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Benefit Corporations: Governance Actually Matters

Corporate, Securities, and Governance


BENEFIT CORPORATIONS:
Governance Actually Matters

CHEAT SHEET

- ***Shareholder primacy.*** Most corporate activity is investor/shareholder focused, causing societal benefits to become a byproduct rather than a primary requirement.
- ***Benefit corporations*.** Benefit corporations are for-profit entities that also account for all of the societal impacts of earning profit.
- ***How-to.*** A company can become a benefit corporation by adopting an amendment to its certificate of incorporation.
- ***Growing investment.*** Privately held benefit corporations have raised close to two billion dollars from investors, including leading venture and private equity investors.

Companies face an increasing conflict between the pressure to demonstrate social and environmental responsibility on the one hand, and pressure to show financial performance on the other. The benefit corporation model, a new form of governance available in 35 states, provides a path to reconcile these demands.

Rising tension

In order to compete for 21st century customers and workers and to preserve a dependable license to operate, companies must demonstrate accountability for their impacts. This is a C-suite issue: Workplaces are prominently rated, supply chains are vigorously audited, and carbon emissions are tallied. The time has passed when these matters could be relegated to corporate social responsibility programs and siloed from operations. Business models cannot ignore social and environmental impact.

But at the same time that corporate accountability for these impacts is rising, managers and boards find themselves increasingly compelled to maximize financial returns to shareholders. No public company general counsel needs to be told that there are literally hundreds of activist campaigns every year or that activist shareholders base success on increasing share prices quickly.

These two currents are difficult to synthesize. On the one hand, markets for products, services, and talent demand that corporations practice authentic value-based principles, while capital markets and legal principles seem to demand a value-free drive for profit. This tension makes it very difficult to earn the combined trust of the very workers, customers, communities, and investors who collectively depend on the corporate enterprise.

The benefit corporation

State legislatures across the United States have quietly created a new model for corporate governance that works for everyone. In the last eight years, 35 states, including Delaware (the center of corporate law in the United States), have created a new form of corporation. These states allow companies to become benefit corporations and thereby allow boards and managers to make lasting commitments to all of their constituencies, encouraging a collaborative atmosphere in which the creation of long-term, durable value for all stakeholders is valued.

Benefit corporations are for-profit entities, but they must account for all of the impacts of earning that profit. Directors must consider the interests of all stakeholders, not just shareholders. This form of governance supports managers who take a long-term, broad approach to value creation, and who want to resist quarterly pressures. At the same time, it should have particular appeal to institutional shareholders who are diversified long-term holders and who suffer the most when companies ignore the long-term and systemic effects of their operations.

The year 2017 saw the creation of the world's largest benefit corporation (DanoneWave, with more than six billion dollars in sales) and the first IPO of a benefit corporation (Laureate Education). There are now almost 6,000 benefit corporations in the United States, and the law is spreading to other countries as well — Italy and Colombia have adopted statutes — and legislation has been introduced in three countries in South America, in the Canadian province of British Columbia, and is being considered in a number of other countries. Benefit corporations have raised close to two billion dollars.

This article explains the thinking behind the new form, how and why a company might choose to adopt the structure, and the broader implications for capital markets.

History: The purpose of corporations

The corporation was a critical financial innovation of the early modern era. States used the corporation to encourage investors to pool savings and invest in capital-hungry businesses and thereby create needed public goods. The inducements to use the corporate form included the privileges of limited liability for investors, corporate life that extended beyond the life of those investors, and free transferability of shares.

For-profit corporations were originally created to fulfill specific public purposes: financing foreign trade and building infrastructures, such as canals, bridges, and railroads. However, the extensive amounts of capital necessary to fund the industrial revolution of the 19th century meant that raising capital became a necessity for many businesses, and eventually governments allowed any business to obtain a corporate charter, without reference to the satisfaction of a particular societal need.

The resulting general incorporation laws allowed disparate investors to pool their funds and invest in a diverse array of enterprises. This fundraising and investment technology resulted in the industrial and information revolutions: An economy of owner-managers simply could not have supported the enterprises necessary to create the modern world. (The alternative, of course, would be state-owned large enterprises, but we know how that story ends.)

Shareholder primacy

In the 20th century, the rise of large public companies with strong central management and weak, disaggregated shareholders created a concern that managers would use savers' capital to favor their own interests — what economists call "the agency problem." In response, courts and markets developed the rule that the directors' primary responsibility is to shareholders. Over time, markets and courts used this principle of shareholder primacy to complete the hollowing out of the public purpose with which the business corporation was initially imbued. Today, conventional corporate activity is investor focused, and societal benefits have become a byproduct of corporate activity aimed at creating value for shareholders, rather than a primary requirement of the corporate enterprise.

