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376. The provisions included from this paragraph to paragraph 382 aim to promote the establishment and encourage the spread of companies, hereinafter referred to as "Società Benefit", which, by performing an economic activity, pursue one or more objectives of common benefit besides sharing profits, and which operate in a responsible, sustainable and transparent manner toward people, communities, territories and the environment, cultural heritage and social activities, entities and associations and other stakeholders.

377. The purposes referred to in paragraph 376 are specifically listed among the objects of the "Società Benefit" and are pursued by balancing the shareholders' interests with those of the other stakeholders. The purposes' can be pursued by any company referred to in Book V, Titles V and VI of the Civil Code, in accordance with the relative discipline.

378. For the purposes of paragraphs 376 to 382, it is meant for:

a) "Common benefit": the pursuit, within the exercise of the economic activity of the "Società Benefit", of one or more positive effects, or the mitigation of the negative effects, on one or more categories mentioned in paragraph 376;

b) "Other stakeholders": the subject or the groups of subjects, directly or indirectly involved in the activity of the corporations referred to in paragraph 376, such as workers, customers, suppliers, lenders, creditors, public administration and civil society;

c) "External evaluation standards": methods and criteria referred to in Annex 4* attached to this Law, which must be necessarily used for the evaluation of the impact generated by the "Società Benefit" in terms of common benefit;

d) "Evaluation areas": sectoral areas, identified in Annex 5** attached to this Law, which must be necessarily included in the evaluation of the common benefit activity.

379. "Società Benefit", with due regard for the provisions of the Civil Code, must indicate, within its company object, the specific goals of common benefit, which intend to pursue. Companies other than "Società Benefit", in case they are willing to pursue also goals of common benefit, are required to amend their certificate of incorporation or by-laws, in consistency with the provisions regulating amendments of the shareholders agreement or by-laws, for each specific type of company; such amendments are filed, registered and published in accordance with the provisions set by Articles 2252, 2300 and 2436 of the Civil Code for each type of company. "Società Benefit" are entitled to introduce, beside the company name, the words "Società Benefit" or the abbreviation "SB" and use such qualification in the issued titles, in the documentation and in the communications to third parties.

380. The "Società Benefit" is managed balancing shareholders' interest, pursuit of the of common benefit purposes and interests of the categories listed in paragraph 376, as provided by the by-laws. The "Società Benefit", without prejudice to other provisions set by the Civil Code for each type of company, identifies the responsible subject or subjects to whom entrust functions and tasks aimed at achieving the above-mentioned purposes.

381. Failure to comply with the obligations referred to in paragraph 380 can constitute a breach of the duties imposed on Directors by Law and by-laws. In case of failure to fulfill the obligations referred to in paragraph 380, Civil Code provisions concerning Directors' responsibility with respect to each type of company, shall apply.

382. For the purposes of paragraph 376 to 384, the "Società Benefit" drafts an annual report regarding the achievement of the goals of common benefit, to be attached to the company's financial statement, including:

a) The description of specific objectives, methods and actions implemented by the Directors to achieve the goals of common benefit and any circumstances that have either prevented or slowed such achievement;

b) The evaluation of the impact generated by using the external evaluation standards with the features described in Annex 4 attached to this Law, which includes the evaluation areas identified in Annex 5 attached to this Law;

c) A section devoted to the description of the new goals that the company intends to pursue the following year.

383. The annual report is published on the website of the company, where possible. For the protection of the beneficiaries, certain financial data of the report can be omitted.

384. "Società Benefit" not pursuing the purposes of common benefits are subject to the provisions of Legislative Decree 2 August 2007, n. 145, for matters of misleading advertising and to the provisions of the Consumer Code, introduced by Legislative Decree 6 September 2005, n. 206. The Competition Authority performs

its tasks and activities, within the limits of available resources and without new or increased burdens on supervised entitities.

*ANNEX 4 (Summary)

"External evaluation standards" set a list of essential characteristics assuring an exhaustive, independent, eligible and transparent impact analysis of Società Benefit's activities (including the public availability of details regarding Directors' and governing body to which development and management of the evaluation standard were demanded as well as concerning the adopted process for modifying and update such standard);

**ANNEX 5 (Summary)

"Evaluation areas" set a list of indicators on which the external evaluation shall focus on:
Governance;
Workers;
Other stakeholders;
External environment.

1 of 1 DOCUMENT

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Note: Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe

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SUMMARY:
... Once the corporation has passed this initial test, it must institutionalize stakeholder responsibility by inserting certain language into its corporate bylaws that allows managers to consider the interests of employees, the community and the environment, which may, in some cases, require companies to reincorporate into a state with a constituency statute allowing for such an amendment. ... Shifting from Shareholder to Stakeholder: The Consequences of Being Generous in a Market-Based Economy in the U.S. and Abroad A For-Benefit corporation seeks to benefit not only its shareholders, but also its stakeholders, creating a risk that directors could be held liable for breaching their fiduciary duty to maximize shareholder profit in favor of benefiting another corporate stakeholder. ... Although the courts have allowed directors to refuse bids that threatened non-shareholder constituencies, it is impossible to determine whether the court upheld this decision based on the threats to shareholders, non-shareholders, or both. ... Although states enacted constituency statutes primarily to give directors another defensive tactic following the explosion of takeovers in the late 1980's, these statutes may also allow directors to consider stakeholder interests when making day-to-day decisions. ... Indeed, if the majority of consumers prefer social businesses over purely profit-driven corporations, what options are available to eliminate the shareholder primacy doctrine? ... Appropriately, For-Benefit corporations are breaking out of the one-dimensional, profit-driven mold, pioneering the path towards a new multi-dimensional and values-driven Fourth Sector.

TEXT:
[*271]

I. Introduction:

Greed-the antithesis of grace-

does nothing but create excessive waste.

This world is ready to create space,

to benefit others, to reject profit-driven disgrace.

But when corporations give grace-when this novel transaction take place-

will the world be ready for the global transformation it will create? n1

In the current market-based economy, directors all over the world are questioning whether corporations should exist solely to maximize shareholder profit. n2 Indeed, many for-profit corporations abide by the neoclassic assumption that in order for a manager to maximize profit, he must "take the wage demand as a given and produce its output at the lowest possible cost." n3 Capitalism, as [*272] commonly understood to be the institution holding maximization of monetary wealth for enterprise owners as the utmost goal, has widely been criticized as a practice fostering such things as global warming, human rights abuse and labor violations. n4 Many of these claims are highly debatable, and aspects of profit maximization have certainly been applied positively to social betterment. However, the fact remains that much of the business world does not properly account for environmental and social impacts, as evidenced by rapid degradation of natural resources and the persistence of global poverty. n5 The suggestion that business can, in fact, be a primary ground for reversing these types of damages is no longer mere idealism. n6

Indeed, many corporate directors no longer abide by Milton Friedman's famous declaration that a corporation's only social responsibility is to provide a profit for its owners. n7 Now more than ever, businesses are refusing to define the highest social good as trading wealth and prosperity freely and fairly in open markets and are choosing to hold themselves to a higher standard of care, enlarging their fiduciary duty to include all stakeholders, including suppliers, creditors, and the community in which the corporation resides. n8 Social entrepreneurs have realized that profit-driven businesses consume resources at a rate that cannot be sustained indefinitely and have adopted a sustainable corporate policy that attempts to benefit the society in which they reside. n9

Will the law allow these public corporations to benefit non-shareholder constituents? At what amount does corporate [*273] philanthropic giving become corporate waste? This note discusses the emergence of a new corporation known as the For-Benefit corporation and how publicly owned For-Benefit corporations in the U.S. and Europe could avoid shareholder derivative suits when other constituents are served. Although there are few cases addressing the legal constraints on socially responsible companies, precedent in the U.S. offers a likely favorable outcome for directors in possible shareholder derivative suits.

II. Global Corporate Transformation: The Fall of the Wall Between For-Profit and Non-Profit Corporations

The concept of a compassionate corporation existed long before the United States of America was formed. In his earlier work, The Theory of Moral Sentiments, Adam Smith speaks of the need for morality and compassion in both commercial and governmental affairs. n10 The debate regarding whether a corporation should be socially responsible began in the U.S. in the 1930s between Professors Adolf Berle and E. Merrick Dodd. n11 This debate raised the question of whether corporations owed a duty of "trusteeship" to constituencies other than shareholders. n12 In the end, Berle conceded that directors are not limited to running a business purely to maximize profit, but are "in fact and recognized in law as administrators of a community system." n13 Yet, state legislators largely ignored the outcome of this pivotal debate on the nature and purpose of a corporation until the late eighties when states enacted constituency statutes, which allow directors to take into consideration stakeholder interests. n14 Around this same time, companies marketing themselves as socially responsible n15 started to emerge, setting the stage for a movement towards a more compassionate corporation. n16

[*274]

A. Double Bottom Line: The Emergence of Green Business

The influential Business Roundtable n17 describes corporations as being entities that are "chartered to serve both their shareholders and society as a whole." n18 Socially responsible corporations became more visible to the public in the 1980s and 1990s with leading companies like The Body Shop and Ben & Jerry's. The Social Venture Network ("SVN"), which was formed in 1991 by socially responsible entrepreneurs, and Business for Social Responsibility ("BSR") formed in 1992, brought together many of these early pioneers. n19

Many people consider Ben & Jerry's as the first "socially responsible" company by introducing the concept of improving the environment as a second bottom line. n20 Others praise Newman's Own as a pioneer for establishing itself as a private sector company to donate all profits and royalties after taxes for educational and charitable purposes. n21 The notion of a double bottom line reflects the understanding that a company is not merely created to make a profit, but should also account for possible deleterious effects on the environment. n22

B. Adding a Third Bottom Line: Corporate Social Responsibility

Despite the novel addition of a second bottom line for measuring corporate success, the lack of guidelines for properly treating [*275] employees and subcontractors jeopardized the reputation of green companies as socially responsible businesses. As a result, in 1994, John Elkington added a new, third bottom line that focused on serving "people" in addition to the planet and profit. n23 This triple bottom line business model maintains fair and equitable business practices toward their employees, the community, and the region in which a corporation conducts business. n24

As triple bottom line companies were emerging, the term Corporate Social Responsibility ("CSR") re-entered the corporate dialogue. CSR in the U.S. is "an ongoing commitment by business to behave ethically and to contribute to economic development while demonstrating respect for people, communities, society at large, and the environment." n25

CSR attracts an integrated community of global citizens who feel an innate calling to be environmental stewards and are interested in sustainable development. The main problem socially responsible companies face is how to succeed in implementing a heightened standard of "socially responsible" values without being overburdened by the financial demands from pragmatic execution of such values. n26

The concept of CSR is now a common term used frequently by multi-national corporations. European interest in CSR promoted the European Council in Lisbon n27 in March 2000 during which the European Council encouraged companies to become more socially responsible by taking into consideration "lifelong learning, work [*276] organization, equal opportunities, social inclusion and sustainable development." n28 Further, the European Commission recognized that shareholder value is not achieved merely through maximizing short-term profits, but also through "market-oriented yet responsible behavior." n29

In addition, European support of CSR businesses is increasing exponentially. n30 On March 13, 2006, the European Commission ("EC") enacted a Resolution entitled, "Corporate Social Responsibility: A New Partnership." n31 In this resolution, Europe acknowledged that CSR has become "an increasingly important concept for competitiveness both globally and within the E.U., and is part of the debate about globalization, competitiveness and sustainability." n32 The resolution led to the creation of the European Alliance for CSR, which recognized that all stakeholders must be taken into account when making business decisions. n33 This Alliance operates around three core principles: 1) raising awareness and improving knowledge on CSR and reporting on its achievements; 2) helping to mainstream and develop open coalitions of cooperation; and 3) enabling the environment for CSR. n34

The definition of CSR in the U.S. mirrors that in Europe. According to the European Commission, CSR is "a concept whereby companies integrate social and environmental concerns in their [*277] business operations and in their interaction with their stakeholders on a voluntary basis." n35 CSR has three main features in Europe. First, it is behavior by businesses over and above legal requirements, voluntarily adopted because businesses deem it to be in their long-term interest. n36 Further, it promotes sustainable development of a business by integrating the economic, social and environmental impact of their activities. n37 Lastly, CSR is not an optional "add-on" to business core activities; instead, it represents the way businesses are managed. n38 Although the European and the U.S. definitions are vague, both embody a conviction that a corporation's existence should not relate solely to making money for the sake of making money but that a corporation has a social responsibility to contribute and improve the community in which it operates.

Muhammad Yunus, the 2006 Nobel Peace Prize recipient, suggests that socially responsible companies in the U.S. take two basic forms: weak and strong. n39 A "weak" CSR company does no harm to people or the planet, unless doing so will sacrifice profit. n40 On the other hand, "strong" CSR companies seek to benefit people and the planet in the course of doing business so long as the profit margin is not lost. n41 Yunus rejects the idea that CSR will cause positive change in business leaders. n42 He states that the concept is often misused by corporate leaders for selfish gain and, as a result, is ineffective. n43 Instead of CSR, Yunus advocates for a completely new entity, which he calls a "social business," a corporation that has an underlying objective of "creat[ing a] social benefit for those whose lives it touches ... [as] cause-driven rather than profit-driven, with the potential to act as a change agent for the world." n44 Maria Eitel, Nike's Vice President for Corporate Responsibility, notes that there is no [*278] perfect factory, just as there is no perfect community, but this should not hinder the business community from creating a system and a framework within which these issues can be addressed, and expressed. n45 Eitel's reference to a "system and framework" is exactly what socially responsible companies need now in order to survive. n46

In order to assess and identify businesses that are trying to position themselves in the vector of Fourth Sector organizations, a number of different rating systems have been developed. n47 One of the most comprehensive of these rating systems was developed in 2004 by S-BAR. n48 More recently B Lab, a 501(c)(3) non-profit corporation, developed a certification scheme, derived from S-BAR and other rating systems, which it uses to identify socially responsible for-profit businesses that it brands as "B corporations." n49 In order to be "B certified," a corporation must score eighty points out of two hundred on a test to determine whether it meets a set of social and environmental performance standards. n50 Once the corporation has passed this initial test, it must institutionalize stakeholder responsibility by inserting certain language into its corporate bylaws that allows managers to consider the interests of employees, the community and the environment, which may, in some cases, require companies to reincorporate into a state with a constituency statute [*279] allowing for such an amendment. n51 B Lab's founders adopted their stakeholder accountability approach from Upstream 21, a holding company which pioneered the idea of incorporating stakeholder language in the articles of its portfolio companies. n52 Once the corporation has become a B corporation, it must donate one-tenth of one percent of its revenue to B Labs. n53

C. For-Benefit Corporations: The Emergence of a New Fourth Sector

Socially responsible businesses and social enterprises in the U.S. are catalyzing a wave towards a new type of "hybrid" organization. This movement has been building for decades and is now at a breaking point when the floodgates are about to burst open. Businesses today are dedicating more resources than ever to providing social and environmental benefits. n54 Similarly, government and social-sector organizations are beginning to emulate for-profit businesses by adopting earned-income governance models as a way to acquire the necessary capital to sustain their social mission. n55 The convergence of the mission and methods of these non-profit and for-profit companies is producing a fourth sector of "hybrid" organizations, which pursue social purposes while engaging in business activities. This Fourth Sector is emerging in the U.S. and abroad, with over twenty different names to describe the activity within the Fourth Sector. n56 It emulates a new generation of value-driven consumers and shareholders who are demanding that corporations benefit their communities. The legal community within the Fourth Sector must decide what alternative approaches or legal [*280] forms might meet the needs of these hybrid social ventures better than existing structures or whether a new legal form makes sense, and if so, what it would look like.

The Fourth Sector Network ("FSN"), which pioneered the concept of a For-Benefit corporation, has conducted a series of conventions focused on further developing a structure and legal framework for a new type of "hybrid" organization. The first of these meetings was held in 2006 at the Aspen Institute. n57 This meeting convened a group of seasoned lawyers, legal scholars, financial experts, and social entrepreneurs to discuss the need for new hybrid legal structures. n58 The idea for a B certification and a new type of hybrid organization referred to as the L3C materialized during this meeting. n59 Following this successful meeting, a second meeting was convened in Boston in April 2007 at a Social Enterprise Alliance ("SEA") conference. n60 The most recent convention on establishing new legal "hybrid" forms was held at NYU Law School on July 17, 2008, bringing together attorneys, investors, funders, scholars, and entrepreneurs to explore the limits to "hybrid" organizations under existing law and to examine possible characteristics of new hybrid forms. n61 This convention resulted in the creation of the first ever "Legal Strategy Group" website that offers all the necessary legal aid for hybrid organizations. More specifically, the website contains a legal document library, a tool and resource library, a social enterprise attorney directory, a discussion forum and a Fourth Sector wiki for social entrepreneurs and attorneys.

As social entrepreneurs and businesses attempt to surf the wave towards a Fourth Sector by seamlessly blending a social purpose with their business agenda, a collaborative effort has begun to develop the essential characteristics of an archetypal Fourth Sector organization, also known as a "For-Benefit" corporation. n62 For-Benefit corporations are a new class of organizations that are "driven by a [*281] social purpose; they are economically self-sustaining, and they seek to be socially, ethically, and environmentally responsible." n63 A For-Benefit corporation represents a new paradigm in organizational design. At all levels, they aim to link two concepts which are held as a false dichotomy in other models: private interest and public benefit. n64

Currently, the Fourth Sector community is building consensus around ten essential characteristics for the For-Benefit corporation. Some of the characteristics that are being considered include: 1) a core commitment to a social purpose which is embedded in the organizational structure, 2) freedom to engage in any legitimate business activity in pursuit of the social purpose, 3) equitable distribution of ownership rights and distribution rights among stakeholders, 4) equitable compensation of employees, investors, and other stakeholders in proportion to their contributions and risk, subject to reasonable limitations that protect the ability of the organization to achieve its mission, 5) commitment to having a net positive social and environmental impact, 6) commitment to full and accurate assessment and reporting of social, environmental, and financial performance, 7) limited liability structure such that the directors of the organization will not be held personally responsible for the actions of the organization as long as the directors conduct any business activity that is consistent with its social purpose and stakeholder obligations, 8) ability to accept debt and equity investments as well as tax deductible donations, 9) exemption on certain business taxes, and 10) lock on assets that prevents them from being privatized upon terminal events. n65

As the Fourth Sector expands, organizations are encountering limitations imposed by existing legal and tax structures. Social entrepreneurs and their attorneys do not have a clear understanding about the existing legal consequences of structuring a For-Benefit corporation. For-Benefit entrepreneurs have little choice but to operate within the constraints of the three existing sectors. In the next section, I discuss the legal consequences of trying to create a For-Benefit corporation under existing law as it relates to the fiduciary duties of For-Benefit directors.

[*282]

III. Shifting from Shareholder to Stakeholder: The Consequences of Being Generous in a Market-Based Economy in the U.S. and Abroad

A For-Benefit corporation seeks to benefit not only its shareholders, but also its stakeholders, creating a risk that directors could be held liable for breaching their fiduciary duty to maximize shareholder profit in favor of benefiting another corporate stakeholder. Such risk is reduced with For-Benefit corporation directors who look to the state constituency statute as support for decisions made in the interest of nonshareholder constituencies. n66

Scholars claim that a corporate manager's only objectives are to sustain monetary growth for the company and to increase company and shareholder value. n67 This obligation stems from the commonly-held belief that the sole interest of a shareholder is to maximize profit and thus, a director must maximize the value of corporate shares to fulfill his fiduciary duty to the shareholder. Under this current legal framework, For-Benefit corporations are significantly limited in the scope of their activity. For example, For-Benefit corporations seek to maximize benefit to all stakeholders and donate one hundred percent of their economic profits towards advancing their social purpose. So, must we assume that all publicly held For-Benefit corporations will be subject to shareholder derivative suits for breaching their fiduciary duty?

More importantly, what obligations will For-Benefit directors have towards their shareholders? In this section, I clarify that a director's fiduciary duty does not always involve maximizing shareholder profit. Additionally, the protection of the business judgment rule protects directors in most cases involving the shareholder primacy doctrine. For-Benefit corporations should not be liable for day-to-day business decisions made in the interest of stakeholders as long as the directors are disinterested and independent, and make decisions in a reasonable manner.

[*283]

A. Standard of Conduct and Fiduciary Duties in the U.S.

i. The Business Judgment Rule

When making day-to-day decisions, courts apply the business judgment rule absent bad faith, or self-dealing, to determine whether a director has violated his duty to uphold the best interests of the corporation. n68 Generally, the business judgment rule protects most lawful disinterested and independent actions of a board of directors provided they were taken in the honest belief that the action was in the best interests of the company, after a reasonable deliberative process. n69 Under this standard, there is the "presumption that in making business decisions the directors of a corporation acted on an informed basis, in good faith and in the honest belief that action taken was in best interest of the company." n70 Because the court presumes valid business purpose, the burden of proof is on the shareholder to show otherwise. n71 When a court decides that a director's decision was a valid exercise of business judgment, the decision is almost always upheld as long as the court can attribute a rational business purpose for such a decision. n72

A shareholder may overcome this presumption by showing a violation of his duty of care or duty of loyalty in connection with a deliberate decision averse to the economic interests of the shareholder. n73 Such a breach is manifest when the board "acts intentionally, in bad faith, or for personal gain." n74 A director acts in bad faith when "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation ... demonstrating a conscious disregard for his duties." n75 Only when the presumption is overcome does the burden of proof shift to the director to prove that his decision was entirely fair to the interests of [*284] the corporation. n76

Delaware law contains very few bright-line rules governing the relationship between directors and shareholders. n77 However, in the non-takeover context, directors may favor non-shareholder constituencies as long as it does not have a significant impact on shareholders. n78 Jurisprudence seems to suggest that the court will be especially deferential when directors claim to have altruistic purposes that benefit the company in the long run because of the possibility that shareholders will eventually receive a higher return on their investment. n79 The court's rationale for refusing to apply the business judgment rule is premised on the belief that shareholders must be protected from self-interested directors. n80 Thus, when a director is focused on benefiting others, the court will be less likely to find a self-interested motive. Additionally, when a For-Benefit corporation establishes non-shareholder constituencies as an essential objective of the corporation, either through stating it in their articles of incorporation or its bylaws, the court may find that the director was acting in the best interests of the corporation, despite the disregard for shareholder interest. Further, if the identity of the corporation is based on distinguishing itself in the market as a value-driven corporation, it may be detrimental to the economic prosperity and [*285] thus shareholder value, if the corporation sacrifices such value for monetary gain.

ii. Unocal's heightened standard of review: exceptions to the business judgment rule n81

Even under a heightened Unocal standard of review, Delaware case law tends to uphold decisions in favor of non-shareholder constituencies. n82 In the context of a hostile takeover or a change of control situation, courts apply a heightened Unocal standard of review n83 under the rationale that managers have a higher tendency toward personal entrenchment at the expense of the shareholders' interests in a takeover or merger. n84 Under this standard, the court will give directors the benefit of the business judgment rule only if they can first demonstrate that they had "reasonable grounds for believing a danger to corporate policy and effectiveness existed" and the defensive measure was "reasonable in relation to the threat posed." n85 In Unocal, the court explained that a "reasonable" decision for a defensive measure is "an element of balance" between, inter alia, the impact of non-shareholder constituencies, the effect on shareholder value, and the effect on the corporation. n86 The balancing test is supported by case law in Delaware and several other states. n87

[*286] For-Benefit corporations that make decisions to uphold the socially-conscious culture of the corporation will be more likely to succeed in shareholder derivative suits than those corporations who fail to establish a connection between their decision and the social purpose of the corporation. n88 Indeed, Delaware case law demonstrates a strong deference when directors make decisions to maintain corporate value despite a change in management situation. n89 In Paramount Communications v. Time, Inc., Time spent two years researching a possible merger opportunity with an entertainment company that would uphold its own values. n90 When the merger deal was almost completed with Warner, Paramount offered Time an all-cash offer for all outstanding shares at $ 175 per share. n91 Time persistently refused Paramount's offer even when the bid rose to $ 200 per share asserting that the Warner transaction had greater long-term value and, unlike Paramount, would not threaten the "culture" of Time. n92 The court found that the directors' actions were justified because "directors are not obliged to abandon a deliberately conceived corporate plan for short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy." n93 Similarly, socially responsible companies who have created a culture and deliberate strategy of balancing a duty to all stakeholders are more likely to win the court's presumption that they are not in violation of their fiduciary duty to maximize shareholder profit.

iii. Maximizing shareholder profit: Revlon's strict standard of review

Scholars claim that in order to uphold corporate philosophy, a [*287] public company must maximize short-term shareholder profits. n94 Commentators cite Dodge v. Ford Motor Co. n95 as the fountainhead of the corporate law rule that the objective of directors must only be to make profits for shareholders. n96 Although the court in Dodge precluded a business decision made in the interest of non-shareholder interests, Dodge is no longer applied as such. n97 Instead, federal and state case law reference Dodge as evidence of the broad discretion a director has in business decisions. n98

Nevertheless, under the Revlon duties, a director has a duty to maximize shareholder value in certain circumstances. The Supreme Court of Delaware states that the Revlon duties are generally triggered "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company," n99 or "where a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company;" n100 According to Revlon, once the board of directors is no longer defending the company from takeover, it must sell to the highest bidder or implement routine defensive strategy to enable the board to negotiate for a higher bid. n101 The court in Revlon suggests that a board of directors may no longer take non-shareholder constituency interests into account when deciding which bid to accept; n102 however, Revlon still "permits consideration of other [*288] constituencies so long as it is "rationally related [to] benefits accruing to the stockholders." n103 Moreover, modern case law has significantly narrowed the scope of an enhanced duty to maximize profits under the Revlon standard so that a company is certain to trigger Revlon only in the context of a sale of the entire company. n104

iv. Business decisions made in the interests of U.S. stakeholders: A hypothetical case study

The cases upholding a defensive action under the stricter Unocal standard based on threats to non-shareholder constituencies are difficult to evaluate because each of these cases also involved a threat to shareholders. n105 Although the courts have allowed directors to refuse bids that threatened non-shareholder constituencies, it is impossible to determine whether the court upheld this decision based on the threats to shareholders, non-shareholders, or both. n106

Essentially, fiduciary duties were created with the primary purpose of redressing the imbalance of power between the fiduciary and the shareholder. n107 This relationship, taken to the extreme is fairly predictable. According to Delaware case law, if a For-Benefit corporation director shut down an unprofitable manufacturing plant immediately, thereby maximizing short-term profit for shareholders, no cause of action would exist against a director for violation of fiduciary duty because the director upheld the shareholder's interest. On the other extreme, if a director left the same manufacturing plant open indefinitely in order to uphold the employees' interest to keep their job, shareholders would have a cause of action for breach of fiduciary duty and possible corporate waste because shareholders [*289] have a financial stake in the corporation and a legally mandated fiduciary relationship with the directors. Therefore, decisions made in favor of stakeholders at the expense of shareholders will most likely be a violation of a director's fiduciary duty.

Delaware case law becomes highly unpredictable in the middle of the two aforementioned extremes. How does a director balance preservation of capital, including a fiduciary duty to shareholders with pursuit of a social purpose to benefit stakeholders? The current U.S. legal system has answered this question by building a wall between the profit and public interest. Essentially, a company must choose between either pursuing a lawful business purpose to maximize profit, thereby attracting investors and shareholders, or pursuing a charitable purpose, which requires preclusion of all private inurement, thereby excluding the possibility for attracting the necessary capital to be successful.

Assuming, arguendo, a For-Benefit corporation director is faced with the decision to either shut down an unprofitable manufacturing plant immediately to maximize shareholder profit, or keep it open for six months, so that employees, and non-shareholders have enough time to find a job, would the court uphold the director's decision? n108 Delaware jurisprudence suggests courts will apply a balancing test, taking into consideration both the interests of shareholders and non-shareholders. Applying the probable balancing test to this hypothetical, a court is likely to uphold such a decision absent implicit self-interest motive and weigh the balance in favor of the directors' decision. Although directors may take into account non-shareholder constituencies, stakeholders lack a legal fiduciary relationship with the corporation under existing law. Accordingly, the court will not allow directors to preference stakeholder interests at the complete disregard of those of a shareholder. Nevertheless, the court will be more willing to favor a decision involving both shareholder and stakeholder interests when the For-Benefit corporation inserts a provision allowing stakeholder bias into the articles of incorporation or the corporate bylaws.

[*290]

v. Constituency Statutes: Reinforcing Business Decisions in Favor of Stakeholders

The balancing scale will swing back in favor of the socially responsible director when he looks to constituency state statutes to preference stakeholder interests over shareholder interests. Constituency statutes vary from state to state: some inevitably overrode the Unocal or Revlon standards, n109 while others simply offer the option for directors to look to stakeholder interests in certain contexts. n110 Although states enacted constituency statutes primarily to give directors another defensive tactic following the explosion of takeovers in the late 1980's, these statutes may also allow directors to consider stakeholder interests when making day-to-day decisions. n111 In effect, constituency statutes codify the right of a director to consider the best interests of the corporation as a whole. n112 Indeed, more than half of the states have enacted constituency statutes n113 [*291] allowing directors to take into consideration the interests of non-shareholder constituencies, which normally include employees, consumers, suppliers, and the local community. n114 In many states, this standard arguably has become the accepted model of corporate governance for public corporations. n115

Courts have not yet provided an analysis of the legality or constitutionality of constituency statutes, or even an explanation of how they should be implemented. n116 Nevertheless, some cases reference constituency statutes as a valid reason for looking to long-term non-shareholder interests instead of short-term shareholder interests in making certain business decisions. n117

[*292] Commentators assert that "the legal effect of such [constituency] laws may be to insulate officers and directors from liability for failing to maximize profits to shareholders." n118 While constituency statutes may be useful in rejecting shareholder primacy, these statutes are limited in application. Most constituency statutes limit the definition of stakeholder constituents to include customers, suppliers, employees, creditors or the community around which a company's office is located. This narrow definition does not include the international community, environmental concerns or broader human rights concerns. n119 Consequently, decisions made in the interest of the broader local community are considerably risky in nature but they are one step in the right direction.

B. European Fiduciary Duties and Corporate Governance

The shareholder primacy doctrine is considered by many scholars as a purely Anglo-American concept. n120 In fact, most industrialized countries besides the U.S. and Great Britain have a stakeholder model integrated into their corporate governance model. n121 The reason why the stakeholder movement is of little concern in non-U.S. countries is because of a lack of the shareholder primacy doctrine, the rarity of shareholder derivative suits, and the lack of hostile takeovers. n122 "In a non-U.S. environment, the director may be more concerned with the effect of a decision on employees or the local [*293] economy than would a U.S. director." n123 Accordingly, there is no need to enact constituency statutes because the stakeholder doctrine is already embedded within the corporate governance.

One example of such stakeholder model is found in Germany. Germany's stakeholder corporate governance doctrine emerged with the aid of the Reform Act of 1870 ("German Reform Act"). n124 The German Reform Act created the Aufsichtsrat, an intermediary outside board between Vorstand, the management team. n125 The Aufsichtsrat was created in order to take into account stakeholder interests including the "investors, workers, the state, and others." n126 After World War II, the government reaffirmed the importance of stakeholder interests by enacting the Codetermination Act of 1976, which requires "all stock corporations, Actiengesellschaft (AG), and all other business entities over a certain employee base, to have a two-tiered board structure that includes significant employee representation on the supervisory Aufsichtsrat board." n127 Arguably, the Aufsichtsrat board oversees the Vorstand board to the same degree that a board of directors oversees corporate officers in a company based in the U.S. n128 Having a board made up of non-shareholder constituencies creates the implicit assumption that non-shareholder interests must also be upheld when making business decisions.

Moreover, U.K. corporations are now moving towards a more stakeholder centered model of governance. n129 The recent enactment of The Companies Act of 2006 ("British Companies Act") incorporates a provision that is consistent with the American version of a constituency statute. n130 Section 172(1) of the British Companies Act allows directors to take into consideration the long-term interests [*294] of the corporation, including those affecting the company's employees, suppliers, customers, the community and the environment. According to the Commission, European businesses should "provide products and services that add value for society and deploy entrepreneurial spirit and creativity towards value and employment creation." n131

Indeed there is a global trend towards the adoption of a more stakeholder-centered corporate governance model. n132 Even Asian countries are turning away from the shareholder maximization doctrine. n133 The global market in which American companies operate is recognizing the importance of taking stakeholder interests into account in their corporate governance. As such, businesses in the U.S. that do not adopt a stakeholder governance model risk losing profit on cross-border ventures.

