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The Capital Markets and Benefit Corporations

By Frederick H. Alexander

In 2010, Maryland became the first state in the United States to adopt a benefit corporation statute, and since then 31 U.S. jurisdictions (along with Italy) have followed suit. In 2013, Delaware, the leading jurisdiction for incorporating in the United States, adopted its own version, authorizing "public benefit corporations." In this short time frame, more than 3,600 companies have been formed as benefit entities, including more than 500 corporations in Delaware. The expanded purpose, accountability and transparency requirements associated with benefit corporation law are discussed in depth elsewhere in this issue. Briefly, benefit corporations directors must consider the interests of all stakeholders, in contrast to the directors of traditional corporations, whose primary duty is to shareholders. The directors of benefit corporations can and must balance the interests of all stakeholders when making important decisions, and even when selling the company. Benefit corporations must also be transparent as to how they address stakeholder concerns, so that shareholders, employees, customers, and other stakeholders can distinguish good companies from good marketing.

From a capital markets perspective, the critical distinction between traditional corporations and benefit corporations is that the latter enable private capital to be deployed in a manner that takes into account all relevant stakeholders, and not just shareholders. This idea is in sharp opposition to the governance model of shareholder primacy that currently dominates our capital markets. As a recent ABA study described the current state of corporate law: "the primary focus of corporations is to return profits to shareholders. If stakeholder needs are considered, they are a secondary concern." The ability for corporations to opt out of this system by using the benefit corporation statutes has the potential to fundamentally alter the system of capital allocation within the United States, and in global markets as well. The rapid uptake of this new model converges with a number of other developments in the capital markets and the legal regimes affecting them. These developments go by many names: ESG (environmental, social, governance); CSR (corporate social responsibility); CSV (creating shared value); sustainability; responsibility, and others. Each of these shares a fundamental idea: corporations bear a responsibility to all of their stakeholders, not just shareholders.

Business Developments in the Direction of Sustainability

The demand for corporations that operate with a broader purpose than simply maximizing shareholder value is clear. For example, a recent Nielsen study showed that, among global online consumers surveyed in 60 countries, 55 percent were willing to pay extra for goods and services from companies that are committed to positive impact on society and the environment. In the United States, the American Sustainable Business Council reports that it represents over 200,000 businesses in promoting a sustainable economy. *Fast Company* reported that more than 50 percent of millennials would take a pay cut to find work that matches their values; they will comprise 75 percent of the work force by 2025, demonstrating the purposeful nature of an enterprise is essential in the war for talent. Businesses that participate in the supply chains of responsible companies must also constantly improve their social and environmental performance in order to satisfy procurements requirements. PwC reported in 2015 that more than two-thirds of surveyed supply chain executives said that sustainability would play an important role in the management of their supply chains. In 2014, US SIF reported that $6.6 trillion in assets under management that is managed with sustainability goals. Thus, throughout the business chain, there is increasing focus on sustainability.

Legal and Regulatory Developments

Regulators are recognizing the importance of sustainability as well. In 2015, the Department of Labor changed its guidance for ERISA trustees to specifically provide that there was no burden placed on trustees who invested in enterprises with an ESG strategy. Indeed, the DOL guidance recognized that such strategies may contribute to improved long-term performance. The Small Business Administration recently released proposed regulations that would formalize their "impact fund" program, which provides special incentives for SBICs that agree to invest at least 50 percent of their assets in companies that have a positive impact on society and the environment. More recently, in April, the SEC issued a concept release asking for comments with respect to periodic reporting. Within that release was a section setting forth specific questions relating to ESG reporting.

A number of NGOs have also focused on sustainability reporting. Principles for Responsible Investment, a UN-backed initiative, has signed up asset owners and managers with $59 trillion under management to encourage responsible investing. The Sustainability Accounting Standards Board has promulgated sets of reporting standards applicable to a number of industries. Other NGOs have constructed well-respected standards, such as the Global Reporting Initiative and IRIS, which have created a catalog of performance metrics used to measure the social, environmental, and financial performance of investments. B Lab, a nonprofit organization that supports benefit corporations, has constructed an actual impact assessment that can assign a score to any for-profit business to determine its performance across a broad array of sustainability metrics.

Need for New Legal Paradigm

All of these developments contribute to the strong market forces demanding responsible and sustainable performance by companies. However, traditional corporate law and financial market norms do not provide a governance model that is fully consistent with operating businesses in a sustainable manner that respects the interests of all stakeholders. Instead, traditional corporate governance emphasizes shareholder value as the primary goal for directors and other fiduciaries. Under this rule of shareholder primacy, the interests of workers, communities and other stakeholders can be considered, but that that consideration is always secondary to maximizing shareholder wealth. Entrepreneurs and others who want businesses to serve the interests of all stakeholders may prefer "mission-aligned" governance, which does not prioritize the interests of shareholders over other stakeholders; benefit corporation law provides such an option.

