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REID AND RIEGE, P.C.

NONPROFIT ORGANIZATION REPORT – FALL 2012

To B or Not to B – That Is the Question: **What Nonprofits Need to Know about Benefit Corporations**

In prior issues of this report we have discussed the topic of social entrepreneurship and hybrid business entities.¹ These entities are not directly related to nonprofit organizations, but they bump up against nonprofits frequently enough to share some of the same space. They are a timely topic because of recent legislative efforts promoting what are called “Benefit corporations” or “B corporations.” B corporation legislation has been adopted in a handful of states, and we have been reviewing it for possible adoption in our home state of Connecticut (and with an eye on the effect the legislation could have on nonprofits).² We believe B corporations are a topic worthy of the space on these pages.

Bifurcation of For-Profit and Nonprofit Law and the Nonprofit Funding Paradigm

To set the stage let’s remind ourselves of the nature of the space we are talking about. In our culture the law bifurcates: (a) proprietary and profit-making taxable organizations (such as General Motors or a family restaurant) whose purpose is to sell goods or services at a profit for the economic benefit of the owners (the shareholders), *from* (b) nonproprietary tax-exempt organizations (such as Yale University or a local homeless shelter) whose purpose is to provide a social benefit of some type.

While there are variations, the sectors are connected economically in four basic ways in what might be called our traditional funding paradigm:

- (1) The people who earn profits can make voluntary tax-deductible gifts to nonprofits;
- (2) A nonprofit may have an endowment (an accumulation of donated gifts) in which it holds the stock of for-profit corporations and receives dividends and capital gains;
- (3) The government can tax profit and allocate collected revenue to nonprofits as grants or under fee for services contracts; or
- (4) A nonprofit may sell mission-related goods or services (such as a university charges tuition or a theatre sells tickets).

Fundamental Premise and Basic Nature of B Corporations

The conceptual premise of a B corporation is that it is possible to squeeze within one legal vessel or entity desirable aspects of both sectors – unification instead of bifurcation. While we will discuss this premise in detail below, there are two preliminary points readers should note:

First, a B corporation is a fully taxable for-profit business entity, subject to the same employment, environmental, licensure, tax and other laws as any other business corporation. A B corporation is owned by its shareholders, and the shareholders elect a board of directors to oversee management. These entities

¹ See, for example, the Spring 2009 Special Supplement of this report entitled “Social Entrepreneurship: When Worlds Collide or the Best of Both?” It is available at www.rrlawpc.com.

² The statutory B corporation language used in this report is taken from the “Model B Corporation Act” which has been developed under the auspices of an organization named B Lab.

will rise or fall based on the acumen of management and the profitability of the business. If they do not turn a profit they will fail. One Connecticut legislator we met described B corporation legislation as a “jobs bill.” This is simply not true. B corporations will have employees to the extent the business is successful and help is needed.

Second, there is no special source of funding for B corporations. The money (capital) they need to operate will come from shareholders who write checks as investments, from loans from banks or others, or from the profit earned on sales. There are no tax-deductible contributions available.

The “Profit Plus” Concept Behind B Corporations

As stated above, the heart of B corporation legislation is the unification of aspects of both sectors under the umbrella of a single entity, which is accomplished by a shift in (1) the purpose of the corporation, and (2) the nature of the fiduciary duties owed by the governing board relative to the purpose. Under traditional corporate law principles, a corporation’s purpose is to conduct a business, and the obligation of the board is to manage the business to maximize value for the shareholders. However, B corporations are required to do something more – what might be called “profit plus.” The “plus” factor has two components: a change in corporate purpose to require the corporation to achieve a social benefit, and a modification of the board’s fiduciary duties to mandate the consideration of factors intended to achieve the benefit.

A look at the statute will help explain the shift in approach. It states that a “benefit corporation shall have a purpose of creating general public benefit,” and that the corporation may also “identify one or more specific public benefits.” A “general social benefit” is defined 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.” Sample specific public benefits included in the statute include “improving human health, promoting the arts, advancing knowledge, and promoting economic opportunity.”³

The new fiduciary factors the governing board members of a B corporation must consider (in addition to the interests of shareholders) when they deliberate include, for example, the employees and the work force of the corporation and the employees of its suppliers, the interests of customers as beneficiaries of the general public benefit, community and societal factors, and the local and global environment.

The Statute Has Teeth – Third Party Standards and Lawsuits to Compel Social Benefit

A significant feature of the B corporation statute is the requirement that the success or failure in achieving a social benefit be tested against a third party standard, and that a benefit report be published annually to assess performance against the standard. This requirement is somewhat similar to what an independent auditing firm does when it certifies an organization’s financial statements. The B corporation statute does not specify who the third party must be (and an actual benefit audit is optional), but does have a robust definition of the type of standard that must be used to insure the independence and integrity of the third party standard being used (think of this in terms of the Generally Accepted Accounting Principles your CPA must follow when preparing financial statements).⁴

³ This is the type of language more typically found in the mission statements of nonprofit organizations.

⁴ Some sample questions from an actual third party standards setting organization will give readers a sense of what is involved. Nonprofit readers may want to ask how they would respond to the following. What multiple is the highest compensated individual paid (inclusive of bonus) as compared to the lowest paid full time worker? Is there a formal written Supplier Code of Conduct policy that specifically holds the company’s suppliers accountable for social and environmental performance? What percentage of the water consumed by your company is returned to the water table at the same or better quality than when it was diverted?