While shareholder primacy was initially a tool to address management malfeasance, it has become a major driver of business conduct. Today, managers feel ever greater pressure to produce shareholder value — and quickly. While that pressure is not new, the last decade has seen a real change in the ability of the investing community, often led by hedge funds and other "active" investors, to apply that pressure effectively. This ability follows from the effectiveness of campaigns to declassify boards, impose majority voting and proxy access, and other corporate law mechanisms to make directors responsive to shareholders.

There is no question that for-profit corporations remain a vital source of goods and services: food, shelter, medicine, clothing, energy, transportation, and technology of every kind are best produced by private industry, and private industry needs the corporate form to marshal capital. But there is a very real concern that the myopic nature of shareholder primacy threatens to destabilize society and our ecosystem. Shareholder primacy may have been acceptable when the costs of external impacts were either limited or unrecognized. But in an increasingly wealthy and interconnected global economy, the costs of ignoring these impacts is becoming apparent and threatening.

The concern over external impacts surfaces in many areas. For example, carbon fuel producers and users may discover that their own best strategy for maximizing shareholder return conflicts with global public perception as to appropriate conduct with respect to climate risk. Business practices that reduce an enterprise's production costs, but exacerbate social inequities, become less tenable as concerns about supply chains increase. Financial industry practices that maximize share value by creating risks borne by the entire economy have already created a "Great Recession" in this century, and those practices seem to be returning. Strategies that minimize taxes to increase the bottom line, but threaten legitimate fiscal policies, risk social and regulatory backlash.

This development can show up in a big way in the technology sector. Companies like Google, Facebook, and Twitter have been so successful that there is now public concern over the impact of the power that they wield.

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Benefit corporation law bridges the divide between for-profit corporations and public purpose

Benefit corporation governance rejects shareholder primacy. It creates a new option for otherwise conventional corporations. A company can become a benefit corporation by adopting an amendment to its certificate of incorporation. This means obtaining a board vote and then (generally) a two-thirds shareholder vote.

Once an amendment takes effect, the corporation and its directors are accountable for all of their impacts, rather than just profit. The statutes are written to ensure that this does not lead to an endless cycle of litigation. In Delaware, for example, the statute (which uses the phrase “public benefit corporation,” often shortened to PBC), specifies that only significant shareholders (but not other stakeholders) may make claims that the interests of shareholders and stakeholders are not being properly balanced. In addition, the statute specifies that the “business judgment rule,” a judicial doctrine that protects directors’ ability to make decisions with very limited judicial interference, will apply to such decisions. Finally, shareholders can only use the new rules to make directors reconsider their decision, not to find the directors monetarily liable.

Despite these limits on enforcement, the law allows companies to return to the original idea that corporations, while operating for profit, are still imbued with a greater purpose — they are institutions that have obligations to the system in which they are embedded.

> **Benefit corporations thus retain all the virtues of the corporation as a capital raising form, but purge it of the excesses of 20th century practices that valued profits over people, place, and our shared future.**

Practical effect of converting

What does this mean practically?

In some ways, the change is not that great. Any good business considers the effects of its operations on all stakeholders. Customers, employees, and communities must be front and center in the minds of all good directors. What will change is how those considerations enter into the business calculus. By giving managers express authority to prioritize stakeholders, benefit corporation governance provides businesses a tool that was unavailable since the advent of shareholder primacy.

For example, directors of a technology company might reject a strategy that, while both legal and profit maximizing, threatens to undermine democratic institutions. Of course, the board of a conventional corporation might reach the same conclusion by determining that the strategy in question would increase regulatory risk and negative public perceptions, which would ultimately have a negative effect on share value. But such reasoning would undermine the strategy — it would suggest that the corporation would continue to threaten those institutions if only it were profitable to do so — hardly a reassuring message.

This internalization does not eliminate the need for regulation but it certainly can reduce it. Rather than having to walk a narrow line of just barely satisfying the law in order to maximize risk adjusted return — or to sell to the highest bidder, whatever that might mean for loyal customers and employees — directors can take the public interest into account. This, in turn, may allow corporations to rebuild a needed reservoir of trust with a skeptical public. Benefit corporations thus retain all the virtues of the corporation as a capital raising form, but purge it of the excesses of 20th century practices that valued profits over people, place, and our shared future.

Will anyone really do this?

Why would a company — and in particular why would its shareholders — want to stop placing shareholder interests first? Won't that reduce investment returns? There are a number of answers to these questions, and each is important in understanding the potential revolutionary impact of the benefit corporation.

