realized $160 million in profits for the CDO, while investors lost hundreds of millions of dollars.[51]

In the complaint against Citigroup's employee, Brian Stoker, the SEC alleged that Citigroup knew it could not place the liabilities of a "CDO-squared" if it disclosed how it had been put together.[52] The SEC, however, failed to include this information in the complaint against Citigroup.[53] Instead, the SEC chose to charge Citigroup with negligence only, even though the allegations appeared to be knowing and fraudulent, which normally result in scienter-based charges.[54]

The SEC filed a proposed consent judgment the same day it filed a complaint against Citigroup.[55] The proposed consent judgment stipulated that Citigroup agree to the entry of an order enjoining them from future violations, "requiring the payment of $285 million, consisting of disgorgement of $160 million, prejudgment interest of $30 million, and a civil penalty of $95 million."[56] Judge Rakoff found the proposed decree "neither reasonable, nor fair, nor adequate, nor in the public's interest."[57] Judge Rakoff then criticized the SEC's long policy of allowing defendants to enter consent judgments without admitting or denying the allegations.[58] He also emphasized the need for more facts to determine whether the proposed decree met the required standard.[59]

Citigroup, however, was not the first time Judge Rakoff expressed his disapproval of the policy and standard applied to consent decrees.[60] In *SEC v. Bank of America*, Judge Rakoff refused to

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51. *Id.*

52. Complaint at 10, SEC v. Stoker, No. 11-CIV-7388, 2011 WL 4965844 (S.D.N.Y. 2011).

53. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 329–30 (noting that language from the *Stoker* complaint is missing from the *Citigroup* complaint).

54. *See id.* at 334 n.7 (noting that the SEC charged Goldman Sachs with scienter-based violations for a factual scenario very similar to the one in *Citigroup*).

55. *See* SEC Mem. of Law, *supra* note 18, at 2.

56. *See id.* at 3.

57. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 335 (concluding that the lack of a factual basis results in a consent judgment that does not meet the public interest standard).

58. *See id.* at 322 (finding that the policy deprives the court of "the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact").

59. *See id.* (concluding that more facts were needed to decide whether relief is justified).

60. *See, e.g.*, SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 310 (S.D.N.Y. 2011) (expressing reservations for questions in future proceedings regarding the "no admit/deny" policy); SEC v. Bank of Am. Corp., Nos. 09 Civ. 6829(JSR), 10 Civ. 0215(JSR), 2010 WL 624581, at *5 (S.D.N.Y. Feb. 22, 2010).

approve a settlement after the SEC alleged that Bank of America misled investors about billions of dollars in payments to former Merrill Lynch employees after Bank of America acquired Merrill Lynch.[61] Judge Rakoff claimed that the settlement proposal "was a contrivance designed to provide the SEC with a façade of enforcement."[62] He also alluded to greater scrutiny because the SEC was asking the court to impose injunctive prohibitions against the defendant.[63]

Through a combination of decisions on SEC settlements, Judge Rakoff focused on three main issues with consent judgments: deference given to the SEC in determining the public's interest, the "no admit/deny" provision in consent judgments, and the lack of factual support for settlements.[64] Judge Rakoff made clear his dissatisfaction with the SEC's "no admit/deny" policy when he hesitantly approved a consent judgment in *SEC v. Vitesse Semiconductor Corp.*[65] The policy, said Judge Rakoff in *Vitesse*, results in "confusion and hypocrisy," leaving the public unaware of the actual truth.[66] Judge Rakoff acknowledged the substantial deference given to the Commission, but also noted that the court determines whether the practice of not admitting or denying allegations is "unreasonable or contrary to the public interest as to warrant its disapproval."[67] Judge Rakoff therefore rejected the SEC's position that when a defendant does not expressly deny the allegations, the public somehow knows the truth about those

61. *See* SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 509–10 (S.D.N.Y. 2009) (ruling that the consent judgment did not meet the necessary standards).

62. *Id.* at 510 (concluding that the proposed consent judgment could not be found fair even under the most deferential review).

63. *See id.* at 508 (noting that because the SEC was asking the court to invoke its own contempt power, a closer review of the proposed consent decree was necessary).

64. *Vitesse Semiconductor Corp.*, 771 F. Supp. 2d at 310 (expressing reservations for questions in future proceedings regarding the "no admit/deny" policy); *Bank of Am. Corp.*, 2010 WL 624581, at *1, *5–6 (recognizing that the updated, proposed consent judgment contained a better developed statement of facts and providing that the court must defer to the SEC, but that deference should never be absolute).

65. *See Vitesse Semiconductor Corp.*, 771 F. Supp. 2d at 310 (stating that the consent judgment was approved only due to unusual circumstances, such as parallel criminal proceedings in which defendants admitted their guilt and the company's financial difficulties).

66. *See id.* at 309 (noting that the public will never know whether the charges brought by the SEC are true if the defendant refuses to admit the allegations and the SEC refuses to provide enough facts to prove the allegations).

67. *But see id.* at 310 (explaining that this case presented a unique set of facts that resulted in admissions of three of the four defendants in parallel criminal proceedings).

allegations.[68] A consent judgment, according to Judge Rakoff, is not evidence of anything;[69] instead, it is viewed as the cost of doing business.[70] The judge further expressed concern that abiding by a process that involves no factual basis precludes the court from exercising its own appropriate judgment.[71]

II. THE TWO STANDARDS AND THEIR DIFFERENT IMPACTS ON CONSENT JUDGMENTS

After the headlining opinion issued in *SEC v. Citigroup Global Markets, Inc.*, it is difficult to tell which standard courts will apply in granting consent judgments moving forward.[72] Judge Rakoff's decision can thus change the way the SEC brings future enforcement cases.[73] Some may call him a hero for demanding greater accountability in cases of alleged Wall Street fraud.[74] Others, however, see his decision as a dangerous shift that requires the SEC to spend more time and money on litigation, ultimately reducing the number of cases it can effectively pursue, which decreases its effectiveness as an agency.[75]

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68. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011) (finding the argument "wrong as a matter of law and unpersuasive as a matter of fact").

69. *See id.* (stating that the allegations have no evidentiary value and cannot be used in subsequent litigation).

70. *See id.* at 333 (citing Memorandum on Behalf of Citigroup Global Markets, Inc. in Support of the Proposed Final Judgment and Consent at 6, SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11 Civ. 7387(JSR), 2011 WL 5386583) (explaining that Citigroup's board members exercised "their business judgment" in deciding to settle the case and avoid litigation against the SEC and other consequences that would result).

71. *Cf. Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 333 (finding that without knowledge of the facts, the court becomes a "handmaiden" to a negotiated settlement).

72. *See* Bondi & Fischer, *supra* note 11 (stating that other judges have begun to question SEC settlements); Felix Salmon, *Judge Rakoff's Fraught Decision*, REUTERS BLOG (Nov. 28, 2011), http://blogs.reuters.com/felix-salmon/2011/11/28/jed-rakoffs-fraught-decision/ (noting that in light of Judge Rakoff's decision, it is unclear what happens next).

73. *See id.* ("If the SEC is unable to impose penalties and obtain injunction in federal court without an admission of wrongdoing by the defendant, the SEC will be forced either to enter into settlements outside of the judiciary's purview, to obtain wrongdoings from defendants, or to prove its allegations at trial."); *see also* Wilczek, *supra* note 11 (reporting that attorneys, in response to Judge Rakoff's decision, believe that the judgment may cause changes in enforcement actions, including more administrative cases).

74. *See, e.g.*, David S. Hilzenrath, *The Honorable Judge Rakoff v. Corporate America, the SEC, Cynicism and the '64 Phillies*, WASH. POST, Jan. 20, 2012, at G1 (describing Judge Rakoff as a "rare authority").

75. *See, e.g.*, Wilczek, *supra* note 11 (noting that critics of Judge Rakoff's decision believe that detailed statements of facts or an admission to wrongful conduct may hurt the SEC's enforcement program and divert resources used for the investigation of other frauds); Hilzenrath, *supra* note 74 (describing Judge Rakoff as a "headline chaser").

Consider the following hypothetical scenario: MG Global Corporation ("MG Global") is a renowned subprime lender[76] with a market value of $25 billion. On February 25, 2012, the SEC filed a complaint alleging that MG Global engaged in misrepresentation in the sale of mortgage-backed securities by misrepresenting the quality of the underlying mortgages. The misrepresentation resulted in losses to investors in the amount of $3 billion and a net profit for MG Global of at least $110 million. The SEC charged MG Global with negligence in violation of Section 17(a)(2) and (3) of the Securities Act of 1933. Individual suits were brought against MG Global's chief executive officer and chief financial officer, alleging that they were behind the misrepresentation of the mortgages.

On the same day, MG Global consented to the entry of a consent judgment without admitting or denying the allegations of the complaint. The consent judgment permanently enjoined MG Global from engaging in future violations of securities laws, required MG Global to pay a disgorgement of $110 million and a civil penalty of $63 million, and required MG Global to undertake certain internal measures for a period of five years. The latter requirement was designed to improve corporate governance. When applied to these facts, the traditional standard and the Rakoff standard can cause diverging results.