Notably, proponents of responsible corporate conduct often argue that sustainability performance and reporting increase financial performance, at least in the long term. If this is true, it may beg the question why a new corporate form is needed to allow managers to take the interests of stakeholders into account. That is, if stakeholder governance benefits shareholders, why is it necessary to change the rules to say that directors can take into account the interest of stakeholders as well as shareholders? Shouldn't they already be doing this in order to maximum return to shareholders? There are several answers to this question, and the relevant answer in a particular situation may influence the advice given when clients consider adopting mission-aligned governance.

The first instance in which a mission-aligned company might make sense would be for an entrepreneur seeking so-called "concessionary" investments. This phrase refers to a situation where investors expect to sacrifice some returns in exchange for ensuring that a business has a positive social impact. This concept appeals to impact investors who are willing to accept a lower return and who are most concerned that their investments have a positive social impact. This is an important use of the benefit corporation model—but it is not the primary use to which it can be put in the capital markets.

A more important function of benefit corporation governance is its use as a tool to create relationships of genuine trust and commitment among companies, investors, communities, workers, and other stakeholders. By allowing companies to make genuine commitments to stakeholders, i.e., commitments that are not contingent on continuing to be the most profitable option, benefit corporations can obtain greater commitment and cooperation from a broad range of stakeholders. Thus, in a seemingly paradoxical result, the legal commitment to pursue *stakeholder* value can create more *shareholder* value. This theory of value has been explained by Colin Mayer, a professor at the Said School of Business at Oxford in his book *Firm Commitment*, and by Lynn Stout, a professor at Cornell, in *The Shareholder Value Myth.* Although this argument may sound somewhat esoteric, it is probably the chief reason for which the form is used today. That is, mission-aligned governance is being used as a tool to prove to other stakeholders that responsible performance is "locked in." Thus, the benefit corporation form is a tool that can demonstrate to regulators that a for-profit business can be trusted over the long term; it shows potential employees that they can work for an employer whose values are part of its DNA. This idea—that doing well by stakeholders is a way to do good for your shareholders—obviously appeals to all investors, whether they prioritize impact or not.

Lawyers may be better able to serve their clients if they understand that the benefit corporation has moved beyond concessionary investments, and is advancing into mainstream capital markets, and if they are able to advise clients who want to take advantage of the new model. Hundreds of millions of dollars have been raised from conventional venture capital investors by benefit corporations. These investors include brand names like Benchmark Capital, Union Square Ventures, Andreessen Horowitz, and Founders Fund. Moreover, benefit corporate governance is beginning to make its way into the public markets. For example, in 2015, Etsy, an online marketer of homemade products, went public as a certified B Corporation (certified by B Lab). The B Corporation certification requires a company to demonstrate a high level of social and environmental performance. In addition, the designation requires that the company change its corporate governance structure to one of mission alignment. In order to retain its B Corporation certification, Etsy will need to become a benefit corporation by August of 2017. In another development, Laureate Education, a KKR backed $4 billion for-profit education company has filed a registration statement on Form S-1 in anticipation of a public offering. In addition, Brazil-based Natura, a multibillion dollar-market capitalization company presented a resolution to its shareholders in 2015 to amend its corporate charter to provide for mission-aligned governance. (In Brazil, there is no need for a separate benefit corporation statute: the current corporate law allows mission-aligned governance if so designated in the charter.) Natura obtained the vote and has amended its charter. Most recently, another Certified B Corp, Sungevity, announced it would go public through a reverse IPO.

Public companies are experimenting with the benefit corporation form in other ways as well. Campbell's Soup owns a benefit corporation called Plum Organics, and United Therapeutics owns a benefit corporation named Lung Bioscience. Other multinational companies are teaming up with B Lab to ensure that both B Labs's certification standards and its legal requirements work in the public markets. That effort, called the Multinational and Pubic Markets Advisory Council, includes multinational companies such as Unilever, Danone, and Campbell's, investors such as Morgan Stanley, Prudential Financial, and Perella Weinberg Partners, and professors from the business schools of Oxford and Harvard.

