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August 5, 2016

VIA U.S. MAIL AND E-MAIL: rule-comments@SEC.gov

Office of the Secretary
Securities and Exchange Commission
100 F Street N.E.
Washington, D.C. 20549-1090

Re: File Number 57-06-1090

Dear Sir or Madam:

Please see the enclosed newsletters on the topic of B (benefit) Corporations and the perspective they provide.

Sincerely,

John M. Horak DAZ

John M. Horak

JMH:daz
Enclosures

REID AND RIEGE, P.C.
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NONPROFIT ORGANIZATION REPORT – SPRING 2016

Redefining Social Enterprise and Benefit Corporations

Better to share the money than to share the mission

Our economic system has three sectors: the governmental sector, the private/for-profit sector, and the intermediate/nonprofit sector. The nonprofit sector is "intermediate" in that it shares traits with the other two: nonprofits are governed by private individuals (fiduciary boards of directors) but operate for the benefit of the public (as does the government).

Approximately 30 years ago the "social enterprise" movement emerged as a variation on this three sector system. It was assembled by combining DNA from the for-profit sector with DNA from the nonprofit sector to create a hybrid way of doing business with the following imperative: "make money, but do good things too."

Despite its good intentions, the movement suffers the following structural and conceptual defects. First, there are no generally accepted standards or definitions of the terms social enterprise, social entrepreneur or social benefit (three synonyms of a sort used in the movement). Second, the dual imperative ("make money, but do good things, too") creates and imposes a board level conflict of interest between the missions. Third, from a conceptual perspective social enterprise falsely presupposes that there is an either/or choice to be made between profit and social good – failing to recognize that profit is a social good too.

In this newsletter we will suggest a method for pursuing the imperative to "make money, but do good things, too" that is both more traditional and objective: make the money in business entities and pursue social benefits in nonprofit entities, but align their interests by giving the nonprofits equity-like (ownership) interests in the profits. We believe this approach would avoid the flaws identified above. First, the uniform and legally enforced standards of Section 501(c)(3) of the Internal Revenue Code would apply to the nonprofits. Second, there will be no conflict of interest because the organizations will each have a single mission. Third, the either/or question evaporates when profit is properly recognized as a social good.

In other words, it is better to share the money than to share the mission. Here is why and how it might be done:

Social Enterprise: the absence of substantive standards. At the start readers should recognize that the terms "social entrepreneur" and "social enterprise" are not trademarked or regulated in their use. They have no owner. They are not defined in any legal or uniform generally accepted manner – which means that any business can hold itself out to the public as a social enterprise. People are free to define "social" or "social benefit" to mean whatever they desire. Mr. Brown's Petroleum Fracking Company and Mr. Green's Wind Power Company can each make a *bona fide* claim to be a social enterprise. The absence of standards dilutes the value of the social enterprise brand to near zero.

This is not the case with nonprofits which must satisfy the finely honed and tested standards of Section 501(c)(3) of the Internal Revenue Code before holding themselves out as public benefit entities.[1]

Benefit corporations. Benefit corporations ("B corporations") are a formalized statute-based variation of what we have discussed so far. Whereas any business can simply proclaim itself to be a social enterprise, if the business is organized as a B corporation the social benefit component must be written into the certificate of incorporation where it becomes an enforceable legal obligation. B corporations and their directors can be sued for failure to advance the social benefit.

However, B corporations suffer the same flaw as social enterprises not organized as B corporations. This is because the "social benefit" (even though written into the certificate of incorporation) can still be defined to mean whatever the owners want it to mean, and they can change the meaning and amend the certificate of incorporation at will – which dilutes the value of the B corporation brand and methodology.[2]

Conflict of Interest and management burdens. Boards of directors have a fiduciary duty of loyalty requiring them to act solely in the "interests" of the for-profit or nonprofit they serve. In the for-profit context this duty was historically interpreted to require boards to act solely to maximize profitability for the shareholders. This interpretation was modified by statute over the years to *permit* (*but not mandate*) directors to use corporate resources (profits) to attend to social factors – but this was done by expanding the scope of what is deemed to be in the interests of the corporation and not by creating a separate social benefit interest to which fiduciary duties are owed by the directors. The voluntary efforts many public companies make to be "good corporate citizens" were enabled by this expanded interpretation of the interests of the corporation.

However, social enterprise, especially in its B corporation manifestation, is profoundly different because it requires the board to act in the interests of a social benefit – creating a duty to the social benefit on par with, if not superseding, the duty to shareholders to operate profitably, and to maximize

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[1] There are international efforts afoot to promulgate Social Reporting Standards (SRS) which are intended to measure social performance in a manner similar to that in which Generally Accepted Accounting Principles (GAAP) measure financial performance on a uniform "apples to apples" basis. Presumably an organization which satisfies SRS would have a *bona fide* claim to call itself a social enterprise and be accepted as such in the marketplace. However, we believe the SRS effort is also quixotic because, while concepts such as "social benefit" have meaning in our daily discourse, they are too subjective to be objectified in the manner that SRS proponents believe. A story in the February 12, 2015, edition of the *Guardian* (England) (titled "Can You Set a Standard for Social Impact") addresses the "proliferation of reporting standards…[t]here's the AccountAbility AA1000 audit; the UN Global Compact; ISO 26000; the German Sustainability Code; the Sustainability Accounting Standards Board; the ESG Disclosure Framework; HACT Value Insight; the Global Reporting Initiative; the list goes on." In addition, there are companies which have developed SRS standards and which have created a trademark/logo with which they are identified. For a fee they will audit and certify an enterprise's compliance with their standards, and allow it to use the trademark/logo in its branding. A company called B Lab is an example. However, this arrangement simply kicks the flaw down the road because if someone does not, for example, like B Lab's standards, he can make up his own and/or find or create another company to certify standards more to his liking.