A. The Consent Judgment Between MG Global Corporation and the SEC Would Be Granted Under the Traditional Standard Because Great Deference Is Given to the SEC, and the "No Admit/Deny" Provision Is Not Questioned

If a court applies the traditional standard to the facts of MG Global, the proposed consent judgment will likely be approved. To determine whether the terms of the decree between the SEC and MG Global are reasonable, adequate, and in the public interest, a court reviews the circumstances in which the decree is proposed.[77]

Reasonableness relates to the relative strength of the parties litigating.[78] The reasonableness of a proposed settlement must

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76. *See Subprime Lender Definition*, INVESTOPEDIA, http://www.investopedia.com/terms/s/subprimelender.asp#axzz258IhpJrb (last visited Dec. 16, 2012) ("[A] type of lender that specializes in lending to borrowers with a tainted or limited credit history.").

77. *See* SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 309–10 (S.D.N.Y. 2011); SEC v. WorldCom, Inc., 273 F. Supp. 2d 431, 436 (S.D.N.Y. 2003).

78. *See* United States v. Cannons Eng'g Corp., 899 F.2d 79, 89 (1st Cir. 1990) (explaining how courts are to determine the reasonableness of a consent decree).

account for foreseeable risks of losses to the Commission.[79] MG Global paid $63 million in penalties even though its misrepresentation resulted in $3 billion in losses to investors. However, a settlement that results in less than full recovery of the losses caused by the defendant's actions can still be reasonable.[80] Here, the $63 million penalty, which is approximately two percent of the total amount of losses suffered by MG Global's shareholders, resembles fines paid (on a percentage basis) in previously approved consent judgments.[81]

An evaluation of a consent judgment is not a chance for the court to "reach beyond the complaint to evaluate claims that the government did not make and to inquire as to why they were not made."[82] Here, the SEC used its own judgment in charging MG Global with negligence and reaching the $63 million penalty through its investigative efforts.[83] Because the SEC is responsible for educating and informing potential and current investors of securities laws violations,[84] one may ask how potential investors know what securities laws MG Global actually violated when the court and the public do not have proof of what actually happened. While this is a legitimate question, the court is not to turn the review of a consent judgment into a trial.[85] The total payment of $63 million in civil penalties was the result of a comprehensive investigation and "reasonably reflects the monetary relief likely to be available to the Commission if successful at trial on the merits."[86]

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79. *See id.* at 89–90 (explaining that determining the reasonableness of a consent decree includes whether the settlement compensates the public for the cost of response measures and takes into consideration the relative strength of the parties).

80. *See id.* at 90 (stating that even if the government has a strong case against a defendant, success at trial still requires time and money, making settlements a preferred option).

81. *See, e.g.*, *WorldCom, Inc.*, 273 F. Supp. 2d at 435 (granting a consent judgment with a penalty of 1.125% of the total amount of losses suffered by shareholders).

82. United States v. Microsoft Corp., 56 F.3d 1448, 1459 (D.C. Cir. 1995).

83. *See* SEC Mem. of Law, *supra* note 18, at 19 (explaining that the penalty sought by the SEC reflects consideration of impact and a number of other factors).

84. *See* SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (describing the means in which the agency protects the public's interest); *see also The Investor Advocate*, *supra* note 16 (stating that the SEC's mission is to protect investors and maintain the markets).

85. *See* United States v. Oregon, 913 F.2d 576, 582 (9th Cir. 1990) (explaining that when a court reviews a consent decree, the court is not to attempt to resolve the factual disputes of the case); *see also* SEC Mem. of Law, *supra* note 18, at 15 (claiming that requiring a factual resolution of the allegations in the interest of transparency goes against the Second Circuit's definition of settlements).

86. *See* SEC Mem. of Law, *supra* note 18, at 19.

Courts applying the traditional standard rarely question or challenge consent judgments when determining the adequacy or fairness of the decree.[87] In applying the traditional standard, courts are likely to place a stamp of approval regardless of the lack of factual basis and the presence of a "no admit/deny" provision.[88] Here, MG Global consented to the judgment without admitting or denying the allegations, so a court would not likely challenge the consent judgment.

Proceeding with an action by injunction rather than litigation requires the SEC to give up a number of advantages.[89] One of the most significant advantages the SEC must give up is the findings of fact and court opinions that clearly set forth all the reasons for a particular result.[90] When a consent decree is brought to a district judge, because it is a settlement, there are no findings that the defendant has actually engaged in illegal practices.[91] Further, remedies that appear to be less than what is deserved might reflect the weaknesses in the government's case, and it is "unwarranted" for a judge to assume that any allegations made in the complaint have been proven.[92] Requiring MG Global to admit to the allegations made in the complaint in order to make the consent judgment more adequate or fair would be "unjustified."[93]

In order to serve the public interest, actions brought by an agency require greater flexibility and deference to the agency's expertise.[94] The duties placed on the Commission to monitor securities make it responsible for serving the public interest.[95] In the hypothetical, the

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87. *See, e.g.*, Bondi & Fischer, *supra* note 11 (stating that the SEC has entered into such consent judgments for nearly forty years without any objection); *see also* SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 310 (S.D.N.Y. 2011) (granting a consent judgment with a "no admit/deny" policy even though the court had reservations about the policy).

88. *See, e.g.*, Hilzenrath, *supra* note 74 (describing Judge Rakoff as a "rare authority" and his position in *Citigroup* as "novel").

89. *See Clifton*, 700 F.2d at 748.

90. *Id.*

91. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 333 (S.D.N.Y. 2011).

92. *See* United States v. Microsoft Corp., 56 F.3d 1448, 1461 (D.C. Cir. 1995) (explaining that a judge is not to measure remedies as if they were fashioned after trial).

93. *See id.* (stating that the question is whether the defendant agrees to the terms of the consent judgment and not whether it will admit wrongdoing).

94. *See* Adam S. Zimmerman, *Distributing Justice*, 86 N.Y.U. L. REV. 500, 551 (2011).

95. *See id.*; *see also* SEC Mem. of Law, *supra* note 18, at 8 (citing *Microsoft Corp.*, 56 F.3d at 1459) (stating that giving deference to a public agency when evaluating consent judgments has constitutional underpinnings).

parties entered an agreement waiving their rights to litigate the issues involved in the case. The SEC negotiated the terms of the settlement and was in the best position to determine why and to what degree the settlement with MG Global advanced the public's interest.[96]

Courts typically give great deference to the SEC and do not question the kinds of policies that have long defined the SEC's enforcement program.[97] As a result, courts tend to defer to an agency's decision that a decree is in the public's best interest.[98] For that reason, a presumption of fairness, adequacy, and reasonableness attaches to the settlement,[99] and a judge applying the traditional standard would approve the proposed consent judgment between the SEC and MG Global.

B. The Consent Judgment Between MG Global Corporation and the SEC Would Be Rejected Under the Rakoff Standard Because There Is No Factual Basis, and the "No Admit/Deny" Provision Does Not Provide the Court with Any Knowledge of the Truth of the Allegations

Under the Rakoff standard, a court would find the consent judgment between the SEC and MG Global inadequate and not in the public interest.[100] Specifically, a court using the Rakoff standard would reject the MG Global proposed consent judgment because the fines are inadequate, there is little to no factual basis, and the public interest would not be served.

When fines are insignificant and do little to deter violators, a consent judgment is inadequate and cannot be granted.[101] There is little deterrence if all a defendant must do after getting caught for

96. *See* SEC v. Randolph, 736 F.2d 525, 529 (9th Cir. 1984) (maintaining that the court's role is to ensure the decree is reasonable, not to determine that a decree is appropriate).

97. *See* SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (indicating that courts rarely challenged the SEC's policy until Judge Rakoff's decision).

98. *See Randolph*, 736 F.2d at 529–30 (explaining that the agency is to decide that a judgment is appropriate and the court is to ensure that proposed judgment is reasonable).

99. *Cf.* Litigation Release, SEC v. J.P. Morgan Sec. LLC (Jun. 21, 2011), http://www.sec.gov/litigation/litreleases/2011/lr22008.htm (noting the standard used to approve a settlement involving the market and structuring of a CDO).

100. *See, e.g.*, SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 334 n.7 (S.D.N.Y. 2011) (opining that Citigroup received the minimum sanctions when compared to previous violations made by other defendants who paid more in penalties); SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 511–12 (S.D.N.Y. 2009) (rejecting a consent judgment due to the low monetary penalty imposed).

101. *See Bank of Am. Corp.*, 653 F. Supp. 2d at 511–12 (rejecting the consent judgment due to the insufficient monetary penalty).

violating securities laws is give back what he gained in profits.[102] In the hypothetical, the consent judgment required a payment of $173 million, consisting of disgorgement of $110 million and a $63 million penalty; yet the actual losses suffered by investors amounted to $3 billion. Moreover, if the allegations are true, the penalty imposed is insufficient when compared to MG Global's wealth and power.[103] Furthermore, without more facts and an admission or a denial, there is no way to determine what really happened and if the remedies sought actually fit the violations.[104]

According to the Rakoff standard, consent judgments that ask the court to impose injunctive relief on the basis of unsupported allegations cannot be granted.[105] Allowing defendants to enter into consent judgments without admitting or denying the underlying allegations deprives the court of the most minimal assurance that the injunctive relief sought has any factual basis.[106] In the hypothetical, MG Global did not admit to any of the violations. All the court has are allegations of negligence.[107] The court reviewing the consent judgment is entitled to know if the misrepresentation MG Global made was due to negligence or fraud to determine the reasonability of the proposed consent agreement. If guilt is neither admitted nor denied, the ultimate effect of the consent agreement on the company

102. *Cf. id.* (concluding that the injunctive relief is pointless because the amount is trivial compared to the company's worth, and because the ones who actually suffer are the victims, not the violators).

103. *See id.* at 512.

