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Washington's Social Purpose Corporation

Insight into the national "social hybrid" corporate structure movement, why Washington State adopted the social purpose corporation, and the requirements for forming a social purpose corporation in Washington.

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4/16/2013

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I. Introduction

On March 30, 2012, Governor Christine Gregoire signed HB 2239 into law, enabling a new type of corporation in Washington State, the social purpose corporation. A social purpose corporation is a shareholder owned, for-profit entity that permits the corporation's directors and officers to consider social and environmental goals—as may be outlined in the social purpose corporation's articles of incorporation—in addition to profits. Washington State's social purpose corporation is a part of the national "social hybrid" movement, a legal movement blending for-profit corporate structures with nonprofit missions.

These materials explain the traditional corporate law constraints spurring the social hybrid movement, the "benefit corporation" that several jurisdictions adopted as a solution, and a summary of the social purpose corporation and its enabling statute, Chapter 23B.25 RCW.

II. Traditional Corporate Law Constraints on Social Enterprise

In a typical week at Apex Law, I'll meet an entrepreneur who has a business idea and wants to start a business with a "triple-bottom line": people, planet, and profits. For example, after one entrepreneur explained his idea to me, he went on to explain that he wanted me to "set up a business" that would incorporate the following goals, saying: "In addition to making a profit, I want to make sure that my business is (1) environmentally sustainable and (2) gives 50% of its profits back to the community." We call these entrepreneurs and their businesses, "Social Entrepreneurs" and "Social Enterprises" because they are businesses that have, at their core, a social goal they strive to achieve alongside profit.

Traditional corporate law posed several constraints on these Social Entrepreneurs, namely, the traditional fiduciary duties directors and officers owe a corporation and the underlying presumption that these duties are to maximize shareholder wealth. The traditional corporate law fiduciary duties directors and officers owe to the company and shareholders are, in summary, to "act in the best interests of the company."[1] What is truly in a company's "best interests" is highly debatable. Because we want our business leaders to make business decisions without a constant fears of being second guessed in a law suit, Washington courts have adopted the "business judgment rule" to permit management the freedom to decide what's in the best interests of the company, so long as they take actions and make decisions in good faith.[2]

Practically speaking—and for actions in the ordinary course of business—the business judgment rule permits corporate managers to consider social and environmental goals at the immediate expense of maximizing shareholder wealth, so long as there is a rational argument that the action is in best interests of the company (and might promote long-term shareholder value). For example, a company can rationalize spending $100,000 to facilitate a contaminated

[1] See RCW 23B.08.300.
[2] *Durand v. HIMC Corp.*, 214 P.3d 189, 199 (2009) (citing *In re Spokane Concrete Prod., Inc.*, 892 P.2d 98 (1995)).

park clean-up in its community instead of reinvesting that same $100,000 in new equipment as being in the best interests of the company because the company's consumers will better respect (and probably purchase from) such a company. But such rationalizations of the business judgment rule must have outer limits. When do social and environmental goals go too far? Could management donate 50% of its yearly profits to charity or a community revitalization project and rationalize that action as in the best interests of the company? What about 75% or 100%?

These questions are difficult to answer. Furthermore, in at least one Delaware chancery court decision, *eBay Domestic holdings, Inc. v. Newmark et al*, we learned about the outer limits of the business judgment rule when Chancellor Chandler wrote "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 consistent with the directors' fiduciary duties under Delaware law."[3] In that case, the individual directors accused of wrong-doing argued, and the court rejected, that they acted rationally to preserve the "company culture." Like most states, Washington courts find Delaware precedent highly persuasive.[4] Ultimately, the corporate law constraint on Social Entrepreneurs is uncertainty surrounding how far the business judgment rule will stretch to protect their triple-bottom line goals.