IV. Liability for Decisions Involving Large Charitable Donations

One way a For-Benefit corporation benefits stakeholders is apportionment of a considerably large percentage of profit to charitable causes. Consequently, For-Benefit corporations may face shareholder derivative suits for corporate waste if a court finds that such donations are unreasonable. n134 To date, the court has never found a corporate charitable donation to be wasteful; however, this does not preclude future adjudication against corporations for [*295] excessive charitable giving. n135

When a public For-Benefit corporation donates an exceptional percentage of their profit to a charitable cause, the court will apply the reasonableness standard of review. n136 What is reasonable is a factual inquiry. Further, the court has never dealt with cases involving donations larger than 10 percent of corporate profit. n137 In Theodora Holding Corp. v. Hendersen, the court found that a donation of 2.7 percent of the corporation's annual gross income was reasonable, explaining that the donation was less than the 5 percent limit for federal tax deductions of charitable donations. n138 In Kahn v. Sullivan, the Court of Chancery found support in the Delaware statute and the Internal Revenue Code to uphold a corporate decision to donate $ 85 million to a museum. n139 The Court found that state legislation has placed no limitation on the size of the gift, and the donation did not exceed the 10 percent deduction limitation of the Internal Revenue Code. n140 Accordingly, 10 percent of a company's taxable income for the year n141 has been considered to be the appropriate threshold for reasonableness. n142

Despite the Internal Revenue Service ("IRS") limitation, it is unlikely that ten percent is the limitation for what a court will allow a For-Benefit corporation to donate. Although state courts have never had to adjudicate cases involving a donation larger than ten percent of corporate profits, both Kahn and Theodora looked to the IRS limitation as only one factor to consider among many in determining whether the donation was reasonable. n143 The court intimates that a [*296] "relatively small loss of immediate income... is far out-weighed by the overall benefits flowing from the placing of such gifts in channels where they serve to benefit those in need of philanthropic or educational support, thus providing justification for large private holdings, thereby benefiting [shareholders] in the long run." n144 Moreover, commentators interpret Theodora as requiring directors to show that donating funds must be reasonable in "amount and purpose," serving both the long-term interest of the shareholders and the corporation. n145 Therefore, if a corporation can show that the donation is congruent with the corporation's purpose and interests, it is highly probable that a court will overlook the fact that the donation exceeds the ten percent IRS limitation.

Additionally, a closer analysis of the language used in Kahn and Theodora demonstrates that directors and managers are not agents of shareholders when directing proceeds toward charitable donations. Therefore, their decisions are presumed to be made in the interests of the shareholders. n146 "Managers are agents of the corporation itself, and directors are sui generis ... there is no explicit legally enforceable agency contract between shareholders and directors." n147 No consideration exists in the exchange between a director and a shareholder and thus is significantly distinguishable from a contractual relationship. Indeed, this relationship is more analogous to the relationship between a trustee and a trustor whereby the shareholder as a beneficiary financially invests broad discretion in the director. Appropriately, when a For-Benefit corporation inserts a [*297] provision in its articles of incorporation that explicitly declares its intent to benefit stakeholders and the community, the investor has a choice of whether to accept the terms before financial investment.

V. Fumbling into Possibility: Amending the Corporate Code in Europe and the U.S. to Accommodate a More Conscious Economy

A. Corporate Code Amendment in the U.S.

A 2000 Business Week/Harris poll asked Americans which of the following statements did they support: 1) corporations should have only one purpose, to make the most profit for their shareholders, and the pursuit of that goal will be best for America in the long run, or 2) corporations should sometimes sacrifice some profit for the sake of making things better for their workers and communities in which they operate? n148 Ninety-five percent of Americans chose the second proposition. n149 Further, according to the Research Collaborative Initiative ("RCI"), a report that surveyed 108 countries covering over 96 percent of the global GDP, the U.S. is far behind in its efforts to promote responsible business practices. n150 Indeed, if the majority of consumers prefer social businesses over purely profit-driven corporations, what options are available to eliminate the shareholder primacy doctrine?

Robert Hinkley, a corporate securities attorney, claims that one way to eliminate shareholder primacy is to amend the corporate code in every jurisdiction. n151 According to Hinkley, under the current corporate code, "corporations are established for one purpose - to make money for shareholders." n152 Consequently, under Hinkley's "Code for Corporate Citizenship Amendment" ("Hinkley [*298] Amendment"), a director will still have a duty to make money for shareholders "but not at the expense of the environment, human rights, the public safety, the communities in which the corporation operates or the dignity of its employees." n153 Hinkley's Amendment adds additional constituencies to the constituency statutes and the requirement for constituency interests to trump those of the shareholders. n154 After more than seven years of advocacy, California and Minnesota attempted to enact legislation to incorporate Hinkley's Amendment but to no avail. n155

Although the Hinkley Amendment is a promising solution to the problem of shareholder primacy, its application renders the amendment useless, adding an additional barrier for For-Benefit corporations. For example, a 2004 California Assembly bill which would preclude directors from making decisions that will cause deleterious effects on, inter alia, the environment, human rights, and public health and safety, n156 was tabled. A new bill was proposed in 2008 that would allow directors to take stakeholder interests and the environment into consideration when making business decisions. n157 After the bill was approved by both the Assembly and Senate, it was rejected by the governor on September 30, 2008, because it allowed directors to consider factors other than the strict financial interest of corporate shareholders. n158 Although Governor Schwarzenegger condoned strict adherence to the shareholder primacy doctrine, he also urged the California legislature to consider and study [*299] "alternative models of corporate governance." n159 Hence, California may be the pioneer in creating the first For-Benefit corporation.

Despite this window of opportunity in California, drafting a new chapter to the California corporate code will take time and may be subject to opposition from powerful interest groups that will lobby to table the bill or kill it in the process. n160 Additionally, it is uncertain whether courts will uphold legislation inherently contrary to case law that offers large deference to the director in making business decisions.

Assuming Hinkley's Amendment is enacted, the final amendment may end up significantly different from the original proposition due to the common compromises and filibusters as seen in California's enactment of the Hinkley Amendment. n161 California's amendment may even pose a threat to For-Benefit corporations because of its vague and over inclusive terms. n162 Many states have proposed new "hybrid" forms including the Socially Responsible Corporations ("SRCs") proposed in Hawaii and Minnesota in 2007, n163 the Non-profit Limited Liability Company enacted in Tennessee and Kentucky, n164 and the Low-profit Limited Liability Company (L3C) [*300] proposed in North Carolina in 2007 n165 and enacted in Vermont in 2008. n166 Although these propositions are a step in the right direction, all fall short of a fully-realized For-Benefit corporation.

B. Europe's Adoption of Similar Socially Responsible Provisions

After much pressure from the Corporate Responsibility Coalition, the United Kingdom enacted the Companies Act, n167 similar to the Hinkley Amendment. The Companies Act requires directors to take into account how their business activities will affect employees, communities and the environment. n168 Although this act is a positive turn in the right direction, companies have received no pragmatic guidance or help as to how exactly they should respond. Moreover, corporations are left unsure as to whether they will be held liable for a breach of their fiduciary duty to stakeholders in addition to shareholders.

Similar encouragement for corporations to acknowledge stakeholder interests is expressed in European Union. In March 2005, the European Council acknowledged that "in order to encourage investment and provide an attractive setting for business and work, the European Union must complete its internal market and make its regulatory environment more business-friendly, while [*301] business must in turn develop its sense of social responsibility." n169 In the Integrated Guidelines for Growth and Jobs (2005-2008), the Council urged Member States to "encourage enterprises in developing their corporate social responsibility." n170

Moreover, the European Parliament has passed resolutions to encourage CSR businesses, notably in its resolutions of 2002 n171 and 2003. n172 In a 2006 resolution, the European Commission recognized that although the market based economy opens up new jobs and business, it "also creates a corresponding need for self-limitation and mobilisation on the part of the business community, in the interest of social stability and the well-being of modern democratic societies." n173 This resolution, inter alia, extends the responsibility of the board of directors to encompass the duty of minimizing any harmful social and environmental impact of companies' activities, seeks to improve working conditions, encourages a multi-stakeholder approach to governance, and aims to resolve issues of corporate transparency and communication. n174 In addition, it requires corporations to create their own CSR reports, bringing forward a proposal for social and environmental reporting to be included with financial reporting requirements. n175 A year later, the European Parliament reaffirmed these guidelines, calling on the commission to implement a mechanism by which victims, including third-country nationals, can seek redress against European companies in the national courts of the Member States. n176

Despite the resolution's enumeration of new alternatives for stakeholder-based business decisions, European companies will not be liable for breach of the resolution's provisions because the resolution is not binding and cannot be enforced under the European Court of Justice. n177 Nevertheless, this resolution may be referred to in the European Court of Justice as a way to explain a law or prove [*302] additional support for a corporation's decision to look to stakeholder interest business decisions.

International Governmental Organization's ("IGOs") are also following in step with the European Union and the U.K. in promoting socially responsible companies. n178 The overall support of CSR companies worldwide should be an encouragement to directors of For-Benefit corporations who intend to expand their business abroad because they will effectively be equipped with many tools to support decisions made in the interests of non-shareholders.

VI. Conclusion: Multinational Multi-Faceted Corporations

In a 1999 Environics International Millennium Poll, where more than 25,000 citizens across six continents were interviewed, two out of three citizens wanted companies to go beyond the historical role of making a profit. n179 The international community is ready for companies to contribute to broader societal goals, and a new Fourth Sector is emerging to fulfill these needs. The Fourth Sector recognizes that corporations are multi-faceted, harboring an innate desire to do good and do well. Environmentalist entrepreneur Paul Hawken claims that this "For-Benefit Sector" will be the guiding light as we shift into a "restorative economy;" an economy that will cure the flaws of our current one. n180

Although the Fourth Sector is emerging in virtually every country, the U.S. is far behind. The For-Benefit corporate model offers a novel possibility for U.S. companies to enter into the Fourth Sector. However, before the For-Benefit corporation can become a [*303] recognized legal entity in every state, it is first necessary to understand how existing law affects For-Benefit corporations and to decide what characteristics a For-Benefit corporation should have.

Within the current legal framework, careful and deliberate decisions made with the utmost devotion towards benefiting the interests of the corporation's socially conscious values should not violate the shareholder primacy doctrine. As Woodrow Wilson so gracefully states: "You are not here merely to make a living. You are here to enrich the world - and you impoverish yourself if you forget the errand." Appropriately, For-Benefit corporations are breaking out of the one-dimensional, profit-driven mold, pioneering the path towards a new multi-dimensional and values-driven Fourth Sector. This pioneering venture is both exciting and terrifying as directors are left with more questions than answers. Will the judiciary discard outdated, market-based application of corporate law? How will social businesses use old constituency statutes for new purposes? Will a new stakeholder primacy doctrine emerge within the Fourth Sector? To remedy these daunting uncertainties, corporations should demand proper revisions in state corporate statutes that support of For-Benefit corporations. Eventually, the tax code will need to recognize a For-Benefit corporation as a new legal entity that will have the ability to apply for tax-exempt status in exchange for certain other limitations. Indeed, the time is ripe for businesses to refuse legal penalty for the simultaneous pursuit of monetary success and positive social impact.

Legal Topics:

For related research and practice materials, see the following legal topics:
Business & Corporate LawCorporationsDirectors & OfficersManagement Duties & LiabilitiesCauses of ActionGeneral OverviewGovernmentsFiduciary ResponsibilitiesPensions & Benefits LawGovernmental EmployeesU.S. Civil Service Retirement SystemGeneral Overview

FOOTNOTES:

n1. I wrote this poem after I finished the first draft of this note. May it be an encouragement to those who desire to do good and do well.

n2. See discussion infra Parts II., IV.

n3. Daniel T. Ostas, Deconstructing Corporate Social Responsibility: Insights from Legal and Economic Theory, *38 Am. Bus. L.J. 261, 285 (2001).*

n4. Institute for Economic Analysis, Towards the Integration of Economic Science, available at http://www.iea-macro-economics.org/int-ec-sci-pol.html (last visited Mar. 17, 2007) ("It has become obvious that continued depletion of economic resources at the present rate cannot be sustained indefinitely, particularly if the rest of the world attempts to achieve the present U.S. standard of waste").

n5. Id.; see also Muhammad Yunus, Creating a World Without Poverty 3-6, 18 (PublicAffairs 2007) [hereinafter "Yunus, World Without Poverty"] (explaining that the "mainstream free-market-theory suffers from a "conceptualization failure,' a failure to capture the essence of what it is to be human."). Yunus further explains that people and businesses are multi-faceted and that business should not be bound to serve one single, purely profit driven objective.

n6. Id.

n7. See Milton Friedman, Op-Ed, The Social Responsibility of Business Is to Increase Its Profits, N.Y. Times, Sept. 13, 1970, at SM17.

n8. See discussion infra Part II.c.

n9. See David G. Mandelbaum, Corporate Sustainable Strategies, *26 Temp. J. Sci. Tech. & Envtl. L. 27, 30 (2007).*

n10. Adam Smith, The Theory of Moral Sentiments (David D. Rafael & Alec L. Macfie eds., Liberty Classics 1982) (1759).

n11. Eric W. Orts, Beyond Shareholders: Interpreting Corporate Constituency Statutes, *61 Geo. Wash. L. Rev. 14, 21 (1992)* [hereinafter "Orts, Beyond Shareholders"].

n12. Id.

n13. Adolf A. Berle, Jr., Forward, in The Corporation in Modern Society ix, xii (Edward S. Mason ed., Harvard University Press 1959).

n14. Orts, Beyond Shareholders, supra note 11.

n15. The definition of a double bottom line companies is discussed in Part II.a.

n16. For a more in-depth discussion on corporate social responsibility, see Corporate Governance and Directors' Liabilities: Legal, Economic and Sociological Analyses on Corporate Social Responsibility 1-177 (Klaus J. Hopt & Gunther Teubner eds., 1985). See also David L. Engel, An Approach to Corporate Social Responsibility, *32 Stan. L. Rev. 1 (1979);* Christopher D. Stone, Corporate Social Responsibility: What It Might Mean, If It Were Really to Matter, *71 Iowa L. Rev. 557 (1986).*

n17. The Business Roundtable is an association of chief executive officers of leading U.S. companies with $ 4.5 trillion in annual revenues and more than 10 million employees. See generally Business Roundtable Home

Page, http://www.business roundtable.org, for more information.

n18. See Orts, Beyond Shareholders, supra note 11, (citing The Business Roundtable, Corporate Governance and The U.S. Competitiveness, 241, 244 (Nov. 1990)).

n19. These include Joshua Mailman and Wayne Silby of Threshold Foundation; Ben Cohen and Jerry Greenfield, co-founders of Ben & Jerry's; and Jeffrey Hollender and Steven Fenichell of Seventh Generation.

n20. Jeffrey Hollender and Steven Fenichell, What Matters Most, 12, (X ed., "publisher" 2004) [hereinafter "What Matters Most"].

n21. The Institute for Social Entrepreneurs, Evolution of the Social Enterprise Industry: A Chronology of Key Events, (2008), http://socialent.org/documents/ EVOLUTIONOFTHESOCIALENTERPRISEINDUSTRY--ACHRONOLOGY OFKEYEVENTS.pdf

n22. What Matters Most, supra note 20.

n23. John Elkington, Towards the Sustainable Corporation: Win-Win-Win Business Strategies for Sustainable Development, Cal. Mgmt. Rev., Winter 1994, at 90-100.

n24. Darrell Brown, et al., Triple Bottom Line: A Business Metaphor for a Social Construct, available at http://www.recercat.net/bitstream/2072/2223/1/UABDT06-2.pdf. For a more detailed analysis, see Harvard Business School Press et al., Harvard Business Review on Corporate Responsibility (2003); Tom Chappell, The Soul of a Business: Managing for Profit and the Common Good (1993); Stuart L. Hart, Capitalism at the Crossroads: The Unlimited Business Opportunities in Solving the World's Most Difficult Problems (2007); Andrew W. Savitz & Karl Weber, The Triple Bottom Line: How Today's Best-Run Companies Are Achieving Economic, Social and Environmental Success - and How You Can Too (2006); Bob Willard, The Sustainability Advantage: Seven Business Case Benefits of a Triple Bottom Line (2006).

n25. See What matters most, supra note 20, at 29 (citing Business: The Ultimate Resource (2002)).

n26. Id. at 192.

n27. Commission Green Paper on Promoting a European Framework for Corporate Social Responsibility, at 3, COM (2001) 366 final (July 18, 2001).

n28. Id.

n29. Communication from the Commission concerning Corporate Social Responsibility: A Business Contribution to Sustainable Development, at 5, COM (2002) 347 final (July 2, 2002), available at http://eur-lex.europa.eu/ LexUriServ/LexUriServ.do?uri=COM:2002:0347:FIN:EN:PDF.

n30. Id.; see also supra note 27. In the past decade, numerous reports have been published on CSR. "The Sustainable Development Strategy for Europe" adopted during the Goteborg European Council of June 2001 acknowledged that long-term economic growth, social cohesion, and environmental protection go hand in hand and encouraged businesses to adopt such policies in their own bylaws. Additionally, the EU Multi-Stakeholder Forum on CSR (CSR Forum) was formed in 2002, and the European Coalition for Corporate Justice (ECCJ) formed in 2006 which has more than ten countries. For more information see http://www.corporate-responsibility.org/C2B/document tree/ViewACategory.asp?CategoryID=35.

n31. Communication from the Commission to the European Parliament, The Council and the European Economic and Social Committee Implementing the Partnership for Growth and Jobs Making Europe a Pole of Excellence on Corporate Social Responsibility, COM (2006) 136 final (March 22, 2006), available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2006:0136:FIN:EN :HTML.

n32. Id. at 2.

n33. Id.

n34. Id. at 11.

n35. A Business Contribution to Sustainable Development, supra note 29, at 3.

n36. Id. at 5.

n37. Id.

n38. Id.

n39. Yunus, World Without Poverty, supra note 5, at 15.

n40. Id.

n41. Id.

n42. Id. at 16.

n43. Id. (stating that the philosophy of these companies "seems to be: Make as much money as you can, even if you exploit the poor to do so-but then donate a tiny portion of the profits for social causes or create a foundation to do things that will promote your business interest...and then be sure to publicize how generous you are!")

n44. Id at 22.

n45. See What Matters Most, supra note 20, at 201.

n46. See generally Simon Zadek, The Civil Corporation: The New Economy of Corporate Citizenship (2001)

n47. See OpenSRI, http://www.opensri.com (last visited Sept. 18, 2008); Oekom Research AB in Germany, http://oekom.ve.m-online.net/index.php?language=ukd# home (last visited Sept. 18, 2008); Dow Jones Sustainable Index, http://www.sustainability-indexes.com (last visited Sept. 18, 2008); Ethibel, http://www.ethibel.org/subs e/4 index/main.html (last visited Sept. 18, 2008); FTSE4Good, http://www.ftse.com/Indices/FTSE4Good Index Series/index.jsp (last visited Sept. 18, 2008); KLD's Domini 400 Social Index, http://www.kld.com/ indexes/ds400index/index.html (last visited Sept. 18, 2008); Corporate Governance Quotient (CGQ), http://www.investopedia.com/terms/c/corporate governance quotient.asp (last visited Sept. 18, 2008); and B Labs in 2007, http://www.bcorporation.net (last visited Sept. 18, 2008).

n48. The Sustainable Business Achievement Ratings (S-BAR) was created in 2004 in response to the inability of the California state legislators to agree upon a working definition of "social business." As a result, a 2004 California bill giving state procurement preference to "social businesses" was tabled. S-BAR is "the first comprehensive system with a market-based, broadly applicable, and transparent means of assessing a company's environmental, economic and social performance." See http://www.sustainabilityratings.com/about/index.html.

n49. "B corporation" is a trademark of B Lab.

n50. See http://www.bcorporation.net.

n51. Hannah Clark, A New Kind of Company, Inc. Mag., July 2007, available at http://www.inc.com/magazine/20070701/priority-a-new-kind-of-company.html [hereinafter Clark, A New Kind of Company].

n52. Id. Upstream 21 was co-founded by Leslie Christian. For more information see http://www.upstream21.com/

n53. Id.

n54. Heerad Sabeti, The Emerging Fourth Sector 3 (2008), http://fourthsector.net/prepdocs/FSExecutiveSummary Draft.pdf.

n55. Id.

n56. "Fourth Sector" organizations are also referred to as Philanthropicapitalism, Hybrid organization, Corporate citizenship , Social enterprise, For-Benefit company, B Corporation, Fourth Sector Organizations, Cooperative corporation, Social entrepreneurship, Cooperative Societies, Community Interest Corporations (U.K), Social Business, Empresa, Social economy enterprises, Le cooperative de solidarite, Societes a finalite sociale, Social Cooperatives, Sociedad Laboral, Corporate social responsibility, Responsablilite social de l'entreprise, and Social investment.

n57. See Thomas J. Billitteri, Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach? Highlights from an Aspen Institute Roundtable, The Aspen Institute, (2007), http://www.nonprofitresearch.org/usr doc/New Legal Forms Report FINAL.pdf [hereinafter Billitteri, Mixing Mission and Business].

n58. Id.

n59. Id.; For more information on L3C, see infra note 169.

n60. See http://www.se-alliance.org/about policy.cfm.

n61. The report for the meeting will be distributed in November 2008.

n62. Sabeti, The Emerging Fourth Sector, see supra note 54.

n63. See generally http://www.fourthsector.net/for-benefit-organizations.php.

n64. Id.

n65. Sabeti, The Emerging Fourth Sector, supra note 54.

n66. See discussion infra Part III.a.iv.

n67. Yunus, World Without Poverty, supra note 5, at 16., see also notes 82-84, infra.

n68. *Ryan v. Gifford, 918 A.2d 341, 357 (Del. Ch. 2007)* (citing *Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984))*.

n69. *Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)* (explaining that a court "under such circumstances will not substitute its own notions of what is or is not sound business judgment").

n70. Id.; see also Model Bus. Corp. Act § 8.30(a) (2005).

n71. Id.

n72. Id.; see also ALI, Principles of Corporate Governance § 4.01(c).

n73. See *Ryan v. Gifford, 918 A.2d at 357*.

n74. Id. (citing *Malpiede v. Townson, 780 A.2d 1075, 1093-97 (Del. 2001)).*

n75. *Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 369 (Del. 2006)* (citing *In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006)).*

n76. See, e.g., *In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 755-58 (Del. Ch. 2005);* see also *Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (De. 1993);* see *In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 755-58 (Del. 2005); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)* (citing *Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1988); Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).*

n77. *In re Tyson Foods, Inc. Consol. S'holder Litig., No. 1106-CC, 2007 Del. Ch. LEXIS 120, at 9* (Del. Ch. Aug. 15, 2007).

n78. Robert A. Ragazzo, Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap, *35 Ariz. L. Rev. 989, 996 (1993)* [hereinafter "Ragazzo, Unifying the Law"].

n79. The GRI Register, BP, Making Energy More - The Sustainability Report 2005 1 (2005), http://www.corporateregister.com/search/report.cgi?num=15081& com=0 (asserting, in the BP Sustainability Report, that taking steps to improve sustainability directly enable businesses to prosper economically); see also David G. Mandelbaum, Corporate Sustainable Strategies, *26 Temp. J. Sci. Tech. & Envtl. L. 27, 32 (2007);* see also Goldman's Sachs Group Inc., GS Sustain Report (2007), http://www.unglobalcompact.org/docs/summit2007/gs esg embargoed until030707pdf.pdf (showing that socially responsible companies can generate high stock prices, outperforming the general stock market by twenty-five percent and have a competitive advantage over their peers.)

n80. See *Sinclair Oil Corp., 280 A.2d at 720;* see also ALI, Principles of Corporate Governance § 4.01(c).

n81. Although the Unocal standard originated in Delaware, twenty-eight states have adopted essentially the same Unocal standard principle in their statutes; see Shani Fuller, COMMENT: Shareholders, Directors, and

Other Constituencies: Who's on First in Oregon Corporate Takeover Law?, *30 Willamette L. Rev. 347, 359 (1994)* [hereinafter Fuller, Takeover Law].

n82. Ragazzo, Unifying the Law, supra note 78, at 996.

n83. *Golden Cycle, LLC v. Allan, No. CIV.A. 16301, 1998 WL 892631* (Del. Ch. Dec. 10, 1998) (mem.); see also *Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985);* see also Wells M. Engledow, Structuring Corporate Board Action to Meet the Ever-Decreasing Scope of Revlon Duties, *63 Alb. L. Rev. 505, 509 (1999)* [hereinafter Engledow, Scope of Duties].

n84. Craig W. Palm & Mark A. Kearney, A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Game (Part II), *42 Vill. L. Rev. 1043, 1066 (1997);* see also Lawrence A. Cunningham, Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance, *84 Cornell L. Rev. 1133, 1160 (1999)* (stating that even when Revlon applies, Delaware still permits corporate boards wide leeway to act); see also Engledow, Scope of Duties, supra note 83, at 531.

n85. Unocal Corp., 493 at 955.

n86. Id.; see also Fuller, Takeover Law, supra note 81, at 360.

n87. See *Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984, 1015* (E.D. Wis.), aff'd on other grounds, *877 F.2d 496* (7th Cir.), cert. denied, *493 U.S. 955 (1989)* (upholding defensive tactics because, inter alia, the pending bid posed "a danger to a corporation's [nonshareholder] constituencies (customers, suppliers, employees)"); *GAF Corp. v. Union Carbide Corp., 624 F. Supp. 1016, 1019-20 (S.D.N.Y. 1985)* (upholding defensive measures on the grounds that "[a] corporation with a perceived threat of dismemberment of large divisions of the enterprise, employing thousands of employees, owes substantial regard for their pension benefits, and in the case of loyal management, severance benefits"); see also *Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985).*

n88. *Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (1990)* (holding that a target company's board does not have to make any financial comparisons to justify defensive action); see also *Cheff v. Mathes, 199 A.2d 548 (Del. 1964)* (regarding directors' defense against hostile takeover that would be harmful to employees).

n89. Id.

n90. *Paramount Commc'ns., 571 A.2d at 1144.*

n91. *Id. at 1147-49.*

n92. *Id. at 1149.*

n93. *Id. at 1154* (citing *Revlon, 506 A.2d 173).*

n94. See David Millon, Theories of the Corporation, *1990 Duke L.J. 201, 230 (1990).* See also Dorman L. Commons, Tender Offer: The Sneak Attack in Corporate Takeovers 139 (1985); Kathleen Conn, For-Profit School Management Corporations: Serving The Wrong Master, *31 J.L. & Educ. 129, 132 (2002).*

n95. *Dodge v. Ford Motor Co., 204 Mich. 459 (Mich. 1919).*

n96. Franklin A. Gevurtz, Symposium: Corporations Theory and Corporate Governance Law: Getting Real About Corporate Social Responsibility: A Reply to Professor Greenfield, *35 U.C. Davis L. Rev. 645, 648 (2002);* see also D. Gordon Smith, The Shareholder Primacy Norm, *23 Iowa J. Corp. L. 277, 315 (1998).*

n97. *Theodoro Holding Corp. v. Henderson, 257 A.2d 398, 402 (Del. Ch. 1969);* see also *Shlensky v. Wrigley, 95 Ill. App. 2d 173, 179 (1968); Commodity Futures Trading Com v. Weintraub, 471 U.S. 343, 348 (1985); Lytle v. Malady, 566 N.W.2d 582, 594 (Mich. 1997); In re Estate of Butterfield, 341 N.W.2d 453, 459 (Mich. 1983); Reed v. Burton, 73 N.W.2d 333,336 (Mich. 1955).*

n98. Id.

n99. *Paramount Commc'ns., 571 A.2d at 1150* (citing *Mills Acquisition Co. v. Macmillan, Inc, 559 A.2d 1261 (1988).*

n100. Id.. (citing *Revlon, Inc. v. Macandrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986).*

n101. *Revlon, 506 A.2d at 182.*

n102. See Ragazzo, Unifying the Law, supra note 78 at 989; see also Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes,*70 Tex. L. Rev. 579, 609 (1992)* [hereinafter "Mitchell, Enforcing Constituency Statutes"].

n103. *Revlon. 506 A.2d 173 at 182.* See generally, Lawrence A. Cunningham & Charles M. Yablon, Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of Revlon Duties?), *49 Bus. Law. 1593 (1994).*

n104. See Ragazzo, Unifying the Law, supra note 78 at 1004-1009 (explaining that a company is certain to trigger the Revlon standard only when there has been a complete sale of the entire company. "The possibility that a sale of control triggers Revlon remains extant but is called into question by Paramount ... changes of control may not, and substantial restructurings do not, trigger enhanced Revlon duties because the corporation continues as an entity.").

n105. See Ragazzo, Unifying the Law, supra note 78, at 997.

n106. Id.

n107. See Mitchell, Enforcing Constituency Statutes, supra note 102, at 598; Lawrence E. Mitchell, The Death of Fiduciary Duty in Close Corporations, *138 U. Pa. L. Rev. 1675, 1684-88 (1990).*

n108. For the purposes of this hypothetical, I will assume that Delaware law will govern considering the novel use of constituency statutes by For-Benefit corporations.

n109. See *15 Pa. Cons. Stat. § 1715* (1991).

n110. See e.g., *Iowa Code Ann. § 491.101B* (West 2008); *Ky. Rev. Stat. Ann. § 271B.12-210(4)* (LexisNexis 2007); *S.D. Codified Laws § 47-33-4(1)* (2008); *Tenn. Code Ann. § 48-103-202*, -204 (2008); *Vt. Stat. Ann. tit. 11A, § 8.30(a)(3)* (2007).

n111. Carol B. Swanson, The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism, *30 Ga. L. Rev. 943, 974 (1996);* see also Ragazzo, Unifying the Law, supra note 78, at 1023 (describing general corporate law and legitimacy of considering interests of non-shareholder constituencies).

n112. See John H. Matheson & Brent A. Olson, Corporate Cooperation, Relationship Management, and the Trialogical Imperative for Corporate Law, *78 Minn. L. Rev. 1443, 1462 (1994)* ("The viability of the shareholder primacy theory derives from economic theory; it says that shareholders' unfettered pursuit of maximum profits promotes economic efficiency ... ."). See also Richard A. Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, *8 Hofstra. L. Rev. 487, 491-97 (1980)* (defending wealth maximization). See also Timothy L. Fort, Corporate Constituency Statutes: A Dialectical Interpretation, *15 J.L. & Com. 257, 261-62 (1995)* (describing corporate constituency statutes).

n113. Thirty-one states have enacted non-shareholder constituency statutes. *Ariz. Rev. Stat. Ann. § 10-2702* (2008); *Conn. Gen. Stat. § 33-756* (2008); *Fla. Stat. Ann. § 607.0830(3)* (West 2008); *Ga. Code Ann. § 14-2-202(b)(5)* (West 2008); *Haw. Rev. Stat. § 414-221* (2008); *Idaho Code Ann. § 30-1602*, -1702 (2008); *805 Ill. Comp. Stat. 5/8.85* (2008); *Ind. Code Ann. § 23-1-35-1* (West 2008); *Iowa Code Ann. § 491.101B* (West 2008); *Ky. Rev. Stat. Ann. § 271B.12-210(4)* (LexisNexis 2007); *La. Rev. Stat. Ann. § 12:92(G)(2)* (2008); *Me. Rev. Stat. Ann. tit. 13-C, § 831* (2008); Md. Code. Ann., Corps. & Ass'ns. § 2-104(b)(9) (West 2008); *Minn. Stat. Ann. § 302A.251(5)* (West 2008); *Miss. Code Ann. § 79-4-8.30(d)* (West 2008); *Mo. Ann. Stat. § 351.347* (West 2008); *N.J. Stat. Ann. § 14A:6-1(2)*, :6-14(4) (West 2008); *N.M. Stat. Ann. § 53-11-35(D)* (West 2008); *N.Y. Bus. Corp. Law § 717(b)* (McKinney 2008); *N.D. Cent. Code § 10-19.1-50(6)* (2007); *Ohio Rev. Code Ann. § 1701.59(E)* (West 2008); *Or. Rev. Stat. § 60.357(5)* (2007); *15 Pa. Cons. Stat. § 1715* (2008); *R.I. Gen. Laws § 7-5.2-8(a)* (2008); *S.D. Codified Laws § 47-33-4(1)* (2008); *Tenn. Code Ann. § 48-103-202*, -204 (2008); *Vt. Stat. Ann. tit. 11A, § 8.30(a)(3)* (2007); *Wis. Stat. Ann. § 180.0827* (West 2008); *Wyo. Stat. Ann. § 17-16-830(e)* (2008).

n114. Rima Fawal Hartman, Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Ideals?, *50 Wash & Lee L. Rev. 1761, 1765 (1993)* (stating that constituency statutes as well as Delaware case law indicates that directors should be allowed to consider the concerns of all stakeholders and in certain situations requires the board to consider certain stakeholders' concerns under certain circumstances).