104. *See, e.g.*, SEC v. Moran, 944 F. Supp. 286, 297 (S.D.N.Y. 1996) (finding a lesser penalty more appropriate because "there is an unmistakable difference between conduct which negligently operates as a fraud when compared to conduct engaged in with intent to defraud"); *see also Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 332 (stating that the court is deprived of any assurance that the relief sought is justified); SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 310 (S.D.N.Y. 2011).

105. *See Vitesse Semiconductor Corp.*, 771 F. Supp. 2d at 310; SEC v. Bank of Am. Corp., Nos. 09 Civ. 6829(JSR), 10 Civ. 0215(JSR), 2010 WL 624581, at *1, *5 (S.D.N.Y. Feb. 22, 2010); *Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 334 (holding that the consent judgment did not include enough proven facts to grant the court's approval).

106. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 332 (explaining that the court is merely a handmaiden to a privately negotiated settlement if the court has no knowledge of some of the underlying facts).

107. *See, e.g., Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 330 (stating that the SEC chose to charge Citigroup with negligence even though it appears that the allegations are knowing and fraudulent). *But see Moran*, 944 F. Supp. at 297 (finding a lesser penalty more appropriate because "there is an unmistakable difference between conduct which negligently operates as a fraud when compared to conduct engaged in with intent to defraud").

is insignificant,[108] seeing that it appears that there was really no wrongdoing on the part of the defendants.[109]

The SEC argues that the truth about a defendant's actions becomes known, and in turn the public interest served, through the litigation the SEC brings against individuals involved in the violations.[110] Consequently, according to the SEC, if the factual disputes are not resolved in the consent judgment between the SEC and the company, the allegations will certainly be resolved in any parallel proceedings.[111] In the hypothetical, individual suits were brought against MG Global's chief executive officer and chief financial officer; however, despite the SEC's assertion, parallel proceedings cannot always resolve the factual allegations. For instance, in *SEC v. Vitesse Semiconductor Corp.*, which the SEC uses to support its argument,[112] the same charges were brought against all defendants who were part of the proposed consent judgment.[113] The individual defendants admitted to guilt in parallel criminal proceedings.[114] Judge Rakoff noted the significance of these admissions in informing the public of the truth of the allegations made against the defendants.[115] In the hypothetical, there have not been any admissions of guilt in any parallel proceedings.

The facts surrounding the consent judgment with MG Global are more similar to the facts in *Citigroup*, where Citigroup was charged only with negligence, even though the SEC alleged in the Stoker complaint fraudulent intent on the part of Citigroup.[116] In *Citigroup*,

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108. *See* Prial, *supra* note 44.

109. *Id.* ("[V]ery few companies that agree to settle SEC allegations of wrongdoing should be able to hide behind the 'neither admitted nor denied guilt' phrase."); *see Bank of Am. Corp.*, 2010 WL 624581, at *5 (criticizing the lack of directed responsibility to specific individuals and noting that the punitive and compensatory measures are likely to have a modest impact on corporate practice).

110. *See* SEC Mem. of Law, *supra* note 18, at 15.

111. *See, e.g.*, *id.* (noting that the ongoing litigation in the Stoker complaint will "provide a vehicle for resolution of the Commission's allegations").

112. *See id.* (citing SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304 (S.D.N.Y. 2011)) (stating that the SEC's allegations against Citigroup will be resolved through the parallel proceedings against the individual defendant).

113. *See Vitesse Semiconductor Corp.*, 771 F. Supp. 2d at 305–06.

114. *Id.* at 310.

115. *Id.* ("[T]he public is not left to speculate about the truth of the essential charges here brought against [defendants], for they have already admitted those charges in another public forum.").

116. *Compare* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 321–30 & 329 n.1 (S.D.N.Y. 2011) (noting that the allegations made against Citigroup and the individual employee, Brian Stoker, are different), *with Vitesse Semiconductor Corp.*, 771 F. Supp. 2d at 306 (noting that Vitesse and individual defendants were held responsible for the same fraudulent practices).

the individual defendant and company were not both included as parties to the consent judgment.[117] Further, the allegations against each defendant appeared differently based on the language used in each complaint.[118] Thus, an admission by one defendant may not answer questions about allegations made against another. As such, parallel proceedings do not always result in a resolution of factual disputes.[119]

In the hypothetical consent judgment, the SEC would ask the court to invoke its contempt power by enjoining MG Global from violating securities laws.[120] The court would consequently review the consent judgment to determine if it is within the bounds of fairness, reasonableness, adequacy, and whether it serves the public interest.[121] The court would therefore need to know the underlying facts.[122] Viewing the consent judgment between the SEC and MG Global as simply the cost of doing business does not take into account the public interest nor does it carefully assess the truth behind the allegations.[123] If a consent judgment rests solely on mere allegations, the truth about the defendant's actions is unknown, and thus the consent agreement would be unreasonable.[124] As a result, the public

117. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 330 (charging Citigroup only with negligence, even though allegations amounting to knowing and fraudulent intent were apparent).

118. *See id.* at 330 (noting that language amounting to knowing and fraudulent intent is missing from the Citigroup complaint).

119. *See id.* at 333 (explaining that even though there was a parallel proceeding, the investors were not in a better situation as a result of that proceeding).

120. *See* SEC v. Bank of Am. Corp., 653 F. Supp. 2d 507, 508 (S.D.N.Y. 2009) (explaining that consent judgments involving a federal agency have aspects of a judicial decree and thus require a closer review of the terms of the consent judgment).

121. *See id.*

122. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 332 (explaining that the difference between a settlement amongst private parties and consent judgments involving a public agency is that private parties can settle a case without ever agreeing on the facts, whereas some knowledge of the facts are required in a settlement with a public agency); *see also* SEC v. Bank of Am. Corp., Nos. 09 Civ. 6829(JSR), 10 Civ. 0215(JSR), 2010 WL 624581, at *1, *5 (S.D.N.Y. Feb. 22, 2010) (noting that the proposed consent judgment's greatest characteristic is that it includes a more developed statement of facts); Johnson, *supra* note 5, at 628 n.5 (defining public interest to include a societal interest in the benefits of "adjudication, transparency, and corporate responsibility").

123. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 333 ("[T]he parties' successful resolution of their competing interests cannot be automatically equated with the public interest.").

124. *See id.* at 335 (finding the consent judgment unreasonable because it is based on mere allegations); *see also id.* at 333 (rejecting the SEC's position that not expressly denying an allegation somehow made the truth about the allegation known to the court and public).

interest would not be served,[125] and the consent judgment between the SEC and MG Global would be rejected.

III. A COMBINATION OF BOTH STANDARDS ALLOWS FOR GREATER ENFORCEMENT AND TRANSPARENCY

A clear standard that establishes the necessary elements of a consent judgment must be adopted in the near future as other courts begin to apply Judge Rakoff's standard.[126] Consent judgments play a significant role in the SEC's enforcement program to stop and punish violators of securities laws.[127] Judge Rakoff's approach to consent judgments brings such decrees closer to the standard of "fair, reasonable, adequate, and in the public interest"; there are, however, drawbacks.[128] If courts adopt Judge Rakoff's more demanding approach, fewer consent judgment settlements will survive,[129] creating a great imposition on the SEC and public.[130] Thus, it is prudent that a combination of both the traditional standard and the Rakoff standard be adopted—a standard that will produce consent judgments that are truly reasonable, fair, adequate, and in the public interest.[131]

In the absence of sufficient facts, the court lacks a framework for determining adequacy.[132] A proposed consent judgment without a

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125. *See id.* at 335 (stating that a successful resolution did not equate to serving the public's best interest).

126. *See* Edward Wyatt, *In Challenging S.E.C. Settlement, a Judge in Wisconsin Cites a Court in New York*, N.Y. TIMES, Dec. 29, 2011, at B4 (referring to a judge in Wisconsin who challenged a consent judgment by citing *Citigroup*).

127. *See Interview: SEC Enforcement Division Director Robert Khuzami*, THOMSON REUTERS NEWS & INSIGHT (April 27, 2012), http://newsandinsight.thomsonreuters.com/Securities/News/2012/04_-_April/Interview__SEC_Enforcement_Division_Director_Robert_Khuzami/ ("[W]e are able to use the resources we save [through settlements] to fight other frauds and return money to other harmed investors.").

128. *See id.* (explaining that without the "no admit/deny" provision fewer defendants will settle because of the civil and criminal consequences of an admission of wrongdoing).

129. *See* Brief for Business Roundtable as Amicus Curiae in Support of Appellants at 7, SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328 (S.D.N.Y. 2011) (No. 11-5527), 2012 WL 2166144 (stating that Judge Rakoff's decision will result in more litigation for the federal judiciary to oversee).

130. *See id.* at 14 (noting that a new approach to proposed consent decrees will deprive agencies of a crucial enforcement tool, force the SEC to incur great costs from litigation, and impose onerous burdens on the judiciary).

131. *Compare* Bondi & Fischer, *supra* note 11 (contending that refusal to accept settlements with a "no admit/deny" policy and requiring additional facts will force the SEC to find alternatives to settlements), *with* Zimmerman, *supra* note 94, at 570 (contending that a closer judicial review will give the court an opportunity to exercise an independent basis for the terms of the consent judgment).

132. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 332 (S.D.N.Y.

factual basis does not serve the public interest because it asks the court to employ its power and assert its authority on the basis of unknown facts.[133] The court's role is to exercise some independent judgment; its role is not to act as a rubber stamp in granting consent judgments.[134] In an economy where greater transparency is needed, the public deserves to know about the occurrence of violations and those responsible for them.[135]

The SEC argues that requiring more facts requires extensive and expensive discovery.[136] However, it is difficult for a court to impose relief on the basis of mere allegations.[137] This is problematic because the consent judgment between the SEC and MG Global asks the court to "employ its power and assert its authority when it does not know the facts."[138] Charging MG Global with negligence and then allowing it to settle without admitting or denying the allegations ends up hurting defrauded investors instead of helping them.[139] Those defrauded investors who try to recoup their losses through private litigation are at a disadvantage because they cannot bring securities claims based on negligence, nor can they derive any collateral estoppel assistance from MG Global's non-admission/denial of the SEC's allegation.[140]

The SEC has a duty to see that the truth emerges.[141] If the court fails to find the truth, it should not grant judicial enforcement for the

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2011) (holding that the consent judgment is "neither fair, nor reasonable, nor adequate, nor in the public interest" mainly because there were not enough facts to determine if the relief was justified under the standards for consent judgments).

133. *See id.* (noting concern that the court may simply become a "handmaiden" to a privately negotiated settlement).

134. *See id.* at 331 (stating that the court's independent judgment is necessary in a settlement involving a public agency asking the court to impose injunctive remedies).

135. *See* Prial, *supra* note 44 (noting that transparency and accountability are key to the SEC's mission, and the public interest is not served if violators of securities laws can avoid the allegations by paying a fine and not admitting guilt).

136. *See* Randall Bodner et al., *SEC Penalties on Trial*, 23 SEC. ENFORCEMENT 18, 25 (2009) (arguing that the point of a settlement is to prevent the costs associated with preparing for trial).

137. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 333 (holding that allegations in a complaint are not evidence of anything and do not provide a factual basis for the court to evaluate the consent judgment).

138. *Id.* at 335.

139. *See id.* at 334–35 (stating that the defrauded investors are not actually protected by the terms of the proposed consent decree because the proposed judgment does not commit the SEC to returning any of the money recovered from Citigroup to the defrauded investors).

140. *See id.* at 334 (finding the combination of the negligence charges with the terms of the proposed judgment to be a "double blow" to investors leaving them "short-changed").

141. *See id.* at 335.

mere sake of convenience and deference.[142] The role of a judge in determining whether a decree protects the public interest should include an evaluation of the facts establishing the allegation.[143] Thus, a better-developed statement of facts is necessary for future consent judgments.[144]

Judge Rakoff's greatest criticism of recently proposed consent judgments is the inclusion of the "no admit/deny" provision.[145] Truth of the allegations, however, cannot be discovered by simply removing the "no admit/deny" provision.[146] Further, requiring an admission of guilt will not create greater enforcement;[147] instead, it will result in fewer settlements.[148] The "no admit/deny" provision is central to the SEC's enforcement strategy.[149] Without it, banks become subject to more litigation from investors.[150] As a result, companies will refuse to enter settlements where they would be forced to acknowledge liability.[151]

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142. *See id.* (finding that if a consent judgment is not supported by facts, then granting such decree would be using the court as an "engine of oppression").

143. *See id.* at 332 (holding that the court and the public need some knowledge of the facts in order to evaluate the justification for the remedies sought in a consent judgment); *see also* SEC v. Bank of Am. Corp., Nos. 09 Civ. 6829(JSR), 10 Civ. 0215(JSR), 2010 WL 624581, at *1, *5 (S.D.N.Y. Feb. 22, 2010) (concluding that the reason the consent decree met the standard was because it was premised on better developed facts, which were scrutinized by the court).

144. *See Bank of Am. Corp.*, 2010 WL 624581, at *5 (stating that the "greatest virtue" of the proposed consent judgment is the better developed statement of facts).

145. *See* SEC v. Vitesse Semiconductor Corp., 771 F. Supp. 2d 304, 310 (S.D.N.Y. 2011) (noting the more troubling aspect of the proposed consent judgment is the fact that the allegations are resolved without the defendant admitting or denying the allegations brought against them); *see also Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 330 (rejecting the proposed consent judgment because the court did not have any "proven or admitted facts" upon which to base its own independent judgment).

146. *Cf. Bank of Am. Corp.*, 2010 WL 624581, at *5 (stating that the new consent judgment has a better developed statement of underlying facts while making no mention of the "no admit/deny" provision's effect on establishing those facts).

147. *See* SEC Mem. of Law, *supra* note 18, at 11–12 (arguing that, by refusing to allow defendants to deny allegations, the SEC prevents confusion over the accuracy of the allegations made in the complaint).

148. *See Interview: SEC Enforcement Division Director Robert Khuzami*, *supra* note 127.

149. *See* Jean Eaglesham & Suzanne Kapner, *SEC Cops Want to Fight U.S. Judge Street*, WALL ST. J. (Dec. 16, 2011), http://online.wsj.com/article/SB10001424052970204844504577098833058976236.html (explaining that if the appeals court upholds Judge Rakoff's ruling in *Citigroup*, it will become highly persuasive authority for other courts around the country, negating an important SEC strategy).

150. *See Citigroup Global Mkts., Inc.*, 827 F. Supp. 2d at 334 (implying that the inclusion of the "no admit/deny" policy serves as a protection for companies who violate securities laws because it limits the number of suits investors can bring against these violators).

151. *See* Prial, *supra* note 44 (indicating that, in the absence of a "no admit/deny" provision, companies will continue to fight the SEC).

Consent judgments are an effective and efficient means for resolving disputes.[152] Due to the advantages associated with settlements, it would be a major disservice to the SEC and the public if consent judgments no longer served the purpose they were intended to serve.[153] With settlements, the SEC is able to spread its limited resources to go after the largest number of cases possible.[154]

A number of factors determine whether judicial enforcement is appropriate. To allow for greater transparency, there needs to be some factual basis in proposed judgments that gives the public insight into what violations actually occurred.[155] The SEC should be required to "explain the evidence which is available, and . . . offer a rational connection between the facts found and the choice made."[156] If there is no admission, there needs to be a stronger framework, i.e., something more than mere allegations.[157] Courts can require the SEC to provide a written factual predicate for why it believes the court should find the proposed settlement judgment fair, reasonable, adequate, and in the public interest.[158] The benefits of providing the court with a written factual predicate provide increased transparency to investors and the markets and enhanced guidance to companies and individuals about the conduct underlying the violation.[159] Removing the "no admit/deny" policy is not the best means to greater enforcement. Instead, there needs to be a balance between the advantages of consent judgment settlements and the need for greater transparency in financial markets.

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152. *See* SEC v. Randolph, 736 F.2d 525, 528 (9th Cir. 1984) (stating that the SEC tries to avoid the risks and costs of litigation by entering into consent judgments).

153. *See* SEC v. Clifton, 700 F.2d 744, 748 (D.C. Cir. 1983) (recognizing that settlements conserve SEC resources and inform potential investors of securities violators); Eaglesham & Kapner, *supra* note 149 (stating that Robert Khuzami, the SEC's Enforcement Director, believes that rejecting settlements will make it harder to police Wall Street).

154. *See Randolph*, 736 F.2d at 529–30.

155. *See* Johnson, *supra* note 5, at 674 (noting that it is in the public's interest to be able to distinguish bad actors from those who have made minor violations of securities laws).

156. Zimmerman, *supra* note 94, at 570 (quoting Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).

157. *See* SEC v. Citigroup Global Mkts., Inc., 827 F. Supp. 2d 328, 330 (S.D.N.Y. 2011) (stating that no admission and no factual basis leaves the court depriving the public of ever knowing the truth and does not meet the standard of "fair, reasonable, adequate, and in the public interest").

158. *See* Wilczek, *supra* note 11 (noting that supporters of Judge Rakoff's decision find it justifiable to have the SEC provide a rationale for the enforcement penalties it is seeking in order to shed light on whether settlements are adequate).

159. *Id.*

CONCLUSION

The decision in *Citigroup* significantly altered many courts' decisions regarding SEC consent judgments. With courts in other districts already citing to Judge Rakoff's famous opinion, the SEC is concerned this could hamper its enforcement program.[160]

The benefits and challenges that come with applying a stricter standard, as suggested by Judge Rakoff, are topics of conversation all over the securities world. Investors will benefit from removal of the "no admit/deny" provision because it will be easier for them to recoup their losses if banks are forced to acknowledge liability. Furthermore, large companies will no longer be able to hide behind the "no admit/deny" policy and eliminate liability by simply paying a fine. Removing this "easy way out" for violators of securities law will promote transparency and accountability.

This more demanding standard, however, poses challenges as well. The SEC settles most of its cases by consent decrees, and creating a more stringent standard can result in more costs and greater risks. Consent judgments save resources, time, and money. As a result, the SEC is better able to effectively and reasonably allocate its resources and bring more charges than it would bring if it had to litigate most of its cases. Judge Rakoff's decision, if approved on appeal, can significantly change the way securities laws are enforced. Requiring an admission subjects defendants to collateral estoppel with regard to the asserted claims. This will compel defendants to defend the allegations made against them rather than settle. With more trials come more costs, which is something the SEC tries to avoid. Due to the advantages and disadvantages that both standards afford, the SEC, the defendants, and the public would be better served with a hybrid standard possessing elements of both.

