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Next phase for benefit corporation governance begins

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Ten or so years ago, the founders of B Lab, a tiny new nonprofit, had an audacious idea. They wanted to create a system that would allow for-profit businesses to account for their impact on all their stakeholders.

In the current environment, businesses are viewed as accountable primarily for the financial return they provide to investors (assuming they stay within the bounds of the law). That's why business accounting tells us how much profit a company produces and what the financial value of its assets and liabilities are — but tells us nothing about its effect on its customers' or workers' lives, or on the environment that we live in.

To address this lacuna, the founders of B Lab began to develop a system of questions that would assess the impact that a business had on each of these stakeholders. That system eventually became the B Impact Assessment, which has been used by more than 50,000 businesses around the world.[1]

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But developing a system of measurement and management was not all they did.

B Lab decided that the law that governed business didn't accommodate a business that wanted to embed positive impact on stakeholders into its core. The default rule in the law (especially in the United States) often requires companies to treat the financial interests of shareholders as paramount — and other interests as subordinate at best, and immaterial at worst ("shareholder primacy"). And in some situations, that default rule could not even be changed.[2]

The audacious part of their project was the decision to change the law, by creating contract language to change the default rule where possible, and by drafting and seeking to pass new legislation where shareholder primacy was legally mandated.

More specifically, it was determined that the corporate law in many states included an unalterable mandate that financial return to shareholders was the primary goal for corporations. States with this rigid shareholder primacy regime included Delaware, the corporate domicile of most public companies in the U.S.

WRITING NEW LAW

So B Lab joined with pro bono counsel to create model legislation that would allow corporations to become "benefit corporations." These statutory provisions would allow a corporation to opt into a regime that would broaden its purposes to include responsibility and sustainability.

The provisions made directors accountable for all of a corporation's impacts, and not just the financial return provided to shareholders.

Finally, benefit corporation law mandated that a corporation disclose its impact performance. The provisions they created were called the Model Benefit Corporation Legislation.

The first benefit corporation statute was adopted in Maryland in 2010, and legislation has since been adopted in more than 30 states, including Delaware.

Legislation has also been adopted in Italy, and in 2017 it was introduced in the legislature in Argentina, Chile and Colombia. It is also being considered in Australia, the United Kingdom, Canada and several other countries.

2 MODELS

Each state has adopted a slightly different form of the legislation, but generally these forms follow one of two models. The first is the one is the MBCL created by B Lab and first adopted in Maryland.

The second form, the public benefit corporation, or PBC, was first adopted in Delaware and has since been followed in several states.

One of the most important differences is that the MBCL allows shareholders to challenge company action as failing to pursue or create "general public benefit," which is defined as "a material positive effect on society and the environment, taken as a whole."

Shareholders can bring such a claim, and the decisions in question do not receive protection under the business-judgment rule. (The rule is a doctrine under which courts will not generally interfere with an informed, disinterested decision made by directors, even if the courts disagree with the decision.)

The MBCL structure may give stakeholder interests an extra measure of protection, but it denies directors and managers the broad discretion generally accorded under corporate law.

The second major difference is that the MBCL requires the corporation to adopt a third-party sustainability standard against which to measure its impact.

As with the absence of business judgment rule protection, the use of a third-party standard was considered an important protection of stakeholder interests by the drafters of the MBCL. The drafters of the Delaware version (myself included) were concerned with restricting the discretion of directors and officers to manage the business and to make their own decisions with respect to the proper assessment of stakeholder impact.

One explanation for the difference in the two models is that the Delaware drafters were very cognizant of the difficulties that public companies might have if normal business decisions were subject to challenge by shareholders without business judgment rule protection — litigation with respect to the achievement of "general public benefit" could raise a myriad of difficult issues. It could also create a wave of litigation that made adoption of the form unpalatable for public companies or other companies with broad shareholder bases.

The same concern would apply to the use of a third-party standard, which would essentially create a second disclosure regime for public companies already subject to regulation by the Securities and Exchange Commission and stock exchanges.

Nevertheless, the two versions of the statute are more alike than different. They both upend the shareholder primacy that pervades corporate law and the capital markets by creating a corporate governance regime under which directors must consider the interests of all their stakeholders.

And both statutes importantly protect directors from monetary liability in making decisions that balance among those interests. Moreover, each statute provides that only shareholders may be bring a claim that stakeholder interests are being slighted.

GETTING TRACTION

There are also more than 5,000 benefit companies, and most of them are not certified by B Lab — the movement toward stakeholder governance has taken on a life of its own. In 2017 Delaware alone passed the 1,000 mark.

While many of these enterprises are small, family-owned entities, they are entering the capital markets. Although it is hard to gather statistics for private companies, I have been able to track 35 benefit corporations in the U.S. that have raised outside capital totaling almost $1.4 billion.

Many of these companies have raised capital from well-known venture capitalists, including Benchmark Capital, Founders Fund, Andreesen Horowitz, Shasta Ventures, Sequoia and Union Square Ventures.

In 2017, for the first time, a benefit corporation went public: Laureate Education closed its initial public offering in February, raising $490 million.