n115. Brian S. Cohen, Corporate Governance for the Entrepreneur, *71 St. John's L. Rev. 125, 125-130 (1997).*

n116. Lynda J. Oswald, Shareholders v. Stakeholders: Evaluating Corporate Constituency Statutes Under the Takings Clause, *24 Iowa J. Corp. L. 1, 7 (1997)* [hereinafter Oswald, Shareholders v. Stakeholders].

n117. See *Baron v. Strawbridge & Clothier, 646 F. Supp. 690, 697 (E.D. Pa. 1986)* (stating that Pennsylvania law requires a director to oppose a tender offer that is harmful to the corporation's long-term interests, even at the expense of short-term shareholder interests); *Thompson v. Central Ohio Cellular, 639 N.E.2d 462 (Ohio 1994)* (stating that directors "must" consider interests of shareholders and "may" consider interests of creditors); *Georgia-Pacific Corp. v. Great Northern Nekoosa Corp., 727 F. Supp. 31 (D. Me. 1989)* (stating that Main law "suggests" that the Directors of a corporation, in considering the best interests of the shareholders and corporation, should also consider the interests of the company's employees, its customers and suppliers, and communities in which offices of the corporation are located); *Murray v. Conseco, Inc., 795 N.E.2d 454 (Ind. 2003)* (citing constituency statute to state the rule that the director's decision was valid because it was made in the interest of the corporation as a whole to remove a director that the shareholders had voted in); *Keyser v. Commonwealth National Financial Corp., 675 F.Supp. 238, 241 (M.D. Pa. 1987)* ("The Board could consider so-called social issues in evaluating merger proposals."). For a more in-depth discussion of the acknowledgment that non-shareholder interests should be considered an essential component to a director's decision, see also Wai Shun Wilson Leung, The Inadequacy of Shareholder Primacy: A Proposed Corporate Regime that Recognizes Non-Shareholder Interests, *30 Colum. J.L. & Soc. Probs. 587, 613-14 (1997).* See also Andrew Keay, Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's 'Enlightened Shareholder Value Approach', *29 Sydney L. Rev. 577, 596 (2007)* [hereinafter Keay, Tackling the Issue].

n118. Mitchell, Enforcing Constituency Statutes supra note 102, at 579.

n119. California is one of the only states that is attempting to incorporate an interest in the environment into its constituency statute with Assembly Bill 2944. As of August 29, 2008, AB 2944 passed both the California

Assembly and Senate and is pending approval by the Governor. See http://www.statesurge.com/bills/50524-ab2944-california (last visited Sept. 22, 2008).

n120. Mark J. Loewenstein, What Can We Learn from Foreign Systems?: Stakeholder Protection in Germany and Japan, *76 Tul. L. Rev. 1673, 1674 (2002).*

n121. Id.; see also Keay, Tackling the Issue, supra note 117, at 578 ("directors are not only to manage the company for the betterment of shareholders, but also in the interests of a multitude of stakeholders (including the shareholders)"); Roberta S. Karmel, Implications of the Stakeholder Model, *61 Geo. Wash. L. Rev. 1156, 1171 (1993)* (the non-anglo-saxon stakeholder model is "premised on the theory that groups in addition to shareholders have claims on a corporation's assets and earnings because those groups contribute to a corporation's capital.").

n122. Loewenstein, Stakeholder Protection, supra note 120, at 1680-82 (explaining that Germany has relatively few hostile takeovers as compared to the United States and Great Britain. Further, shareholder derivative suits are unknown to German companies.).

n123. Id. at 1674.

n124. Id. at 1675.

n125. Id.

n126. Id. at 1675.

n127. Id. at 1676-77.

n128. Id. at 1677. ("For entities that have between 500 and 2000 employees, one-third of the supervisory

Aufsichtsrat board must consist of employee representatives. For entities with 2000 or more employees, one-half of the supervisory Aufsichtsrat board must be employee representatives, and some of these must be representatives of the unions. Typically, if the company has more than 20,000 workers, the Aufsichtsrat board consists of twenty members, of which ten represent the shareholders, seven the workers, and three the unions.").

n129. Keay, Tackling the Issue, supra note 117, at 588-95.

n130. Id. at 594-95.

n131. See supra note 31, at 3.

n132. Id. (Europe urged directors to take all stakeholders into account, declaring that "Europe does not need just business but socially responsible business that takes its share of responsibility for the state of European affairs."). Additionally, many European countries have already enacted the equivalent of a For-Benefit corporation including the Sociedad Laboral in Spain, Society for Social Purpose in Belgium, Social Cooperatives in Italy, and the Social Solidarity Cooperatives in Portugal.

n133. The Social enterprise in South Korea, enacted by the 2007 Act on Social Enterprise Promotion, the Seed Money project launched by the Social Welfare Department in 2001 in Hong Kong, the New Labor Contract Law of 2008 in China, the Singapore Compact for Corporate Social Responsibility launched by National Tripartite Initiative in 2004, the Singapore Companies Act of 2004, and the Council for Better Corporate Citizenship launched in 2002 in Japan.

n134. See *Kahn v. Sullivan, 594 A.2d 48 (Del. 1991); Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. Ch. 1969); Sullivan v. Hammer, No. CIV.A.10823, 1990 WL 114223* (Del. Ch. Aug. 14, 1990); see also Faith Kahn, Pandora's Box: Managerial Discretion and the Problem of Corporate Philanthropy, *44 UCLA L. Rev. 579, 606 (1997)* [hereinafter Kahn, Pandora's Box].

n135. *Theodora Holding Corp. v. Henderson, 257 A.2d at 404;* see also *Kahn, 594 A.2d at 61* ("The Court of Chancery recognized that not every charitable gift constitutes a valid corporate action.").

n136. Kahn, Pandora's Box, supra note 134, at 606 ("The standard of reasonableness was also endorsed by the Delaware Supreme Court in Kahn v. Sullivan, and it appears, to date, to be the authoritative standard.").

n137. Id.

n138. *Theodora Holding Corp. v. Henderson, 257 A.2d at 405.*

n139. *Kahn, 594 A.2d at 61.* Kahn is the only litigation involving a shareholder challenge to a corporate contribution by a public corporation. See Faith Kahn, Symposium: Corporate Philanthropy: Law, Culture, Education, and Politics: Article: Legislatures, Courts and the SEC: Reflections on Silence and Power in Corporate and Securities Law, *41 N.Y.L. Sch. L. Rev. 1107, 1124 (1997)* [hereinafter Kahn, Corporate Philanthropy].

n140. Id.

n141. *26 U.S.C. 170*(b)(2)(2005).

n142. See Kahn, Corporate Philanthropy, supra note 139, at 1130-31.

n143. *Kahn, 594 A.2d at 61* (taking into consideration the percentage of income, as well as the benefit to the corporation, finding that "the net worth of Occidental, its annual net income before taxes, and the tax benefits to Occidental" in concluding that the gift to the Museum was within "the range of reasonableness" established in Theodora).

n144. *Theodora Holding Corp., 257 A.2d at 405.*

n145. See Oswald, Shareholders v. Stakeholders, supra note 116, at 6 ("Although corporate law doctrine does permit corporations to use some corporate assets for charitable and other non-profit-related purposes, these eleemosynary acts are usually tempered by a requirement that they be in the best long-range interest of the corporation and thus in the best long-range interest of the shareholders."); see, e.g., *Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968);* see also David S. Ruder, Public Obligations of Private Corporations, *114 U. Pa. L. Rev. 209 (1965);* see also Kahn, Corporate Philanthropy, supra note 142.

n146. Margaret M. Blair, A Contractarian Defense of Corporate Philanthropy, *28 Stetson L. Rev. 27, 34 (1998).*

n147. Henry N. Butler & Fred S. McChesney, Symposium: Why they give at the office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation, *84 Cornell L. Rev. 1195, 1213 (1999).*

n148. Robert Hinkley, 28 Words to Redefine Corporate Duties: The Proposal for a Code for Corporate Citizenship, available at http://www.multinationalmonitor.org/ mm2002/02july-aug/july-aug02corp4.html.

n149. Id.

n150. The RCI report listed the U.S. as #18 on a list, just above Japan and China following France and Singapore.

n151. Hinkley, Redesigning Corporate Law Business Ethics, available at http://www.mailarchive.com/sustainablelorgbiofuel@sustainableli sts.org/ msg32019. html; see also Robert Hinkley, Citizenship: Oxymoron or Necessity, available at http://www.commondreams.org/archive/2007/11/30/5521/; see e.g., http://www.c4cr. org/.

n152. Id.

n153. Robert Hinkley, 28 Words to Redefine Corporate Duties: The Proposal for a Code for Corporate Citizenship, available at http://www.multinationalmonitor.org/ mm2002/02july-aug/july-aug02corp4.html; see also Ron James, President Bush's Economic Reform (2002), available at http://www.c4cr.org/ethicalbiz.html; Gili Chupak, The Code for Corporate Responsibility: Widening the Perspective of Management (2004), available at http://www.c4cr.org/paper01.html.

n154. Id.

n155. California Senate Bill (SB) 917, available at http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb 0901-0950/sb 917 bill 20030221 introduced.pdf (amends *section 309 of California's Corporate Code*, requiring corporate directors to ensure that profits do not come at the expense of the environment, human rights, public health and safety, the welfare of communities, and employee dignity); Minnesota also tried to enact a similar bill: Bill S.F. 1529, available at http://www.revisor.leg.state.mn.us/ bin/bldbill.php?bill=S1529.0&session=ls83. (Both bills have been tabled and are no longer active as of 2004.).

n156. Id.

n157. See California Assembly Bill 2944 available at http://info.sen.ca.gov/cgi-bin/postquery.

n158. Id.

n159. Id.

n160. Minnesota legislation has tabled the bill in the judiciary and no further action has been taken to bring the amendment back to life.

n161. In addition to the twenty-six word amendment, the California Assembly inserted subsections (d) through (k) that indicate a director may be personally liable for a violation of the Hinkley Amendment in addition to any person that is under his control.

n162. Section 309 subsection (d) through (i) asserts that an individual director may be sued as well as anyone under his control unless the director can somehow prove that he voted against such action or the decision was made prior to his entrance on the board. Subsection (j) gives the attorney general broad discretion in determining when a corporation has violated its duty to stakeholders and what appropriate penalties will be imposed. Vague terms such as "human rights" or "employee dignity" are spread throughout the amendment without any real clarification.

n163. See Minnesota Responsible Business Corporation Act, ch. 304A, § 2(2), 84th Legis. Sess. (Minn. 2006), available at http://www.revisor.leg.state.mn.us/ bin/bldbill.php?bill=S3786.0.html&session=ls84; see also H.B. 3118, § 2, 23d Leg. (Haw. 2006), available at http://www.capitol.hawaii.gov/site1/archives/2006/ getstatus.asp?query=HB3118&showstatus=on&showtext=on&am p;showcommrpt=on&currpage=; see also Billitteri, Mixing Mission and Business, supra note 57, at 14.

n164. Enacted in Kentucky in 1994, revised in 2007 KRS§§275.025-275.540; enacted in Tennesse in 2001, revised in 2004 *Tenn. Code Ann. § 48-101-801-809*; see generally James M. McCarten & Kevin N. Perkey, Tennessee Nonprofit LLCs -- A New Option for Tax-Exempt Organizations, *3 Transactions 15 (2001).* See also Larry E. Ribstein, Reverse Limited Liability and the Design of Business Associations, *30 Del. J. Corp. L. 199, 212-13 (2005).*

n165. See also B. 91, 2007 Gen. Assem., Reg. Sess. (N.C. 2007), available at http://www.ncleg.net/sessions/2007/Bills/Senate/PDF/S91v5.pdf; H.B. 39, 2007 Gen. Assem., Reg. Sess. (N.C. 2007), available at http://www.ncleg.net/sessions/ 2007/bills/house/PDF/H39v1.pdf; see also Michael Gottesman, From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations, *26 Yale L. & Pol'y Rev. 345, 353 (2007).*

n166. See H.B 0775 available at http://www.leg.state.vt.us/database/status/ summary.cfm; see generally Billitteri, Mixing Mission and Business, supra note 57 at 13-14.

n167. Section 172(1) of the Companies Act 2006 states that: (1) A director of a company must act in a way that he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly between the members of the company. Companies Act, 2006, c.46, § 172 (United Kingdom).

n168. Id.; see also Marking the Moment: Implementation of The Companies Act, http://www.corporate-responsibility.org/C2B/PressOffice/display.asp?ID=86&Type= 2 ; See also. Marking the Moment: Implementation of The Companies Act, http://www.corporate-responsibility.org/C2B/PressOffice/display.asp?ID=86 &Type = 2; see also, Keay, Tackling the Issue, supra note 120 at 591.

n169. See supra note 31, at 4.

n170. Id.

n171. P*5 TA(2002)0278.*

n172. P*5 TA(2003)0200.*

n173. See supra note 31, at 2.

n174. Id. at 12.

n175. Id. at 11.

n176. Corporate social responsibility: implementing the partnership for growth and jobs INI (2006) 2133 (Mar. 13 2007).

n177. See, e.g., http://eur-lex.europa.eu/en/droit communautaire/droit communautaire.htm#1.3.

n178. United Nations Global Compact published a code of social conduct for large businesses in 2000 which requires businesses to consider stakeholder interests such as human rights, labor rights and environmental rights, available at http://www.unglobalcompact.org/; see also the U.N.'s research program seeking to promote research and policy discussions about CSR in developing countries, available at http://www.unrisd.org/engindex/research/busrep.htm; see also ILO Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy, available at http://www.ilo.org/public/english/employment/multi/tridecl/ index.htm; ILO database on Business and Social Initiatives, available at http://oracle02.ilo.org:6060/vpi/vpisearch.first (database on Business and Social Initiatives relating to social and labor conditions where corporations are located); OECD Guidelines for Multinational Enterprises ("MNEs"), available at http://www.oecd.org/daf/investment/guidelines/ (2000); see also, OECD Principles for Corporate Governance, available at http://www.oecd.org/daf/governance/ principles.htm (1999).

n179. what matters most, supra note 20, at 47.

n180. Clark, A New Kind of Company, supra note 51.

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Operating In Two Worlds: Tandem Structures In Social Enterprise

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Ingrid Mittermaier and Joey Neugart

Can a charitable nonprofit successfully operate in tandem with a for profit? Yes, but it requires scrupulous attention to Code requirements.

A NONPROFIT CORPORATION that gains tax-exemption as a charity under section 501(c)(3) of the Internal Revenue Code (a "charitable nonprofit" or "charity") is a frequent choice of entity for social entrepreneurs. (Although beyond the scope of this article, entrepreneurs may have reasons to consider nonprofit choices other than charitable nonprofits, such as a nonprofit corporation with section 501(c)(4) exemption or a taxable nonprofit corporation. Section references in this article are to the Internal Revenue Code, unless otherwise indicated.) Charities enjoy tax exemption for most forms of income, can raise money from individuals through charitable donations, and have an easier time attracting private foundation grants and certain types of government support. Notwithstanding these benefits, a charity may not be the exclusive or best option if some or all of an entrepreneur's planned activities do not fall within the charitable scope permitted by section 501(c)(3). Even when proposed activities do arguably advance charitable purposes, entrepreneurs may nonetheless consider housing those activities in a for profit that can — unlike a charity — raise money through offering equity, options, and other similar securities. In addition, privately held for profits (unlike nonprofits) avoid extensive regulatory restrictions and disclosure regimes. As another consideration, entrepreneurs might want to take advantage of perceptions associated with different vehicles (e.g., that for profits are effectively run business operations or that charities clearly emphasize the philanthropic motivation behind the founders' endeavors). Finally, if the enterprise will operate internationally, the laws in other countries sometimes drive the choice of entity.

Increasingly, social entrepreneurs are questioning whether they have to choose only one entity. With correct planning, the entrepreneur can pursue a tandem structure, forming both a charitable nonprofit and a for profit that operate in a complementary fashion to pursue the founder's goals. (We avoid using the term "hybrid" to describe this structure, in order to distinguish two-entity tandem structures from hybrid entities, such as a low-profit limited liability company (L3C) or benefit corporation, that display nonprofit and for profit characteristics within one legal entity.) For example, a nonprofit entity that operates businesses (bakery, restaurant, catering, moving, computer repairs) to provide education and job training to certain populations might establish a for profit entity to house a very similar business that can provide jobs to graduates from the nonprofit program. As another example, a variety of for profit service providers (such as web design and publicity, fundraising, educational consultants, psychotherapists) have been involved in establishing charitable entities to provide similar services on a subsidized basis to other charities or particular disadvantaged groups.

In some tandems, which we refer to as having a brother-sister structure, the organizations are linked together, often only loosely, by some overlap in board members and possibly executive management, and often enter into licensing, services, resource sharing, or other agreements. Alternatively, an entrepreneur can use a parent-subsidiary structure in which the charity holds some or all of the equity in a for profit subsidiary, and thus has some or total control over the for profit. (Less commonly in the social enterprise arena, a for profit entity can control a nonprofit entity as its member or designator. This structure is typical for a company and company foundation, for example. However, if the charity engages in operations that are similar to those of the for profit, such control by a for profit entity of a charity makes it difficult for the charity to demonstrate sufficient independence and focus on its own charitable goals. Thus, control by the for profit entity over the charity is typically not a good fit for a social enterprise tandem.)

Tandem structures allow entrepreneurs to take advantage of some of the benefits offered by both charities and for profits. However, operating in two worlds is not without its complications. In exchange for their tax exemption and ability to receive tax-deductible contributions, charities must comply with a broad range of rules, and are regulated by the IRS, state attorneys general, state tax authorities, and possibly additional agencies. This article discusses ten key considerations applicable to a charitable nonprofit involved in a tandem relationship with a for profit entity. Unless otherwise noted, the considerations are relevant to both the brother-sister and parent-subsidiary contexts.

1. Charities Must Further A Recognized Charitable Purpose

While the social entrepreneur may think of the tandem she creates as being part of one social enterprise in which the two parts work together for some greater social good, the charity needs a distinct and specific kind of identity. In order for the charitable nonprofit to receive and maintain section 501(c)(3) tax exemption, it is crucial for the charity to have a clearly identified charitable purpose that it furthers through its activities. The purpose must fall under those purposes recognized as charitable under section 501(c)(3), accompanying regulations, and rulings, such as aiding the poor and distressed, educating individuals or the public, promoting health, or protecting the environment. Very importantly, the charity's initial exemption application that a charity presents to the IRS, as well as future annual filings and other information on the charity, should demonstrate that the intent of the charity is *not* to further the purposes of the for profit entity (which the IRS will tend to assume are not charitable), or even some joint purpose that does not clearly fall under the section 501(c)(3) definition. While the section 501(c)(3) rules are flexible enough to permit insubstantial non-charitable activities, the charity needs to show that it primarily furthers IRS-recognized charitable purposes.

2. Be Careful Using Pass-Through Entities Or Single-Member LLCs For The For Profit

In tandem structures where the entrepreneur wants the charity to hold equity in the for profit, the entrepreneur needs to exercise some caution in the type of legal entity he or she chooses for the for profit subsidiary. Choices could include a C corporation, a limited liability company (LLC) or a partnership. (Charitable nonprofits typically avoid holding shares of an S corporation because of unrelated business income tax concerns, so all references to corporations are to C Corporations.)

Partnerships and multiple member LLCs are typically, taxed on a "pass through" basis, meaning the entity pays no entity-level tax, and simply passes profits and losses (and the related tax obligations) through to the partners/members. If there are no outside investors, the for profit entity could also be structured as single-member LLC, which typically elects to be disregarded for federal tax purposes. Treas. Reg. section 301-7701-3.

As discussed above, charities must be substantially operated for charitable purposes or else risk their tax exempt status. Activities (including those unrelated to a charitable purpose) that are housed in a for profit C corporation are not generally attributable to charities that hold stock in the corporation, and thus should not threaten the charity's exemption. In contrast, where a charity holds equity in, and participates in the management of, a pass-through for profit, the IRS may view the charity as participating to some extent in the activities of that for profit. (The activities of an LLC treated as a partnership are considered to be the activities of the nonprofit member when evaluating whether the nonprofit is operated exclusively for exempt purposes). Rev. Rul. 98-15, 1998-1 C.B. 718. If the pass-through entity is carrying out unrelated activities, those activities may be partially attributed to the charity. If the activities attributed to the charity are a large enough portion of what the charity does, they may endanger the charity's exempt status. (Similar issues arise where a charity is engaged in a joint venture with an unrelated for profit.)

If the unrelated activities of the pass-through generate net income, the charity may receive unrelated business taxable income (UBTI) and need to pay taxes. IRC section 512(c) requires a tax-exempt partner to include as UBTI any income earned by a partnership from activities that would be unrelated businesses if operated directly by the tax-exempt partner. In a single-member LLC, the activities of the LLC will be attributed to the charity for purposes of analyzing if the charity is operating in furtherance of charitable purposes. (Announcement 99-102, 1999-2 C.B. 545 and Richard A. McCray and Ward L. Thomas, *Limited Liability Companies as Exempt Organizations—Update,* IRS Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001 (2001) at 29.) For purposes of further discussion, we will assume that the social entrepreneur chooses a taxable C Corporation for the for profit portion of the tandem structure.

3. Consider Carefully Who Will Control Each Entity: Avoid 100 Percent Overlap On Boards

Two key governance decisions for the entrepreneur establishing a tandem social enterprise are who will appoint and remove the governing board of each entity and who will serve as directors on each governing board. With respect to for profits, in a brother-sister tandem, the founding entrepreneur, possibly with other collaborators and/or investors, may be the controlling equity holder of the for profit, and thus may appoint herself and others to the for profit's governing board. In a parent-subsidiary structure, the nonprofit is the only (or at least the controlling) equity holder of the for profit, and thus appoints the for profit's directors. On the nonprofit side, it is legally possible for the founder to act as member or designator with the right to appoint all or a majority of the nonprofit's governing board. On the other hand, a typical nonprofit governance structure is to have directors elect their own successors. The nonprofit's bylaws can also permit a combination of these options. Either entity's bylaws could also require a certain amount of overlap between the two boards. Having control through appointment power and/or overlapping boards ensures that the two entities will stay aligned in their parallel missions. However, there are several reasons to avoid 100 percent control and overlap between the two entities.

Focus On Charitable Purpose

As mentioned above, a charity needs to operate for clearly defined charitable purposes that are not blurred with the purposes of the for profit. Having board members of the charity that only serve on the charity's board and have no connection to the for profit can help the charity to focus on its charitable purposes and help convince charity regulators that it is operated for charitable purposes. Avoiding 100 percent overlap also helps the directors on both boards be very clear about when they are meeting as the board of the for profit or the board of the nonprofit, which can get confused if the board compositions are identical.

Approving Interested Party Transactions

For certain legal transactions, it is required or at least highly desirable for the charity to have some board members who are not affiliated with the for profit entity. Various regimes provide that in a transaction between the two entities within a tandem, where anyone in a position to influence the charity's decisions has an interest in the for profit, the interest must be disclosed, and the transaction needs to be approved by the "disinterested directors" of the charity; i.e., those directors who do not have an interest in the transaction because of their relationship to the for profit. Furthermore, under typical state corporate laws, directors of the charity have a duty of loyalty to the charity, making it difficult for them to review and vote on transactions with the for profit entity if they have a financial stake in or have fiduciary duties to the for profit entity as well. Again, to avoid a breach of fiduciary duties, only directors of the charity without interests in the for profit should approve transactions between the two entities. (The same fiduciary duties apply to the directors of the for profit corporation; a for profit director who has an interest in or fiduciary duty to the nonprofit should abstain from voting on transactions with the nonprofit.) It is legally unclear whether the fact that a for profit insider, such as the founder, appoints otherwise unaffiliated directors to the nonprofit board makes those directors "interested," since there is a sense that they are beholden to the person who appointed them. The conservative approach would be to treat them as interested directors as well.

Separate Identities

As indicated above, if a for profit is set up in corporate form, even if the charity is the sole shareholder, the IRS will tend to respect the two legal entities and not ascribe the for profit's activities to the charity (which could result in loss of exemption). However, in some rulings, the IRS has expressed some reluctance to treating the activities of a charity's for profit subsidiary as separate if, among other things, too many of the subsidiary's directors consist of directors or officers of the charity parent. Priv. Ltr. Rul. 95-42-045 (July 28, 1995).

4. Special Issues Where A Charity Holds a Controlling Share Of The Stock Of A For Profit.

In addition to the considerations discussed above regarding control and overlap between the tandem entities, special legal issues are raised when a charity has a controlling share of the stock of a for profit. Note that with limited exceptions for program related investments and functionally related businesses, discussion of which go beyond the scope of this article, charities that are categorized as private foundations holdings must avoid owning a controlling stake in for profits so this section applies only to charities classified as public charities for federal tax purposes. (Discussed below.)

Unrelated Business Taxable Income

The unrelated business taxable income rules set forth in sections 511 through 514 go beyond the scope of this article. However, if a charity has more than 50 percent control over a for profit subsidiary, then certain otherwise non-taxable passive income streams from the for profit to the charity (e.g., rents, royalties, capital gains, interest) become taxable to the charity. For a subsidy set up as a regular stock corporation, control is determined by reference to vote or value, for a partnership, control is determined by the total profits interest or the total capital interests, and for other entities, control is determined by the beneficial interests. §512(b)(13)(D). If such income is anticipated or necessary under the entrepreneur's business plan, the charity may consider reducing its equity and thus its control over the for profit to less than 50 percent. Depending on the circumstances, it may alternatively plan to avoid or reduce those types of income streams, or simply decide that it is acceptable to pay the tax.

Disclosure Rules Capturing Related Organizations

Charities over a certain size have to file the Form 990 information return with the IRS (and often with state regulators) on an annual basis. Although there is a Form 990-EZ for organizations between the $50,000 and $200,000 marker (for 2011), charities that control a for profit cannot file Form 990-EZ, and must instead file the regular Form 990. (The comments in this section are not relevant to filers of the very simple Form 990-N (for 2011, charities with gross receipts that are normally less than $50,000).) The Form 990 is a public document. When charities own more than 50 percent of the stock (by vote or value) of a subsidiary, the charity has to disclose information about that for profit (and sometimes its employees) that would otherwise have remained private. Entrepreneurs may find it surprising that if any of the charity's directors, officers, or key personnel are also on the payroll of the subsidiary, their pay from that for profit is included in a very prominent compensation table within the charity's Form 990. In addition, there is a stand-alone schedule at the back of the Form 990 in which the charity identifies its interest in the subsidiary and describes the type and amount of the transactions between the charity and the for profit. Charities should also be familiar with state disclosure rules applicable to them, some of which can be broader than the federal regime. Depending on the specifics of the relationship, aspects of a brother-sister tandem relationship may also need to be disclosed.

5. The Two Entities Must Respect Their Separate Legal Status

Under state corporate law, the separation of sister corporations or parent-subsidiary corporations may not be acknowledged, and thus someone suing one corporation may be able to reach the assets of the other corporation, if in fact the two corporations do not operate as two separate entities, but rather as a "single enterprise." One important factor in protecting the separation of the two corporations is to carefully observe all corporate formalities, such as separate meetings of staff, boards, and committees, and separate minutes of meetings. Another factor is avoiding commingling of assets, by always using separate bank accounts. The entities should maintain an arm's length relationship, for example by not using the assets of one entity to pay for an obligation of the other entity without a written agreement, or having one entity provide goods or services to the other entity without a written agreement. Keeping these legal boundaries separate can be important for liability protection, as well as to help persuade the IRS that the charity has discrete charitable operations and is carefully managing its charitable assets with well-defined boundaries between itself and its for profit counterpart. If the two entities do want to share resources such as staff or offices, a written resource sharing or services agreement is important.

6. The Charity Must Demonstrate Independence In Its Operations

In many tandems, the parties are interested in entering into licensing or services contracts with each other. For example, a public relations for profit may plan to offer its services to a tandem charity, which will in turn offer these public relations services to other charities at a significantly discounted rate. The charity must have a sense of independence in working with the for profit. A charity should only enter into a services or resource-sharing contract with the for profit if the terms are at least as favorable as those it could achieve with a third party. If another service provider can offer a better deal, the charity needs to have the willingness and ability to work with the other entity. In addition, the IRS typically does not like to see contracts in which the charity would be required to work with the related for profit for a long period of time without the ability to terminate the contract. If the charity does end up primarily working with the tandem for profit, its Board meeting records should reflect a thoughtful consideration of that choice, and the disinterested directors should approve the agreement. Note that the focus is on protecting the options of the charity. It would be acceptable, for example, for the charity to require the for profit to only engage with the charity for certain purposes that benefit the charity, if the charity has the option to terminate the contract.

7. Be Aware of Restrictions On The Use of Charitable Capital

In some tandems, the entrepreneur is interested in having the charity invest charitable dollars in the for profit, either as an equity investment or possibly as a loan. In cases where a tandem structure is being used for some reason other than the need to spin out so-called "unrelated activities" to a subsidiary, the charity may be able to make the argument that its contribution to the for profit (debt or equity) should fall outside the ambit of any state law investment standards because the charity's outlay of cash is directly furthering its charitable purposes and that its investment is a program-related asset, similar to a grant. In contrast, where a tandem is being used because of the presence of unrelated activities in the for profit, the charity's contribution in return for stock or loan is typically treated as a "real" investment. In addition to complying with any restrictions in its own charter documents or any gift instruments through which it received its assets, the charity should be aware of any applicable state law prudent investment standards, which may be found, among other places in versions of The Uniform Prudent Management of Institutional Funds Act, adopted in many states. (If the nonprofit is categorized as a private foundation for federal tax reasons, it is subject to another (not necessarily the same) prudent investor standard set forth in section 4944.) Based on these standards, the charity will often be limited in the amount of charitable assets it can invest in the for profit, especially a new, speculative venture.

8. The Charity Should Attempt To Avoid Private Foundation Status

We have assumed that the charitable entity in the tandem structure is a charity described in section 501(c)(3). section 501(c)(3) entities are classified for federal tax purposes as either private foundations or public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. The private foundation laws impose a two percent tax on investment income, limit self-dealing and business holdings, require annual distributions, prohibit lobbying entirely, and restrict the organization's operations in other ways. Also, large donors to a private foundation have a lower ceiling on the amount of deductible gifts they can claim each year. Given that a private foundation is limited in how much of a for profit enterprise it can own, a charity wanting to own a for-profit subsidiary may want to consider how to avoid private foundation status.

A section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any of three ways:

- By being a certain kind of institution, such as a church, school, or hospital. §509(a)(1).;
- By meeting one of two mathematical public support tests. §509(a)(2); or
- By qualifying as a supporting organization to another public charity. §509(a)(3).

Given the restrictions on private foundations, it is worth careful consideration whether the charity in a tandem structure can qualify as a public charity. For example, one strategy may be to raise public donations into the charity but direct other types of revenues, such as royalties, to the for profit subsidiary.

9. Charities Cannot Unduly Benefit Private Actors, Especially Insiders

A general federal tax principle applicable to all section 501(c)(3) organizations prohibits them from operating in a way that benefits private rather than public interests. Private interests could include the financial interests of a sister or partly-owned subsidiary (or outside investors in such entities). Egregious violations of this broad prohibition could result in revocation of tax-exempt status.

The IRS is particularly sensitive to a charity providing benefits to charity insiders. Section 4941 prohibits many financial transactions between private foundations and certain insiders, such as leases or licensing agreements, even those which may have been done at fair market value,. For public charities, section 4958 contains technical rules (albeit more permissive than section 4941) about "excess benefit transactions" between charities and anyone in a position to exercise substantial influence over the charity (or certain of their family members or businesses in which such insiders or family members hold more than a 35 percent interest) — a group that the Code calls "disqualified persons." Notably, if an entrepreneur forms a tandem in which she sits on the Board of the charity, and in which she has a greater than 35 percent personal stake in the for profit, the for profit itself becomes a disqualified person and inter-company dealings (e.g., if the charity makes a loan to the for profit) become subject to section 4958. The Code allows the IRS to levy a penalty tax on any disqualified person who is deemed to receive more from a charity (or its controlled subsidiary) than what the charity receives in return. (In addition to a penalty levied against the charity, any charity managers who knowingly participated in the excess benefit transaction could be exposed to personal tax liability related to the value of the excess benefit conferred.) Also under section 4958, the disqualified person is required to correct the transaction and repay the excess benefit to the charity. Section 4958 provides that if a charity engages in careful due diligence and has the disinterested directors approve a transaction, the transaction receives a rebuttable presumption of reasonableness. Thus, such a procedure is recommended for most public charity transactions with disqualified persons. One strategy to avoid this heightened IRS scrutiny, or, for a private foundation, the outright prohibition of a transaction, is to ensure that certain individuals or entities avoid disqualified person status in the first place.