Requiring defendants to admit to the SEC's allegations while at the same time requiring the SEC to provide a more factual basis for those allegations defeats the purpose of a settlement. In settlements where the defendant does not admit or deny the allegations, a court should require more facts to establish a greater framework. This will give courts a better idea of whether the terms of the decree fit the violations alleged. For cases where the court is left with little factual basis, it is fair to require an admission of guilt because the court will have some knowledge of the truth of the allegations. Further, the

160. *See* Eaglesham & Kapner, *supra* note 149 (explaining that negotiations for several consent judgments stalled because the SEC is unsure about what it must ask for in the settlements).

court can better justify the penalties imposed and properly determine whether those penalties fit the violations. To ensure that consent judgments meet the standard of reasonable, fair, adequate, and in the public interest, courts should apply a standard that combines both the traditional standard and the Rakoff standard. Until then, the ambiguity in the law will leave the SEC unsure of the proper means of enforcement, and the public will not receive the transparency it deserves.

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NOTE

FORWARD-LOOKING IMPROVEMENTS TO LICENSING THE NEXT GENERATION OF NUCLEAR REACTORS

BY ARJUN PRASAD*

Nuclear regulation has faced a variety of challenges since the Atomic Energy Commission first introduced the procedure of two-step licensing, in which construction and operational licenses are issued separately to nuclear reactor developers. Since 1974, and the establishment of the Nuclear Regulatory Commission, the process for licensing a nuclear power plant has changed dramatically. In addition to the two-step licensing process of old, developers now have the option of choosing a one-step combined license, which offers more flexibility in terms of developing technical specifications. The two-step and combined license options are codified under 10 C.F.R. §§ 50 and 52, respectively. Although intended to streamline the process and avoid expensive licensing periods that plagued plant development under the old regime, the newer combined license method is not being executed as planned and runs the risk of confronting developers with the same economic hurdles. This Note examines both licensing options and posits that a new strategy must be developed to efficiently license the next generation of nuclear power plants.

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INTRODUCTION

The success of the commercial nuclear industry has fluctuated significantly over the past several decades due to a wide variety of safety related, economic, and political developments.[1] Recently, there has been a growing movement towards expanding nuclear power in the United States once again.[2] Despite the renewed interest, support for nuclear power has

1. *See* Toni Johnson, *Nuclear Power Expansion Challenges*, COUNCIL ON FOREIGN REL. (Mar. 18, 2011), http://www.cfr.org/united-states/nuclear-power-expansion-challenges/p16886#p4 (noting the impact of the environmentalist movement, changing federal regulations, and the large cost required to construct a reactor).

2. *See Licensing New Nuclear Power Plants*, NUCLEAR ENERGY INST. (Oct. 2010), http://www.nei.org/resourcesandstats/documentlibrary/newplants/factsheet/licensingnewnuclearpowerplants/?page=4 [hereinafter NEI LICENSING FACTSHEET] (attributing policy makers' increased support for nuclear power to factors, such as reliability, pollution concerns, and desires for a diversified energy portfolio); *see also Economic Benefits of New Plants*, NUCLEAR ENERGY INST., http://www.nei.org/keyissues/newnuclearplants/economicbenefitsofnewnuclearplants/ (last visited Mar. 16, 2012) (detailing the significant economic benefits plant construction presents to state and

also proven to be polarizing; concerns over improper nuclear waste disposal and plant safety are hotly debated issues.[3] Public opposition to nuclear plants was propelled further following the accident at Three Mile Island in 1979, calling into question the desirability of large-scale nuclear power production.[4] These concerns have been surfaced yet again following the recent developments at Japan's Fukushima Daiichi plant in 2011.[5]

Notwithstanding the myriad safety concerns, the economics of plant development remains perhaps the most significant barrier to nuclear production.[6] The construction and operation of nuclear facilities is an expensive business, which must also factor in decommissioning and waste disposal costs, among others.[7] Cost overruns and construction delays witnessed in the 1970s and 1980s remain a crucial issue today in the debate over the economics of nuclear power.[8] Long construction periods tend to significantly increase financing costs and push overall project costs well beyond initial estimates.[9] Furthermore, with abundant shale-gas deposits contributing to even lower electricity rates,[10] the high cost of developing a plant due to extended construction and engineering time may easily "dampen enthusiasm for major nuclear expansion."[11]

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local economies).

3. *See* Johnson, *supra* note 1 (describing the obstacles and arguments against nuclear power).

4. *See* David A. Repka & Kathryn M. Sutton, *The Revival of Nuclear Power Plant Licensing*, 19 NAT. RES. & ENV'T. 39, 39 (2005) (characterizing the state of the industry as "moribund" following the Three Mile Island disaster).

5. *See* Johnson, *supra* note 1 (describing how the Fukushima disaster "has raised new questions" about nuclear power safety and whether it is a necessary component of the country's energy future).

6. *See id.* (characterizing spiraling costs as the "biggest hurdle" for the nuclear industry); *see also The Dream That Failed*, ECONOMIST, Mar. 10, 2012, http://www.economist.com/node/21549098 (noting that forecast reductions in capital costs for plant construction have not materialized while construction periods have lengthened).

7. *See The Economics of Nuclear Power*, WORLD NUCLEAR ASS'N (July 2012), http://www.world-nuclear.org/info/inf02.html (discussing the impact of fuel procurement and management, capital costs, and financing on the cost competitiveness of nuclear generation, compared to other energy alternatives).

8. *See* Justin Gundlach, *What's the Cost of New Nuclear Plants? The Answer's Gonna Cost You: Risk-Based Approach to Estimating the Costs of New Nuclear Power Plants*, 18 N.Y.U. ENVTL. L.J. 600, 620 (2011) (outlining the argument between opponents and proponents of new nuclear development).

9. *See The Economics of Nuclear Power*, *supra* note 7 (illustrating the variability in financing costs with Georgia Power's proposed AP1000 reactors as an example, which were estimated to cost between $9.6 million and $14 billion depending on whether the project could be financed progressively by ratepayers).

10. Rebecca Smith, *Cheap Natural Gas Unplugs U.S. Nuclear-Power Revival*, WALL ST. J., Mar. 16, 2012, at A1.

11. *See* SHARON SQUASSONI, NUCLEAR ENERGY: REBIRTH OR RESUSCITATION? 34 (2009), *available at* http://carnegieendowment.org/files/nuclear_energy_rebirth_resuscitation.pdf (arguing that the combination of federal subsidies and policies that disincentivize carbon-based electricity generation may overcome financial barriers to

At the nexus of these issues is nuclear regulation. The government oversees nuclear licensing and regulation in the United States and must balance the need for advancing economical electricity generation with public opinion and safety.[12] This Note examines broadly the licensing options available to nuclear plant developers today and suggests that the regulations need to be adapted to avoid the economic pitfalls of costly design and engineering-related delays for the advanced nuclear systems known as Generation IV reactors. Part I describes the history of nuclear reactor licensing, provides background on the Generation IV initiative, and introduces the prototype being developed in the United States, known as the Next Generation Nuclear Power Plant ("NGNP"). Part II outlines the feasibility of licensing a Generation IV reactor under today's available alternatives, while Part III provides broad suggestions for improving these alternatives.

I. A BACKGROUND ON NUCLEAR POWER REGULATION AND GENERATION IV TECHNOLOGY

A. Historical Underpinnings of Nuclear Power Regulation

The Atomic Energy Act of 1954 ("1954 Act") governs the operation and regulation of nuclear energy[13] and gave licensing and enforcement power to the Atomic Energy Commission ("AEC"), which previously maintained jurisdiction over both military and civilian applications of nuclear technology.[14] Eventually, Congress decided to abandon the AEC entirely due to its controversial policies and split the organization's regulatory and promotional duties under the Energy Reorganization Act of 1974.[15] As part of the split, Congress granted authority over civilian nuclear regulation, enforcement, and licensing to the newly created Nuclear Regulatory Commission ("NRC").[16] The NRC formally began its regulatory oversight

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production).

12. The Nuclear Regulatory Commission is tasked with regulating nuclear reactors, materials, and waste. *See About NRC*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/about-nrc.html (last updated Mar. 29, 2012).

13. Atomic Energy Act of 1954, 42 U.S.C. § 2011 (2012).

14. *See Governing Legislation*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/about-nrc/governing-laws.html (last updated Sept. 25, 2012).

15. *See History*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/about-nrc/history.html (last updated Sept. 5, 2012) (describing the increasing scrutiny of the Atomic Energy Commission's regulations in the 1960s, particularly its policies on siting and radiation and environmental protection standards).

16. *See* Christopher C. Chandler, *Recent Developments in Licensing and Regulation at the Nuclear Regulatory Commission*, 58 ADMIN. L. REV. 485, 487 (2006) (reporting that later amendments to the Energy Reorganization Act also provided protection for whistle blowers).

duties in 1975.[17]

B. Two-Step Licensing Under 10 C.F.R. § 50

The NRC continued to use the licensing process developed by the AEC under the 1954 Act, codified in 10 C.F.R. § 50 ("Part 50") of the AEC's regulations.[18] The primary components of the two-step licensing process are the construction permit and the operating license.[19] Applicants must first apply for a construction permit, which requires extensive review by the NRC of the preliminary reactor design specifications.[20] Following a successful public hearing and an environmental review conducted in accordance with the National Environmental Policy Act, the NRC may approve a construction permit or authorize the licensee to complete a minimal amount of construction on the plant before the permit is issued.[21]

Developers must next obtain operating licenses to bring a constructed plant into full operation.[22] Operating license applications are only permitted once the plant's construction is substantially complete.[23] The applications, furthermore, contain a final safety analysis, an environmental report on the plant's design, as well as emergency plans in case of a malfunction.[24]

C. Combined Licensing Under 10 C.F.R. § 52

In 1989, the NRC developed new regulations, codified in 10 C.F.R § 52 ("Part 52"), as an alternative to licensing a nuclear power plant. The regulation[25] attempts to mitigate the economic burden and cost overruns of nuclear plant development by enabling developers to resolve design and

17. Energy Reorganization Act, 42 U.S.C. §§ 5841–5845 (2006) (including safety oversight, license renewal, and application review for new nuclear plants as among the duties of the NRC); *see History*, *supra* note 15.