Why would a company — and in particular, why would its shareholders — want to invest in a company that didn't put shareholder interests first? Won't that reduce investment returns?

There are a number of answers to this question, and each is important to understanding the potential revolutionary impact of the benefit corporation.

First, there is the simple fact that some entrepreneurs may not be comfortable with the shareholder primacy paradigm. They may have great ideas and leadership skills that can bring correspondingly great rewards to investors.

But these entrepreneurs may only be willing to put those ideas and skills to use in a legal environment where they can treat their workers and customers as having a priority equal to that of their investors.

If that is the value proposition offered, investors may believe that it offers a market return due to the skill of the team and the value of the product. Alternatively, some investors may value the social return their investment creates and be willing to risk a lower return.

But I do not believe either of these alternatives will ultimately drive investors to prefer or even accept the benefit corporation structure.

For investors who are in it for the long run, and particularly for those who are diversified across the market (so-called "universal owners," like pension funds and insurance companies), broad adoption of the benefit corporation model is likely to yield better returns.

First, empirical work is beginning to show that companies that pay attention to environmental, social and governances issue are likely to perform better.[3]

In addition, a company that makes enforceable commitments to treat its workers, customers and other stakeholders as equal in importance to shareholders is likely to engender a measure of trust not available to conventional entities, and this trust is critical to creating shared and durable value over the long term.[4]

These latter two ideas are powerful, and they suggest that a responsible corporate citizen can in many circumstances generate a better return for shareholders over the long run than can an irresponsible one.

But it is naive to suppose that there will not be instances where a corporation could earn a return superior to its peers (even adjusted for reputational risks and other downsides) by creating the type of negative externalities that create social and environmental costs in order to increase the individual corporate bottom line. It is in response to this problem that the benefit corporation structure has the greatest potential to engender real change.

That temptation — to earn a profit by creating harm that others absorb — might create financial value for a single company. But it actually hurts universal owners, who rely on overall market performance over the long term.

Thus, enlightened diversified shareholders should prefer that companies in their portfolios forgo such ill-gotten profits, since they will pay for them in the rest of their portfolios.

THE ROLE OF THE UNIVERSAL OWNER

Universal owners are beginning to recognize their responsibilities in this area. In March, one of the world's largest public pension funds made exactly this point:

> Although investment level approaches like low emission indexing allow the fund to minimize its direct exposure to these risks, the fund's large size and broad holdings mean that *direct and indirect exposure to market-level risks is inevitable*. The fund is also mindful that *when market level efforts create a rising tide that lifts all boats, the fund is among those who will benefit most.* For this reason, the fund focuses its shareholder engagement efforts on companies that underperform their peers on disclosure and other ESG-related issues, especially carbon emissions. ... This effort benefits the fund, its portfolio companies and the broader market.[5]

Also in 2017, one of the largest organizations of institutional investors in the world recognized the cost to portfolios of negative externalities, stating:

> Investors generally do not want to encourage the financial sector to focus on generating short-term returns *if this could lead to further systemic risks and negatively impact overall portfolio returns*.[6]

Finally, managers of public corporations are increasingly recognizing that affirmatively adopting benefit corporation governance can be a powerful tool for addressing the short-term pressures that plague our public markets.

As John Mackey, founder of Whole Foods, put it following a sale of the publicly traded company he founded (which sale followed a shareholder activist campaign), "Boy, oh boy, oh boy do I wish we had been a B corp."[7]

An entity's status as a benefit corporation does not prevent shareholders from exercising their rights the way a traditional corporate anti-takeover defense (such as a "poison pill," which limits sales to hostile bidders) does. However, it communicates a commitment to a certain set of values and attracts investors that share those values — and will be more likely to stick to those values even if it means forgoing a short-term price bump.

WHAT THE FUTURE MAY HOLD

Benefit corporation governance is a new player on the scene, but it has established a track record and is becoming more popular as it begins to enter the public markets.

An increasing recognition by institutional shareholders of the need to think broadly about their investment mandate, along with corporate recognition of the value of using benefit corporation governance to enhance commitments, may lead to more adoption of this form of governance — and that is likely to be a good thing for all of us.

NOTES

1 *See* B Impact Assessment, bimpactassessment.net (last visited Dec. 4, 2017).

2 *See* Frederick Alexander, Benefit Corporation Law and Governance: Pursuing Profit with Purpose Chapter 2 (Berrett-Koehler Publishing 2018).

3 *See* Gordon L. Clark, Andreas Feiner & Michael Viehs, *From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance* (2015) (meta-study of over 200 studies and sources on sustainability concluding, among other matters, that "companies with strong sustainability scores show better operational performance and are less risky").

4 Colin Mayer, Firm Commitment: Why The Corporation Is Failing Us And How To Restore Trust In It (2013).

5 Office of the New York State Comptroller, New York State Common Retirement Fund Environmental, Social and Governance Report 11 (2017) (emphasis added).

6 Int'l Corp. Governance Network, ICGN Viewpoint on Governance Questions Posed by the Changing U.S. Political Landscape (2017) (emphasis added).

7 Corporation, Facebook (Oct. 5, 2017), http://bit.ly/2AC4o2c (at 1:47:00).

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