First, there is the simple fact that some entrepreneurs and talented individuals 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 individuals may only be willing to put those ideas and skills to use in a legal environment where workers and customers have a priority equal to that of their investors. If that is the value proposition offered, investors may believe that it offers a favorable return due to the skill of the team and the value of the product. Alternatively, some investors may be willing to take the risk that they receive a marginally lower return if they can avoid exploiting other people and the planet (and diversified investors may believe their portfolio will do better as a whole if individual companies forgo profitable but socially irresponsible practices).

This is already happening. Privately held benefit corporations have raised close to two billion dollars from investors, including leading venture and private equity investors. One company, Laureate Education, completed an IPO in which it raised US$490 million.

But what about companies that are not raising money, particularly public companies? Are they likely to change course and convince current investors to go along with the new form, providing the vote necessary for a charter amendment? I think the answer may be "yes" and that the current public concern over corporate activity may induce companies to make the switch.

For long-term investors who are diversified across markets (so-called "universal owners," like pension and sovereign wealth funds, 401(k) savers, 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 governance issues are likely to perform better. Moreover, when a company makes real commitments to workers, customers, and other stakeholders, it will 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.

How might this begin to manifest itself? There are a number of highly visible companies that are, to some degree, the victims of their own success. Some are technology companies, with tremendous market power over social and communications networks that remain largely unregulated. Others are in the financial industry and, due to their scale, operate with implicit government guarantees of great value. Still, others may operate in controversial areas and be perceived as earning a profit by capitalizing on negative externalities — social and environmental costs borne largely by others. Other companies may simply compete in a talent market where a strong signal of trustworthiness is required.

Such companies all have significant concerns about trust, regulation, and their license to operate: Will shifting economic and political climates lead to harmful regulation or government induced break-ups and restrictions on activities? Will the millennial workforce look for opportunities where profit does not trump responsibility? For these companies, the adoption of a model that literally changes the raison d'etre, turning them into engines of societal value, rather than simply shareholder value, may be part of the answer.

Yes, but ...

Is this just wishful thinking? If a benefit corporation rejects shareholder primacy as an operating principle, but otherwise retains standard corporate governance rules, will the outcome of shareholder ac¬tivist campaigns be any different? Won't shareholders have the exact same tools with which to challenge the incumbent board and management — and doesn't that mean that if shareholders want to force the company to take short-term and irresponsible measures to increase share price, the ultimate result of their efforts will be the same? To put a finer point on it, the ultimate tool for activists is the ballot box — they can run proxy contests to replace incumbent directors with candidates who are more will¬ing to take steps like cutting long-term research, borrowing money to buy back shares, or selling the company in order to boost the share price — regardless of such measures' effect on a corporation's purpose and stakeholders.

Thirty years ago, when I began practicing law, such campaigns were rare — almost all proxy contests back then revolved around takeover battles and were led by hostile bidders. Now, due to a host of factors, there are hundreds of activist campaigns every year, many led by hedge funds, that tend to take concentrated positions for relatively short time periods. In 2016, for example, there were close to 500 activist campaigns at public companies. Most of these campaigns never got all the way to a proxy contest and many never even become public. Instead, companies and activists use PR firms, proxy solicitors, and other advisors to try and get a sense of the likely outcomes of a vote and negotiate based on the perceived strength of their respective hands.

In light of this dynamic, the question is whether the presence of benefit corporation governance would strengthen the hand of management or otherwise change the outcome of a contest that pitted shareholder value against responsible corporate citizenship. Since any potential proxy fight would be governed by the same rules (benefit corporation law has no effect on shareholder franchise rights), it might seem as if the expanded purpose and accountability provisions of benefit corporation law would not come into play at all: The directors' expanded obligation to consider all stakeholders would not in any way affect the ability of shareholders to replace those directors.

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Shareholder relationships: Building trust

A large part of the answer to this conundrum lies in something my mentor Lew Black taught me back in the days of hostile takeovers: Most proxy battles are decided before they start. Good management teams develop quality relationships with their shareholders on clear days so that shareholders have confidence in the management and understand its strategy. This is borne out by the fact that most activist campaigns settle early — boards know who is going to support them and activists know who isn't.

It is in this trust-building process that benefit corporation governance can play a crucial role. As long as a corporation retains traditional governance, there is really only one story that it can tell its shareholders: We have figured out the best way to maximize your return on our shares because that is what shareholder primacy demands (and, crucially, share price represents a market consensus as to the likely value of that return).

In contrast, once a company becomes a benefit corporation, management has the ability — and credibility — to explain that a project or process creates a positive (or reduces a negative) impact on society and the environment, even if the delivery of that benefit (or refraining from harm) has a potential cost that is reflected in the share price. They will also have a structure in place that recognizes that a value-maximization model is ultimately self-defeating in a climate where workers and customers are distrustful of business. This will appeal to many shareholders and especially to the universal owners who dominate the global markets.