10. Getting Assets Back Out Of An Entity Can Be Difficult

Before an entrepreneur puts assets into either of the tandem vehicles, he or she should consider carefully the limits on getting the assets back out again. Once assets have been transferred to or developed in the charity it can only transfer assets to a related for profit (or to any other non-charity or private individual) if such a transfer is in the charity's best interest, complies with any purpose restrictions imposed on the assets, and typically only if it obtains fair market value. Private foundations would not be able to enter into this kind of transfer at all if the for profit or individual transferee is an insider under section 4941. The charity would, in many cases, be exempt from tax on the gains recognized in the transfer. In contrast, although there are no charitable restrictions on removing assets from the for profit, corporate for profits will face tax consequences if the entrepreneur decides at a later point in time to liquidate the for profit or to dispose of the for profit's assets. As a general matter, sections 336 and 337 require corporations to recognize gain or loss when appreciated or depreciated property is distributed in complete liquidation or sold in connection with such liquidation. Thus, if the for profit corporation holds highly appreciated real property, for example, a liquidation could result in considerable capital gains tax on the appreciation.

CONCLUSION • Social enterprise is very much about avoiding rigid distinctions between business and charitable vehicles and focusing rather on the social good an entrepreneur wants to accomplish. However, given the highly regulated nature of section 501(c)(3) charities, entrepreneurs need to be attentive to and precise about requirements for correctly operating them, especially when a charitable nonprofit is operating in tandem with a for profit. Fortunately, with sufficient attention to these requirements, an entrepreneur can operate successfully in the two worlds of for profits and nonprofits.

Summary Table

Ten Considerations for Tandems Involving a Charity	Model	
	Brother / Sister Model	Nonprofit Parent - For Profit Subsidiary
1. Charity Must Further 501(c)(3) Charitable Purposes	Yes	Yes
2. Careful about Structuring For Profit Entity as Pass Through Entity	Not a problem	Careful - activities may be attributed to parent charity
3. Avoid 100% Overlap of Boards	Avoid	Avoid
4 a. Control Can Lead to Unrelated Business Taxable Income	Not an issue	Control can result in UBTI
4 b. Control Can Trigger 990 Disclosure Issues	No control, but aspects of relationship still may need to be disclosed	Yes
5. Need to Respect Corporate Formalities, etc.	Yes	Yes
6. Charity Must Demonstrate Independence in Operations	Yes	Yes, except that charity may require for profit to do certain things
7. Careful about Charity Investing in For Profit Entity	Careful, may be deemed imprudent	Careful, although investment in controlled subsidiary more likely to be deemed prudent
8. Charity Should Attempt to Avoid Private Foundation Status	Yes	Yes, especially to avoid excess business holding rules
9. Charity Must Avoid Private Benefit, Benefit to Insiders	Yes	Yes
10. Difficulties Getting Assets Out of Entities	Similar considerations	Similar considerations

IMPACTBASE
IMPACT INVESTMENT FUND DATABASE

IMPACTBASE SNAPSHOT

AN ANALYSIS OF 300+ IMPACT INVESTING FUNDS

APRIL 2015

What's Inside...

INTRODUCTION

The impact investing industry is growing in prominence and size. In *Spotlight on the Market* (2014), a J.P. Morgan-GIIN report, 125 impact investors worldwide reported plans to increase impact investing commitments by 19% in 2014, from USD 10.6bn in 2013 to USD 12.7bn. Respondents also reported growth in their number of investments by 20% in 2013 and committed capital by 10%.[1]

Out of the 125 respondents, nearly half (61) were fund managers. These fund managers reported managing a total of USD 15.7bn in impact investment capital. Further, out of the 64 non-fund manager respondents, 47 reported investing at least some capital via intermediaries. Intermediaries are attractive to investors for various potential reasons. Given the nascent and frontier nature of many impact investing markets, intermediaries offer geographic and sectoral expertise that investors may lack. Further, given the relatively small size of some impact investments, investing via intermediaries offers many investors the opportunity to invest in larger amounts consistent with their mandates. In summary, the intermediary landscape is an increasingly important one in impact investing, and one worthy of further analysis.

ImpactBase is a preeminent source of data on impact investing funds[2] worldwide. Since its launch in August 2010, ImpactBase has steadily grown the number of funds listed on its platform, today profiling over 300 funds operating across geographies, sectors, asset classes, and impact themes. Although the database is not necessarily fully representative of the global impact investing fund landscape at large,[3] it is a significant and growing data set which provides several useful insights into the intermediary landscape.

This report—the GIIN's first comprehensive analysis of the data in ImpactBase—aims to highlight observable trends that will provide actionable data for impact investors. These report findings are based on data from **310 FUNDS** downloaded from ImpactBase in **AUGUST 2014**.[4]

Key Takeaways

- **THE IMPACT INVESTING FUND LANDSCAPE IS BROAD.** There are investment opportunities for nearly every investor, regardless of their target geography, asset class, impact theme, or rate of return.
- **THE IMPACT INVESTING FUND LANDSCAPE IS DEEP.** Over 40% of funds in ImpactBase report 3+ years of track record.
- **THERE ARE SIGNIFCANT MARKET-RATE INVESTMENT OPPORTUNITIES IN THE INDUSTRY.** More than 75% of the funds target returns comparable to traditional investments of a similar risk-return profile.
- **FUND MANAGERS ARE ACTIVELY LOOKING TO RAISE CAPITAL.** The average fund committed capital is USD 52.5m and the average fund target AUM is USD 110m.
- **IMPACT MEASUREMENT IS CORE TO FUND MANAGER ACTIVITY.** Nearly all impact fund managers use metrics to quantify their social and/or environmental impact, and over half track IRIS-compatible metrics. Many also report that they have been formally rated on their impact performance.

1 Saltuk, et al., *Spotlight on the Market*, 2014.

2 This report will use the terms 'funds' and 'intermediaries' interchangeably.

3 Given when ImpactBase first came online, many funds that launched prior to 2011 have not listed on ImpactBase, especially if they have not been in the process of raising additional capital. The data presented may exhibit a selection bias towards newer funds and those that are actively soliciting fundraising. Further, socially conscious funds tend to express the greatest interest in GIIN membership, and GIIN members are more likely to be aware of/list on ImpactBase. As a result, environmentally-focused funds are perhaps underrepresented on ImpactBase.

4 Note: All data used in this report is self-reported by fund managers contributing to ImpactBase. While the GIIN team makes best efforts to ensure accuracy of data, this is primarily the responsibility of contributors. Further, funds update their information in ImpactBase with varying frequency.

OVERVIEW OF FUNDS

Three key features that funds in ImpactBase report on are geographic focus, asset class type and target impact theme (see Appendix A for a taxonomy of impact themes). Tables 1-3 break down the number of funds in ImpactBase by these three features.

PE/VC funds represent approximately half of the funds profiled on ImpactBase. About 20% of funds are fixed income, while 20% also invest using multiple instruments. While PE/VC funds are quite dispersed in terms of geographic focus, fixed income and real asset funds have an especially strong focus on North America. The majority of fixed income funds have a social focus (76%), while PE/VC funds are more evenly distributed between being either only socially focused or having a triple bottom line strategy (i.e. funds that have both social and environmental impact objectives).

Over 25% of funds on ImpactBase invest only in North America (82). Forty-two funds invest only in Africa, 37 target only Asia, while 52 invest across multiple emerging market continents. There are also 42 funds that invest across a range of both emerging and developed markets.

Nearly half the funds on ImpactBase have a social focus (151), while 42 funds have an environmental focus. Environmental funds tend to focus their investment opportunities in North America (50%) while socially focused funds are more evenly distributed in terms of geographic focus. A sizeable number (115) have a triple bottom line focus.

TABLE 1: NUMBER OF FUNDS BY TARGET GEOGRAPHY AND ASSET CLASS

		ASSET CLASS					
TARGET GEOGRAPHIES	FIXED INCOME ONLY	PE/VC ONLY	REAL ASSETS ONLY	PUBLIC EQUITIES ONLY	FUND OF FUNDS ONLY	MULTIPLE INSTRUMENTS	TOTAL
AFRICA ONLY	3	27	3	0	0	9	42
ASIA ONLY	2	29	2	0	0	4	37
LATIN AMERICA ONLY	6	17	0	0	0	4	27
EUROPE ONLY	1	17	1	0	0	2	21
NORTH AMERICA ONLY	21	31	18	0	0	12	82
OCEANIA ONLY	0	0	4	0	0	1	5
MULTIPLE EMERGING MARKETS	13	19	0	0	2	18	52
MULTIPLE DEVELOPED MARKETS	0	0	1	0	0	1	2
MULTIPLE GEOGRAPHIES	16	13	1	2	0	10	42
TOTAL	62	153	30	2	2	63	310

TABLE 2: NUMBER OF FUNDS BY TARGET GEOGRAPHY AND IMPACT THEME

TARGET GEOGRAPHIES	IMPACT THEME: ENVIRONMENTAL FOCUS	SOCIAL FOCUS	TRIPLE BOTTOM LINE	OTHER[5]	TOTAL
AFRICA ONLY	0	24	17	1	42
ASIA ONLY	3	27	7	0	37
LATIN AMERICA ONLY	1	15	11	0	27
EUROPE ONLY	7	3	11	0	21
NORTH AMERICA ONLY	21	22	39	0	82
OCEANIA ONLY	3	1	1	0	5
MULTIPLE EMERGING MARKETS	3	37	12	0	52
MULTIPLE DEVELOPED MARKETS	0	0	2	0	2
MULTIPLE GEOGRAPHIES	4	22	15	1	42
TOTAL	42	151	115	2	310

TABLE 3: NUMBER OF FUNDS BY ASSET CLASS AND IMPACT THEME

ASSET CLASS	IMPACT THEME: ENVIRONMENTAL FOCUS	SOCIAL FOCUS	TRIPLE BOTTOM LINE	OTHER	TOTAL
FIXED INCOME ONLY	4	47	11	0	62
PE/VC ONLY	20	71	60	2	153
REAL ASSETS ONLY	13	3	14	0	30
PUBLIC EQUITIES ONLY	0	0	2	0	2
FUND OF FUNDS ONLY	0	1	1	0	2
MULTIPLE INSTRUMENTS	5	29	27	0	61
TOTAL	42	151	115	2	310

5 Two funds chose ‘other’ when reporting on their impact themes.

In the analysis that follows, certain categories will be removed due to low sample sizes: the 'public equities only' and 'fund of funds' only asset class categories and the 'other' category for impact theme. Geographic focus will be consolidated into three broader categories to streamline report findings.

Fund size is not specifically defined in ImpactBase, but is another useful tool for evaluating broader trends within this data set. Two-hundred and forty-one funds reported on committed capital (USD) and they are designated as follows:

- **SMALL**: Committed capital less than or equal to USD 20 million
- **MEDIUM**: Committed capital between USD 20 million and USD 50 million
- **LARGE**: Committed capital greater than USD 50 million

By comparing fund size against asset class and geography, certain industry assumptions are confirmed (see Figures 1 and 2). In general, real asset funds are more likely to be large in size, while emerging market funds tend to be smaller. Interestingly, there are more than twice as many 'small' PE/VC funds than there are 'large' ones.

FIGURE 1: ASSET CLASS AND FUND SIZE

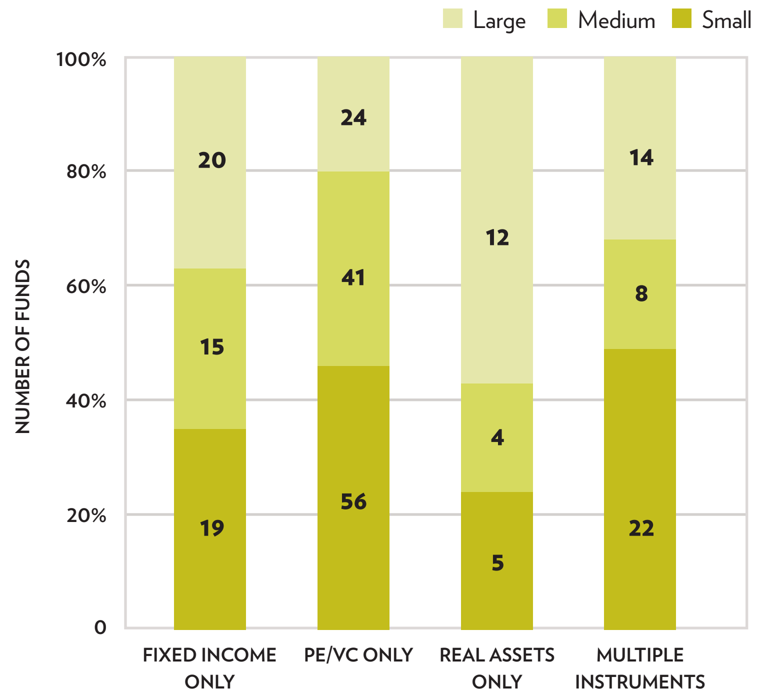
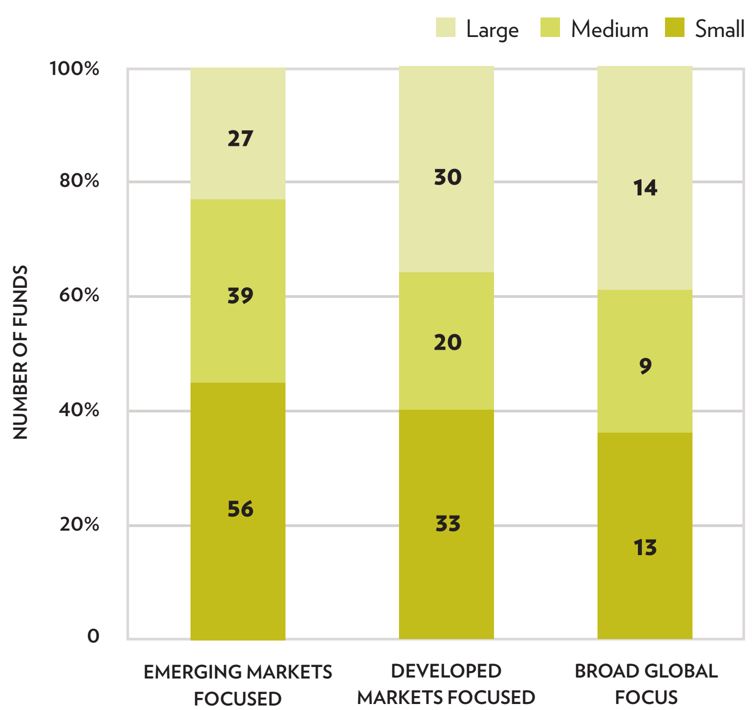


FIGURE 2: GEOGRAPHIC FOCUS AND FUND SIZE



INCEPTION YEAR AND TRACK RECORD

Most funds listed on ImpactBase have been incepted in recent years (please refer to footnote 3 for further information). As can be seen from Figure 3, nearly 70% were launched after 2009. Meanwhile, only 13% of funds were incepted prior to 2006. In particular, it is PE/VC funds that have driven recent growth (see Figure 4). Of funds that were incepted prior to and including 2005, nearly 50% were fixed income, while about 25% were PE/VC. However, of funds incepted post-2005, only 16% have been fixed income, while over 50% have been PE/VC.

Consistent with the distribution presented in Figure 3, most funds are currently open (72%, see Figure 5). Indeed, only 8% are currently marked as 'Completed' or 'Closed: no longer investing.'

FIGURE 3: FUND DISTRIBUTION BY INCEPTION YEAR

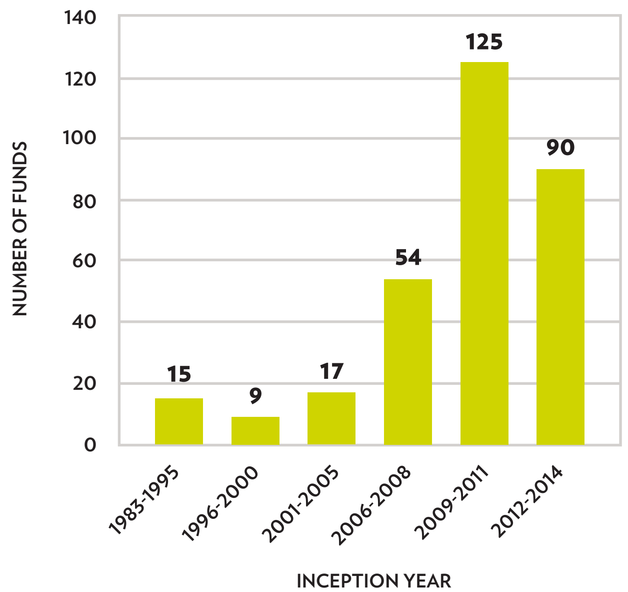


FIGURE 4: INCEPTION YEAR BY ASSET CLASS

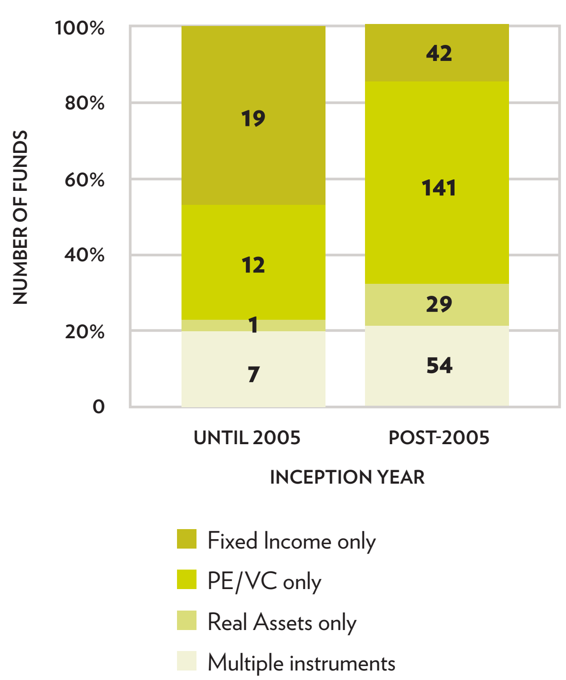
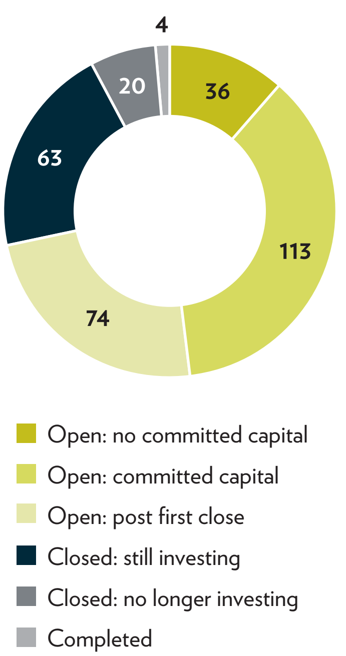


FIGURE 5: FUND STATUS (NUMBER OF FUNDS)



There is broad dispersion in terms of fund and fund manager track record amongst the funds listed in ImpactBase. Of the 308 funds reporting on track record, over 40% report 3+ years of track record, while just below 40% report no track record (either a new fund manager or a fund manager with some experience, but the fund itself has no track record).

The data does not indicate large variations across geography, impact theme, or fund size but breaking down track record by asset class reveals several noteworthy trends. Fixed income funds tend to have the most experienced fund managers, with over 69% of funds reporting 3+ years of track record. On the other hand, 60% of real asset funds have no established track record.

FIGURE 6: TRACK RECORD

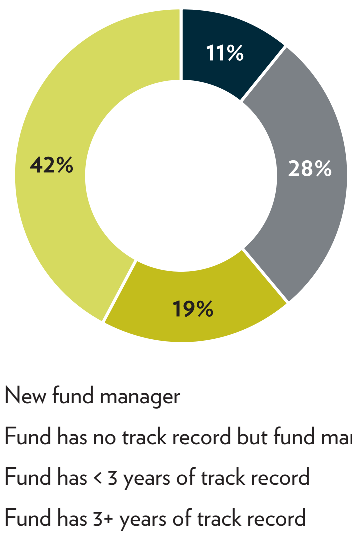
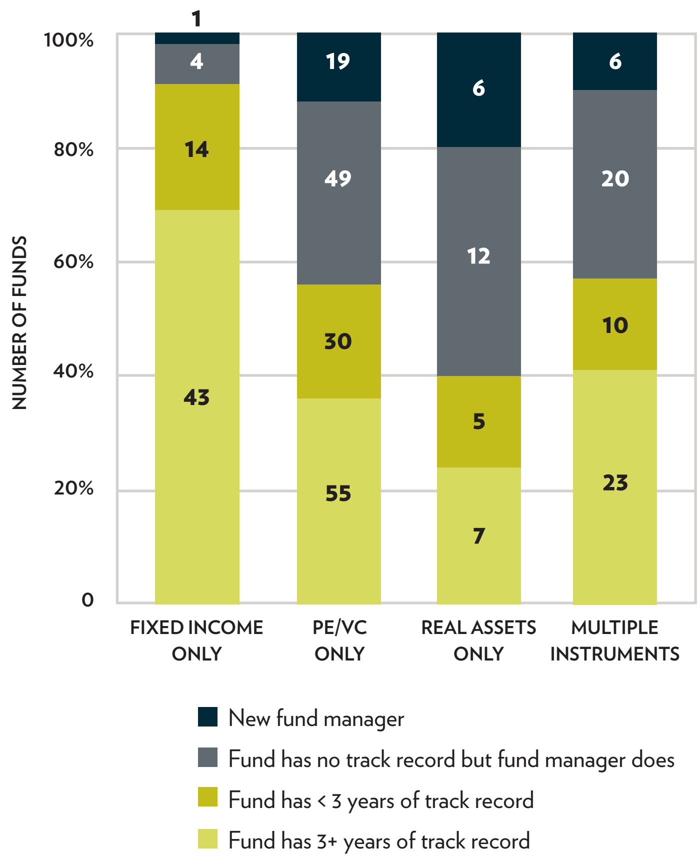


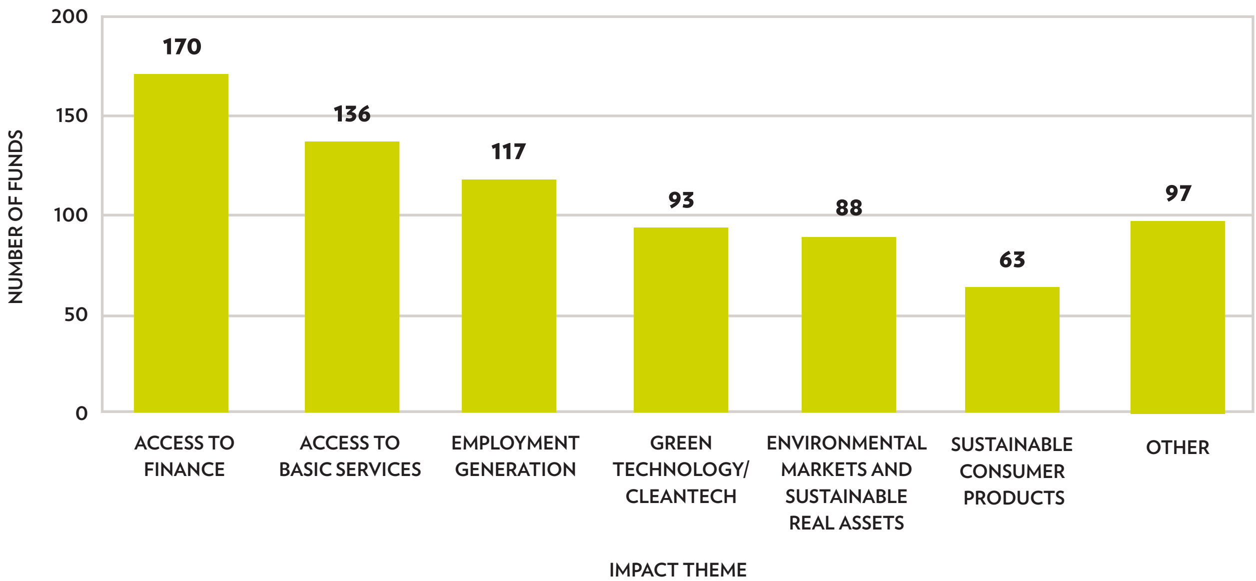
FIGURE 7: TRACK RECORD BY ASSET CLASS



IMPACT THEMES

As noted earlier, all fund managers reporting to ImpactBase provide information on their target 'impact themes.' Fund managers select from a range of impact themes across six broad categories (see Appendix A for a complete mapping). As can be seen from Figure 8, 55% percent of funds include 'access to finance' as an impact theme, 44% include 'access to basic services' and 38% 'employment generation.'

FIGURE 8: IMPACT THEMES[6]



There are also several sub-themes within the broader thematic categories that fund managers can select from. The most popular sub-themes are identified in Table 4. Within 'access to finance,' for instance, 'SGBs' and 'microcredit' are popular themes. 'Agriculture and food' and 'education' are the two most popular impact themes within 'access to basic services,' while 'sustainable land use' and 'energy efficiency' are also popular impact themes in other categories.

TABLE 4: POPULAR IMPACT THEME SUB-CATEGORIES[7]

IMPACT THEME	ACCESS TO FINANCE	ACCESS TO BASIC SERVICES	GREEN TECHNOLOGY / CLEANTECH	ENVIRONMENTAL MARKETS AND SUSTAINABLE REAL ASSETS	SUSTAINABLE CONSUMER PRODUCTS
TOP SUB-THEMES	Small Enterprises / SGBs (62) Microfinance-Microcredit (50) Medium Enterprises (44)	Agriculture and Food (43) Education (42) Health (37) Affordable Housing (37)	Energy Efficiency (37) Energy, Fuels & Generation (32) Waste Management / Recycling (17)	Sustainable Land Use (39) Carbon & Environmental Commodities (21) Green Real Estate / Green Building (18)	Food Products / Organics (25) Green Consumer Products / Services (14)

6 Impact themes are multi-select, i.e. fund managers can select more than one theme.

7 There are no sub-categories for 'employment generation'; see Appendix A for more details.

SOCIAL & ENVIRONMENTAL METRICS

Ninety-six percent of ImpactBase funds use performance metrics to quantify their social and environmental impact, of which over half track IRIS-compatible metrics.[8] The 13 funds that report not tracking impact metrics are concentrated in developed markets (10 are North American-based and three are European).

While most funds use social and environmental performance metrics, fewer than 100 funds listed on ImpactBase have been formally rated.[9] Of those that have, 37.5% identify as a Global Impact Investing Rating System (GIIRS) Pioneer Fund and the rest are rated by some other rating system, such as ImpactAssets 50, the CDFI Assessment & Ratings System (CARS), and IFC Performance Standards. It should be noted that 110 funds did not provide information on whether they've been rated.

FIGURE 9: SOCIAL AND ENVIRONMENTAL METRICS (NUMBER OF FUNDS AND PROPORTION)

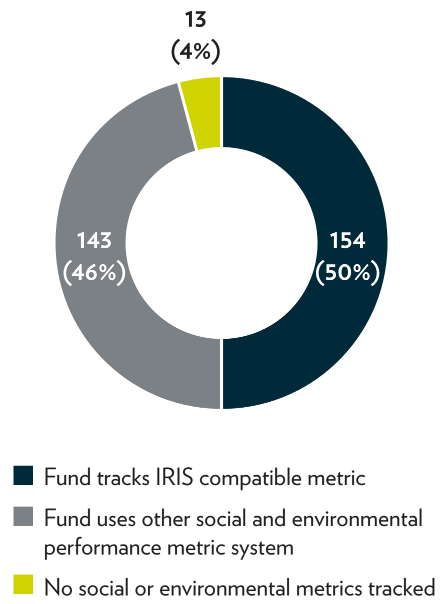
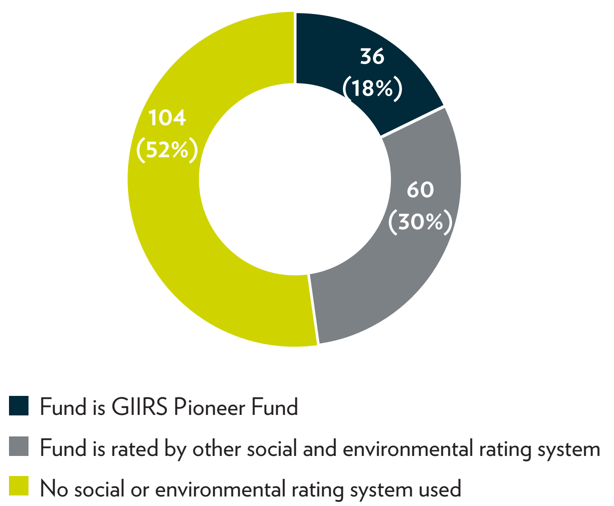


FIGURE 10: SOCIAL AND ENVIRONMENTAL RATINGS (NUMBER OF FUNDS AND PROPORTION)



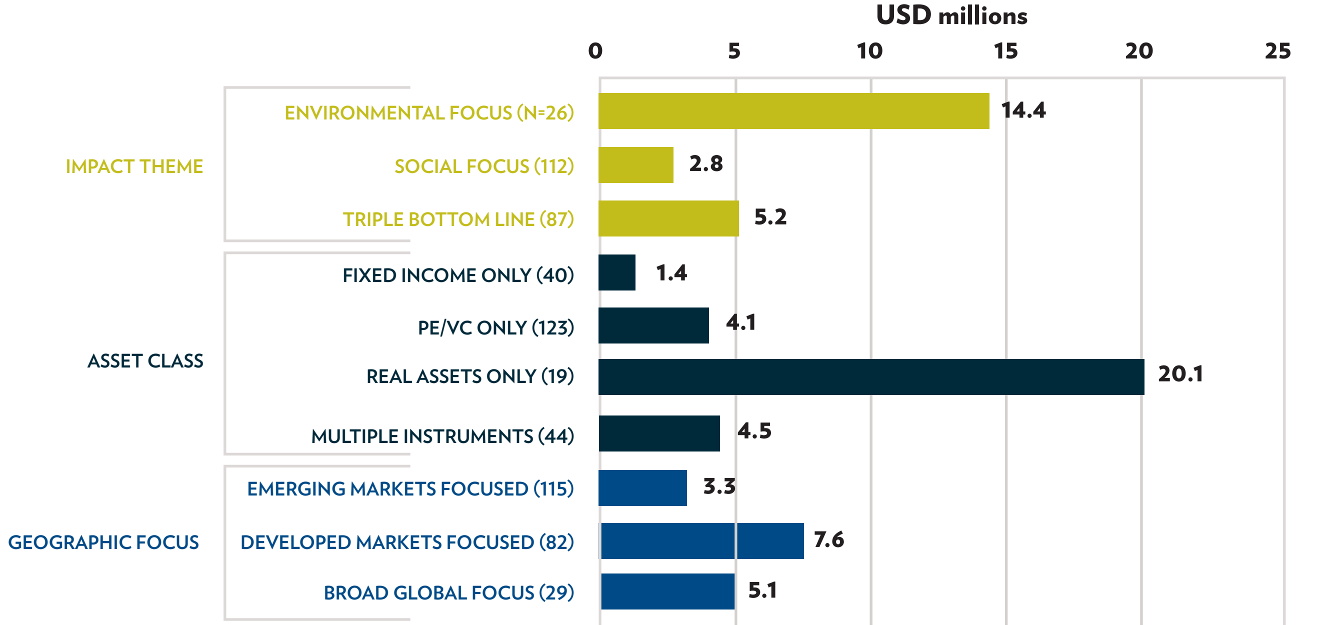
8 IRIS is the catalog of generally-accepted performance metrics that leading impact investors use to measure social, environmental, and financial success, evaluate deals, and grow the credibility of the impact investing industry.

9 200 funds report on social and environmental ratings.

FUND ACTIVITY

Many of the fund managers on ImpactBase report on average investment sizes. As might be expected, funds focused on making environmental investments have much larger average deal sizes (5×) than do those with a social focus. By asset class, those making real asset investments have significantly larger average deal sizes than others. Finally, those investing in developed markets have average deal sizes over 2× larger than those investing in emerging markets.

FIGURE 11: AVERAGE INVESTMENT SIZES BY IMPACT THEME, ASSET CLASS AND GEOGRAPHIC FOCUS



All funds also report data on the number of investments and exits they have made to date. The term 'exits' should be interpreted in context: In the case of fixed income, an exit could be the repayment of a loan which, for a revolving loan fund for instance, could lead to a high number of reported 'exits.' Table 5 shows that 55% of reported fixed income deals in ImpactBase have been exited. This compares with 14% for PE/VC and just 2% for real assets.

TABLE 5: INVESTMENTS AND EXITS TO DATE BY ASSET TYPE

	FIXED INCOME ONLY	PE/VC ONLY	REAL ASSETS ONLY	MULTIPLE INSTRUMENTS
INVESTMENTS TO DATE	14,644	975	228	2,037
EXITS TO DATE	8,093	139	4	269
% EXITED	55.3%	14.3%	1.8%	13.2%

FUND ECONOMICS

Table 6 presents the distribution of management fees, carried interest, and hurdle rates by asset class. Fixed income funds have the lowest average management fees, while PE/VC and real asset funds have the highest average carried interest.