Further, as the quote from *eBay Domestic holdings, Inc. v. Newmark et al* illustrates, it's important to remember that directors and officers are fiduciaries to the company's shareholders. Shareholders are investors—the (presumed) reason why shareholders relinquish their capital to the trust of a corporation is to see a return on their investment. Therefore, to accommodate shareholder rights, when a company is being sold, taken-over, or otherwise in danger of losing its control, management cannot rely on the business judgment rule to shield their decision making in these instances. Instead, a heightened standard of review applies (typically referred to as the "Unocal"[5] or "Revlon"[6] standard). In fact, in the event of a sale, the duty that the board owes transforms from "defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[7] So the constraint on Social Entrepreneurs is that, in these situations, they cannot consider their social goals because the *only* decision is shareholder wealth maximization.

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[3] *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (2010).
[4] *See, e.g., Sound Infiniti, Inc. v. Snyder*, 169 Wn.2d 199, 237 P.3d 241 (2010) (relying on Delaware precedent to resolve the legal standard for a derivative suit).
[5] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
[6] *Revlon Inc., v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).
[7] *Revlon Inc.*, at 182.

III. The Benefit Corporation, a "Social Hybrid" Solution

In an attempt to alleviate these traditional corporate law constraints on Social Entrepreneurs, B-Lab, a Pennsylvania nonprofit corporation,[8] created the benefit corporation. A benefit corporation is a legal structure that requires the company's management to make an overall positive impact on society and the environment, and in so doing, the structure permits management to take social and environmental factors into account when making decisions.

The first state to adopt the benefit corporation was Maryland on April 13, 2010,[9] and since that time, 11 other states have adopted a version of the benefit corporation including California, New York, and Illinois.[10] A thorough discussion of the benefit corporation is beyond the scope of these materials—indeed each state adopting the benefit corporation has slightly different statutory variations—but a basic understanding is useful when learning about Washington's social purpose corporation. The main characteristics of a benefit corporation are summarized below.

1. General and Specific Public Benefit

A benefit corporation must pursue a "general public benefit." This "general public benefit" under most state statutes means "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."[11] In addition, a benefit corporation may pursue a specific public benefit, if any such benefit is included in the corporation's articles of incorporation.[12]

2. Annual Benefit Report and Third Party Standard

As mentioned above, the benefit corporation must measure its general public benefit against a third-party standard. Each year the corporation must issue an annual public benefit report to shareholders, which report must include: (1) how the corporation pursed a general public benefit (and specific benefits, if any); (2) an assessment of pursuing public benefit against a third-party standard; (3) the compensation of directors and officers; and (4) a disclosure of each person who owns 5% of more of the corporation.[13] A benefit corporation is required to issue an annual benefit report to its shareholders, make the report public on its website, and, in some states, send the report to a government agency.[14]

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[8] For more information about B-Lab, visit: http://www.bcorporation.net/ .
[9] Maryland HB 1009; see http://www.bcorporation.net/what-are-b-corps/passing-legislation .
[10] As of March 8, 2013, these states are California, New York, New Jersey, Pennsylvania, South Carolina, Vermont, Hawaii, Illinois, Massachusetts, Virginia, and Louisiana.
[11] Laws of New York, BSC section 1702(b).
[12] *See* Laws of New York, BSC section 1702(e).
[13] Laws of New York, BSC section 1708.
[14] For reporting to government agency, See Laws of New York, BSC section 17(d).

Using a transparent third-party standard is the backbone of the benefit corporation. The third-party standard promotes transparency and seeks to ensure that corporations are truly following their stated general benefit goals. B-Lab wanted to make sure that corporations were not using the benefit corporation moniker as a marketing ploy to "greenwash" their business.