This movement is accelerating. As discussed above, responsible corporate behavior is just good business. It attracts customers and employees, and is important to government in their capacity as both regulators and customers. But just as importantly, there is another element that is beginning to motivate investors. Most investors in the market, including insurance companies, pension funds and individuals managing their own 401(k)s, are highly diversified. That is, they own most of the market. For them, company-by-company performance is not as important as the performance of the market as a whole. Investors are beginning to realize that companies that operate solely on a principle of chasing share value are incentivized to take actions that may hurt the rest of the market. For example, in the run-up to the 2008 financial crisis, financial companies had the incentive to take great risks in order to chase large returns, but the result of that risk-taking was absorbed not simply by those companies' shareholders, but by the entire stock market. Moreover, the ultimate beneficiaries of pension funds and insurance companies are the pensioners and the insured, and to them, it is important that the companies they invest in not harm the world in which they live. All of this means that active investors will begin to encourage mission-aligned governance as a way of maintaining valuable portfolios over the long term, and company advisors should be prepared to discuss these issues, and tools like benefit corporation governance.

The Role for Lawyers

As part of my job as head of legal policy at B Lab, I often hear that investors and entrepreneurs who want to pursue a benefit corporation structure are discouraged by some lawyers, who worry that the model is untested or unnecessary. Law firms that want to provide a full complement of options to their clients, especially clients that want to take leadership positions in the sustainable economy, should consider learning about this structure. Of course, reading the other mini-theme articles in this issue of *Business Law Today* would be an excellent way to begin that process. Resources are also available at www.benefitcorp.net, including a free ePub version of *The Public Benefit Guidebook*, which includes practical advice as to how to form and operate a Delaware benefit corporation. These and other resources can help lawyers to answer questions about how governance of benefit corporations differs from traditional governance. This new governance framework, which requires directors to balance and consider all stakeholders will, like any new legal concept, require thoughtful counseling.

There are two critical concepts behind the adoption of benefit corporation statutes—the need for legal change and the stakeholder-based solution. Advocates have persuaded legislatures to adopt benefit corporation statutes because the traditional law—developed in well-known cases like *Revlon* and *eBay*—precludes corporations from making authentic commitments to stakeholders, and this disability prevents corporations from entering into long term relationships based on trust. It also prevents corporations and their investors from agreeing to forgo short-term strategies that interfere with the creation of long-term value. Benefit corporation law is intended to serve as a turnkey solution to this problem, which will allow corporations to expand corporate purpose to include stakeholder interests, while providing for corresponding accountability and transparency with respect to those concerns. It provides management with tools such as an expanded business judgment rule and special liability protections that allow a corporation to make commitments to stakeholders that are on par with its commitment to shareholders. The CEO of Laureate Education explained this principle in the company's registration statement:

> I believe that balancing the needs of our constituents has been instrumental to our success and longevity, allowing us to grow even in challenging economic times. For a long time, we didn't have an easy way to explain the idea of a for-profit company with such a deep commitment to benefitting society. So we took notice when in 2010 the first state in the U.S. passed legislation creating the concept of a Public Benefit Corpora-

tion, a new type of for-profit corporation with an expressed commitment to creating a material positive impact on society. We watched this concept carefully as it swept the nation, with 31 states and the District of Columbia now having passed legislation to allow for this new class of corporation, which commits itself to high standards of corporate purpose, accountability and transparency. This includes Delaware, the state that we have selected as our new domicile and which has the most up-to-date Public Benefit Corporation law.

In light of these developments, lawyers may want to equip themselves to help clients who want to take a leadership role by creating or investing in benefit corps. Indeed, becoming knowledgeable is a good way for lawyers who are interested in stakeholder governance to show leadership.

Lawyers active in this field can also help benefit corporation fulfill their reporting requirements. As Haskell Murray points out elsewhere in this issue, it appears that many benefit corporations are out of compliance, and transparency is a key element in the structure. Specific examples of benefit corporation reports can be found here. That page also includes a good description of the reporting requirements. One easy resource that clients can be referred to is a free tool to create a benefit report based on B Lab's B Impact Assessment. Your client can create a benefit report by starting here.

Lawyers can also work to break down barriers to mission-aligned governance. In the 20 states that have yet to adopt a benefit corporation statute, bar associations can work to ensure that this tool is available to local businesses without requiring them to incorporate in another state. (And it is important to understand that the social purpose and flexible purpose statutes that a few states have adopted do not necessarily supply the turnkey solution that benefit corporation law does.) Local bar associations can also develop forms and materials for their states, as well as CLE programs and other teaching materials.

Corporate law underwent a massive change in the latter part of the last century, culminating in the Delaware Supreme Court's holding that corporations are to be managed for the benefit of shareholders only. It many ways, this fundamentally changed our process of allocating capital in the private markets, and the results have not always been positive. The benefit corporation governance alternative gives business lawyers the opportunity to be on the cutting edge not simply of a change in the law, but of a change in the way that capital markets work, and in the ability of business to address some of our most pressing concerns.

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