18. *See* U.S. NUCLEAR REG'Y COMM'N, NUREG/BR-0298, NUCLEAR POWER PLANT LICENSING PROCESS 2–3 (July 2004), *available at* http://www.nrc.gov/reading-rm/doc-collections/nuregs/brochures/br0298/br0298r2.pdf.

19. *Id.* at 2.

20. The review requires that applicants provide safety analysis information, environmental reviews, and financial statements. *See id.* at 2–3.

21. *See* NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 2–3 (explaining that applicants are allowed to commence plant construction only after the NRC is satisfied with the proposed site and preliminary plant design); *see also* 10 C.F.R. § 50.10(c), (d)(1)–(3) (2012) (clarifying both the scope and the conditions under which an applicant will be granted a limited work authorization, which allows for preliminary construction, such as driving of piles, subsurface preparation, or foundation installation).

22. NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 4.

23. M. Stanford Blanton et al., *The NRC's Improved Licensing Process for Commercial Nuclear Power Plants—in Theory and Practice*, 49 INFRASTRUCTURE 3, 7 (2010).

24. NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 4.

25. *See* 10 C.F.R. § 52.0(a) (2012).

environmental licensing requirements *before* the start of construction by giving applicants more options.[26]

Long Island's Shoreham facility serves as a stark reminder of the licensing issues the NRC intends to avoid with Part 52; it was the first full-sized nuclear power plant to be decommissioned and closed before being fully powered.[27] The Shoreham plant collapsed under intense scrutiny following disagreements over a proposed emergency evacuation plan.[28] In the end, Shoreham's cost was approximately eighty times higher[29] than original estimates and saddled Long Island ratepayers with some of the highest electric rates in the nation.[30]

Part 52 employs a more modular approach to licensing and was enacted, among other reasons, to prevent another Shoreham-like saga from burdening ratepayers. The major components of the licensing scheme under Part 52 are the Early Site Permit ("ESP"), Standard Design Certification ("SDC"), and the Combined License ("COL").[31]

The ESPs grant NRC approval of a proposed site with a permit that lasts roughly ten to twenty years from the date it is issued.[32] The permits address site safety, environmental, and emergency issues, which are investigated independent of a nuclear plant's design and in conjunction with the Federal Emergency Management Agency.[33]

SDCs signify NRC approval of the design of a nuclear plant and are

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26. Blanton et al., *supra* note 23, at 8. Public hearings were also streamlined under Part 52 to be less formalized and more affordable, thereby encouraging public participation. *See* Repka & Sutton, *supra* note 4, at 44.

27. *See* Blanton et al., *supra* note 23, at 8 (describing the issues, mostly related to public safety and emergency procedures, that caused the Shoreham facility to be denied an operating license); *see also Shoreham Advisory Committee*, LONG ISLAND POWER AUTH., http://www.lipower.org/shoreham/history.html (last visited Oct. 15, 2012) (chronicling the decommissioning process, which began in 1991 and cost $186 million).

28. *See* Timothy Bolger, *Nuclear Waste: 20 Years After Shoreham's Closure*, LONG ISLAND PRESS, June 11, 2009, at 12, *available at* http://www.longislandpress.com/2009/06/11/nuclear-waste-20-years-after-the-closure-of-the-shoreham-power-facility/ (observing the public relations impact of the Chernobyl and Three Mile Island meltdowns on Shoreham's development).

29. *Shoreham Advisory Committee*, *supra* note 27.

30. *Frequently Asked Questions*, LONG ISLAND POWER AUTH., http://www.lipower.org/residential/custserv/faq/faq-shoreham.html (last visited Oct. 15, 2012); *FIX LIPA*, CITIZENS CAMPAIGN FOR THE ENV'T, http://www.citizenscampaign.org/campaigns/fix-lipa.asp (last updated Mar. 30, 2010).

31. 10 C.F.R. § 52.0(a) (2012).

32. *See Early Site Permit Applications for New Reactors*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reactors/new-reactors/esp.html (last updated Mar. 29, 2012) (stating that the public may participate in application reviews or request hearings on ESP issuances).

33. *See* NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 6–7 (listing information required for a complete application, such as seismic data and emergency evacuation plans).

reviewed independently of applications to bring the plant into operation.[34] SDCs also verify the design of a reactor for roughly fifteen years and include "proposed tests, inspections, analyses, and acceptance criteria for the standard design" ("ITAAC").[35] This SDC stage is particularly important under the new licensing scheme and allows the developer to submit a design control document ("DCD"), which describes all the "essential features and functions of the nuclear plant" for approval before the NRC begins reviewing the combined operating and construction license.[36]

The COL is the most important addition to Part 52. It allows developers to apply for a construction and operational license in one phase while referencing a previously approved ESP and DCD.[37] A COL is issued based on a certified set of design specifications and requires the licensee to demonstrate that the ITAAC referenced in the DCD are satisfied.[38] Once approved, a COL is valid for forty years.[39]

D. Generation IV Technology and the Next Generation Nuclear Plant Project

Reactors in operation today are most commonly based on light water technology and use ordinary water as a coolant.[40] These reactors were primarily constructed in the 1960s and 1970s and are classified as "Generation II" designs.[41] Reactor designs currently planned for construction and licensing are known as "Generation III" or "III+" reactors, which offer simpler designs and more advanced safety features.[42] The even more advanced "Generation IV" energy systems, which may not be

34. During the design certification review, the NRC also informs stakeholders and the public how they can participate in the regulatory process. *See Design Certification Applications for New Reactors*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reactors/new-reactors/design-cert.html (last updated July 3, 2012).

35. *See* NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 8 (describing limitations on changes to NRC certified designs).

36. *See* Blanton et al., *supra* note 23, at 8.

37. *See id.* (noting that the NRC intended for licensees to "finalize design and site issues before applying for a combined license").

38. 10 C.F.R. § 52.103(g) (2012); *see* NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 9 (describing the requirements a licensee must demonstrate to ensure the plant has been constructed safely).

39. *Combined License Applications for New Reactors*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reactors/new-reactors/col.html (last updated Mar. 29, 2012).

40. *Light Water Reactor*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reading-rm/basic-ref/glossary/light-water-reactor.html (last updated Mar. 29, 2012) (noting that boiling water reactors and pressurized water reactors are the most common types of reactors in the United States).

41. Gundlach, *supra* note 8, at 623.

42. *See id.* at 622–23 (noting that newer designs have more generating capacity and feature "passive" safety systems, which can operate autonomously).

commissioned for commercial use until 2030, depart from the water-cooled design model and are currently being researched.[43]

The Generation IV International Forum is coordinating the multinational research effort to develop these advanced systems.[44] Ten countries agreed to cooperate on Generation IV research and develop six prototype technologies to be deployed internationally by 2030.[45] The Generation IV Initiative strives to develop advanced nuclear technology that will make waste more manageable, increase safety performance, and improve the long-term economic viability of new plants.[46] In terms of performance, Generation IV reactor designs mark an improvement over existing reactors by offering greater safety, reliability, and efficiency.[47] The new systems will also reduce toxicity and heat generated by nuclear waste and instead provide "process heat" for a wide variety of secondary applications, such as large-scale hydrogen production.[48]

The Energy Policy Act of 2005 ("2005 Act") played a significant role in furthering the development of advanced nuclear plants by funding research and providing significant financial incentives to developers.[49] The 2005 Act also formally authorized the NGNP Project as the official pilot program for next generation nuclear reactors in the United States.[50] Among the candidates considered by the Initiative is the Very-High Temperature Reactor ("VHTR"), a helium-cooled reactor concept that operates at much

43. *See Generation IV Nuclear Reactors*, WORLD NUCLEAR ASS'N, http://world-nuclear.org/info/inf77.html (last updated Dec. 2010) (detailing the six different technologies being researched for Generation IV reactors).

44. *See generally* U.S. DEPT. OF ENERGY RES. ADVISORY COMM. & GENERATION IV INT'L. FORUM, A TECHNOLOGY ROADMAP FOR GENERATION IV NUCLEAR SYSTEMS: TEN NATIONS PREPARING TODAY FOR TOMORROW'S ENERGY NEEDS (2002), *available at* http://www.gen-4.org/PDFs/GenIVRoadmap.pdf [hereinafter GEN IV ROADMAP] (summarizing the need to develop new nuclear systems to meet future energy demands).

45. Argentina, Brazil, Canada, France, Japan, the Republic of Korea, the Republic of South Africa, Switzerland, the United Kingdom, and the United States were initial members of the multi-national research initiative. *See id.* at 5–9.

46. *See id.* at 5–6 (emphasizing seven goals of the international effort and the need to collaborate on research and development).

47. *See* Jacques Bouchard & Ralph Bennett, *Generation IV Advanced Nuclear Energy Systems*, 26 NUCLEAR PLANT J. 42, 45 (2008), *available at* http://www.gen-4.org/PDFs/NPJ_Vol26_No5_Generation_IV_Bouchard_Bennett_Sep-Oct_2008.pdf (noting that Generation IV reactors extract energy from a larger fraction of uranium in fuel than Generation III reactors, extending the life of the fuel considerably).