3. Director and Officer Duties

Benefit corporation officers and directors are required to take into consideration the "stakeholders" of the corporation when taking action. Most benefit corporation statutes state that the directors and officers:

> **Shall** consider the effects of any action upon:
>
> (A) the ability for the benefit corporation to accomplish its general and any specific public benefit purpose;
> (B) the shareholders of the benefit corporation;
> (C) the employees and workforce of the benefit corporation and its subsidiaries and suppliers;
> (D) the interests of customers as beneficiaries of the general or specific public benefit purposes of the benefit corporation;
> (E) community and societal considerations, including those of any community in which offices or facilities of the benefit corporation or its subsidiaries or suppliers are located;
> (F) the local and global environment; and
> (G) 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.[15]

The "shall" is important to note. Directors and officers of benefit corporations are required to take into consideration the above when making any decision.

IV. Washington State's Social Purpose Corporation

Eventually, benefit corporation legislation made its way to Washington State, but Washington State didn't adopt the benefit corporation, at least not the legislation as proffered by B-Lab. Instead of simply adopting the new benefit corporation structure as offered, the Washington State Bar Business Section's Corporate Act Revision Committee ("**CARC**") reviewed the benefit corporation legislation, took the time to analyze the early benefit corporation provisions against how those provisions might be improved for Washington State, and ultimately came up with the social purpose corporation. The key difference between benefit corporations adopted in other jurisdictions and Washington's social purpose corporation is that the social purpose corporation statute is more permissive and flexible for founders and management. The heavy administration requirements requiring directors and officers to consider stakeholders are replaced so that management "may" take such considerations into account. In addition, the yearly assessment against a third-party standard is not a requirement of the social purpose corporation, but founders may elect to require such a standard for their corporation.

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[15] Laws of New York, BSC section 1707(a)(1)(emphasis added).

This section summarizes Chapter 23B.25 RCW by first explaining the requirements to create a social purpose corporation. Part 2 provides the options available for social purpose corporations. Part 3 finishes with general notes about the social purpose corporation include the ability of current, traditional corporations to become social purpose corporations. And finally, to put it into practice, I've provided an example set of articles of incorporation at Appendix B with my commentary on forming a social purpose corporation.

1. Social Purpose Corporation Requirements

As explained in parts (a) through (c) in this section, there are only three required provisions to forming a social purpose corporation. Then, after formation, there are three maintenance requirements for social purpose corporations, provided in parts (d) through (f) in this section.

a. Name

The name of the corporation must include "social purpose corporation" or a version of the abbreviation "SPC."[16] This is an important public policy requirement because the name is a clear clue to outsiders—and investors in particular—that a social purpose corporation is unlike a traditional corporation.

b. Citation to Chapter 23B.25 RCW; Statement

Within the articles of incorporation, a social purpose corporation must state that it is governed by Chapter 23B.25 RCW. In addition, the follow phrase must be included:

> "The mission of this social purpose corporation is not necessarily compatible with and may be contrary to maximizing profits and earnings for shareholders, or maximizing shareholder value in any sale, merger, acquisition, or other similar actions of the corporation."[17]

c. General Social Purposes

Similar to the benefit corporation, a social purpose corporation must be formed for at least one general social purpose. These general social purposes are provided by statute, which are "to promote positive short-term or long-term effects of, or minimize adverse short-term or long-term effects of, the corporation's activities upon any or all of (1) the corporation's employees, suppliers, or customers; (2) the local, state, national, or world community; or (3) the environment."[18]

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[16] RCW 23B.25.040(1)(a).
[17] RCW 23B.25.040(1)(e).
[18] RCW 23B.25.020.

d. Annual Social Purpose Report

Also similar to the benefit corporation, a social purpose corporation's directors are required to furnish an annual social purpose report to shareholders and to make the report public by posting it on the corporation's website. The annual social purpose report is a narrative description that must describe (1) the short-term and long-term goals of the corporation with respect to its social purposes; (2) the material actions taken to achieve those goals over the last year; (3) future actions the corporation expects to take to achieve those goals; and (4) a description of the financial, operating, or other measures used by the corporation during the year for evaluating its performance in achieving its social purposes.[19] Unlike the benefit corporation, using a third-party standard to evaluate performance is not required by statute; however, the option of utilizing a third-party standard, as explained below, is an explicitly provided for in the statute. Using such a standard should be included in the annual social purpose report.