[2] Here is a hypothetical: Mert owns several run-down apartments in a sleazy part of town. In polite social circles people have started referring to him as a slum lord. Mert wants to improve his image and brand and decides to become a social entrepreneur. He incorporates his apartment business in the form of a B corporation and includes the following social benefit standard in the certificate of incorporation: *Making affordable housing available to people who would otherwise be homeless*.

profits. In other words, the B corporation statute actually creates a conflict of interest between the two different missions and foists it on the board of directors and management to resolve.[3] Boards of directors and management are not burdened by conflict when separate for-profit and nonprofit entities are used, because each has only one mission.

The either/or fallacy of social enterprise. Finally, the social enterprise movement is biased against for-profit private enterprise. The placement of the word "social" before the word "enterprise" says it all – implying that a business and its profits are "good" if derived in a "socially beneficial" manner and "not good" if they are not.

In the first instance, we do not see how it is possible for social enterprises generally to pass judgment on other (non-social) enterprises because of the lack of a measuring stick – definitions or standards to make comparison even possible. It would be like saying an inch is as long or as short as you want it to be. But on a secondary level the either/or question baked into the social enterprise project is false because profit is a social good *per se* – as necessary to society as the fulfillment of the social missions pursued by nonprofits. Profit is necessary to our jobs and survival; it is the source of tax revenue and charitable donations.[4] Similarly, nonprofits are necessary because they make civil society possible by attending to needs outside the domain of the for-profit sector. The sectors are not opponents caught in an interminable tug of war over resources and claims to the moral high ground.

Redefining the method. We first wrote about Social Enterprise in the Spring 2009 special supplement of this newsletter (*Social Entrepreneurship – When Worlds Collide or the Best of Both?).* At that time we concluded that its motives were honorable, but that time would tell if it is an evolutionary dead end or a revolutionary step forward. Today we are opining that it is more likely the former for the reasons stated above. It is too cumbersome and unwieldy to try to jam a dual mission

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[3] For example: Should board members of a B corporation vote to invest in a risky new product that may lose money for a while (and possibly fail) but which has great upside potential – meaning fewer resources would be available currently for the "social benefit"? The very existence of this question is an encumbrance on board deliberations. Maintaining profitability is a full-time job for most boards. Moreover, the social enterprise/B corporation methodology is extraordinarily complicated in that the monetary expense of fulfilling the social benefit is incurred at the operational level – baked into the profit and loss statement requiring that ordinary course of business decisions on everything from pricing and vendor selection to HR policies be made on the basis of its bearing on the social benefit and not solely on the basis of cost and quality. This point becomes clear by looking at the scope of the questions B Lab (Footnote 1) asks of organizations seeking its certification, such as: what portion of management is evaluated in writing on their performance relative to social targets; do you evaluate the social and environmental performance of your vendors and suppliers; do you permit employees paid or nonpaid time off for community service; what percentage of the company is owned by employees; and do you give preference to sustainable or fair trade suppliers? While there is nothing wrong with these inquiries *per se*, the point is that attending to them introduces a level of operational complexity and expense – almost as if the enterprise is supposed to weave its "charitable donation" into the operating budget each year in the form of the additional costs incurred to fulfill the social mission.

[4] We suspect that this antipathy to profit is rooted in the false but lingering medieval belief that profit-making is by its nature a zero sum game in which one wins (profits) only if someone else loses – meaning that profit will always bear the moral taint of having been "taken" from the loser. Our claim about the nature of profit as a social good is derived from the fact that the "value added" in products and services that leads to profitability is primarily a function of what someone is willing to pay for them in the market – and from the necessity of distinguishing profit from the people who make and control its distribution. There are bad people who make a profit (or excess profit) by exploiting people and resources, and there are good people who make a profit fairly and are generous with its use.

into a for-profit vessel, and we need these vessels creating as much profit as possible to circulate through the system. Let for-profits do what they do best, and let nonprofits do what they do best.

However, we also believe it would be a good thing if more of the profit being created found its way into the budgets of nonprofit organizations, and suggest that social entrepreneurs would be better off trying to find ways to make this happen. In essence, they should try to monetize a business's claim to be a social enterprise by measuring the extent to which it is willing to commit to putting its money (profit) where its mouth is.

The monetization could take different forms, but our suggestion is a derivative of the means by which nonprofits with endowments enjoy dividends and capital gains each year (both of which are a function of profitability). A few years ago we prepared documentation for a corporate client to create a class of "special preferred" stock which by its terms could only be owned by Section 501(c)(3) organizations and which paid a preferred dividend and enjoyed a "liquidation preference" in the event of a sale of the company. Something of this type might also be accomplished with phantom shares or appreciation rights, or in the case of a limited liability company, an economic interest that would be entitled to some percentage of annual profit. An interesting side effect of a technique like this is that the nonprofit would have an interest in the for-profit's operating as profitably as possible. Finally, if someone's claim to be a social enterprise were based on this platform, it would be easier to create uniform standards for comparison purposes because the amount distributable to the nonprofits could be expressed as a percentage of profits (as calculated in accordance with Generally Accepted Accounting Principles).

As always, we invite relevant comments from our readers.

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 and/or edited 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.

For information or additional copies of this newsletter, or to be placed on our mailing list, please contact Carrie L. Samperi at (860) 240-1008 or info@rrlawpc.com, or members of Reid and Riege, P.C., One Financial Plaza, Hartford, CT 06103. For other information regarding Reid and Riege, P.C., please visit our website at www.rrlawpc.com.

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]

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[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

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[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.

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