48. *See id.*

49. *See U.S. Nuclear Power Policy*, WORLD NUCLEAR ASS'N, http://world-nuclear.org/info/inf41_US_nuclear_power_policy.html (last updated Sept. 2012) (discussing federal incentives under the 2005 Act, including federal risk insurance, tax credits, and loan guarantees up to eighty percent of the project cost for advanced reactors).

50. U.S. DEPT. OF ENERGY, NEXT GENERATION NUCLEAR PLANT: A REPORT TO CONGRESS 3 (Apr. 2010), *available at* http://www.ne.doe.gov/pdfFiles/NGNP_ReporttoCongress_2010.pdf [hereinafter 2010 NGNP REPORT].

higher temperatures than existing light water reactors ("LWR").[51] In addition to its increased generation capacity, the VHTR can recycle spent fuel from LWR and VHTR reactors to reduce the amount of resulting waste.[52] This gas-cooled design was selected as the prototype reactor for the NGNP[53] and is to be constructed at Idaho National Laboratory, where the efficiency of the new reactor as well as its applicability to the industrial and transportation sectors will be studied.[54] The higher temperature of the reactor will enable the plant to produce electricity for industrial processes, such as coal or synthetic oil refinement, as well as other uses.[55]

The NGNP Project executes in two phases.[56] Phase 1 covers conceptual design work and technical work, while Phase 2 covers the final design leading to the construction and licensing of the prototype reactor.[57] Phase 2 aims to establish a full licensing implementation plan for the advanced reactor design.[58] Among other considerations, the unique design of the plant and its fuel procedures will likely require some changes to the current regulatory structure.[59]

II. 10 C.F.R. § 52 IS AN IMPROVEMENT OVER THE PREVIOUS LICENSING SCHEME, BUT MUST BE FURTHER OPTIMIZED FOR INCOMING GENERATION IV REACTORS

Existing regulations have been developed primarily based on technical experience with Generation II LWR technology.[60] Due to several

51. *See* GEN IV ROADMAP, *supra* note 44, at 48.

52. *See id.* at 51 (noting the VHTR's symbiotic fuel cycle, which can "achieve significant reductions in waste quantities").

53. *See* 2010 NGNP REPORT, *supra* note 50, at 3 (explaining that the VHTR was identified as the economical choice for development). Specifically, the High Temperature Gas Reactor, a helium-cooled VHTR, was selected as the NGNP prototype. *The High Temperature Gas Cooled Reactor (HTGR)*, NGNP INDUSTRY ALLIANCE LTD., http://www.ngnpalliance.org/index.php/htgr (last visited Dec. 15, 2012).

54. *U.S. Nuclear Power Policy*, *supra* note 49.

55. *Id.*

56. Energy Policy Act of 2005, Pub. L. No. 109-58, §§ 641–643, 119 Stat. 594, 794 (codified at 42 U.S.C. §§ 16021–16023 (2006)) (establishing the NGNP Project and detailing how it should be organized).

57. *See* Energy Policy Act of 2005 § 643, 119 Stat. at 794 (outlining the research, development, and demonstration efforts to occur in Phase I).

58. *See id.*

59. Anticipating this need, the NRC planned for the project to take five years, with an anticipated COL application filed within the next few years. *See U.S. Nuclear Power Policy*, *supra* note 49.

60. *See* WILLIAM D. TAVERS, COMM'N PAPER SECY-02-019, PLAN FOR RESOLVING POLICY ISSUES RELATED TO LICENSING NON-LIGHT WATER REACTOR DESIGNS (2002), *available at* http://www.nrc.gov/reading-rm/doc-collections/commission/secys/2002/secy2002-0139/2002-0139scy.html [hereinafter NRC POLICY PAPER] (explaining that current regulations reflect experience gained from LWR operation).

technology-neutral provisions, the existing regulatory framework can be used to structure licensing for non-LWR systems.[61] Still, the operational systems of Generation IV reactors are substantially different from LWRs.[62] Considering the technical complexity of advanced reactors and historical shortcomings of the licensing process, the existing licensing options may be insufficient for Generation IV systems.

A. 10 C.F.R. § 50 Is Not Well-Suited to Efficiently License Generation IV Nuclear Reactors

Supporters of licensing under Part 50 suggest a plant could be deployed and available for commercial use more quickly than under other alternatives, providing more certainty for investors.[63] Although an earlier construction start is more feasible with Part 50, construction rework and severe delays are more probable, as the industry has little experience with the more technically complex Generation IV reactors.[64] If initial capital costs are deemed by investors to be unrecoverable within a reasonable time after the plant is operational, construction may be suspended or even cancelled.[65]

Perhaps most indicative of the drawbacks of licensing under Part 50 is the NRC's overhaul in 1989 of the licensing process to create a more "attractive environment for new utility investments in nuclear power."[66] In the end, the gains observed by accelerated initial construction are likely offset by extensive delays and expensive retrofits, thereby jeopardizing the development and future commercial operation of the entire plant.[67]

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61. *See id.*

62. *See* Wolfgang Hoffelner et al., *New Generation Reactors*, *in* ENERGY AND POWER GENERATION HANDBOOK: ESTABLISHED AND EMERGING TECHNOLOGIES Ch. 23, 12 (K.R. Rao ed., 2011), *available at* http://www.krrao.org/images/DKM_Comments_Chapter23_corrected_version_aug23.pdf (explaining that the advanced structural materials operate under more demanding conditions and must endure "different types of damage during their life time").

63. The perception is that private-sector financing would be more attracted to the quicker initial timeline, and thus, readily available under this licensing alternative. *See* U.S. DEPT. OF ENERGY & U.S. NUCLEAR REG'Y COMM'N, NEXT GENERATION NUCLEAR PLANT LICENSING STRATEGY: A REPORT TO CONGRESS 15 (Aug. 2008), *available at* http://www.ne.doe.gov/pdfFiles/NGNP_reporttoCongress.pdf [hereinafter 2008 NGNP REPORT]. Yet, the DOE and NRC disagree with this viewpoint, asserting that licensing under Part 50 presents the "greatest risk." *See id.* at 16.

64. *See id.* at 16 (predicting that, should issues remain unresolved, "significant design changes will likely be required during the [operational license] stage of review").

65. *See* Richard Goldsmith, *Regulatory Reform and the Revival of Nuclear Power*, 20 HOFSTRA L. REV. 159, 186 (1991) (noting that licensing delays, exponential cost growth, and investor concerns under the two-step process resulted in fewer plant orders).

66. *Id.*

67. Post-investment delays are an investor's "greatest fear." Gundlach, *supra* note 8, at 642 (citing Roland M. Frye, Jr., *The Current 'Nuclear Renaissance' in the United*

B. 10 C.F.R. § 52 Is an Improvement That Can Be Further Optimized to Better Facilitate Generation IV Reactors

1. Part 52 Is Not Functioning as Intended

In 1989, the NRC introduced licensing under Part 52 to provide developers with a more predictable and efficient licensing process suited for new reactors (namely Generation III+) with more advanced features.[68] In this regard, Part 52 would be useful for certifying Generation IV reactors, as its objective is to resolve design issues up front, regardless of how advanced or unfamiliar the technology may be.[69]

Despite the improvements under Part 52, the regulatory process is still vulnerable to significant delays and cost overruns given the complexity and uncertainty of examining a nuclear reactor.[70] Furthermore, the "order of operations" laid out by the NRC in Part 52 is not being executed as planned due to the Commission's flexibility.[71] All four standard designs approved by the NRC since Part 52 took effect incorporated amendments and changes to their initial design specifications; for example, the Vogtle plant AP1000 reactor incorporated an amendment to a previously certified design.[72] In other words, the four designs approved by the NRC since Part 52 took effect were not finalized by the time of the COL application, as all four designs were eventually amended.

Despite the NRC's original vision when authoring Part 52, licensees pursued a COL in parallel with uncertified designs.[73] There are several factors that contribute to deviations from the Part 52 framework. For example, responding to economic pressures, some licensees attempt to

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States, Its Underlying Reasons, and Its Potential Pitfalls, 29 ENERGY L.J. 279, 338 (2008)).

68. *See* Repka & Sutton, *supra* note 4, at 39–40 (defining the NRC's objective of licensing newer, but still familiar, reactor technology); *see also* Gundlach, *supra* note 8, at 623 (listing the features of Generation III+ systems, such as passive safety systems that do not require operator intervention to shut down).

69. *See* Blanton et al., *supra* note 23, at 8 (elaborating on the flexibility Part 52 grants to licensees seeking a combined license).

70. Gundlach, *supra* note 8, at 642 (commenting on the financial impact of uncertainty and construction schedule delays).

71. *See* Blanton et al., *supra* note 23, at 1, 3, 8.

72. *See Design Certification Applications for New Reactors*, *supra* note 34 (listing pending design certification applications); *see also Design Certification Application Review - AP1000 Amendment*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reactors/new-reactors/design-cert/amended-ap1000.html (last updated Mar. 29, 2012) (noting that revisions to the AP1000 were submitted to the NRC roughly one year after the design was approved). The amendment to the AP1000 initial design was finally approved by the NRC on December 22, 2011. Press Release, Westinghouse, NRC Grants Design (Dec. 22, 2011), http://westinghousenuclear.mediaroom.com/index.php?s=43&item=303.