e. Share Certificates and Shareholder Information

If a social purpose corporation issues share certificates to evidence share ownership, then the following must be included on the face of the certificates:

> "This entity is a social purpose corporation organized under Title 23B of the Washington Business Corporation Act. The articles of incorporation of this corporation state one or more social purposes of this Corporation. The Corporation will furnish the shareholder this information without charge on request in writing."[20]

If a social purpose corporation does not issue share certificates, then, similar to traditional corporations, certain information must be furnished to each new shareholder. In addition to information required of all corporations, a social purpose corporation is required to furnish a copy of its articles of incorporation to shareholders.[21]

f. Shareholder Voting Requirements

Shareholders of a social purpose corporation are entitled to vote on a variety of matters affecting the social purpose nature of the corporation. The statute requires a two-thirds majority shareholder vote before the corporation may institute: (1) any amendment affecting social purpose;[22] (2) a plan of merger or share exchange that results in cancelling the social purposes;[23] or (4) selling, leasing, exchanging or disposing of all or substantially all property that results in cancelling the social purposes.[24] As explained below, the two-thirds vote is the statutory

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[19] RCW 23B.25.150.
[20] RCW 23B.25.070.
[21] RCW 23B.25.040(3).
[22] RCW 23B.25.090.
[23] RCW 23B.25.100.
[24] RCW 23B.25.110.

minimum vote, but this can be increased in the articles of incorporation to a larger vote if desired.

2. Social Purpose Corporation Options

Flexibility is the defining characteristic of the social purpose corporation, and this section explains the options available when forming a social purpose corporation. In the end, an entrepreneur may create a corporation that is functionally the same as a benefit corporation.

a. Specific Social Purposes

In addition, a social purpose corporation's founders may write in a specific social purpose.[25] What constitutes a specific social purpose is not defined in the statute. Founders and entrepreneurs are free to define this term themselves!

b. Director and Officer Duties

As Part II of these materials explain, the reason for having hybrid entities is to allow officers and directors to take into account social purposes in addition to maximizing profits without fear of fiduciary liability. The social purpose corporation is no different, as officers and directors are permitted by statute—but not required—to take into account the social purposes of the corporation when taking or refraining from taking action. A founder has the flexibility, however, to require officers and directors to take social purposes into account when taking action by writing such a requirement into the corporation's articles of incorporation. Furthermore, a founder may require that directors and officers give more weight to certain considerations, such as social purposes, than other considerations, such as making a profit. Again, such requirements can be written in to the articles of incorporation.

c. Third Party Standard

Again, there is not a requirement that a corporation adopt a third-party standard to measure progress toward social purpose goals, but RCW 23B.25.040(2)(b) expressly provides for this option by writing the requirement into the articles of incorporation. If this requirement is written into the articles, then the corporation's success under the third party standard must be included in the annual social purpose report provided to shareholders and the public.

d. Increased Shareholder Voting

As explained in Section IV.1.f., social purpose corporation shareholders are entitled to vote on corporate matters affecting the social purposes of the corporation, and a two-thirds majority vote is required to take such actions. Under RCW 23B.25.040(2)(c), this statutory floor may be increased. By way of example, New York's benefit corporation law requires a three-

[25] RCW 23B.25.030.

quarters majority before New York benefit corporations may conduct such these corporate actions.[26] A founder—or group of founders—may choose to increase the shareholder voting threshold to better secure the social purposes of the corporation against future changes.

3. General Notes about the Social Purpose Corporation

The above sections explain the formation requirements and options of the social purpose corporation, but there are additional provisions in the social purpose corporation statute worth mentioning. These provisions, and other general notes, are provided below.

a. Amendment to Washington's Business Corporations Act

The social purpose corporation statue is an amendment to Washington's Business Corporation Act (the "**Act"**). Accordingly, other than the explicit differences in Chapter 23B.25 RCW, the Act governs social purpose corporations and their managers.

b. Shareholder Rights; a Cause of Action?