Moreover, the B corporation statute authorizes a new type of lawsuit that can be brought against a B corporation and its board members for “failure to pursue or create a general or a named specific public benefit.” These suits are described in the legislation as a “Benefit Enforcement Proceeding.” While there may be ways to limit the number of people who can bring an enforcement proceeding, and the type of liability (monetary damages as opposed to an injunction), the bottom line is that if there is enough of a disagreement about the social benefit the matter will be put into the hands of a judge to decipher.⁵

Is This Better Described as “Profit Minus” for Nonprofits

Upon drilling down to B corporation bedrock and analyzing the economics we wonder if the B corporation movement is a zero sum game for traditional nonprofits. Will these new entities help or hurt? Should the nonprofit sector encourage the adoption of B corporation statutes? We are not sure, and some of our thoughts are as follows:

First, achieving the social benefit will almost certainly mean lower profits for shareholders – which, of course, is the method behind the movement. The shareholders/owners of B corporations presumably will accept a lower return on investment because of their belief in the social purpose. In other words, unlike the traditional funding paradigm which requires after the fact (after the profit is earned) transfers to nonprofits, in a B corporation the transfer to socially beneficial purposes happens before and as the profit is earned, and as determined by the members of the board of directors of these entities. Is this a form of nonprofit turf intrusion?⁶

Second, if B corporations go to scale will there be less profit available to transfer to nonprofits under the funding paradigm? For example, would people invested in B corporation stock be less inclined to make charitable gifts (which are deductible) because they believe they have satisfied their social obligations sufficiently by means of this investment? Will they have less to give because of the lower returns on their shares?

Third, if a nonprofit has investment assets (a formal endowment or some savings) would it ever invest in B corporation stock (accept a lower return), or would it invest in high profit stocks so that it will have more money for its social purpose and mission? How would the nonprofit board members satisfy their own fiduciary duties in making this determination?

The Limits of Language and the Law

As much as we respect the good intentions behind the B corporation movement, each time we analyze the statute we come away feeling that something is missing – that the attempt to combine for-profit and nonprofit elements within a single entity is a linguistic and legal leap too far – as quixotic as it is noble. Lawyers must be very careful with the language they use because lives, money and time can turn on a lack

⁵ In our experience we suspect that many judges would be loath to have these suits in their courtrooms – because judges, by their own admission, are not in the business of managing a business and are reluctant to second guess judgment calls made by management. This would especially be the case with these entities given the subjectivity inherent in the concept of social benefit (see the example at the end of this newsletter). Litigation of this type could be expensive (legal fees) and consume significant amounts of time.

⁶ The costs associated with these entities will also reduce available profit, and we have to wonder if there is a corresponding benefit. For example, the sample third party standards we have seen strike us as burdensome, costly and intrusive (see footnote 4). Will we see the emergence of a new wave of consultants who will sell themselves as social benefit certifiers – which begs the question of who certifies the certifiers?

of clarity or an ambiguity; and it just may be that there are some meaningful and good concepts that cannot be captured precisely enough with legal language to be efficacious. Ultimately this may prove to be the Achilles heel of the B corporation, as the following hypothetical suggests.

A Simple Hypothetical

Let us suppose that two B corporations are formed: the first is Kleen Frackers Amalgamated, Inc., and its third party benefit standard is provided by Global Cooling Associates; the second is Wind Power Providers, Inc., and its third party benefit standard is provided by Global Warming Associates.

Kleen Frackers believes that its business operations satisfy the statute's benefit requirement (*a material positive impact on society and the environment*) because the natural gas produced by fracking emits less carbon dioxide than other fossil fuels (and, as such, is beneficial to the environment); and that it provides additional social benefit by virtue of the well-paying jobs it brings to distressed communities. These conclusions satisfy Global Cooling Associates' standards. Wind Power Providers believes that its business operations, by their very nature, satisfy the benefit requirement because it manufactures wind turbines – and the theme of its marketing campaign is that its products have a material positive impact on the environment – as opposed to the material negative effect on the environment of all hydrocarbon fuels. These conclusions satisfy the third party benefit standard published by Global Warming Associates.

The task before us is not to take sides on the fractious environmental debate presented by the hypothetical – but to ask if each of these companies can make a reasoned argument (based on facts, data, studies, etc.) that it fits within the social benefit standard of the statute. We think that each has a rational claim that it does so. However, if two diametrically opposed organizations each have an equal claim under the same language, then we have to ask if the enforcement of the statutes (in a Benefit Enforcement Proceeding, for example) would be akin to chasing windmills with a horse and lance.

Maybe we are wrong, and in time these entities will grow to scale and produce the social benefits which are their dream and their goal. On the other hand, the linguistic/legal problem they present is, we think, absent in the bifurcated world in which business entities can focus single mindedly on creating value (subject, of course, to environmental, employment, tax and other applicable law), and nonprofits can focus on their mission as they choose to define it (subject to their ability to attract profit to their cause under the funding paradigm) – with transfers from one sector to the other suggestive of the cash we put in the collection basket in church each week – recognizing as we do so that even the church needs a share of the profit to keep the roof over its congregation.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

This issue of the Nonprofit Organization Report was written by John M. (Jack) Horak, Chair of the Nonprofit Organizations Practice Area at Reid and Riege, P.C., which handles tax, corporate, fiduciary, financial, employment and regulatory issues for nonprofit organizations. While this report provides readers with information on recent developments which may affect them, they are urged not to act on this report without consultation with their counsel.

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