TABLE 6: FUND ECONOMICS BY ASSET CLASS

	AVG MGMT FEE	N	AVG CARRIED INTEREST	N	AVG HURDLE RATE	N
FIXED INCOME ONLY	1.3%	40	2.7%	21	—	—
PE/VC ONLY	2.4%	127	18.2%	120	6.2%	95
REAL ASSETS ONLY	1.7%	28	18.1%	27	7.7%	25
MULTIPLE INSTRUMENTS	2.0%	51	14.2%	44	6.0%	31

Looking more closely at PE/VC funds only (Tables 7 and 8) shows how fund economics for these funds vary by geographic focus and fund size. The data suggests that, compared to funds focused on developed markets, those focused on emerging markets tend to have higher management fees, carried interest and hurdle rates. It is also evident that average management fees decrease with fund size, while carried interest and hurdle rates increase with fund size.[10]

TABLE 7: FUND ECONOMICS BY GEOGRAPHIC FOCUS FOR PE/VC FUNDS ONLY[11]

	AVG MGMT FEE	N	AVG CARRIED INTEREST	N	AVG HURDLE RATE	N
EMERGING MARKETS FOCUSED	2.5%	70	19.0%	67	6.8%	55
DEVELOPED MARKETS FOCUSED	2.3%	46	17.6%	44	5.2%	33

TABLE 8: FUND ECONOMICS BY FUND SIZE FOR PE/VC FUNDS ONLY

	AVG MGMT FEE	N	AVG CARRIED INTEREST	N	AVG HURDLE RATE	N
SMALL	2.4%	46	16.7%	44	4.7%	35
MEDIUM	2.3%	35	19.4%	33	6.6%	31
LARGE	2.1%	20	19.0%	18	8.4%	17

10 This analysis was repeated to look only at those funds that target 'market rate' returns (i.e. ignoring those that have a 'below-market' return philosophy) and the overall trends remained the same.

11 Not showing data for 'broad global focus' funds due to small sample sizes.

ImpactBase funds also provide data on target assets under management (AUM), which makes it interesting to compare committed capital with future fundraising targets. The average fixed income fund has achieved 65% of target AUM in committed capital, while the average PE/VC and real asset funds have greater funding gaps. When examining the breakdown by geographic focus, committed capital for North America focused funds is 65% of target AUM, while Africa- and Asia-only funds average 26% and 33% respectively (see Figure 13).

FIGURE 12: TARGET FUND AUM AND COMMITTED CAPITAL, BY ASSET CLASS[12]

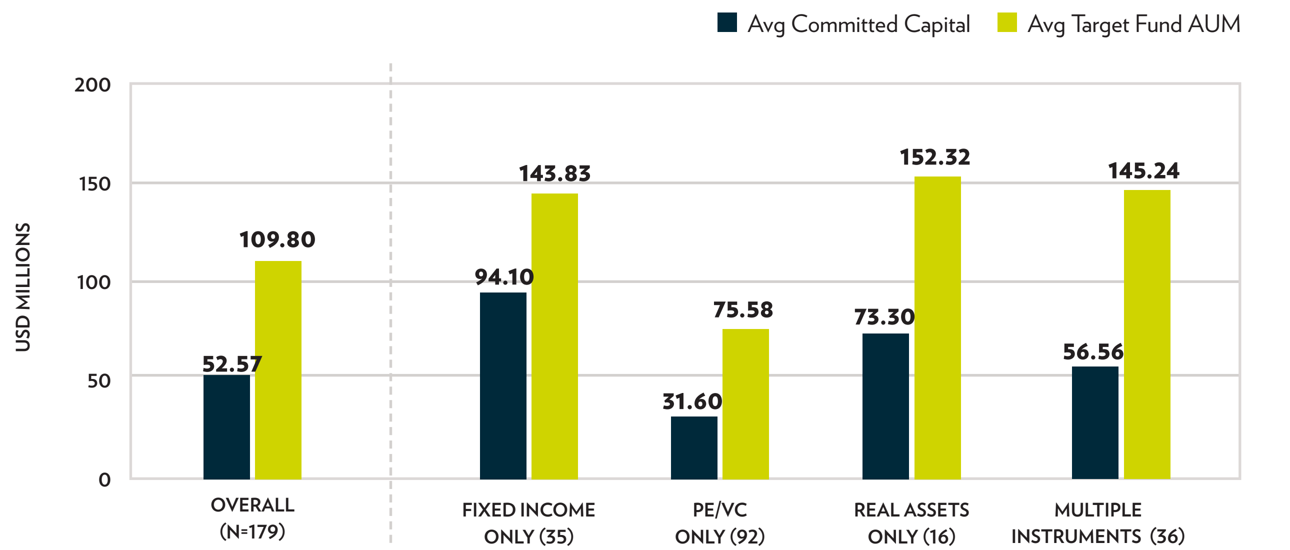
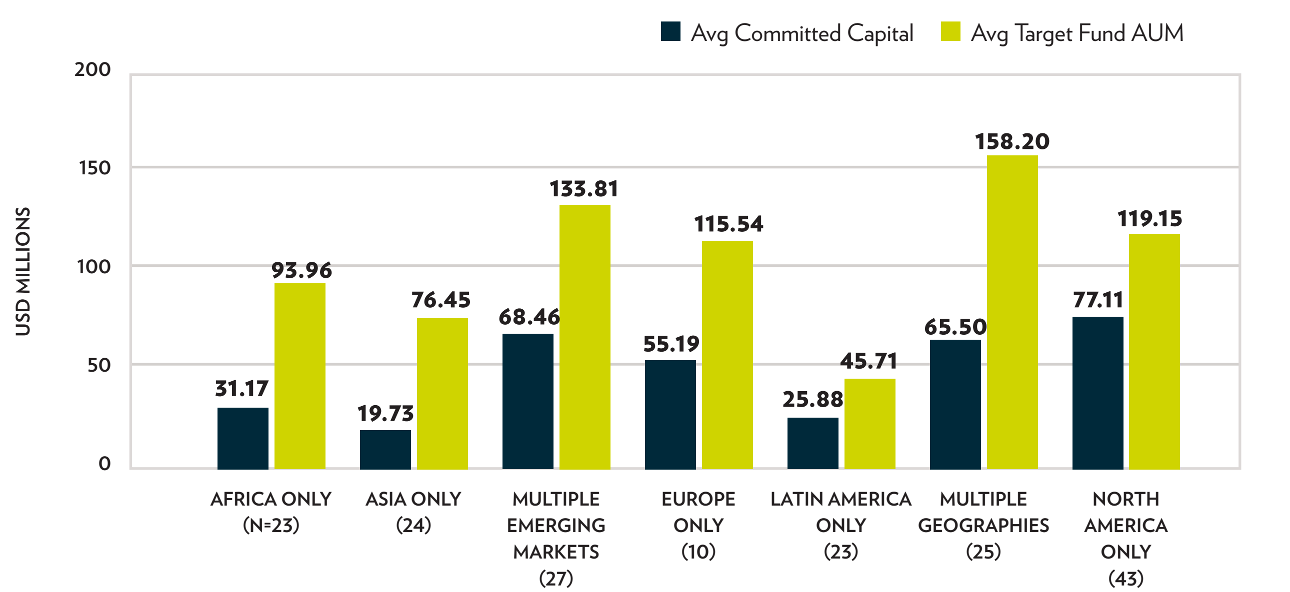


FIGURE 13: TARGET FUND AUM AND COMMITTED CAPITAL BY TARGET GEOGRAPHY[13]



12 Chart only includes cases where funds have submitted data for both target fund AUM and committed capital, a total of 179 funds.

13 Not showing regions with small sample sizes.

TARGET RETURNS

All 310 funds report on their general return philosophy—below-market, market rate, or both—and there are some interesting variations here by impact theme and asset class. Whereas nearly one-third of socially focused funds target below-market returns, environmentally focused funds overwhelmingly target market rate returns. By asset class, fixed income funds are the most likely (about 50%) to pursue below-market rates (see Figure 15). One might have thought that fund age may be driving this trend—many of the early impact investing funds made fixed-income deals only and when the impact investing industry was still in its infancy, it may have been more common for funds to target below-market returns. However, of the 28 below-market, fixed income funds, only four have an inception of 2005 or earlier. So, it appears that more recent fixed income funds are still embracing the philosophy of below-market returns. Real asset funds are all market rate, while about 80% of PE/VC funds also target market rate returns. While there are noticeable differences across asset class and impact theme, return philosophy does not vary by target geography.

Additionally, 215 funds reported their target IRR. Figure 16 displays how target IRRs range by asset class. In general, fixed income funds have significantly lower average target IRRs (4.8%) than do other asset classes, while PE/VC funds have the highest (17.5%).

FIGURE 14: NUMBER OF FUNDS BY GENERAL RETURN PHILOSOPHY AND IMPACT THEME

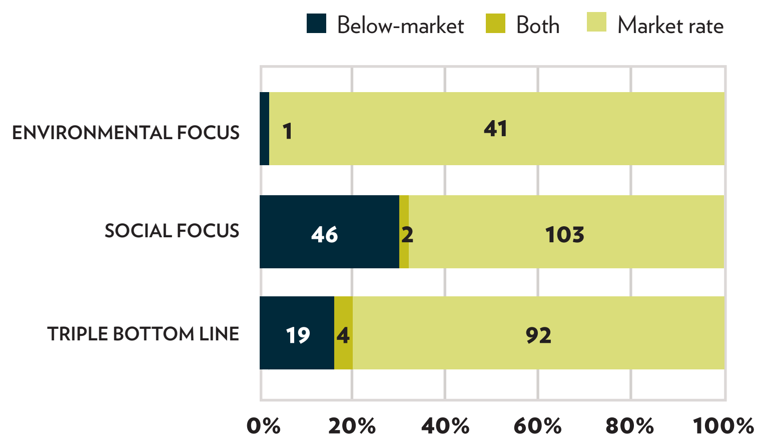


FIGURE 15: NUMBER OF FUNDS BY GENERAL RETURNS PHILOSOPHY AND ASSET CLASS

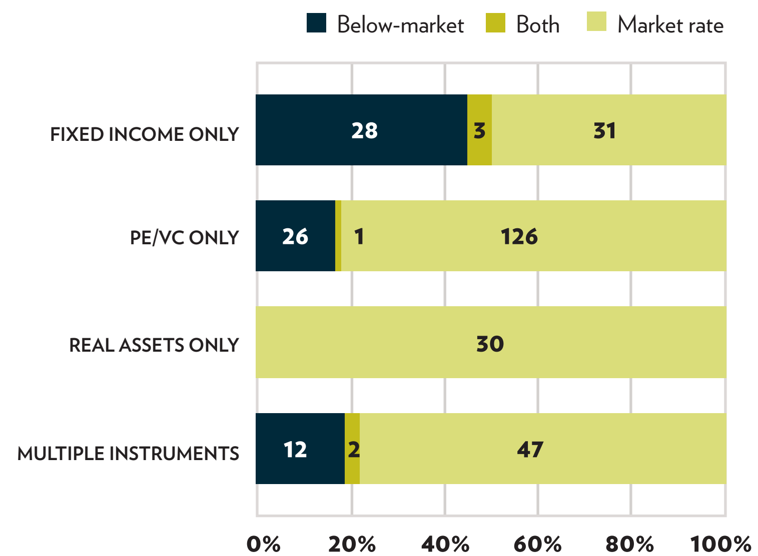
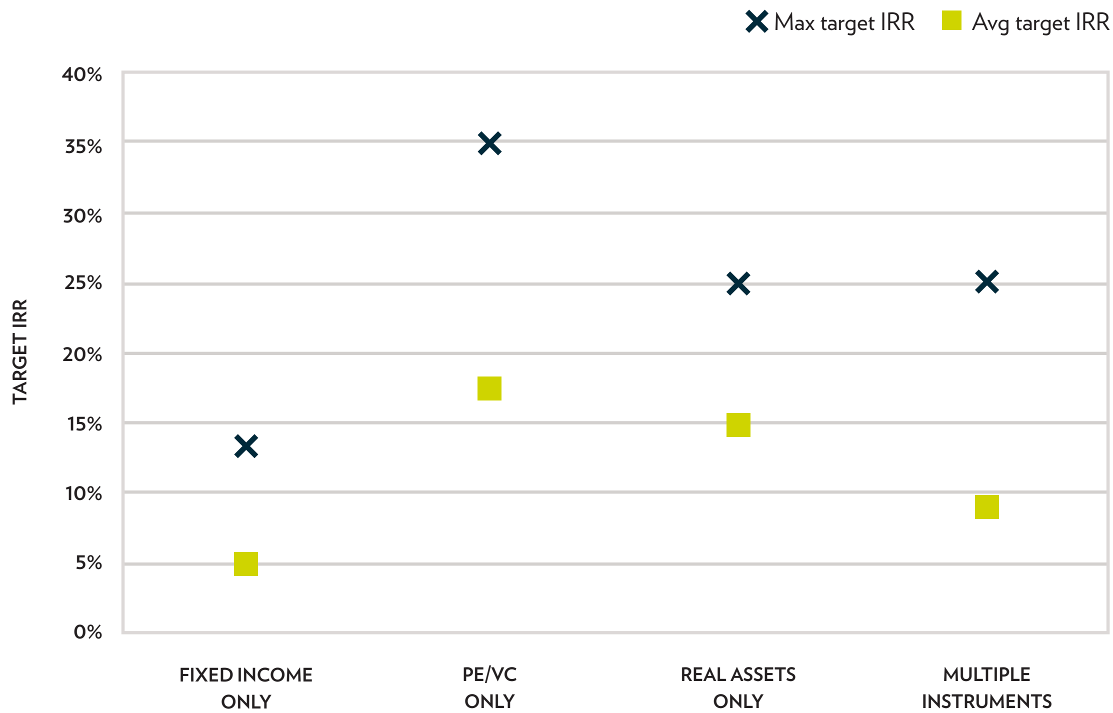


FIGURE 16: TARGET IRR BY ASSET CLASS [14]



In order to examine target IRR more closely, it is instructive to separate market rate and below-market funds (Table 9). Indeed, it is evident that target return categories can mean different things depending on target audience. For instance, fixed income funds seeking 'below-market' returns target an average IRR of 2.9%, while PE/VC funds seeking 'below-market' returns target 5.5% on average. Meanwhile, PE/VC funds seeking 'market rate' returns target 19.3% on average, while 'market rate' fixed income funds target 6.2%.

TABLE 9: AVERAGE TARGET IRR BY ASSET CLASS [15]

	MARKET RATE	BELOW-MARKET
FIXED INCOME ONLY	6.2%	2.9%
PE/VC ONLY	19.3%	5.5%
REAL ASSETS ONLY	14.9%	—
MULTIPLE INSTRUMENTS	13.9%	5.4%
OVERALL	16.2%	4.4%

14 These percentages are targets and should not be considered confirmation of actual returns. Only two funds reported a target IRR of 0%.

15 See Fig 15 for sample sizes for each cell.

FUNDRAISING

ImpactBase funds are asked to indicate the types of investors they target for fundraising. To clarify, these investor types are those which fund managers report *targeting*, rather than those from which they have necessarily actually raised capital. Tables 10-13 outline the target funding sources for market rate versus below-market funds as well as by impact theme, asset class, and geographic focus for 290 reporting funds.

Overall, 76% of market rate funds target family offices/HNWIs (High Net Worth Individuals) when fundraising and 71% appeal to foundations. At the other end, only 17% target retail investors, which is not surprising perhaps given that these are largely private funds available only to accredited investors. Interestingly, the biggest bucket (79%) is 'other institutional investors,' which would include insurance companies and commercial banks. When considering below-market funds, 86% appeal to foundations, while 'other institutional investors' and family offices/HNWIs are also prominent. Perhaps not surprisingly, whereas 50% of market rate funds target pension funds, only 21% of below-market funds do so.

TABLE 10: TARGET INVESTOR TYPES BY RETURN PHILOSOPHY

	DFIS/ DEVELOPMENT BANKS	ENDOWMENTS	FAMILY OFFICE/HNWI	FOUNDATIONS	PENSION FUNDS	OTHER INSTITUTIONAL INVESTORS	RETAIL INVESTORS
MARKET RATE OVERALL %	47%	43%	76%	71%	50%	79%	17%
MARKET RATE # OF FUNDS	111	103	181	170	119	187	41
BELOW-MARKET RATE OVERALL %	42%	39%	68%	86%	21%	71%	30%
BELOW-MARKET RATE # OF FUNDS	28	26	45	57	14	47	20

The data indicates some interesting differences in fundraising targets based on the geographic focus of funds. While 67% of emerging market-focused funds target Development Finance Institutions (DFIs) for funding, only 25% of developed market-focused funds do so. Meanwhile, 86% and 54% of developed market-focused funds appeal to foundations and pension funds, respectively, while only 69% and 39% of emerging market-focused funds do so.

TABLE 11: TARGET INVESTOR TYPES BY GEOGRAPHIC FOCUS

	DFIS/ DEVELOPMENT BANKS	ENDOWMENTS	FAMILY OFFICE/HNWI	FOUNDATIONS	PENSION FUNDS	OTHER INSTITUTIONAL INVESTORS	RETAIL INVESTORS
EMERGING MARKETS FOCUSED	66.5% (105)	39.2% (62)	72.2% (114)	69.0% (109)	38.6% (61)	76.6% (121)	16.5% (26)
DEVELOPED MARKETS FOCUSED	24.5% (27)	50.0% (55)	79.1% (87)	85.5% (94)	53.6% (59)	78.2% (86)	24.5% (27)
BROAD GLOBAL FOCUS	31.0% (13)	45.2% (19)	73.8% (31)	73.8% (31)	47.6% (20)	83.3% (35)	28.6% (12)

When examining the data by impact theme, one sees that environmentally-focused funds tend to solicit family office/HNWIs (90%) and foundations (88%) over DFIs/Development Banks (26%) for capital. In comparison, 51% of socially-focused funds target DFIs.

TABLE 12: TARGET INVESTOR TYPES BY IMPACT THEME

	DFIS/ DEVELOPMENT BANKS	ENDOWMENTS	FAMILY OFFICE/HNWI	FOUNDATIONS	PENSION FUNDS	OTHER INSTITUTIONAL INVESTORS	RETAIL INVESTORS
ENVIRONMENTAL FOCUS	26.2% (11)	52.4% (22)	90.5% (38)	88.1% (37)	57.1% (24)	81.0% (34)	23.8% (10)
SOCIAL FOCUS	51.0% (77)	35..8% (54)	66.9% (101)	69.5% (105)	35.8% (54)	75.5% (114)	19.9% (30)
TRIPLE BOTTOM LINE	48.7% (56)	51.3% (59)	80.9% (93)	79.1% (91)	52.2% (60)	80.0% (92)	20.9% (24)

Real asset funds are significantly more likely to appeal to pension funds (83%) and endowments (70%) than are other asset classes. Proportionally, fixed income funds are much more likely to target retail investors.

TABLE 13: TARGET INVESTOR TYPES BY ASSET CLASS

	DFIS/ DEVELOPMENT BANKS	ENDOWMENTS	FAMILY OFFICE/HNWI	FOUNDATIONS	PENSION FUNDS	OTHER INSTITUTIONAL INVESTORS	RETAIL INVESTORS
FIXED INCOME ONLY	40.3% (25)	43.5% (27)	75.8% (47)	82.3% (51)	38.7% (24)	80.6% (50)	41.9% (26)
PE/VC ONLY	50.3% (77)	35.9% (55)	75.8% (116)	70.6% (108)	34.6% (53)	74.5% (114)	13.7% (21)
REAL ASSETS ONLY	30.0% (9)	70.0% (21)	76.7% (23)	80.0% (24)	83.3% (25)	80.0% (24)	6.7% (2)
MULTIPLE INSTRUMENTS	54.1% (33)	50.8% (31)	72.1% (44)	77.0% (47)	60.7% (37)	85.2% (52)	23.0% (14)

APPENDIX A—
IMPACT THEME TAXONOMY

THEMATIC AREA	SUB-THEMES	BROAD CLASSIFICATION
Environmental Markets and Sustainable Real Assets	■ Carbon & Environmental Commodities ■ Conservation Finance ■ Green Real Estate / Green Building ■ Sustainable Land Use (Agriculture or Forestry) ■ Water Quality & Rights Trading	Environmental
Green Technology/Cleantech	■ Energy, Fuels & Generation ■ Energy Efficiency ■ Materials Science ■ Transportation/Infrastructure ■ Water Technologies ■ Waste Management/Recycling	Environmental
Sustainable Consumer Products	■ Green Consumer Products/Services ■ Food Products/Organics	Environmental
Access to Basic Services	■ Affordable Housing ■ Agriculture & Food ■ Community Facilities/Infrastructure ■ Digital Access, Media, Technology ■ Education ■ Energy (Access) ■ Health ■ Water	Social
Access to Finance	■ Community Lending ■ Microfinance (Microcredit) ■ Microfinance (Other Services) ■ Medium Enterprises ■ Small Enterprises/SGBs ■ Trade Finance	Social
Employment Generation		Social
Other		

GIIN® IMPACTBASE

ABOUT THE GIIN AND IMPACTBASE

ImpactBase, an initiative of the Global Impact Investing Network (GIIN®), is a searchable, online database of impact investment funds and products designed for investors. ImpactBase provides players in the industry (such as individual investors, foundations, endowments, financial advisors and consultants, family offices, private bankers and development finance institutions) an efficient and organized mechanism for finding the information on funds that may fit with their impact investment interests and objectives.

The GIIN is a nonprofit organization dedicated to increasing the scale and effectiveness of impact investing. Impact investments are investments made into companies, organizations, and funds with the intention to generate social and/or environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below-market to market rate, depending upon the circumstances. The GIIN builds critical infrastructure and supports activities, education, and research that help accelerate the development of a coherent impact investing industry. For more information, please visit www.thegiin.org.

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CUI BONO?
OTHER CONSTITUENCIES STATUTES, BENEFIT CORPORATIONS AND FLEXIBLE PURPOSE CORPORATIONS

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TABLE OF CONTENTS

Page

CUI BONO?
OTHER CONSTITUENCIES STATUTES, BENEFIT CORPORATIONS AND FLEXIBLE PURPOSE CORPORATIONS

I. "TRADITIONAL" CORPORATIONS

A. Standards of Review Applicable to For-Profit Delaware Corporations

1. **Business Judgment Rule**—Generally speaking, the business judgment rule provides that a decision by a board of directors in which the directors possess no direct or indirect personal interest, which is made with reasonable awareness of all reasonably available material information and after prudent consideration of the alternatives, and which is in good faith furtherance of a rational corporate purpose, will not be interfered with by the courts, either prospectively by injunction, or retrospectively by imposition of liability for damages upon the directors, even if the decision appears to have been unwise or to have caused loss to the corporation or its stockholders.

    - *McMullin v. Beran*, 765 A.2d 910, 916 (Del. 2000) (holding that the business judgment rule "combines a judicial acknowledgement of the managerial prerogatives that are vested in the directors of a Delaware corporation by statute with a judicial recognition that the directors are acting as fiduciaries in discharging their statutory responsibilities to the corporation and its shareholders").

    - *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995) (holding that "a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be 'attributed to any rational business purpose'").

    - *Gagliardi v. Trifoods Int'l, Inc.*, 683 A.2d 1049, 1053 (Del. Ch. 1996) (holding that the business judgment rule "provides that where a director is independent and disinterested, there can be no liability for corporate loss, unless the facts are such that no person could possibly authorize such a transaction if he or she were attempting in good faith to meet their duty").

2. **Entire Fairness**—Where a board of directors of a target corporation does not consist of a majority of disinterested directors, entire fairness scrutiny may apply to acquisition transactions: the transaction must be fair as to both price and process.

    - *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110 (Del. 1994) ("It is a now well-established principle of Delaware corporate law that in an interested merger, the controlling or dominating shareholder proponent of the transaction bears the burden of proving its entire fairness.”).

- *In re Cysive, Inc. S’holders Litig.*, 836 A.2d 531 (Del. Ch. 2003) (holding that 35% stockholder and founder of company was controlling stockholder and applying entire fairness test despite presence of majority of disinterested, independent directors and effective special committee process; concluding after trial that management buy-out was entirely fair).

- *In re Southern Peru Copper Corp. S’holder Deriv. Litig.*, 30 A.3d 60 (Del. Ch. 2011) (applying entire fairness standard to review merger in which NYSE-listed company (Southern Peru) acquired its majority stockholder’s (Grupo Mexico) 99% stake in a mining corporation (Minera); holding, post trial, that Grupo Mexico and the Grupo Mexico affiliated directors on Southern Peru’s board breached their duty of loyalty and awarding $1.26 billion (plus interest) in damage), *aff’d sub nom. Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012).

- *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 460 (Del. Ch. 2011) (holding that “[w]hen a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections, the transaction will be reviewed for entire fairness with the burden of proof on the defendant fiduciaries”; stating that a “reverse split under those circumstances is the ‘functional equivalent’ of a cash-out merger”).

- In *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), the Delaware Supreme Court confirmed that a board’s decision to reject a merger offer is generally subject to the business judgment standard of review, but held that the entire fairness standard would apply if the plaintiffs could show that the board’s decision to reject the merger offer was not made in the good faith pursuit of a legitimate corporate purpose. The *Gantler* Court found that plaintiffs had met this burden by showing that a majority of the members of the board acted disloyally.

- However, entire fairness does not apply to “short form” mergers, absent fraud or illegality, *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001), and may not apply in controlling stockholder squeeze-outs if a properly-functioning, independent special committee approved the transaction and it was conditioned upon approval of a majority of the minority stockholders, *In re CNX Gas Corp. S’holders Litig.*, 2010 Del. Ch. LEXIS 119 (Del. Ch. May 25, 2010).

3. "Intermediate" Standards: *Revlon, Unocal* and *Blasius*

a. ***Revlon***—A number of Delaware cases have imposed a heightened standard on directors approving a change in control transaction. In such a situation, directors must maximize the short-term value of the consideration to be received by the stockholders, and courts will scrutinize the methods utilized to do so.

(i) Transactions Triggering Enhanced Scrutiny of *Revlon*

- *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (holding that when directors decide to sell the company in a cash-out merger to a third party, their role changes from protectors of the corporate entity to "auctioneers" whose duty is to get the best price for stockholders).

- *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1290 (Del. 1994) (quoting *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990)) (holding that the heightened standard will be applied: "(1) 'when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company'; (2) 'where, in response to a bidder's offer, a target abandons its long term strategy and seeks an alternative transaction involving the breakup of the company'; or (3) when approval of a transaction results in a 'sale or change of control'").

(ii) Stock/Cash Consideration Affecting Applicability of *Revlon* Review

- *In re Smurfit-Stone Container Corp. S'holder Litig.*, 2011 WL 2028076 (Del. Ch. May 20, 2011) (concluding, "based on . . . economic implications and relevant judicial precedent," in deciding a motion to preliminarily enjoin a merger, that *Revlon* duties applied to a mixed stock and cash consideration transaction in which 50% of the consideration was cash and 50% of the consideration was stock, but noting that the matter is "not free from doubt" because the Supreme Court "has not yet addressed this issue directly").

- *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022 (Del. Ch. 2012) (stating that a mixed consideration deal of 65% stock—in a widely traded, public company—and 35% cash did "not qualify as a change of control under our Supreme Court's precedent" because "control of the corporation remains, post-merger, in a large, fluid market," and, therefore, did not implicate *Revlon*).

- *But see Steinhardt v. Howard Anderson,* C.A. No. 5878-VCL, tr. at 4 (Del. Ch. Jan. 24, 2011) (TRANSCRIPT) (suggesting, but not holding, in context of transaction involving 50% stock and 50% cash that *Revlon* should apply regardless of the composition of consideration because there is a "final stage transaction," meaning "[t]his is the only chance that [target] stockholders have to extract a premium, both in the sense of maximizing cash now, and in the sense of maximizing their relative share of the future entity's control premium").

(iii) Ability to Treat Different Bidders Differently

- *In re Novell, Inc. S'holder Litig.*, 2012 WL 6761917 (Del. Ch. Jan. 3, 2013) (denying motion to dismiss plaintiffs' claims that outside directors breached their fiduciary duties by "treat[ing] a serious bidder in a materially different way and that approach might have deprived shareholders of the best offer reasonably attainable" in connection with a sale of the company transaction where target corporation's financial advisor contacted over fifty potential buyers in a pre-signing market check, but plaintiffs alleged that (1) the board treated two bidders who had submitted roughly comparable bids—the eventual winning bidder and "Party C"—differently by permitting the winning bidder, but not Party C, to partner with other investors and by providing the winning bidder, but not Party C, with certain information that, if known to Party C, might have led to an increased bid and (2) one director who was previously affiliated with one of the winning bidder's partners provided information regarding confidential board deliberations to his former affiliate; noting that the board "could have dealt with bidders differently if the shareholders' interests justified such a course," but that the court could not determine if such reasons existed on a motion to dismiss).

(iv) *Revlon* and Banker Conflicts

- *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432 (Del. Ch. 2012) (concluding that plaintiffs had shown a reasonable probability of success on their *Revlon* claims challenging a merger where, among other issues, (1) target board retained target's longtime investment bank to represent the target in connection with a spin-off that was being considered as the main alternative to the merger where the financial advisor held a *disclosed* $4 billion stake in the acquiror and the lead banker on the financial advisor's team representing the target held an *undisclosed* $340,000 stake in the acquiror and (2) the valuation advice and tactics of a second financial advisor retained to advise target in connection with the merger—to "cleanse" any conflict of the longtime advisor—were "questionable" because, at the insistence of the target's longtime banker, the second financial advisor was not entitled to any fee in connection with the spin-off; declining to enjoin the merger because the balancing of the harms weighed against issuing an injunction).

- *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011) (enjoining a stockholder vote on a merger for 20 days, and the application of no-solicitation, match-right, and termination fee provisions relating to topping bids during that period, and holding that plaintiffs had a reasonable probability of success in showing that directors breached their fiduciary duties under *Revlon*, where: (1) the target board's financial advisor, "secretly and selfishly manipulated the sale process" by seeking permission from the board to provide buy-side financing before a price was agreed upon with the buyers, failing to disclose that it had sought to provide such financing from the beginning of the process, and, in further concealment from the board, pairing bidders in a manner that violated "no-teaming" provisions in the bidders' confidentiality agreements and limited price competition between bidders (one of whom, KKR, was a significant client of the advisor), and (2) the board, although unaware of the extent of the advisor's activities, approved its request to provide buy-side financing, in the absence of any need to do so, permitted the advisor to continue to run the process, including the go-shop period, and approved the pairing orchestrated by the advisor; also holding that there was a reasonable probability that KKR, as buyer, aided and abetted the directors' breaches).

- *In re Ness Technologies, Inc. S'holders Litig.*, 2011 WL 3444573 (Del. Ch. Aug. 3, 2011) (holding that plaintiffs "possibly" stated colorable price/process and disclosure claims that the target corporation's financial advisors suffered from conflicts of interest that impaired their ability to render impartial fairness opinions given statements in the proxy that the advisors had in the past provided, and would continue to provide, financial advisory and financing services to the acquiror).

b. ***Unocal***—When a board unilaterally (i.e., without stockholder approval) adopts defensive measures, an enhanced level of scrutiny applies to that decision, and the board must establish that it had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and that its response to that threat was reasonable (i.e., not preclusive or coercive). This rule is generally applied to mergers that are designed to fend off hostile bids to acquire the corporation. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). *Unocal* enhanced scrutiny might apply if a board adopts deal protections to fend off a bidder, even if *Revlon* does not apply.

- *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 (Del. Ch. 1999) ("When corporate boards assent to provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the policy concerns that animate the *Unocal* standard of review might be implicated. In this case, for example, if [the no-talk provision of the merger agreement] is read as precluding board consideration of alternative offers—no matter how much more favorable—in this non-change of control context, the [target] board's approval of the Merger Agreement is as formidable a barrier to another offer as a non-redeemable poison pill.").

- *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999) (indicating that *Unocal* would apply to board's decision to enter into a merger agreement containing a 6.3% termination fee, stating that such fee "certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point").

- *But see Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (finding that *Unocal* did not apply to a board's rejection of a friendly merger offer because the rejection of a merger offer is not a defensive action in the absence of any hostile takeover attempt or similar threatened conduct).