Under RCW 23B.25.080, entitled "Instituting or maintaining proceedings—shareholders only," only shareholders are permitted to bring a suit in the right of a social purpose corporation. This is an important express statutory provision because other beneficiaries may be named, directly or indirectly, within specific purpose in the articles of incorporation. For example, a specific social purpose may be "for the benefit of education in the Ballard area." Accordingly, under this provision, students and teachers in Ballard would not have a cause of action against the social purpose corporation or its management if officers or directors failed to properly consider this social purpose. But what if a shareholder brought such a suit?

RCW 23B.25.080 is unclear regarding a shareholder's right to bring suit where the articles of incorporation require a director or officer to consider certain social purposes and they fail to do so. Presumptively, a shareholder could bring suit in the name of the social purpose corporation to compel such consideration, but the damages or relief available is not explicitly provided in the statute. It remains to be seen how the courts will shape the rights of shareholders in such a situation.

In addition, under RCW 23B.25.150(5), shareholders have the express right to seek relief from superior court to compel a board of directors to issue an annual social purpose report if the company has failed to do so. This right is limited, however, to a situation where a social purpose report has not been furnished to the shareholders for two consecutive years.

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[26] Laws of New York, BSC section 1702(d)(2).

c. Becoming or Ceasing to be a Social Purpose Corporation; Shareholder Dissent

A current Washington corporation may elect to become a social purpose corporation. The process for a corporation to become a social purpose corporation is provided by RCW 23B.25.130, and the central preliminary step is that the directors must submit the decision to a vote of the shareholders. The vote required is a two-thirds majority of the voting group comprising all the votes of the electing corporation's shareholders entitled to be cast on the decision, and by two-thirds of the outstanding shares of each class or series, voting as separate voting groups, and each other voting group entitled under the articles of incorporation to vote separately on the corporate action. The idea is that all shareholders, even those who may not otherwise be entitled to vote, must provide a supermajority vote as a group before becoming a social purpose corporation.

Then, if the vote is approved, the corporation must amend its articles of incorporation to at least meet the requirements for a social purpose corporation under RCW 23B.25.040(1) and explained in Section IV.1 (a) through (c). Additionally, any dissenting shareholders are entitled to an opportunity to sell their shares to the corporation for fair market value of their shares.[27] After all, some shareholders would not have chosen to invest in a social purpose corporation in the first place, and they should be entitled to remove their capital if such a change is made.

Similarly, a social purpose corporation can cease to be a social purpose corporation and become a traditional corporation. The process mirrors the process explained above to become a social purpose corporation in that the shareholders are entitled to a vote, and the two-thirds threshold must be met before ceasing to be a social purpose corporation.[28] Note that the number of shareholder votes required to cease to be a social purpose corporation may be increased if written into the articles of incorporation. Also similar to becoming a social purpose corporation, ceasing to be a social purpose corporation requires an amendment of the articles of incorporation filed with the secretary of state removing the required provisions at RCW 23B.25.040(1), and dissenting shareholders are entitled to the fair market value of their shares.[29]

[27] RCW 23B.25.120.
[28] RCW 23B.25.140.
[29] RCW 23B.25.120.

Further Reading and Resources:

Apex Law Blog: http://www.apexlg.com/index.php/blog/

B-Lab's homepage: http://www.bcorporation.net/

"The Truth About Ben & Jerry's", Stanford Social Innovation Review: http://www.ssireview.org/articles/entry/the_truth_about_ben_and_jerrys

Howe, Brian, "Putting Good To Work", Seattle Business Magazine, September 2012: http://seattlebusinessmag.com/article/commentary-putting-good-work

Orsi, Janelle, "Practicing Law in the Sharing Economy: Helping People Build Cooperative, Social Enterprise, and Local Sustainable Economies." June 16, 2012. ABA Book Publishing.