73. *See* NUCLEAR POWER PLANT LICENSING PROCESS, *supra* note 18, at 8 (noting that changes to the certified design should only occur under "limited circumstances").

condense the schedule by filing COL applications in parallel with design certification reviews.[74] Additionally, the agency often must make a cost-benefit analysis and focus on the most complete designs submitted, delaying the progress for licensees with more incomplete designs and prompting them to submit further changes or suspend the application altogether.[75] Lastly, design issues continue to present challenges to the licensing framework, as advancements in technology and engineering experience can induce post-certification changes that are inconsistent with the design control document approved by the NRC.[76]

Referencing pending designs may not be consistent with the vision of the new licensing scheme; however, it is expressly authorized under Part 52.[77] The NRC anticipated these challenges during the first wave of COL applications, and the agency works to manage the licensing proceedings to give effect to the intent of Part 52 while allowing parallel proceedings to continue.[78] It therefore appears that the NRC is stretching to accommodate the needs of its applicants while also trying to satisfy the original intentions of Part 52.[79]

2. *Licensing the Next Generation Nuclear Plant Prototype*

As per the 2005 Act, the NGNP Project Team intends to establish a regulatory framework and licensing scheme that enables the successful licensing, construction, and operation of the reactor prototype.[80] Since the NGNP will use a new technology, the NRC recognizes the need for an alternative licensing strategy and submitted a report detailing the

74. *See* Blanton et al., *supra* note 23, at 8–9 (explaining that some applicants were hopeful for completion dates before 2020 and emphasizing the impact of design amendments on the construction and regulatory timeline).

75. *See id.* at 9 (suggesting that the NRC is forced to selectively review applications due to limited resources).

76. *See id.* at 10 (citing the example of General Electric's advanced boiling water reactor ("ABWR"), which incorporated an ITAAC incompatible with the design already approved by the NRC and referenced a design element which was unable to be engineered as planned); *see also Design Certification Application Review—ABWR Amendment*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reactors/new-reactors/design-cert/amended-abwr.html (last modified Mar. 12, 2012) (detailing the chronology of the ABWR amendment and NRC's response).

77. *See* 10 C.F.R. § 52.55(c) (2012) (stating that applicants are permitted to reference "a design for which a certification application has been docketed but not granted," doing so at their own "risk").

78. The NRC has allowed parallel design and combined licensed proceedings when the approach efficiently conserved NRC resources and maintained the "consistency" of licensing regulations. *See* Blanton et al., *supra* note 23, at 11 (citing *Progress Energy Carolinas, Inc.*, CLI-08-15, 68 NRC 1, 4 (2008)).

79. *See id.* (concluding that, no matter how the process evolves, NRC must remain flexible with applicants).

80. Energy Policy Act of 2005 §§ 641–643, 119 Stat. at 794; *see* 2010 NGNP REPORT, *supra* note 50, at 14 (describing the team's progress, as per the guidelines established in the 2008 NGNP Report to Congress).

recommended licensing approach.[81] Of the licensing alternatives considered, the NRC concluded that the NGNP prototype will be licensed under Subpart C of Part 52.[82] In terms of the licensing timeline, the selected licensing approaches will benefit the NGNP by providing an expedited timeframe for construction and final licensing.[83] By requiring only critical safety design elements to be passed on to the COL phase, the NGNP team can obtain NRC approval before significant construction begins and can thus identify "first-of-a-kind non-LWR" technical issues in parallel to the COL review.[84]

III. THE NRC CAN PREVENT GENERATION IV DESIGN-RELATED DELAYS BY REFORMING REGULATIONS AND FURTHERING STANDARDIZATION EFFORTS

The technical complexity of Generation IV systems will make it more difficult for developers to expeditiously adapt design specifications in the initial years after the technology is deployed. Given the flexibility the NRC allows in the licensing process currently,[85] the next generation of nuclear plants could continue to see delays and present economic barriers to developers. As an alternative to the existing dual framework, the NRC could make Part 52 licensing mandatory for untested or new reactor technology and include more stringent rulemaking provisions for these advanced systems to avoid the licensing delays of the past.[86]

In addition, the NRC should embrace a more aggressive standardization policy to preempt licensing delays caused by the variety of available designs.[87] From an engineering standpoint, standardization offers greater efficiency in the operation of a plant and will lower maintenance, training,

81. *See* 2008 NGNP REPORT, *supra* note 63, at 1 (acknowledging the challenge in adapting current regulations to an unproven reactor design); *see also* GEN IV INT'L FORUM, GIF R&D OUTLOOK FOR GENERATION IV NUCLEAR ENERGY SYSTEMS 11 (Aug. 21, 2009), *available at* http://www.gen-4.org/PDFs/GIF_RD_Outlook_for_Generation_IV_Nuclear_Energy_Systems.pdf [hereinafter GIF R&D OUTLOOK] (describing the unique components and materials needed for the VHTR, such as thicker reactor pressure vessels).

82. *See* 2008 NGNP REPORT, *supra* note 63, at 8–9 (acknowledging that the applicant would not be required to submit a complete design).

83. *See id.* at 3 (characterizing the licensing, design, and construction strategy as "aggressive").

84. *See id.* at 10 (suggesting that the NRC's recommended approach will provide lessons for developing risk-informed criteria for future NGNP designs).

85. Blanton et al., *supra* note 23, at 8–11.

86. *See* T.L. Fahring, *Nuclear Uncertainty: A Look at the Uncertainties of a U.S. Nuclear Renaissance*, 41 TEX. ENVT'L L.J. 279, 304 (2011) (arguing that, if it is indeed more efficient and less costly, there is no downside to the new streamlined licensing process).

87. Standardization involves confining reactors to one family of designs with few engineering differences. NEI LICENSING FACTSHEET, *supra* note 2 (noting that international experience demonstrates the advantages of reactor fleet standardization).

and parts-procurement.[88] Moreover, standardization would facilitate shared learning among vendors and operators, leading to more predictability and safety.[89]

While there are substantial benefits to this suggested approach, standardization also presents a variety of technological and economic challenges.[90] Among the engineering challenges, there are difficult questions about what degree of standardization is desirable and how to develop uniformity for components.[91] There are also safety concerns that emerge with standardization, such as the inability to incorporate newly developed safety features due to complacency among industry-side developers who are "deterred" from altering previously approved plants.[92] Additionally, a design defect may be undetected and replicated in each standardized reactor.[93]

Standardization of reactor designs is not a novel solution, as the NRC has stated before that it is a policy objective for the agency's future.[94] So far, this policy has not yet fully materialized.[95] The reactors in the United States are distinct from one another and are virtually "one-of-a-kind."[96] France, conversely, has a higher degree of standardization in reactor types than anywhere in the world and has benefited from significant savings due to standardization in plant development.[97] If it is to replicate a program on

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88. *Id.*

89. *See* WORLD NUCLEAR ASS'N, WNA REPORT: INTERNATIONAL STANDARDIZATION OF NUCLEAR REACTOR DESIGNS 2 (2010), *available at* http://world-nuclear.org/uploadedFiles/org/reference/pdf/CORDELreport2010.pdf [hereinafter WNA STANDARDIZATION REPORT] (discussing the possibility of developing best practices from shared feedback throughout "the full plant lifecycles of a worldwide nuclear fleet").

90. *See* Leonard M. Trosten & David M. Moore, *Nuclear Power Plant Standardization: Promises and Pitfalls*, 15 WM. & MARY L. REV. 527, 528 (1974) (discussing the gains to administrative efficiency when generic plant designs receive prior approval).

91. *See id.* (describing tradeoffs when determining the scope of standardization; for example, deciding "the extent to which components rather than criteria should be standardized").

92. Under the "engineering complacency" scenario, newly developed safety features may be omitted from already pre-approved designs, posing a safety risk. *See id.* at 531.

93. Fahring, *supra* note 86, at 296 n.192.

94. *See Backgrounder on New Nuclear Plant Designs*, U.S. NUCLEAR REG'Y COMM'N, http://www.nrc.gov/reading-rm/doc-collections/fact-sheets/new-nuc-plant-des-bg.html (last updated Feb. 4, 2011) ("The NRC has long sought standardization of nuclear power plant designs.").

95. JOHN F. AHEARNE ET AL., THE FUTURE OF NUCLEAR POWER IN THE UNITED STATES 19, 32 (2012), *available at* http://www.fas.org/pubs/_docs/Nuclear_Energy_Report-lowres.pdf.

96. *See* NEI LICENSING FACTSHEET, *supra* note 2 (commenting that standardization would represent a departure from the first generation of reactors in the United States).

97. *See id.*; *see also* Tinu Mario Mathew, *Nuclear Energy in France: Lessons to Learn for India*, INST. OF ENERGY MGMT. & RESEARCH 4 (Jan. 14, 2011), *available at*

a scale similar to France, the NRC must address the aforementioned safety risks to ensure that standardization will succeed, as safety is obviously a critical component for long term nuclear energy growth.[98]

CONCLUSION

The current strategy for licensing the prototype NGNP, if extended to other advanced reactors, may prove problematic. While Part 52 is a marked improvement over two-step licensing, the same risks are present today when design specifications are finalized in parallel to the COL phase of licensing. Improvements to this process may help nuclear developers avoid the same fate of the 1970s and 1980s and potentially save billions of dollars in the process.[99]

http://greatlakes.edu.in/gurgaon/pdf/Nuclear_Energy_in_France.pdf (lauding France's standardized fleet, which facilitated cheaper generation due to economies of scale in the component manufacturing process).

98. AHEARNE ET AL., *supra* note 95, at 31.

99. *See* Jonathan Kahn, *Keep* Hope *Alive: Updating the Prudent Investment Standard for Allocating Nuclear Plant Cancellations*, 22 FORDHAM ENVTL. L. REV. 43, 47 (2011) (noting that plant cancellations in the 1980s "prompted *Forbes* magazine to call the nuclear power industry 'the largest managerial disaster in business history'").

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