- *See generally Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011) (stating that "Delaware has three tiers of review for evaluating director decision-making" and discussing *Unocal* review and *Revlon* review each as an example of the same "intermediate standard of review," i.e., "enhanced scrutiny").

c. ***Blasius***—In *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), the Delaware Court of Chancery held that a board's action in adding two new members to the board in order to thwart a consent solicitation seeking to take control of the board was invalid even though the board may have acted in good faith and with appropriate care. The *Blasius* standard applies to board actions taken with the "primary purpose of preventing or impeding" a stockholder vote. Such action will be found invalid unless the board has a compelling justification for thwarting the stockholder vote.

B. Measure Adherence to Duty By Stockholder Value?

- *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) (recognizing directors' broad discretion regarding payment of non-mandatory dividends, but ordering that a special dividend be paid after Henry Ford revealed that he withheld dividends not to benefit stockholders but instead to build cheaper cars and pay better wages).

- *Katz v. Oak Indus. Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) ("It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation's stockholders . . . .").

- *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (when a corporation is to be sold in a cash-out merger, directors' duty is to maximize the short-term value to stockholders, regardless of interests of any other constituencies).

- *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)) ("In the board's exercise of corporate power to forestall a takeover bid our analysis begins with the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders. As we have noted, their duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders.").

- *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 33 (Del. Ch. 2010) ("Promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders"; directors who failed to establish how their actions would lead to shareholder value "failed to prove . . . that they acted in the good faith pursuit of a proper corporate purpose"). *See id.* at 34:

  > As an abstract matter, there is nothing inappropriate about an organization seeking to aid local, national and global communities . . . . Indeed, I personally appreciate and admire [the directors and majority stockholders'] desire to be of service to communities. The corporate form in which [the corporation] operates, however, is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. [The directors and majority stockholders] opted to form [the corporation] as a *for-profit Delaware*

> *corporation* and voluntarily accepted millions of dollars . . . as part of a transaction whereby [the minority investor] became a stockholder. Having chosen a for-profit corporate form, the [corporation's] directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that.

C. <u>Other Constituencies in the Traditional Corporation</u>

1. Control Transaction Context

- *Mills Acq. Co. v. MacMillan, Inc.*, 449 A.2d 1261, 1282 n.29 (Del. 1989) (permitting a board to consider "the impact of both the bid and the potential acquisition on other constituencies, *provided that* it bears some reasonable relationship to general shareholder interests") (emphasis added).

- *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1000 n.23 (Del. Ch. 2005) ("Precisely how stockholder-focused directors must be is not entirely clear but the predominance of the stockholders' interest in receiving the highest, practically available bid in our Supreme Court's *Revlon* jurisprudence is undeniable.").

2. Defensive Context

- *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955-56 (Del. 1985) (citing Lipton and Brownstein, *Takeover Responses and Directors' Responsibilities: An Update*, p. 7, ABA National Institute on the Dynamics of Corporate Control (Dec. 8, 1983)) ("A further aspect [to the reasonableness of a takeover defense provision] is the element of balance. If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed. This entails an analysis by the directors of the nature of the takeover bid and its effect on the corporate enterprise. Examples of such concerns may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange. While not a controlling factor, it also seems to us that a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.").

- *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1989) (upholding a target board's defensive actions aimed at protecting the unique "Time culture"; "The usefulness of *Unocal* as an analytical tool is precisely its flexibility in the face of a variety of fact scenarios. . . . The open-ended analysis mandated by *Unocal* is not intended to lead to a simple mathematical exercise: that is, of comparing the discounted value of [the company's] expected trading price at some future date with [the tender offeror's] offer and determining which is the higher. Indeed, in our view, precepts underlying the business judgment rule militate against a court's engaging in the process of attempting to appraise and evaluate the relative merits of a long-term versus a short-term investment goal for shareholders. To engage in such an exercise is a distortion of the *Unocal* process. . . .").

- *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011) (upholding board decision to keep poison pill stockholder rights plan in place in face of hostile, fully-financed, all-cash, all-shares tender offer where target board had spent over a year communicating its conclusion that the offer was inadequate, even though the board conceded that stockholders had enough information to decide whether to accept offer; "[t]his case brings to the fore one of the most basic questions animating all of corporate law, which relates to the allocation of power between directors and stockholders. That is, when, if ever, will a board's duty to the corporation and its shareholders require the board to abandon concerns for 'long term' values (and other constituencies) and enter a current share value maximizing mode?") (internal quotations and brackets omitted).

3. Business Judgment Context

- *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.75 (Del. Ch. 2006) ("Even when a corporation is solvent, the notion that the directors should pursue the best interests of the equityholders does not prevent them from making a myriad of judgments about how generous or stingy to be to other corporate constituencies in areas where there is no precise obligation to those constituencies.").

D. Multiple Owner Constituencies

1. Insolvent and Near-Insolvent Entities

- In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101-03 (Del. 2007), the Delaware Supreme Court held that directors of an insolvent corporation or a corporation in the "zone of insolvency" do not owe direct fiduciary duties to creditors. However, the Court held that "creditors of an insolvent corporation" take the place of stockholders as residual beneficiaries of any increased value and may maintain derivative suits against directors on behalf of the corporation. *Id.* at 101-02. S*ee also Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp.*, 805 A.2d 221 (Del. Ch. 2002) (refusing to enjoin merger where creditors of insolvent surviving corporation claimed that directors breached fiduciary duties to noteholders and preliminarily concluding that business judgment rule applied and protected the directors' decisions from such claims of creditors).

- In *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004), the Court of Chancery held that directors in the zone of insolvency have the protection of the business judgment rule and that a Section 102(b)(7) exculpatory provision limits the liability of directors when creditors' claims are derivative. *See also Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n.75 (Del. Ch. 2006) ("The judicial decisions indicating that directors owe fiduciary duties to the firm when it is insolvent . . . seem to [be] . . . a judicial method of attempting to reinforce the idea that the business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and that the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.").

- *Global Asset Capital, LLC v. Rubicon US REIT, Inc.*, C.A. No. 5071-VCL, tr. at 59 (Del. Ch. Nov. 16, 2009) (TRANSCRIPT) (in a situation in which the corporation was considering making a bankruptcy filing, "[y]ou will not be held to have breached your duty of loyalty to stockholders if you do consider creditors' interests. In fact, you are expected to consider all corporate constituencies, because the duties run to the corporation. But that is very different from some free-standing duty to creditors").

- *Credit Lyonnais, Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991) (presenting a hypothetical corporation in which one outcome would result in the company holding significant stockholder value and other more likely outcomes in which creditors may not receive complete repayment; noting that directors might reach one decision "if we consider the community of interests that the corporation represents," but finding that that decision "will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will realize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act").

2. Entities With Multiple Classes of Stock—How should a director of a troubled corporation with two classes of stock approach a potential transaction that one class (e.g., holders of preferred stock with a liquidation preference that would be satisfied in the transaction) might favor, but that another class (e.g., common stockholders who might prefer to "roll the dice" rather than receive little or nothing in the transaction) disfavors?

- E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 Bus. Law. 761 (2008) (generally discussing the difficulties that might be faced by directors appointed by preferred stockholders in this situation).

- *In re Trados Inc. S'holder Litig.*, 2009 WL 2225958 (Del. Ch. July 24, 2009) (denying motion to dismiss a challenge to a merger in which preferred stockholders received almost the entirety of their liquidation preference while common stockholders received nothing, in part because plaintiff alleged that a majority of the directors were conflicted because they were employees of the various venture funds that were preferred stockholders).

- *In re Trados Inc. S'holders Litig.*, C.A. No. 1512-VCL, Tr. at 43-44 (Del. Ch. Aug. 22, 2012) (TRANSCRIPT) ("[Y]ou could imagine there being multiple classes of stock, but you have to think of it as an undifferentiated block of equity and maximize the value of that undifferentiated block rather than looking to protect someone's contractual preference which only gets contract protection, not fiduciary protection.").

- *In re Delphi Financial Group S'holder Litig.*, 2012 WL 729232 (Del. Ch. Mar. 6, 2012) (finding a reasonable probability of success on the merits that founder and controlling stockholder with high-vote stock and target board breached their fiduciary duties by negotiating and approving a merger in which the founder received a premium for his high-vote stock at the expense of the low-vote stock largely held by the public when a charter provision required that the two classes receive the same consideration, but denying a preliminary injunction based on the balancing of the equities).

- *See LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 449-50 (Del. Ch. 2010) (apart from special committee, comprised of directors holding only "a nominal amount" of common stock and stock options, tasked with evaluating various bids, preferred stockholder plaintiffs argued that, "[i]deally, in fact, the Board should have employed a bargaining agent on [the preferred stockholders'] behalf to vigorously contend for the proposition that the largest part of the roast should be put on the preferred stockholders' plate"). However, we are not aware of a Delaware court ever finding that a board was obligated to form such a committee. *See, e.g.*, *In re General Motors Class H S'holders Litig.*, 734 A.2d 611, 616 (Del. Ch. 1999) (failure to form a special committee charged with representing the interests of one class of stock rather than another did not constitute a breach of fiduciary duty, particularly when that class was "offer[ed] the ultimate procedural protection—the right to affirm or veto the decision at the corporate ballot box"). *But see In re FLS Holdings, Inc. S'holders Litig.*, 1993 WL 104562, at *5 (Del. Ch. Apr. 2, 1993) (challenging the process of a board of directors "who owned large amounts of common stock" in part because "[n]o independent adviser or independent directors' committee was appointed to represent the interests of the preferred stock who were in a conflict of interest situation with the common . . .").

- *Cf.* Frederick H. Alexander & James D. Honaker, *Power to the Franchise or the Fiduciaries?: An Analysis of the Limits on Stockholder Activist Bylaws*, 33 Del. J. Corp. L. 749, 750 (2008) ("[I]n the classic model, stockholders select directors, and directors oversee the management of the assets. This structure allows owners with very different profiles to pool their assets with confidence that no single group of dominating owners can 'hijack' the corporate assets for its own purposes.").

3. Stockholders With Idiosyncratic Goals—Directors beholden to a stockholder with unique interests in a transaction or corporation may not receive the benefit of the business judgment rule if the court believes that they are acting in pursuit of those interests, rather than value maximization.

a. Liquidity—A court may find a director/stockholder interested in a transaction because of his or her need for cash.

- In *N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, 2011 WL 4825888, at *11 (Del. Ch. Sept. 30, 2011), the court found that the plaintiff sufficiently alleged that a director and 37% stockholder was materially interested in a merger because the transaction provided him with desperately needed liquidity to defeat a motion to dismiss. He had no salary, owed over $25 million, and had plans to launch a new business entirely with his own money. He received $100 million in the merger, which he initiated and pursued through a "pattern of threats" and the "domination" of the rest of the board.

- *In re Answers Corp. S'holders Litig.*, 2012 WL 1253072, at *8 n.48 (Del. Ch. Apr. 11, 2012) (finding that plaintiffs' complaint adequately alleged facts sufficient to infer that (1) two directors appointed by a 30% stockholder were interested in a merger where the 30% stockholder desired to exit its otherwise illiquid investment and (2) otherwise disinterested and independent directors acted in bad faith by consciously failing to seek the highest value reasonably available for all stockholders based on allegations that, against their own financial advisor's advice, those directors acquiesced in an expedited sale process in order to accommodate the 30% stockholder; noting that the court "wonder[ed] if an explanation will emerge [for the independent directors' decision to conduct an expedited market check] because disinterested and independent directors do not usually act in bad faith").

- *McMullin v. Beran*, 765 A.2d 910 (Del. 2000) (denying motion to dismiss plaintiffs claims based on theory that controlling stockholder conducted a "fire sale" of its 80%-owned subsidiary in order to obtain cash to fund a $3.3 billion acquisition where 8 of the 12 subsidiary directors were affiliated with the controller); *In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, 30 A.3d 60, 81 (Del. Ch. 2011) (finding that, although board designee of 14% stockholder in a controlled company did not act in "less than good faith" in negotiating a transaction involving registration rights for the stockholder's illiquid 14% equity stake, the liquidity interest of the stockholder meant that its board designee was "less than ideally situated to press hard" in negotiations with the controller), *aff'd sub nom. Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012)

- *But see In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012) (suggesting that, at least in the context of a transaction in which all stockholders receive the same pro rata consideration, there are "very narrow circumstances in which a controlling stockholder's immediate need for liquidity could constitute a disabling conflict of interest" and that "[t]hose circumstances would have to involve a crisis, fire sale where the controller, in order to satisfy an exigent need (such as a margin call or default in a larger investment) agreed to a sale of the corporation without any effort to make logical buyers aware of the chance to sell, give them a chance to do due diligence, and to raise the financing necessary to make a bid that would reflect the genuine fair market value of the corporation").

b. Social Cachet—The Court might believe that a controlling stockholder might sacrifice a "boring" investment in order to buttress some other holding that he prefers for an idiosyncratic reason—even if that means that minority stockholders who do not share in those non-"economic" benefits would prefer another alternative.

- *In re Synthes Inc. S'holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012) ("The world is diverse enough that it is conceivable that a mogul who needed to address an urgent debt situation at one of his coolest companies (say a sports team or entertainment or fashion business), would sell a smaller, less sexy, but fully solvent and healthy company in a finger snap (say two months) at 75% of what could be achieved if the company sought out a wider variety of possible buyers. . . .).

- *Hollinger Inc. v. Hollinger Int'l, Inc.*, 858 A.2d 342, 384-85 (Del. Ch. 2004) ("[I]nvestors in public companies do not invest their money because they derive social status from owning shares in a corporation whose controlling manager can have dinner with the Queen. Whatever the social importance of the *Telegraph* [one of the company's assets] may have in Great Britain, the economic value of that importance to [the company] as an entity is what matters for the *Gimbel* test [to determine whether a stockholder vote on a sale of assets is required], not how cool it would be to be the *Telegraph*'s publisher. . . . The 'trophy' nature of the *Telegraph* Group means that there are some buyers . . . who are willing to pay a higher price than expected cash flows is prudent, in purely economic terms, in order to own the *Telegraph* and to enjoy the prestige and access to the intelligentsia, the literary and social elite, and high government officials that comes with that control.").

E. Academic Literature Discussing Ownership Versus Enterprise Models of the Firm

1. Enterprise/Entity Model of Corporate Law—A corporation is viewed as a vehicle chartered by the state and thus "tinged with a public purpose" to serve the interests of multiple constituencies.

a. Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 Va. L & Bus. Rev. 163 (2008) (advancing the theory that the language in *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) supporting the property model of corporate law is *dicta* and counter to a proper, nuanced understanding of the corporation).

b. Lynn A. Stout, *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public* (2012) (positing that neither corporate law, economic theory nor empirical evidence support the validity of the ownership model).

c. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 Cardozo L. Rev. 261, 276 (1992) (discussing the distinction) (noting, pre-*eBay*, that "[n]evertheless, ultimately both our courts and, more importantly, our legislatures have, in effect, endorsed the entity view").

a. Adolph Berle & Gardiner Means, *The Modern Corporation and Private Property* at 355 (1932) (shareholders "have surrendered the right that the corporation should be operated in their sole interest").

2. Ownership/Property Model of Corporate Law—A solvent corporation is viewed as a vehicle with the sole purpose of maximizing the wealth of its owners, the stockholders.

a. Leo E. Strine, Jr., *Our Continuing Struggle With the Idea That For-Profit Corporations Seek Profit*, 47 Wake Forest L. Rev. 135, 153 (2012) ("The whole design of corporate law in the United States is built around the relationship between corporate managers and stockholders, not relationships with other constituencies.").

b. William B. Chandler, *Hostile M&A and the Poison Pill in Japan: A Judicial Perspective*, 2004 Colum. Bus. L. Rev. 45, 56 (2004) ("One of the advantages of the federal system in the United States is that each state's law serves as a kind of testing ground to try out the effects of theories such as these. Corporation law has infused directors' fiduciary duties with requirements to pursue the best interest of the corporation's stockholders, recognizing the fundamental objective of the corporate form as the maximization of shareholder wealth, even though some states may allow boards to justify defensive measures based on social concerns. Directors are permitted to consider the interests of other constituencies (such as creditors, employees, and the local community in which the company operates), but Delaware law emphasizes that they should consider these other interests only to the extent that they affect stockholder interest. This position obviously aligns the Delaware courts with the school of thought holding that the corporation's sole purpose is to achieve the best financial return for the present group of stockholders.").

c. Leo E. Strine, Jr., *Lecture and Commentary on the Social* Responsibility *of Corporate Entities: The Social Responsibility of Boards of Directors and Stockholders in Change of Control Transactions: Is There Any "There" There?*, 75 S. Cal. L. Rev. 1169, 1170 (2002) ("The predominant academic answer is that corporations exist primarily to generate stockholder wealth, and that the interests of other constituencies are incidental and subordinate to that primary concern.").

d. Henry Hansmann and Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001) ("There is no longer any serious competitor to the view that corporate law should principally strive to increase long-term shareholder value.").

e. Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 172 (1992) ("Corporate law conventionally instructed boards to consider only the shareholders' interests (to maximize profit) for good reason. Maximizing equity share prices provides managers with a clear-cut decision rule, on which all shareholders agree in a perfectly competitive capital market, with the following benefits: (1) it allocates resources efficiently and thereby maximizes social welfare; (2) it maximizes shareholder utility because investors can trade against the increased share value to fulfill their diverse, preferred consumption patterns; and (3) it best matches organizational design with incentives because equity investments, as residual claims, are more vulnerable than other stakeholders' investments, which can be protected by contract.").

3. Does the Ownership/Enterprise Distinction Matter?

a. Jonathan R. Macey, *A Close Read of an Excellent Commentary on* Dodge v. Ford, 3 Va. L. & Bus. Rev. 177, 190 (2008) ("As long as corporate directors and CEOs claim to be maximizing profits for shareholders, they will be taken at their word, because it is impossible to refute these corporate officials' self-serving assertions about their motives.").

b. William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 Cardozo L. Rev. 261, 281 (1992) ("In this process [of contrasting the ownership and enterprise models], efficiency concerns, ideology, and interest group politics will commingle with history (including our semi-autonomous corporation law) to produce an answer that will hold for here and now, only to be torn by some future stress and to be reformulated once more. And so on, and so on, evermore.").

c. Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 171 (1992) ("It should be noted . . . that managers are able to thwart bids even without these [other constituencies] statutes' assistance, through a number of defensive tactics approved by courts. It appears that poison pills and defensive charter amendments are, in fact, quite potent substitutes for takeover statutes.").

F. Breadth of the Business Judgment Rule

- *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. 1968) (rejecting minority stockholder's claim that directors mismanaged the company and wasted corporate assets by refusing to install lights at Wrigley Field because of "personal opinions 'that baseball is a 'daytime sport' and that the installation of lights and night baseball games will have a deteriorating effect upon the surrounding neighborhood'"; noting that "the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating" and holding that the decision not to install lights was properly within the directors' business judgment because plaintiff "showed no fraud, illegality or conflict of interest in their making of that decision").

- Note that the language in *eBay* supporting the ownership model of the corporation was in the context of a decision reviewed under the heightened *Unocal* standard, rather than the business judgment rule. *Cf. eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 33 (Del. Ch. 2010) ("When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value. Under the *Unocal* standard, however, the directors must act within the range of reasonableness.").

- Jonathan R. Macey, *A Close Read of an Excellent Commentary on* Dodge v. Ford, 3 Va. L. & Bus. Rev. 177, 180-81 (2008) ("[E]ven though I believe. . . that corporate law requires directors to maximize shareholder value, I also recognize that it simply is not possible or practical for courts to discern ex post when a company is maximizing value for shareholders and when the officers and directors are only pretending to do so.").

- Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. Corp. L. 637, 651 (2006) ("Although *Dodge v. Ford* is frequently cited, no modern court has struck down an operational decision on the ground that it favors stakeholder interests over shareholder interests.").

G. <u>Statutory Authority to Alter Fiduciary Duties?</u>

1. Exculpatory Provision

a. 8 *Del. C.* § 102(b)(7) (permitting inclusion of a provision in the certificate of incorporation of a traditional Delaware corporation that would eliminate or limit the personal liability of a director to the corporation or its stockholders for monetary damages for a certain fiduciary duty breaches; but not permitting exculpation for (i) breach of the duty of loyalty, (ii) acts or omissions not in good faith, (iii) liability under the dividend provisions of the statute, or (iv) transactions from which the director derived an improper personal benefit).

b. Changes the mechanism available to enforce fiduciary obligations, but does not alter the fiduciary obligations themselves.

2. Corporate Opportunity Provision

a. 8 *Del. C.* § 122(17) (empowering a traditional Delaware corporation to "[r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders").

b. A valid corporate opportunity provision could permit a fiduciary to accept for himself a business venture otherwise available to the corporation in a manner that, absent the corporate opportunity provision, might be seen as a breach of the fiduciary's duty of loyalty to the corporation.

3. Broader Permissive Self-Ordering?

a. *See* 8 *Del. C.* § 102(b)(1) (providing that a traditional Delaware corporation's certificate of incorporation may contain "[a]ny provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders. . . if such provisions are not contrary to the laws of this State").

4. Limits

- *See Siegman v. Tri-Star Pictures, Inc.*, 1989 WL 4876 (Del. Ch. May 5, 1989, *revised* May 30, 1989), *rev'd in part on other grounds sub nom. In re Tri-Star Pictures*, 684 A.2d 319 (Del. 1993) (finding that a certificate of incorporation provision purporting to eliminate director liability in specified circumstances involving the taking of corporate opportunities would arguably restrict liability for breaches of the fiduciary duty of loyalty in violation of the limitations in 8 *Del. C.* § 102(b)(7)).

- *See also Jones Apparel Group v. Maxwell Shoe Co.*, 883 A.2d 837, 846 (Del. Ch. 2004) (noting that where a certificate of incorporation provision is assertedly contrary to statute, "the court must first apply settled rules of statutory construction to determine whether the provision violates the statute, and, if those rules do not yield a clear result, the court must next carefully consider the statutory text at issue and the policy values at stake as reflected not only in the DGCL but also in our common law, and only invalidate a certificate provision if it 'transgress[es]'—i.e., vitiates or contravenes—a mandatory rule of our corporate code or common law").

II. <u>"OTHER CONSTITUENCIES" STATUTES</u>

A. <u>Intent</u>

1. These provisions <u>*permit*</u> a board of directors to consider the interests of "other constituencies" when making decisions, rather than focusing solely on the interests of stockholders.

2. Intent, made explicit in some of these states, is to avoid *Revlon*-style enhanced scrutiny, but instead to ensure that directors receive business judgment deference when considering a change-of-control transaction.

B. <u>Adoption</u>

1. Thirty states have adopted some form of other constituency statute. Leo E. Strine, Jr., *Our Continuing Struggle With the Idea That For-Profit Corporations Seek Profit*, 47 Wake Forest L. Rev. 135, 163 n.87 (2012) (citing William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. Ill. L Rev. 1, 35-36 (2009)).

2. *See generally* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 171-73 (1992) (providing an overview of "other constituency" statutes).

3. **Pennsylvania** (1983)—the first state to adopt an "other constituencies" statute. 15 Pa. Const. Stat. Ann. § 1408(B) (1983); 15 Pa. Const. Stat. Ann. § 1715 (1990).

C. <u>Considerations an Other Constituency Director May Take Into Account</u>

1. Employees, customers, creditors, suppliers, communities in which the corporation has facilities.

2. National and state economies and other community and societal considerations.

3. The long-term and short-term interests of the corporation and its stockholders.

4. The desirability of remaining independent; and the resources, intent and conduct (past, stated and potential) of a person seeking to acquire control of the corporation.

5. The corporation's officers.

6. Any other pertinent factors.

D. Example of "Mandatory" Other Constituencies Provision

1. Indiana (1987)—statute *explicitly provides* that directors of Indiana corporations are permitted to consider other constituencies. Accordingly, *every* Indiana corporation is an "other constituencies" corporation.

a. Indiana Code 23-1-35-1(d) ("A director may, in considering the best interests of a corporation, consider the effects of any action on shareholders, employees, suppliers, and customers of the corporation, and communities in which offices or other facilities of the corporation are located, and any other factors the director considers pertinent . . . [and] . . . directors are not required to consider the effects of a proposed corporate action on any particular corporate constituent group or interest as a dominant or controlling factor.").

b. Indiana Code 23-1-35-1(f) "reaffirm[s]" that business judgment review would apply to decisions made pursuant to subsection (d), even in the change-of-control context:

> Certain judicial decisions in Delaware and other jurisdictions, which might otherwise be looked to for guidance in interpreting Indiana corporate law, including decisions relating to potential change of control transactions that impose a different or higher degree of scrutiny on actions taken by directors in response to a proposed acquisition of control of the corporation, are inconsistent with the proper application of the business judgment rule under this article.

c. *See* Henry N. Butler, *Corporation-Specific Anti-Takeover Statutes and the Market For Corporate Control*, 1988 Wis. L. Rev. 365, 374 & n.29 (1988) (citing Miller, *How Indiana Shielded a Firm and Changed the Takeover Business*, Wall St. J., July 1, 1987, at 1, col. 6) (stating that the Indiana Control Share Acquisition Chapter was passed at the urging of Arvin Industries in order "to avoid takeover by the Belzberg family of Canada," and that president of the Indiana Senate, who "arranged for the passage of the bill to have top priority" had been friends with the company's chairman "since junior high school").

2. Compare **Connecticut**'s other constituency provision, applicable to corporations with "a class of voting stock registered pursuant to Section 12 of the Securities Exchange Act of 1934." In 2010, Connecticut amended § 33-756(d) to provide that a public company director "*may* consider" certain other constituency factors "in determining what he reasonably believes to be in the best interests of the corporation," along with "any other factors he reasonably considers appropriate in determining what he reasonably believes to be in the best interests of the corporation." Prior to 2010, that section provided that the director "shall consider" those enumerated factors. The summary accompanying Connecticut's 2010 bill effecting this change merely states that "The bill allows, rather than requires, the director of a corporation to consider certain factors in determining what he or she reasonably believes to be in the corporation's best interests." Connecticut House of Representatives HB No. 5530 (As Amended by House Amendment Schedule "A") April 23, 2010 (available online: http://www.cga.ct.gov/2010/FC/2010HB-05530-R000633-FC.htm).

E. Example of "Permissive" Other Constituencies Provision

1. **Georgia** (1989)—Statute *permits* a Georgia corporation to include a provision in its articles of incorporation permitting its board of directors to consider constituencies other than solely the stockholders when making decisions.

2. *See* Ga. Code Ann. § 14-2-202(b)(5):

> The articles of incorporation may set forth: . . . A provision that, in discharging the duties of their respective positions and in determining what is believed to be in the best interests of the corporation, the board of directors, committees of the board of directors, and individual directors, in addition to considering the effects of any action on the corporation or its shareholders, may consider the interests of the employees, customers, suppliers, and creditors of the corporation and its subsidiaries, the communities in which offices or other establishments of the corporation and its subsidiaries are located, and all other factors such directors consider pertinent; provided, however, that any such provision shall be deemed solely to grant discretionary authority to the

directors and shall not be deemed to provide to any constituency any right to be considered.

F. Model Business Corporation Act

1. In 1990, the ABA Corporate Laws Committee considered adopting an "other constituencies" provision to the Model Business Corporation Act.

2. Ultimately, the ABA determined not to do so:

> In conclusion, the Committee believes that other constituencies statutes are not an appropriate way to regulate corporate relationships or to respond to unwanted takeovers and that an expansive interpretation of the other constituencies statutes cast in the permissive mode is both unnecessary and unwise. Those statutes that merely empower directors to consider the interests of other constituencies are best taken as a legislative affirmation of what courts would be expected to hold in the absence of a statute. Interpreting the statutes to have the same force as the express Indiana provision would accomplish a change in traditional corporate law so radical that it should be undertaken only after there has been extensive and broad based deliberation on the effects of reshuffling of fundamental relationships among shareholders and other persons who may be affected by the affairs of an incorporated business.

Committee on Corporate Laws, *Other Constituencies Statutes: Potential For Confusion*, 45 Bus. Law. 2253, 2270-71 (1990).

G. Litigation

1. Ability to Achieve Success on the Merits

a. Brian J.M. Quinn *Constituency Provisions and Intermediate Scrutiny Outside of Delaware.* Nov. 23, 2009. "M&A Law Prof Blog," Available online (http://lawprofessors.typepad.com/mergers/2009/11/unocal-duties-outside-of-delaware.html) ("If a rust belt company is approached with an offer to go private at $21, it could well respond, 'I'm sorry, but at $21, this deal is not good for our employees, the local community or the environment.' Imagine the surprise of constituencies when at $25, the board changes its mind, and takes the offer. In the end, the only constituency with standing is the shareholder community. Consequently, one shouldn't be surprised if/when directors use these statutes as little more than bargaining levers at the expense of the communities they were meant to protect.").

b. Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 Yale J. on Reg. 119, 171 (1992) (other constituency "statutes, ironically, protect managers more effectively than workers. Workers have no right to challenge board decisions for failing to consider their interest, while shareholders' ability to sue managers successfully for opposing a bid is diminished.").

c. Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 Wash. & Lee L. Rev. 1423, 1438 (1993) (noting that, under a "multi-fiduciary duty" standard, "management could freely pursue its own self-interest by playing shareholders off against nonshareholders. When management's interests coincide with those of shareholders, management could justify its decision by saying that shareholder interests prevailed in this instance, and vice-versa").

2. Case Law

a. *Baron v. Strawbridge & Clothier*, 646 F. Supp. 690, 697 (E.D. Pa. 1986) (citing Pennsylvania's other constituencies statute and noting that "[i]t was proper for the company to consider the effects the . . . tender offer would have, if successful, on the Company's employees, customers and community").

b. Global Contribution Corp. "Governance" (available online: globalcontributioncorp.com) (noting that it became one of the first Maryland benefit corporations and explaining that "[i]n any of the 19 states without a constituency statute, when a company is 'in play,' directors' discretion under the business judgment rule is narrowed as a result of the *Revlon* ruling in Delaware, requiring them to 'take the highest offer' regardless of the impact of that decision on non-financial interests" and that "[i]n any of the 31 states with a constituency statute, the lack of case law regarding those statutes leaves lawyers and the directors and officers they counsel with a lack of clarity about how a court would rule if directors made a decision based on broader considerations than just the highest offer").

III. BENEFIT CORPORATIONS

A. Intent

1. *Requiring* that benefit corporations consider the general public welfare, not solely stockholder interests, before acting or failing to act.

2. *Permitting* a benefit corporation to identify additional constituencies/specific public benefits in its governing documents, and requiring consideration of those more specific interests as well.

3. *Specifying* that these interests are to be considered even in the change of control context.

B. Statute-Based Structure

1. A benefit corporation statute is appended to a state's general corporation law provisions: accordingly, an entity incorporating as a benefit corporation will generally be subject to the same rules as a traditional corporation incorporated in that state, albeit as modified by the rules specifically provided for benefit corporations.

2. Most states adopting benefit corporation provisions, along with the model statute proposed by B Lab, include a statement that "[a] provision of the articles or bylaws of a benefit corporation may not relax, be inconsistent with or supersede a provision of this [chapter]."

C. Interests to be Considered By a Benefit Corporation

1. General Public Benefit—Every benefit corporation "shall" have a purpose of "creating a general public benefit," generally 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."

a. Third-Party Standard—a method of measuring compliance with adherence to its public benefit goals. The standard is to be:

(i) Comprehensive (i.e., assessing the effects of the business on employees, customers as beneficiaries of the general and specific public benefits, community and society and the local and global environment).

(ii) Developed by an independent organization that has expertise to assess overall social and environmental performance and that does not have close ties to any specific industry.

(iii) Transparent, in that the inputs for the standard, and the identity of the organization developing the standard, are to be disclosed publicly.

b. William H. Clark, Jr. and Larry Vranka, White Paper, *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form that Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public*, at 18 (Jan. 18, 2013 version) (referring to the third party standard as being "in many ways . . . the heart of benefit corporation legislation" because it helps protect against "greenwashing," but also as "the most contentious and misunderstood provision").

2. Specific Public Benefits—Benefit corporations may also identify the pursuit of one or more special public benefits in their governing documents as being *additional* purposes of the benefit corporation—but these specific benefits do not modify the obligation to "create a general public benefit." Most benefit corporation statutes provide a non-exhaustive list of acceptable specific public benefits, "including":

a. providing low-income or underserved individuals or communities with beneficial products or services.

b. promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business.

c. preserving the environment.

d. improving human health.

e. promoting the arts, sciences or advancement of knowledge.

f. increasing the flow of capital to entities with a public benefit purpose.

g. conferring any other particular benefit on society or the environment.

3. Mandating Consideration of Common "Other Constituencies" Interests—Most benefit corporation statutes provide that directors "shall consider the effects of any action or inaction" on:

a. the benefit corporation's stockholders.

b. the employees and work force of the benefit corporation, its subsidiaries and its suppliers.

c. the benefit corporation's customers "as beneficiaries of the general public benefit or specific public benefit purposes."

d. community and societal factors—"including" the communities in which the offices or facilities of the benefit corporation, its subsidiaries and its suppliers are located.

e. the local and global environment.

f. the short-term and long-term interests of the benefit corporation, and the effect of remaining independent (i.e., not acquired) on the benefit corporation's ability to serve these interests.

g. the ability of the benefit corporation to accomplish its general and specific public benefit purposes.