> **The best route to avoiding federal regulation may well be greater leadership among the company's public companies and institutional investors.**

In short, benefit corporation governance allows management and shareholders to formally recognize that what might appear to be "tradeoffs" between shareholders and stakeholders are in fact patient and proven methods for creating long-term value for society, as well as the shareholders who have a financial stake in society's growth and stability.

Universal owners and responsible stewardship

If shareholders understand that decision and have been brought into it, then an activist campaign to raise the share price by forgoing responsible practices or eliminating a strategy that creates long-term value for all stakeholders is less likely to succeed. This might sound naïve because it suggests that shareholders would agree to sacrifice share value to allow corporations to create value for other stakeholders. But shareholders acting with the enlightened self-interest recognize that the value of their portfolios depends on actors in the private economy acting responsibly. ICGN, one of the largest networks of institutional investors in the world, made exactly this point:

> *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.*

Saker Nusseibeh, CEO of Hermes Asset Management, a large UK pension fund manager, explained it this way:

The ownership of shares must, therefore, evolve so that it becomes the conduit for bringing about long-term sustainable prosperity for the entire system.

Universal owners, like Hermes and the members of ICGN, are broadly diversified, and have no choice but to hold their shares for the long term. They also own most of the market — much more than short-term, concentrated holders like hedge funds that can take the money and run when corporations boost share price with tactics that create systemic risk. Benefit corporation governance allows universal owners to use their voting rights to combat these tactics. This is important not simply for those funds, but for the human investors whose funds they ultimately manage, as explained in the academic writing of Leo E. Strine Jr., the Chief Justice of the Delaware Supreme Court:

Most human investors, in fact, depend much more on their labor than on their equity for their wealth and therefore care deeply about whether our corporate governance system creates incentives for corporations to create and sustain jobs for them. And because human investors are, for the most part, saving for college and retirement, they do not gain from stock price bubbles or unsustainable risk taking. They only gain if the companies in which their capital is invested create durable value through the sale of useful products and services.

So where does this leave us? Some activists seek short-term measures that increase share price but do not benefit the enterprise over the long run. There are many stakeholders who may benefit from a strong enterprise: employees, the community, and, yes, shareholders. To be honest, it isn't always clear who will benefit the most from long-term responsibility because, well, long-term predictions are hard.

Might federal law get their first?

Shortly before this article went to press, Senator Elizabeth Warren surprised observers by introducing a bill to require every company with more than one billion dollars in sales to obtain a federal benefit corporation charter. Many fans of the benefit corporation idea worry that imposing a federal solution in one fell swoop is a mistake. Our federalized system of corporate chartering has allowed states to experiment with different corporate law concepts in a classic "laboratories of democracy" series of experiments. Moreover, forcing this solution on all companies is likely to create real angst among shareholders, rather than allowing them to understand why, over the long run, they are best served by a more stakeholder-oriented view of capitalism. It will also make it difficult for the law to develop in a gradual and considered fashion.

Nevertheless, the idea of mandating benefit corporation status is out there now, and companies should not ignore it. The best route to avoiding federal regulation may well be greater leadership among the nation's public companies and institutional investors. If there is a growing feeling that companies are ignoring the legitimate interests of stakeholders, then, unless companies begin to voluntary adopt a more stakeholder friendly model, congress may be choosing one for them in the not-too-distant future.

The benefit corporation path to trust and durable value

It is clear that shareholders who are dependent on a robust economy and stable environmental and social systems should care about a company's effects on those systems. And companies that adopt benefit corporation governance have the legal orientation to explicitly work with those shareholders to ensure that corporate strategy promotes real and durable value creation. The adoption of this orientation is itself a way of building trust with shareholders and other stakeholders: A benefit corporation's commitment to positive impact is real and will survive changes in management, in ownership, and in circumstance. The existence of these relationships of trust will make it harder for activists to win the hearts and minds of shareholders by promoting risky short-term tactics that detract value from the real economy we all depend on.

This will play itself out when CEOs faced with activist campaigns are able to remind firms like BlackRock, State Street, and Vanguard that the shininess of a quick share price increase does not outweigh the long-term interests of their beneficiaries. Those beneficiaries are ultimately the human beings described by Chief Justice Strine — they rely on stable and thriving social and economic systems to support the value of their entire portfolio, not to mention the quality of their lives. Just as these universal owners are coming to understand the importance of supporting shareholder resolutions intended to protect the climate, they will also support managers against campaigns that threaten all of our long-term interests in a vital and growing real economy, as long as they can trust that the company is committed to those interests as well. Conventional corporate law and contemporary capital markets have eroded that trust; benefit corporation governance can reestablish it.

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