4. Permitting Consideration of Additional "Constituencies"—Beyond the above interests, which a director *must* consider when considering "the effects of any action or inaction," the statutes generally *permit* the directors to consider (1) any other constituencies included in that state's "other constituencies" statute and (2) "other pertinent factors or the interests of any other group that they deem appropriate."

5. Priority of Interests to be Considered

a. Statute authorizes a benefit corporation to adopt a provision in its articles of incorporation to "give priority to certain interests related to its accomplishment of its general public benefit purpose or of a specific public benefit purpose."

b. But if priority is not specified in the company's charter, directors "need not give priority to the interests of a particular person or group" listed in the mandatory or permissive constituencies.

c. Regardless of whether there is a listed priority, the fact that the consideration of certain constituencies is mandatory implies that at least those constituencies must be considered each time that the board decides to take, or to fail to take, an action.

D. <u>Additional Benefit Corporation Concepts</u>

1. Annual Benefit Report—A benefit corporation must publish a report, made available to its stockholders each year.

a. Content—The report will provide a discussion and assessment of:

(i) The corporation's efforts to pursue and create a general public benefit and any specified specific public benefits as measured against the "third party standard."

(ii) The process and rationale for selecting or changing the third-party standard used to prepare the benefit report, along with disclosure of any connection between the party establishing the standard and the benefit corporation or its affiliates (including financial connections that might "materially affect the credibility of the use of the third-party standard").

(iii) Any circumstances hindering the corporation's ability to create these benefits.

(iv) A statement whether the company complied with its obligation as a benefit corporation during the relevant period.

b. Availability

(i) To stockholders: Report to be delivered to the stockholders within 120 days of the end of the benefit corporation's fiscal year, or contemporaneously with delivery of an annual report (e.g., a Form 10-K).

(ii) To the public: Report is also to be posted on the company's website (or to be delivered upon request to "any person that requests a copy" if it does not have a website). Most states also require a filing with the Secretary of State of the state of incorporation. This version may exclude the portions of the report discussing director compensation and the company's financial or proprietary information.

2. Benefit Director—One member of the board whose role is to prepare an opinion to be included in the annual benefit report as to whether the benefit corporation acted in accordance with its public benefit purposes and whether the directors and officers complied with their obligation to consider the mandatory interests discussed above.

a. Independence: the benefit director may not be an employee of the benefit corporation or any of its subsidiaries in the past three years; may not be an immediate family member of an executive officer (other than the benefit officer, if any) in the past three years; and may not own, or be the 5% owner, director, officer or manager of an entity that owns, 5% or more of the outstanding shares of the benefit corporation.

3. Benefit Officer—If an officer is designated as the benefit officer, he is charged with preparing the benefit report.

4. Benefit Enforcement Proceeding—Many benefit corporation statutes provide for derivative litigation permitting certain persons to file suit challenging the entity's "(1) failure . . . to pursue or create general public benefit or a specific public benefit purpose set forth in its articles or (2) violation of any obligation, duty or standard of conduct" under the benefit corporation statute, including a duty to file an annual benefit report.

a. Standing to Bring a Benefit Enforcement Proceeding—The model statute provides that a stockholder, a director, or the holders of 5% or more of the equity interests of a 50%-or-greater stockholder of the benefit corporation may initiate derivative litigation to bring a benefit enforcement proceeding. It also permits a corporation to identify other acceptable derivative plaintiffs in its charter or bylaws.

b. Potential Defendant—The model statute indicates that the benefit corporation itself, its directors and its officers could all be defendants in a benefit enforcement proceeding.

E. <u>Liability</u>

1. Prohibition Against Monetary Damages—Most benefit corporation statutes explicitly prohibit the benefit corporation and its directors from being found liable for monetary damages for failure to create general or specific public benefits.

a. *But see* California's benefit corporation statute, providing that there shall be no monetary damages "for any failure to create a general or specific public benefit" but also stating that a court "may award an amount sufficient to reimburse the plaintiff for the reasonable expenses incurred by the plaintiff, including attorney's fees and expenses, in connection with the benefit enforcement proceeding."

b. Similar indemnification and exculpatory provisions are generally available in the general corporation law provisions that also apply to benefit corporations.

c. D&O liability insurance is available for directors and officers of both for-profit and non-profit corporations. *See* Stephen M. Foxman, *Directors and Officers Liability Insurance for Nonprofits: Is Your Client Adequately Protected?*, 18 Bus. Law Today (July/Aug. 2009). But as the benefit corporation concept is relatively new, it might be more difficult for an insurer to provide an accurate quote for D&O insurance in this context, as the market is necessarily less fully developed—if available at all. *See* Kevin LaCroix, *The Benefit Corporation Concept and Related Director and Officer Liability Issues*, The D&O Diary (March 12, 2012) (available online: http://www.dandodiary.com/2012/03/articles/corporate-governance/the-benefit-corporation-concept-and-related-director-and-officer-liability-issues/) ("As a for-profit venture organized to pursue a public good, a benefit corporation does not really fit within the usual D&O insurance framework, which divides the world between non-profit and commercial enterprises. In addition, the benefit corporation regime has unique aspects that could have insurance implications, such as the possibility of a benefit enforcement action.").

2. Specific Protections for Benefit Director and Benefit Officer—Benefit corporation statutes provide additional protection from liability for acts or omissions "in the capacity of" the benefit director or benefit officer, unless the act or omission implicates certain loyalty concerns. *See* Louisiana Revised Statutes, Ch. 27, R.S. 12:1822(E) ("Regardless of whether the bylaws of a benefit corporation include a provision eliminating or limiting the personal liability of directors authorized by R.S. 12:24(C)(4), a benefit director shall not be personally liable for an act or omission in the capacity of a benefit director unless the act or omission constitutes self-dealing, willful misconduct, or a knowing violation of law.").

3. *See, e.g.*, Vermont Benefit Corporations Act, § 21.09(a)(4) (directors "shall not be subject to a different or higher standard of care when an action or inaction might affect control of the benefit corporation").

F. "Wrinkles" in Various State Benefit Corporation Statutes

1. Reconciling General and Specific Benefits—Maryland, New Jersey and Vermont define "general public benefit" by explaining that it can be obtained "through activities that promote some combination of specific public benefits." *See* § 14A:18-1 of the New Jersey General Corporation Act; § 21.03(4) of the Vermont Business Corporation Act. *See also* § 5-6C-01(c) of the Maryland Benefit Corporation statute (using the phrase "a combination of specific public benefits").

2. Nomenclature—Hawaii generally follows the B Lab model, but names the entity a "sustainable business corporation," rather than a "benefit corporation."

3. Consideration of Other Constituencies

a. Hawaii's statute makes consideration of certain of the common "other constituencies" interests permissive, rather than mandatory as it appears in the B Lab model statute and in most other benefit corporation statutes. The only interests that directors of a Hawaii sustainable business corporation must consider are the interests of the stockholders, the accomplishment of general public benefits and any specific public benefits set forth in the company's charter.

b. Maryland does not mandate consideration of "short-term and long-term interests" but includes an expansive permissive "other pertinent factors" provision.

c. States have identified certain other considerations that could be considered. Some examples are below:

(i) CA, NY, SC, VA: "the resources, intent, and conduct, including past, stated, and potential conduct, of any person seeking to acquire control of the corporation."

(ii) MA: "the interests of the economy of the state, the region and the country."

(iii) HI: use of patent rights in a way that would "(A) creat[e] and retain[] good jobs within the State as well as throughout the United States; (B) uphold[] fair labor standards nationally and internationally . . . ; and (C) enhanc[e] environmental protection nationally and internationally."

(iv) LA: excluding the typical "any other particular benefit" catchall, but including "Historic preservation" and "Urban beautification."

4. Definition of "Third Party Standard"—Most states (other than South Carolina) provide for a more general description of the third-party standard than the B Lab model legislation currently provides. For example, only South Carolina and the model legislation require "a public comment period of at least 30 days to develop" the third-party standard to be used by the benefit corporation.

5. Specific "Benefit Director" and "Benefit Officer" Roles—California, Maryland, New York and Virginia have not adopted specific "benefit director" or "benefit officer" roles. Presumably this means that the whole board will be responsible for the benefit report, and that there is no requirement for an "independent" director.

6. Benefit Enforcement Proceedings

a. Availability—New York and Maryland do not include specific provisions for a benefit enforcement proceeding process.

b. Benefit Enforcement Plaintiffs—There appears to be significant variety among the benefit corporation states regarding who might be acceptable derivative plaintiffs. Many have not included language permitting 5% stockholders of the benefit corporation's majority stockholder to file suit, or, in the case of New Jersey and Vermont, a 10% stockholder block is required. Hawaii appears to permit "shareholders and directors," and any other parties given such authority in the company's bylaws, to be derivative plaintiffs. Louisiana permits the benefit director or the stockholders to commence derivative benefit enforcement proceedings, but not the other directors (presumably unless otherwise provided in a company's governing documents).

c. Benefit Enforcement Defendants—South Carolina's statute might be read to imply that only directors are proper defendants in a benefit enforcement proceeding, and New Jersey's and Vermont's statutes might be read to imply that only "a director or officer" may be a defendant, perhaps suggesting that the corporation itself may not be a proper defendant in a benefit enforcement proceeding in those states.

G. <u>Delaware's Proposed Public Benefit Corporation Legislation</u>

1. Status—The Council of the Corporation Law Section of the Delaware State Bar Association has proposed a bill intended to be effective August 1, 2013, creating a new "Public Benefit Corporations" subchapter of the Delaware General Corporation Law (8 *Del. C.* §§ 361-368).

2. Requiring A Specific Public Benefit

a. Along with the mandatory obligation to consider "the best interests of those materially affected by the corporation's conduct," each Delaware public benefit corporation would also be obligated to "identify within its statement of business or purpose [in its certificate of incorporation] one or more specific public benefits to be promoted by the corporation . . . ." 8 *Del. C.* § 362(a).

b. **Definition**—"'Public benefit' means a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technical nature." 8 *Del. C.* § 362(b).

c. John Montgomery, *Delaware Proposes Historic Benefit Corporation Legislation*, Great From the Start: How Conscious Corporations Attract Success (available online: http://www.greatfromthestart.com/delaware-proposes-historic-benefit-corporation-legislation/) (quoting B Lab as explaining that, "[i]n other words, Delaware goes a step further than the model benefit corporation legislation by requiring a declaration of a specific public benefit or benefits in addition to the general public benefit corporation of all stakeholders").

3. **Tripartite Balancing**—*see* 8 *Del. C.* § 365(a) ("The board of directors shall manage or direct the business and affairs of the public benefit corporation in a manner that balances the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation.").

4. **Reports**—*see* 8 *Del. C.* § 366:

a. **Biennial**—Assessing the corporation's promotion of public benefits every other year (as opposed to annual reports, as the other benefit corporation statutes provide).

b. **Non-public**—The report is to be provided to the company's stockholders: it does not specify that the reports must be publicly filed.

c. **No "Third Party Standard" Obligation.**

d. **Additional Requirements Can Be Made Mandatory By Charter Provision**—8 *Del. C.* § 366(c) specifies that the certificate of incorporation may require the corporation to provide more frequent reports, make the reports available to the public, use a third party standard or attain a third party certification.

5. Derivative Suits

a. 2% Plaintiff—Individual or collective holders of at least 2% of the outstanding shares (or, if public, $2 million in market value) may maintain a derivative lawsuit to enforce directors' tripartite balancing requirement. 8 *Del. C.* § 367.

b. Presumption of Good Faith

(i) *See* 8 *Del. C.* § 365(b) ("[W]ith respect to a decision implicating the balance requirement . . . [a director] will be deemed to satisfy such director's fiduciary duties to stockholders and to the corporation if such director's decision is both informed and disinterested and not such that no person of ordinary, sound judgment would approve.").

(ii) *Cf.* 8 *Del. C.* § 141(e) (traditional corporation directors "shall . . . be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation").

c. Extended Exculpation/Indemnification Protection—"The certificate of incorporation of a public benefit corporation may include a provision that any *disinterested* failure to satisfy this section shall *not*, for the purposes of § 102(b)(7) [permitting exculpatory charter provisions for certain fiduciary duty breaches] or § 145 [permitting indemnification for certain good faith acts] of this title, constitute an act or omission not in good faith, or a breach of the duty of loyalty." 8 *Del. C.* § 365(c) (emphasis added).

d. Self-Dealing Remains the Likely Focus of Derivative Claims—Based on the scope of Delaware's proposed protective provisions, it is likely that the Court of Chancery will focus on whether directors' decisions were disinterested.

6. High Vote To Opt In

a. *See* 8 *Del. C.* § 363(a) (requiring approval of 66 2/3% of the outstanding shares of each class of stock of a traditional corporation, whether voting or non-voting, in order to (i) amend its certificate of incorporation to include a public benefit provision or (ii) effect a merger resulting in the traditional corporation's shares being exchanged for equity interests in a domestic or foreign public benefit corporation or similar entity).

b. 8 *Del. C.* § 363(b) (granting appraisal rights to any traditional corporation stockholder that did not vote for or consent to an amendment or merger into a benefit corporation entity).

c. 8 *Del. C.* § 363(d) (prohibiting nonprofit nonstock corporations from engaging in a merger into a public benefit corporation).

7. High Vote To Opt Out—Approval of two-thirds of the outstanding shares of each class of stock of a public benefit corporation, whether voting or non-voting, is required to effect an amendment or deletion (by merger, consolidation or otherwise) of a certificate of incorporation provision that specifies public benefits or requires more specific reporting requirements. 8 *Del. C.* § 363(c).

8. Limited Intended Effect on Traditional Delaware Corporations—*see* 8 *Del. C.* § 368 ("This subchapter shall not affect a statute or rule of law that is applicable to a corporation that is not a public benefit corporation, except as provided in § 363 of this title" relating to the voting and appraisal requirements for a non-public benefit corporation effecting an amendment or merger to become a public benefit corporation).

H. Entities Interested in the Benefit Corporation Structure

1. B Lab

a. The non-profit organization that first developed the concept of the benefit corporation and has been advocating for its adoption across the country.

b. B Lab goes through a process of certifying socially conscious for-profit entities as "certified B Corporations," essentially a "seal of approval" that corporations use for marketing purposes.

c. Note that B Lab has certified 690 entities as "B Corporations." (http://www.bcorporation.net/community). But not all of these entities are incorporated under a state benefit corporation statute. *See* B Lab "Legal Roadmap" (available online: http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/1057-legal-roadmap) (noting that "no further legal action is needed" with regard to governance changes for a benefit corporation to meet the legal requirements for B Lab certification, but also explaining steps that foreign and domestic corporations, LLCs and sole proprietorships can take to obtain B Lab certification).

2. Entities Creating and Measuring "Third Party Standards"—B Lab has collected a list of 12 third party standards governed by different groups. B

Lab Benefit Corp Information Center, *List of Standards* (available online: http://www.benefitcorp.net/selecting-a-third-party-standard/list-of-standards). These standards include "ISO 26000," governed by ISO International; "Sustainable Farm Certification," governed by Sustainable Agriculture Network; and "B Impact Assessment," governed by B Lab.

3. Socially Minded Entrepreneurs

a. *See* Equilibrium Capital, *Sustainable Alpha* (available online: http://www.eq-cap.com/defining-sustainable-alpha/) (describing a strategy to "manage an asset so that it can produce value today, and continue to do so 10, 20, 50, even 100 years from now . . . in a way that does not deplete or damage the asset, the environment or the community").

b. *See, e.g.*, John Tozzi, *Patagonia Road Tests New Sustainability Legal Status,* Bloomberg (Jan. 4, 2012) ("Among companies with altruistic streaks, Patagonia has long stood out for the environmental philanthropy championed by founder Yvon Chouinard. The maker of outdoor clothing and gear has redirected a portion of profits to green causes since 1986 and discloses the chemicals it uses in its products. . . . Today the law has finally caught up with Patagonia's do-good efforts . . . .").

4. Investors in Socially-Conscious Corporations

See Christopher C. Geczy, Robert F. Stambaugh & David Levin, *Investing in Socially Responsible Mutual Funds*, (Mar. 2003, revised Oct. 2005) (available online: Available at SSRN: http://ssrn.com/abstract=416380 or http://dx.doi.org/10.2139/ssrn.416380) (defining socially responsible investment as "an investment process that considers the social and environmental consequences of investments, both positive and negative, within the context of rigorous financial analysis").

5. Greenwashing?—attempting to cash in on the cachet in the marketplace of "going green" or being seen as socially conscious without actually causing such a benefit.

See Katherine R. Lofft, Purvi B. Maniar & Tamar R. Rosenberg, *Are Hybrids Really More Efficient? A 'Drive-By' Analysis of Alternative Company Structures*, Bus. L. Today (Sept. 2012) (defining greenwashing as "the use of marketing and other devices by a business to create the generally unfounded perception that . . . its goals and policies are environmentally friendly, whether to attract customers or investors, or otherwise to increase profits").

IV. FLEXIBLE PURPOSE CORPORATION ("FPC") STATUTES

A. Intent

1. Permitting each corporation to decide what public interests it may or will consider, by specifying such interests in its articles of incorporation.

B. Charter-Based Structure

1. Private Ordering—FPC statutes generally permit each corporation to set the rules of operation in its articles of incorporation. For example, the corporation may determine if it wants to permit, or instead to require, the directors to take the specified public interests into consideration when making a decision, again by specifying in the articles of incorporation whether such consideration is permissive or mandatory.

2. Social Purpose Report—The existing FPC statutes provide for reports along the lines of a benefit corporation's annual benefit report to be sent to stockholders either annually or upon the happening of certain events. However, the statute does not mandate adherence to a "third-party standard" if that is not required in the charter.

C. Adoption

1. To date, two states have adopted FPC statutes: California, effective January 1, 2012 (*Cal Corp. Code* § 2600 *et seq.*) and Washington, effective June 7, 2012, where it is called a "social purpose corporation" (*Wash. Rev. Code* § 23B.25).

2. California adopted both a benefit corporation statute and a FPC statute on the same day. Regents of the University of California, *Two New Types of Corporations to Enable Socially Responsible Businesses, Effective January 1, 2012*, Continuing Education of the Bar, California (available online: http://ceb.com/lawalerts/flexible-purpose-corps.asp) (Dec. 1, 2011).

D. Washington's "Social Purpose Corporation" Statute

1. Permits the social purpose provided in the articles of incorporation to be narrowly tailored or as broad as that of a benefit corporation:

> **a.** "Every corporation governed by this chapter must be organized to carry out its business purpose . . . in a manner intended 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." *Wash. Rev. Code* § 23B.25.020 (emphasis added).

b. Requiring the articles of incorporation to include, among other things, "(c) A statement setting forth the general social purpose or purposes for which the corporation is organized pursuant to RCW 23B.25.020; (d) If the corporation has designated one or more specific social purpose or purposes pursuant to RCW 23.B.25.030, a statement setting forth such specific social purpose or purposes; and (e) A provision that states the following: '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.'" *Wash. Rev. Code* § 23B.25.040(1)c)-(e).

2. Social Purpose Report—Required to be published on the company's web site within four months after the close of the fiscal year, including a discussion of the corporation's efforts to promote its social purposes, but not necessarily in accordance with a third-party standard. *Wash. Rev. Code* § 23B.25.150:

3. Permissive Acts May be Made Mandatory—*See Wash. Rev. Code* § 23B.25.040(2)(a)-(b):

> [T]he articles of incorporation of a social purpose corporation may contain the following . . .
>
> (a) A provision requiring the corporation's directors or officers to consider the impacts of any corporate action or proposed corporate action upon one or more of the social purposes of the corporation;
>
> (b) A provision requiring the corporation to furnish to the shareholders an assessment of the overall performance of the corporation with respect to its social purpose or purposes, prepared in accordance with a third-party standard . . . .

4. Standards for Discharging a Director's Duties

a. *See Wash. Rev. Code* § 23B.25.050(1) (providing that a director must discharge her duties "in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the director reasonably believes to be in the best interests of the corporation in accordance with RCW 23B.08.300" (i.e., the general standards for directors of a traditional Washington corporation, which requires the director to act in good faith, with due care and "[i]n a manner the director reasonably believes to be in the best interests of the corporation")).

b. Subsections (2)-(5) of *Wash. Rev. Code* § 23B.25.050 provide additional flexibility and protection for FPC directors:

> (2) Unless the articles of incorporation provide otherwise, in discharging his or her duties as a director, the director of a social purpose corporation may consider and give weight to one or more of the social purposes of the corporation as the director deems relevant.
>
> (3) Any action taken as a director of a social purpose corporation, or any failure to take any action, that the director reasonably believes is intended to promote one or more of the social purposes of the corporation shall be deemed to be in the best interests of the corporation.
>
> (4) A director of a social purpose corporation is not liable for any action taken as a director, or any failure to take any action, if the director performed the duties of the director's office in compliance with this section.
>
> (5) Nothing in this chapter creates any liability or grants any right in or for any person or any cause of action by or for any person, and a director shall not be responsible to any party other than the corporation and its shareholders.

5. Notice to Transferees

a. "Prior to the transfer of shares, the transferor shareholder shall give notice of the transfer to the corporation. Within a reasonable time after receiving notice, the corporation shall provide the prospective transferee with a copy of the articles of incorporation in the form of a record." *Wash. Rev. Code* § 23B.25.040(4).

b. Stock certificates are to include the following legend: "This entity is a social purpose corporation organized under Title 23B RCW 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." *Wash. Rev. Code* § 23B.25.070(2).

E. <u>Litigation</u>

1. Dana Brakman Reiser, The Next Big Thing: Flexible-Purpose Corporations, Brooklyn Law School Legal Studies Research Papers, Accepted Paper Series, Research Paper No. 311, at 17-18 (Oct. 2012) ("FPC directors' discretion to consider multiple non-prioritized purposes will frustrate shareholders' efforts to hold them accountable under the duty of care. . . . But, at least wholly irrational decisions are theoretically the basis for potential scrutiny and liability in an ordinary for-profit. This 'two masters' problem makes even this minimal level of review more challenging for an FPC, though admittedly not as challenging as the virtually unlimited 'masters' in a benefit corporation.").

V. **“ALTERNATIVE ENTITIES”**

A. **Limited Liability Companies and Limited Partnerships**

1. Contracting Around “Default” Fiduciary Duties—Allowing for private ordering as to the desired obligations of managers of the firm.

a. *Auriga Capital Corp. v. Gatz Properties, LLC,* 40 A.3d 839 (Del. Ch. 2012), (finding that LLC’s managing member owed, and breached, fiduciary duties of care and loyalty to the other members in connection with the sale of the company at an “auction” structured and won by the managing member; expressing a view that default fiduciary duties exist in the LLC context, but that they can be supplanted or modified by clear contractual provisions); *Auriga Capital Corp. v. Gatz Properties, LLC* ___ A.3d ____, 2012 WL 5425227 (Del. Nov. 7, 2012), *aff’g* 40 A.3d 839 (affirming the holding on contractual grounds, but noting that the Court of Chancery’s “statutory pronouncements” regarding existence vel non of default fiduciary duties in the LLC context “must be regarded as dictum without any precedential value”).

b. *Feeley v. NHAOCG, LLC,* __ A.3d ___, 2012 WL 6840577 (Del. Ch. Nov. 28, 2012) (finding that a manager owes default fiduciary duties to an LLC and its members; referencing Section 18-1101(c) of Delaware’s LLC Act, which permits the expansion, restriction or elimination of fiduciary duties by provisions in an LLC agreement, implying that default fiduciary duties exist that can be eliminated by contract).

2. Implied Covenant of Good Faith and Fair Dealing—Applies to every Delaware contract, including LLC agreements. Has been described in two potentially conflicting ways:

a. A limited “gap-filler” requiring the Court to arrive at an answer for a situation not explicitly accounted for in the contract. *See Nemec v. Shrader*, 991 A.2d 1120, 1125 (Del. 2010), *aff’g* 2009 WL 1204346 (Del. Ch. Apr. 30, 2009) (“The implied covenant of good faith and fair dealing involves a ‘cautious enterprise,’ inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated.”).

b. A broader method for a court to require parties to “refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving” the benefit of the bargain. *See Dunlap v. State Farm Fire & Casualty Co.*, 878 A.2d 434, 442 (Del. 2005) (quoting *Wilgus v. Salt Pond Inv. Co.*, 498 A.2d 151, 159 (Del. Ch. 1985)).

c. A court will enforce explicit contractual provisions, even if they may appear to be onerous or one-sided. *See, e.g., Greenmont Capital*

Partners I, LP v. Mary's Gone Crackers, Inc., 2012 WL 4479999, at *6 & n.24 (Del. Ch. Sept. 28, 2012) (quoting *Seidensticker v. Gasparilla Inn, Inc.*, 2007 WL 4054473, at *3 (Del. Ch. Nov. 8, 2007)) ("While [the Series B preferred stockholder's] interpretation makes sense" in that it seems unlikely that the Series B would have bargained for a conversion provision that could have forced it to convert into common stock if the more junior Series A preferred stockholders elected to convert, the Series B preferred stockholder's "'interpretation is not *reasonable* in light of the indisputably clear language of the contract'") (emphasis in original).

d. But a court will attempt to reconcile competing interests fairly when a result is not clearly specified in the contract. *See Gerber v. EPE Holdings, LLC*, 2013 WL 209658, at *6 (Del. Ch. Jan. 18, 2013) (quoting *In re LJM2 Co-Inv., L.P.*, 866 A.2d 762, 777 (Del. Ch. 2004)) ("The Delaware Revised Uniform Limited Partnership Act ('DRULPA') permits a limited partnership agreement to eliminate all duties, other than the implied contractual covenant of good faith and fair dealing, that a person acting under that agreement may owe to a limited partnership and its limited partners. Only 'if the partners have not expressly made provisions in their partnership agreement . . . will [a court] look for guidance from the statutory default rules, traditional notions of fiduciary duties, or other extrinsic evidence.'").

e. The LLC structure is sufficiently flexible to create an other constituency/benefit corporation arrangement through private ordering.

(i) In fact, several LLCs are already certified "B Corps" (e.g., Afghanistan First, LLC; Changematters, LLC; Clean Currents, LLC; Healthy Markets, LLC; Solar Honey Benefit LLC; Solarfire Engineering, Benefit LLC; Substance151, Benefit LLC; Takoma Park Solar, Benefit LLC; and Vera Solutions, Benefit LLC).

(ii) But practically speaking, the LLC agreements for these entities, no matter how tightly drafted, will necessarily still include gaps where the implied covenant of good faith and fair dealing will apply. It remains to be seen how the court will apply the implied covenant in such a context.

3. *See* William H. Clark, Jr. and Larry Vranka, White Paper, *The Need and Rationale for the Benefit Corporation: Why it is the Legal Form that Best Addresses the Needs of Social Entrepreneurs, Investors, and, Ultimately, the Public*, Appendix C at 3 (Jan. 18, 2013 version) ("[M]any investors have a policy, or at least a strong preference, for investing in a corporation rather than an LLC. While some LLC's have gone public, LLC's still represent a small minority of IPOs over the last decade, and there remains material resistance among venture firms to investing in LLCs.").

B. <u>L3Cs (Low-Profit Limited Liability Companies)</u>

1. Explicit That Social Mission Trumps Profits

2. Purpose

a. Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 Del. J. Corp. L. 879, 882 (2010) ("By statute, an L3C's purposes are tightly restricted. The restrictions are designed to implement the L3C's central purpose—'to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations'—so as to allow foundations to invest some of their assets in private, profit-making enterprises formed to advance socially desirable goals.").

b. Anne Field, *IRS Rule Could Help the Fledgling L3C Corporate Form*, Forbes, May 4, 2012 (available online: http://www.forbes.com/sites/annefield/2012/05/04/irs-rules-could-help-the-fledgling-l3c/) ("By law, foundations have to direct 5% of their assets every year for charitable purposes to keep their tax-exempt status. They can do that through grants, of course. But they also can make investments, as long as the entity they're putting their money in primarily is aimed at a charitable or educational purpose and making a profit isn't a significant goal. Those investments are called PRIs. . . . [H]owever, foundations have been slow to make such investments. That's because they've been afraid of being socked with a big excise tax by the IRS for engaging in speculation if the agency finds the organization they've invested in isn't kosher.").

3. Need for Revenue Ruling—Does investing in L3Cs, as opposed to properly-crafted LLCs, avoid the need for a PRI to obtain a revenue ruling for each investment?

a. If the definition of an L3C requires adherence to the same sorts of requirements for an investment to qualify as a PRI, would such a blanket revenue ruling that L3C's are acceptable conduits of PRI investments do any good, or would it simply shift the question to whether the L3C actually meets the definition of being an L3C, without actually providing clear comfort to investors?

b. Could L3C's obtain legal opinions regarding their status as such? Why couldn't a traditional LLC just as easily get a similar opinion that its membership interests qualify as PRIs?

4. **Vermont's L3C Provisions**—the first L3C statute, adopted in 2008:

a. *Vt. Stat. tit.*11, § 3001(27):

> "L3C" or "Low-profit limited liability company" means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:
>
> (A) The company: (i) significantly the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170(c)(2)(B); and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
>
> (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
>
> (C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D).
>
> (D) If a company that met the definition of this subdivision (27) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit LLC, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company. The name of the company must be changed to be in conformance with subsection 3005(a).

b. *Vt. Stat. tit.* 11, § 3005(a):

> (1) Except for low-profit limited liability companies, the name of a limited liability company as set forth in its articles of organization shall contain the words "limited liability company" or "limited company" or the abbreviation "L.L.C.," "LLC," "L.C.," or "LC." . . . (2) The name of a low-profit limited liability company . . . shall contain the abbreviation L3C or l3c.

Access to Finance
FORUM
Reports by CGAP and Its Partners
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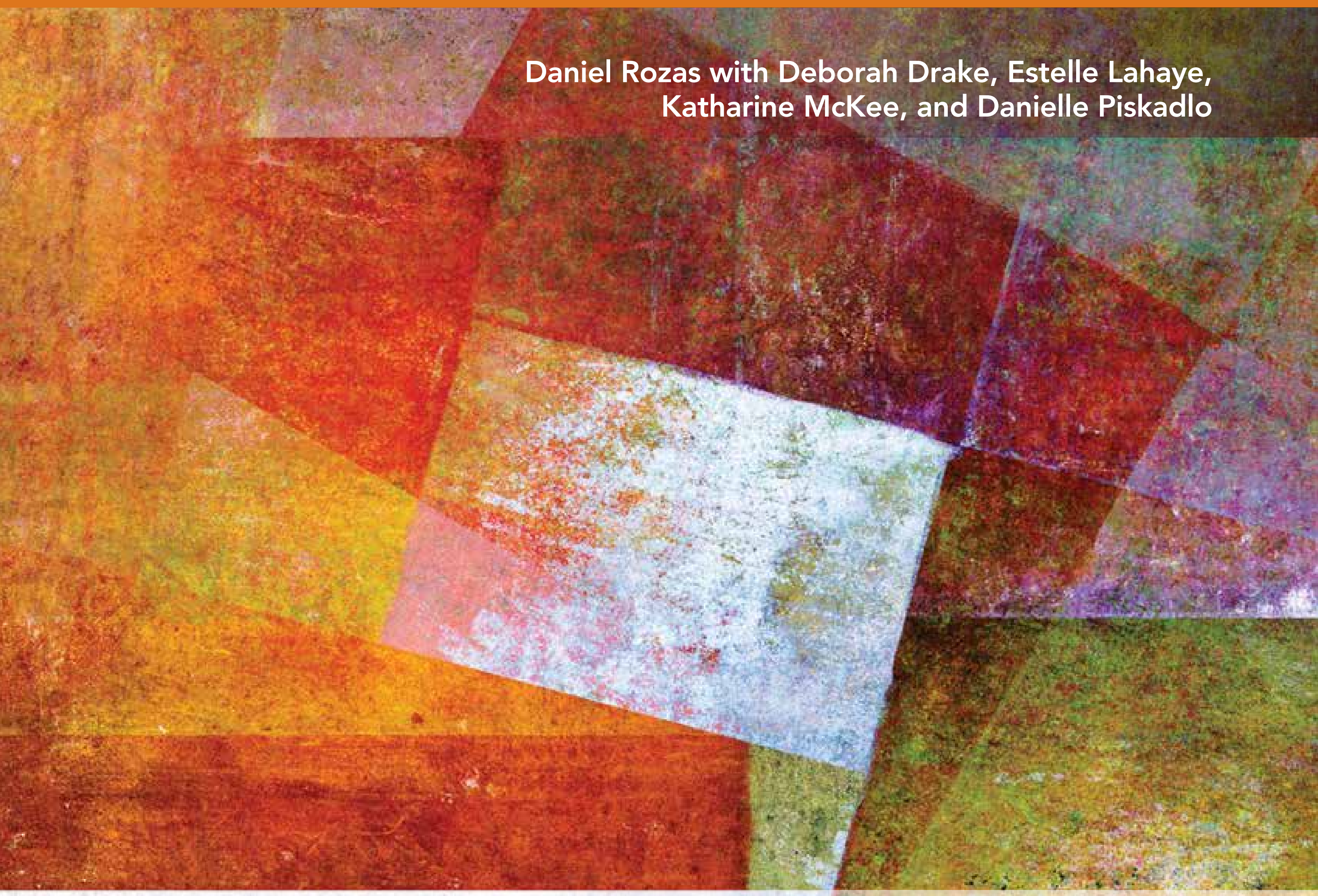
The Art of the Responsible Exit in Microfinance Equity Sales



Daniel Rozas with Deborah Drake, Estelle Lahaye, Katharine McKee, and Danielle Piskadlo

CGAP

CENTER for FINANCIAL INCLUSION | ACCION

As the microfinance industry matures, a question that has come into sharper focus is how social investors committed to advancing responsible finance practices should "exit responsibly" from the microfinance institutions (MFIs) in which they have invested over the years. As they prepare to sell their stakes, what options do development-minded investors have to help ensure responsible behavior by their partner MFI into the future and healthy development of the broader market?

In this paper the Center for Financial Inclusion at Accion (CFI) and the Consultative Group to Assist the Poor (CGAP) seek to spark discussion among the stakeholders working to advance financial inclusion and in particular the investor community that will result in greater clarity around the goal of responsible exits and the policies and practices that would support it.

Acknowledgments

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Contents

SECTION 1

Introduction

Equity as a funding instrument is particularly important to responsible development of financial markets. At its core, it supports the growth and diversification of microfinance institutions (MFIs) and other financial institutions that serve the poor, and it is especially vital to the expansion of deposit services.

But beyond that, equity holdings can add value when paired with active governance.[1] First, they offer development-minded shareholders the opportunity to provide leadership to partner MFIs, including guidance to ensure that the overall strategy and specific products and practices are responsible. Second, they can promote responsible development of the broader market to the extent that they demonstrate the viability of responsible MFI business models (including by sharing relevant information on partner MFIs' performance with other market actors) and crowd in additional investors with goals and funding types that are appropriate for microfinance. This point is especially important for development finance institutions (DFIs), which are owned by donor governments and thus are mandated to be catalytic and "additional" in promoting private sector development.

Most microfinance investment intermediaries (MIIs) and DFIs have committed explicitly to do right by clients through industry initiatives such as the Smart Campaign and the Principles for Investors in Inclusive Finance (PIIF), which urge and support them to choose partners carefully and integrate specific responsible finance practices throughout their investment processes.

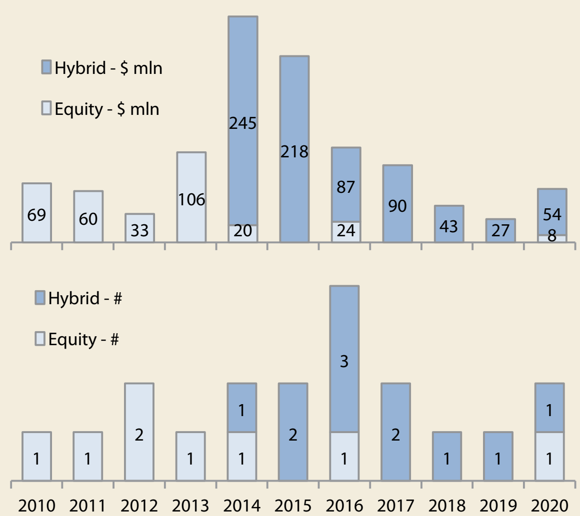
As the holdings of MIIs and DFIs mature, the sale of equity stakes is becoming an increasingly important task and one that requires consideration of additional dimensions of responsible finance and responsible market development. When investors that seek to be socially responsible exit, they face the challenge that they will give up their right to help oversee or govern the investee. To what extent can—or should—investors seek to ensure that the sale of their stakes in MFIs will result in ongoing responsible behavior by their (former) partners and new owners and even contribute to healthy development of the overall market? And what if they reinvest the proceeds from a sale into younger mission-focused institutions and underserved markets: is such an exit then automatically socially responsible?

Equity exits are not a new phenomenon in a sector where the first funds were created well over a decade ago and a number of sales have already happened (Glisovic, Gonzalez, Saltuk, and Rozeira de Mariz 2012). They are also expected to accelerate. According to MicroRate/Luminis, between 2014 and 2016, at least two equity and six hybrid funds worth nearly $600 million are scheduled to mature (Figure 1).

In this context, this paper seeks to explore the concept of a responsible exit along four strategic decisions: (*i*) the timing of the equity sale, (*ii*) buyer selection, (*iii*) the governance and use of shareholder agreements to achieve social objectives, and (*iv*) how social and financial returns are balanced when selecting among bids. We also examine how DFIs can use exits

FIGURE 1

Microfinance Fund Maturity Schedule



Source: MicroRate/Luminis

1. However, DFIs and MIIs do not always succeed in providing active governance support to partner MFIs. McKee (2012) and recent studies from CFI on governance and investor and board behavior during sectoral crises document that equity investors often fail to provide adequate guidance and expertise in the board room and other governance processes.

to encourage responsible market development given their particular role as publicly funded entities. We interviewed more than 40 representatives from MIIs, nongovernment organizations (NGOs), DFIs, MFIs, and merger-and-acquisition (M&A) specialists to capture their experience, perspectives, and emerging lessons on equity sale transactions. In addition, we conducted six case studies of equity exits, which are described in detail in the appendices.

This paper is not intended to be prescriptive. The practice of selling equity in MFIs is still evolving, and the complexities of the transactions make each sale unique. Rather than setting out specific guidelines, we hope to draw on investor experiences to highlight key exit-related decisions for MIIs and DFIs, and in so doing, we hope to spur a focused debate on how to exit in such a way that the interests of investors, MFIs, and their clients are balanced.

BOX 1

Key Findings

Exits of equity investments are still relatively recent but lessons on how to ensure ongoing responsible behavior by partners and the broader market are emerging. There are several overarching themes that affect the options that investors are likely to face: market context and stage of development; share of ownership being sold; and the MFI's ownership structure, governance arrangements, and place in its life cycle. As a result, there is no single approach to ensure a responsible exit. However, investors need to carefully think about four main strategic decisions:

1. When? The desired timing and avenue of exit should form a key part of an investor's decision to invest. These plans and preferences should be discussed with the other equity investors and the MFI's management. That said, rarely did the exit opportunity materialize exactly as planned, and ability to adapt and respond flexibly was a feature in many exits. For fixed-term funds, exit timing is built into the prospectus, but at least one case study suggests that this structure may not be optimal for the specific role of anchor investor.

2. To Whom? There are advantages and disadvantages of selling to a microfinance investor versus an investor outside of the microfinance ecosystem. On the one hand, it is easier to find a like-minded buyer within the ecosystem, which can mitigate concerns about mission drift or reputation risk. On the other hand, for more mature MFIs, investors such as local or regional banks might be better placed to play a strategic role by bringing strong balance sheets, operational expertise, and local market linkages that the MFIs need to develop further. Exiting DFIs and MIIs can be guided by careful and deliberate due diligence to ascertain the buyer's intentions and commitment to the MFI's mission, combined with judgment about the kind of capital and expertise the MFI most needs in its next chapter.

3. How? In principle, putting provisions in shareholder agreements and setting up alternative mission-oriented governance structures could help enshrine the MFI's mission and social commitments to send an important signal to potential investors when current owners seek a buyer for their shares. We analyze several examples of this approach. It should be noted, however, that the legal enforceability of such provisions varies widely and their relevance may be limited when a controlling stake is being sold. The risk also exists that overly restrictive and complex legal provisions could pose unreasonable barriers to exit.

4. How Much? The selling party may have multiple offers to choose from, with each bidder offering a different mix of price and nonprice characteristics. Since cashing out nearly always entails giving up say over the investee's future social or developmental mission, we examined more specifically how investors described weighing price- versus mission-related features of the potential new owner. The findings suggest that many investors currently may be using a two-step process in which they first screen buyers for suitability (including mission fit) and then make their final selection based on the most attractive price. We also note that high-priced sales to new buyers in the microfinance sector may risk locking an MFI into a strategy that may harm both its clients and the broader market.

Finally, because of their specific mandate, DFIs have a special role to play in private-sector development. The way they exit—when, how, to whom, and for how much—can send important signals to other market players. By integrating a market development dimension into these four key decisions, DFIs have an opportunity to fulfill their mandate to play a broader catalytic role.

SECTION 2

Four Decisions

As noted in Box 1, there are four key questions equity investors have to wrestle with when trying to responsibly exit an MFI: (1) when to sell, (2) who to sell to, (3) with what conditions, and (4) at what price. Several overarching themes affect these decisions and the actual options that investors have: the context and stage of development of the market (e.g., less-developed markets tend to have more circumscribed exit opportunities); the size of the stake being sold ("anchor" investors face a different set of choices than investors selling noncontrolling stakes); and the MFI's stage in its own life cycle, ownership structure, and governance arrangements. The decision might also create tensions with other shareholders and/or the MFI management, making the selling process more complicated to manage. Ultimately, the final decision requires balancing among competing demands, demonstrating that exiting responsibly is an art of tradeoffs.

2.1 When?

Plan your exit before you enter. This phrase was repeated in so many interviews that it seems almost a mantra for equity investors. In fact, the exit plan can be an integral part of their decision to invest. Our findings suggest that a few investors are starting to integrate exit criteria into their pre-investment due diligence, including the possible exit strategies according to the stage of market development. Some investors also suggested discussing exit planning upfront with pre-existing shareholders, co-investors, and the MFI's management, and referencing the question of exits in the shareholders' agreement or the MFI's charter.

Upfront plans notwithstanding, exits rarely materialize exactly as planned—the ability to adapt and respond flexibly to unexpected circumstances is no less important. When the early stage investor Aavishkaar Goodwell invested in Equitas in India (Appendix B), the plan was to stay in for at least five years, during which Aavishkaar Goodwell expected to be actively involved in governance and provide technical support. However, within two years Equitas had grown so fast that it had far outstripped the needs of typical early stage MFIs. Aavishkaar Goodwell's stake had been diluted in the process, and it had to give up its board seat. Unable to put up additional capital and continue its influential advisory and governance roles, Aavishkaar Goodwell decided to sell half of its shares and worked with the MFI management to select the most appropriate buyer. Despite the unusual limitations attached to Equitas' stock, the investor had no difficulty in finding willing and suitable buyers. Indeed, the MFI's extraordinary growth as well as the excitement around the SKS initial public offering (IPO) created attractive conditions.[2] The fund was then able to redeploy its capital in younger markets and institutions where it expected to have a greater impact and better fulfill its double bottom line.

For fixed-term funds and their investees, the "when" question can be particularly challenging. For example, the Indian fixed-term fund Bellwether was an anchor investor in Arohan and had been instrumental in supporting this MFI in its early stages of growth (Appendix D). However, when Arohan was facing a severe liquidity shortage at the height of the Andhra Pradesh microcredit crisis, Bellwether was unable to provide the capital Arohan needed. With its equity already fully invested and the fund itself scheduled to mature soon, Bellwether had few options. Meanwhile, with Arohan struggling for survival and the sector in crisis, conditions for sale were exceptionally poor. Ultimately Bellwether found a willing buyer in Intellecash, but this was not the exit it had planned.

Bellwether's example highlights the important role of anchor investors and their investing strategies. Anchor investors generally hold a large (although not necessarily majority) stake that comes with a governance role that is often more active than that of other shareholders. Ideally, anchor investors should have sufficiently long investment horizons and deep enough pockets to be able to support their investees with additional capital when needed, while providing strategic guidance and necessary expertise on the board of directors. However, as Bellwether's case demonstrates, the fixed-term funds' timing limitations and limited capacity for later stage investment may result in negative consequences for both the investor and the MFI. Fixed-term funds can play an important role in bringing diversified capital into the sector, especially by crowding in local sources of funding, but their structures may not be best suited for the role of anchor investor.

2. On 28 July 2010 SKS, India's largest MFI, became the first Indian MFI to float its shares through an IPO.

For anchor investors, the stakes are higher in an exit, especially with respect to balancing social and financial returns. Consider the case of the sale of Edyficar in Peru by the large international NGO CARE International (Appendix E). CARE founded Edyficar as an NGO MFI in 1985 and, over the next quarter-century, supported its development, including transformation into a regulated, deposit-taking institution. However, following Edyficar's transformation, CARE was increasingly unable to provide the requisite technical expertise and governance support. Having recognized that it was becoming an impediment to Edyficar's development, CARE sought to sell its anchor shareholding position. Unlike Bellwether, it did not face any fixed exit horizons, yet CARE's decision to sell Edyficar was not easy, especially in light of the long and close history of the two institutions.

Edyficar's sale illustrates the critical role anchor investors play in MFI development. In the course of our research, we identified cases where the limited capacity of such anchor investors (including founding NGOs) to provide growth capital and technical expertise may have constrained the partner MFI's ability to diversify products and scale up. (In some cases, lack of access to growth equity may even force MFIs to finance growth with retained earnings, which in turn can create pressure to maintain higher profit margins including through higher prices for their clients.)

2.2 To Whom?

No other aspect of an equity sale looms quite as large as the selection of the buyer. The decision consists of two key issues: first, ascertaining to what extent the buyer is a like-minded investor that shares a commitment to the MFI's stated mission and can be trusted to "stay the course" over time; and second, whether the buyer can add value to the MFI in terms of strategic direction, specialized expertise, and growth capital.

For purposes of defining "like-minded investor," prospective buyers fall into two broad categories: members of the microfinance investment ecosystem (such as current shareholders, MIIs, DFIs, or large MFIs or their holding companies) and external actors (often local or regional investors, including commercial banks and venture capital firms).

Within the microfinance ecosystem most investors share somewhat similar goals and responsible finance commitments, and nearly all tend to subscribe to the sector's basic set of client protection principles and social performance expectations.[3] Most importantly, the small size of the ecosystem and the limited number of actors involved mean that a seller is likely to have longstanding knowledge of the buyer and its reputation. As a result, selling within the microfinance ecosystem simplifies the process of meeting the minimum standard for a "responsible" buyer and is less likely to raise significant concerns about mission drift or reputation risk.

A good example of a sale within the microfinance ecosystem is the purchase of Accion Investments (AINV) by Bamboo Finance (Appendix A). Both Accion and Bamboo are long-term members of the sector and subscribe to the same responsible finance commitments. The familiarity goes further still—Bamboo and its former sister organization, Blue Orchard, had direct investments in many of Accion's MFIs, and one of Bamboo's senior staff was a director of AINV. As the seller, Accion had little need to evaluate the buyer's like-mindedness on the issues that mattered; it knew where Bamboo stood.

Despite the apparent advantages, selling within the ecosystem is not necessarily the best course of action. In some cases, seeking buyers outside the microfinance ecosystem is an outright necessity: most MIIs in the market do not have sufficient capital to buy large stakes in mature MFIs while maintaining a diversified portfolio. For mature MFIs, local actors such as domestic commercial banks can make excellent strategic investors, bringing operational depth, a more diversified product line, and longstanding regulatory relationships, in addition to capital and access to low-cost deposits. Such actors are usually found in markets with growing economies or relatively well-developed financial sectors—the same markets where large MFIs are also more likely to develop. As a result, for selling shareholders, finding such investors has not generally been difficult.

The chief challenge of going outside the microfinance ecosystem is the difficulty of assessing buyer like-mindedness. To start with, the seller is less likely to be familiar with the potential buyer. And such buyers are also less likely to be aware of, and have subscribed to, industry standards such as the Smart Campaign Client Protection Principles. In our interviews, selling investors mention paying close attention to the following in their due diligence on prospective buyers:

- The buyer's rationale for the purchase and its strategic plans and alignment with the MFI's own strategy
- Willingness to reference mission-related objectives in the shareholder agreement among owners of the MFI[4]

3. The Social Performance Task Force (SPTF) brings together more than 1,500 members (MFIs, donors, investors, associations, etc.) to agree on a common social performance framework and to develop an action plan to move social performance forward. SPTF facilitates a social investors working group that aims to explore good practices related to investment for social as well as financial outcomes and also promote social investment.
4. A shareholders' agreement is an agreement among the shareholders of a company, and it supplements (or supersedes) the company's charter. It is common practice in a company where there are a relatively small number of shareholders and often regulates issues such as voting rights, control and management, dispute resolution, etc. Shareholders' agreements are not always legally enforceable.

- The prospective buyer's prior activities or investments in micro, small, and medium enterprises (MSME) or low-income finance
- The comfort level of the MFI's management and, where relevant, the founding NGO/promoter with the potential shareholder

One example of the challenge of assessing buyers is the case of Sathapana, a Cambodian MFI held by several social and development investors (Appendix F). The outside-the-ecosystem bidder in that case was Maruhan Japan Bank (MJB), an existing commercial bank in Cambodia that was already lending to Sathapana and other MFIs. The bid was financially attractive and brought many strategic advantages. However, one concern that arose was that MJB was wholly owned by Maruhan Corporation in Japan, whose business includes slot-machine gaming. To address this concern, the sellers requested a specific legal commitment from the parent company that the scope of its Cambodian operations would remain limited to the banking sector and would not extend into gaming.

Another example is the case of CARE's sale of Edyficar (Appendix E). As an NGO focused on fighting poverty around the world, CARE faced a considerable challenge in assessing like-mindedness when it sold its majority stake in Edyficar to Banco del Credito del Peru (BCP), a purely commercial bank with no explicit social mission. However, BCP offered Edyficar the banking expertise and balance sheet strength that CARE could not possibly provide. A key factor that played into CARE's decision was BCP's claim that it would in fact maintain Edyficar's mission—and do so out of largely commercial motives. BCP had previously tried to build its own microcredit operation. While it was not successful, the bank took away the lesson that microfinance required an inherently different approach from its retail banking model. This experience enhanced the credibility of BCP's assertion that it would not change Edyficar's mission or operations, especially when BCP underscored its commitment by agreeing to sign year-long contracts with key management. The signals proved convincing, and CARE chose BCP from among its options. Even now, with three years of hindsight, both CARE and Edyficar's long-time management regard the sale as successful and consistent with the long-term goals of all parties to the transaction.

However, not all such sales to buyers outside the sector end as well. Our interviews yielded cases that were described as less successful, including the 2005 sale of Russian KMB Bank to Italian bank Intesa, which within a few years had abandoned KMB's original focus on SME lending, largely undoing the efforts of its founding investors. Another scenario that could become increasingly common is that of a commercial bank bidder that engages in substantial consumer lending directly or through an affiliate. This fact might merit additional due diligence on the seller's part to assess the bidder's commitment to responsible finance and better understand whether and how this line of business might affect the character of the MFI.

In summary, when looking for a buyer, it helps to consider whether an existing microfinance investor is likely to come forward, since such investors almost by definition pose a lower risk to the MFI's mission. However, particularly when large equity stakes are involved, such buyers may prove unsuitable or altogether unavailable, and going outside the microfinance ecosystem can bring other advantages and may prove a better choice. In such cases, most of those interviewed found it likely that a seller with a careful and deliberate due diligence process could reasonably ascertain the bidder's intentions. At the same time, the microfinance investment sector also would benefit by broadening the capacity of socially responsible funds to absorb larger-ticket equity transactions (see Box 2).

BOX 2

A Fund to Invest in Mature MFIs

For some time, MIIs have exhibited a common investment model: each usually seeks to invest around $3 million to $5 million, most want a board seat, and most have an eventual exit timeline. This limits the range of investable MFIs to small and mid-sized operations. Institutions that grow past that threshold—around $100 million in assets—no longer present realistic investment options for these funds.

The recent launch of the responsAbility Participations fund is meant to fill this void. Specifically designed to invest in mature MFIs and small emerging market banks, the fund expects its typical investments to be in the $20 million to $25 million range, entitle the fund to a board seat, and be subject to social performance requirements. In other words, it meets the "desirable buyer" criteria for many other funds seeking to sell their stakes in mature MFIs. The fund is distinctive in one other dimension—it has an "evergreen" structure that focuses on delivering dividend yield rather than capital gains, which enables it to avoid a specific exit timeline.

2.3 *How?*

While efforts to assess buyer like-mindedness and commitment to the MFI's mission are critical, these are not the only doors through which development-oriented sellers can exit gracefully. What if they could put in place some mechanism to constrain buyers from steering the MFI away from its mission even after the sale? The research uncovered growing interest in, and use of, the shareholders' agreement to codify the MFI's mission and social commitments. Such provisions can send an important signal to potential investors, a warning to those who would prefer not to be thus constrained. That said, the legal enforceability of such shareholder provisions varies widely from one jurisdiction to another, and this approach would work only so long as the majority of investors support these commitments. (And this option can become moot in cases where a controlling stake is being sold.)

Shareholders' agreements in the microfinance sector often have provisions that serve to protect minority shareholders when others are seeking to exit. In fact, the right of first refusal (ROFR) was commonly cited during our interviews.[5] ROFR permits existing investors to acquire shares before a third party buys them. It can enable existing investors to send strong signals to potential bidders, keep a tighter control on who buys the MFI's shares, and protect its adherence to its mission and social commitments. Minority shareholders can typically use these protective provisions to exit when the proposed transaction significantly alters their planned strategy for the MFI, or more simply, to take advantage of a favorable price. But couldn't such rights also be exercised to protect the social mission of the institution?

Such minority shareholder protections can have down sides, however. For one, they set up a structure of dual rights among the shareholders (those initiating the sale and those exercising minority protections) that can lead to tension among shareholders. They can also have unintended consequences. For example, when one social investor decided to exit from an MFI owned by a mix of social and commercial shareholders, a commercial investor decided to exercise its ROFR prerogative to buy the stake. This threatened to shift the balance on the board away from the social investors that made up the governing majority unless the remaining social investors exercised their own ROFR rights to increase their stakes (which they did). Some investors mentioned situations where minority shareholder protections present so great a barrier for the seller as to make an exit impossible altogether.

Minority shareholder rights are not the only means for keeping an MFI focused on its mission. Other avenues include executing long-term contracts with existing management or putting in place self-perpetuating governance structures that prevent takeover by any one shareholder. There are also examples where investors can exercise post-exit influence (e.g., by adding the requirement that key institutional decisions be made by a super-majority or ascribing majority voting rights to minority shares). Some legal structures[6] specifically allow minority shareholders to have a significant say on certain key issues, including changes to the institution's mission, while other structures may allow minority shareholders to exercise outright control (see Box 3).

These structures need to be approached with care, to ensure that otherwise suitable potential investors are not put off by having less say in governance. However, when done correctly, alternative governance structures to support a strong social mission can remain attractive on a strictly commercial basis.

Equitas offers one such example (Appendix B). Since a majority of its board members serve as independent directors, shareholders are prevented from having full run of the institution's governance. Furthermore, Equitas' shareholder agreement sets a return on equity (ROE) ceiling of 25 percent and earmarks funds for charitable activities. Despite these limitations and lack of shareholder control, Equitas has remained attractive to purely commercial investors. One private equity firm, Canaan Partners, which purchased Equitas shares before the Andhra Pradesh crisis pointed out that it was drawn by the fact that Equitas' governance structure, combined with its strong management, helped generate solid but stable returns over the long term, in clear contrast to the potentially higher-return but more volatile model of many of Equitas' competitors at the time.

BOX 3

Governing from a Minority

Companies can choose to have multiple classes of common stock, usually denoted as Class A and Class B shares with one class having more voting rights than the other. This can set up a system whereby a relatively small minority of shareholders could maintain governing control of the company. For example, in 2006, when McDonald's sold its Class B shares of Chipotle Mexican Grill it provided its holders 10 times the voting power of Class A holders' while holding fewer outstanding shares.

Other examples of such governance include family-owned institutions and entities chartered by foundations, where the founders seek to retain significant say in governance, even as they raise equity from public investors. State-owned enterprises, especially where governments own minority stakes, are likewise vehicles that provide a strong governing voice with a limited equity investment.

5. First refusal rights are common to commercial private equity and venture capital investments and are not unique to microfinance.
6. Such as the *Kommanditgesellschaft auf Aktien* in Germany.

Mechanisms that embed a self-sustaining social mission in organizational governance structures are among the least understood elements of social investing. Future analysis could shed further light on how such techniques can attract a broader spectrum of capital while maintaining a strong social mission.

The board of directors plays a leading role in changes in shareholder composition and governance structures. An exit that entails a significant change in board composition is likely to bring with it important changes in the governance balance among directors and that between directors and the CEO. Naturally, that would include cases where the exiting shareholder is selling a controlling stake. But minority shareholders may also have an outsize influence on the institution's governance. Such influence may be exercised by founding investors whose stakes may have diluted over time, or perhaps by network NGOs that provide technical assistance and institutional support as well as equity. An exit by such investors may substantially shift the institution's governance—a change for which boards should prepare in anticipation of the exit.

Beyond the board, the perspective of the CEO and the top leadership team is no less important. Except in cases where management is expected to be replaced, getting its buy-in is critical. If management's incentives are not aligned with the sale, the result can be problematic to all parties involved (Rhyne, et al. 2009). This was a key consideration for both Edyficar and Sathapana, whose managers had been leading the organizations for many years. Their buy-in and comfort with the new shareholder was key, and the buyers' willingness to extend management contracts as part of the purchase agreement played an important role in securing the confidence of both management and the selling shareholders.

2.4 How Much?

The concept of balanced returns is relevant to all MFIs and their funders but takes on particular significance for MII and DFI equity investors. Unlike creditors, shareholders earn their primary (and sometimes only) financial return upon sale. Yet the sale nearly always entails giving up a say over the investee's future social or developmental mission.

Thus, the fourth key decision we explored is the price investors look for when they sell their shares and how they choose between competing bids that offer different combinations of financial versus (future) social returns. Despite its critical importance to achieving balanced returns, pricing is one of the areas that few investors proved willing to comment on in-depth. One of the most common themes voiced by those interviewed for this paper was that price was an important, but not the driving element, in deciding which offer to accept. Among the cases studied, only one shareholder volunteered that the price was the topmost factor in its decision. And yet, delving deeper into other cases, it became apparent that the final sale nearly always went to the highest or second-highest bidder.

Since few investors were willing to discuss details of their decisions on price and accepted (and rejected) bids, we attempted an experiment, by presenting a focus group of 33 equity investors with a hypothetical scenario in which they were selling an MFI with social objectives (Appendix G). All sale prices were purposefully set well above a reasonable return threshold (substantially exceeding average stock-market returns, for example), and the hypothetical buyers offered a wide range of social returns: a local commercial bank that appeared to provide partial support to the MFI's social objectives made an offer equivalent to 2.1 price-to-book (P/B), a holding company with a strong social focus offered 1.6 P/B, and a private equity investor with no documented social mission offered 2.7 P/B.

Stating that they were "going with their mind, rather than their heart," most investors chose the mid-priced offer (67 percent average annual return) from a local commercial bank, which held out the benefit of a strong balance sheet and local and regional market depth but only partially sup-

BOX 4

The Perils of High Valuations

Under normal circumstances investors will choose a higher price over a lower one, all else being equal. But is there such a thing as too high a price?

For social investors, the answer should be yes. An equity valuation is a reflection of the buyer's expectations of future profits and gains in enterprise value. If those two factors run significantly below expectations, the buyer may not meet its required return or potentially suffer a loss—even if the institution itself remains profitable. As a result, when the purchase price is based on expectations of very high profits and/or growth, it can make it difficult for the company to change course down the road.

Consider the examples of Compartamos and SKS, whose IPOs both commanded high valuations. In the case of Compartamos this may have affected management's willingness and ability to reduce interest rates charged to clients. In the case of SKS, the high valuations paid in the run up to the IPO may have contributed to what has now proven to be unsustainable growth. In both cases, the exceptionally high valuations either attracted unsuitable buyers or motivated unsustainable behaviors by the institutions themselves or by others seeking to capitalize on the apparent high profits in the sector.

Source: O'Donohue, et al. (2010).

ported the MFI's social objectives. Only one out of the four investor groups chose the lowest-priced, but still highly profitable offer (46 percent average annual return), even though most investors acknowledged that the buyer provided the best support for the MFI's social objectives. Meanwhile, all investors unanimously rejected the highest-priced offer (91 percent average annual return) from a short-term investor with no interest in the MFI's social mission.

If this admittedly primitive experiment indicates actual investor preferences, then the outcome could be interpreted to suggest that investor choices may be guided by a two-step process in which they first screen buyers for suitability and then make their final selection based on the most attractive price. This example stresses the trade-offs investors face in balancing returns of social and financial performance.

To the extent that DFIs or MIIs seek to maximize their profit—even after first applying a social performance filter to the bids—merits further investigation, since a high-priced sale could lock an MFI into pursuing a strategy that could hurt its clients or even pose risks to the broader microfinance sector. When an MFI's shares command too high a price, two factors are at play: high growth, high profit margins, or both. High-priced equity can increase risks of market volatility compared to markets with moderately priced equity.

SECTION 3

Market Development Considerations for Exiting DFIs

As publicly funded institutions, DFIs' mandate is to provide longer-term, patient capital to the private sector for investments that promote development. As a result, their investments are best placed where private investors fail to invest sufficiently because of real or perceived risks. But beyond developing individual retail institutions to the point where they can demonstrate the viability of the business and attract private investments, DFIs could aspire to play a broader catalytic role in developing more inclusive financial markets. They could make their investment decisions based on a broader and a more detailed assessment of market needs (El-Zoghbi and Lauer 2013). Often, the most catalytic priorities for market development are in three areas: (1) improving information, (2) building the capacity of all market actors, and (3) creating market incentives and an enabling policy environment. DFIs may already engage in these different areas to some extent, depending on the nature of their funding instruments among other factors. But they face inherent limitations in their ability to be the local, neutral, flexible "facilitator" that could support market-building across the board over the longer term. In fact, DFIs likely will contribute more to market development to the extent they can coordinate closely with local "facilitators" that undertake deep and ongoing market analysis and engage in these three catalytic areas.

This market development perspective has implications for DFIs' equity investments at both the entry and exit stages that require further analysis and discussion. For example, entry into a relatively immature or "frontier" market might itself have a more catalytic effect than putting the same funds into a more established market, as it offers more opportunities to demonstrate the viability of base-of-the-pyramid market segments and the MFI business model. Whether the MFI partner is a startup or an existing institution, the specifics of how a DFI engages over time, including in governance, can encourage private investors to "crowd in" or even take the DFI's place outright.

The way a DFI exits—when, how, to whom, and for how much—can send important signals to other market players. To the extent that the buyer is a local commercial investor or bank, rather than another DFI or DFI-funded entity, this might offer stronger proof of the attractiveness of the core microfinance business. Likewise, a DFI's return expectations can provide an important indication for what other market actors ought to expect. On the one hand, relatively high returns could help bring in mainstream sources of capital, but as noted, when price expectations go beyond a certain range, they also risk attracting future buyers with growth and profitability goals that are hard to reconcile with the nature of microfinance products and clients segments. As the sector's viability is proven, the risk premium should decrease over time in most markets.

To date there has been only a handful of DFI exits from MFIs. Several factors explain this. Our research suggests that while DFIs analyze and discuss their future exit options at entry, DFIs' longer time horizon and incentives may weaken the "exit culture." In their desire to mitigate reputational risk and/or help ensure steadfast commitment of MFIs to their mission, some of these publicly funded institutions have tended to include a number of restrictions in their shareholder agreements. When they do look to sell, these provisions combined with the overall complexity of the legal documents and procedures have had the effect of slowing down the sales process or putting off interested buyers. In addition, DFIs typically have preferred taking a minority stake, which can be less attractive to potential bidders (especially if the holding period is long and the stake has been diluted). While these present serious challenges, our interviews suggest that DFIs are starting to push themselves to find ways to exit.

One example of DFI exits is with start-ups or "greenfield" institutions sponsored by international networks or holding companies (Appendix C). These retail institutions are often created in frontier markets and are meant to set examples for others to follow, by demonstrating the viability of the microfinance segments they serve, as well as efficient operations and responsible practices.[7] After showing several years of sustainability, some DFIs have sold their greenfield MFI shares back to the holding company. The result typically changes only the nature of their involvement in the MFIs' governance, without changing its ultimate ownership since they usually are also a major shareholder in the holdings.

7. A recent IFC and CGAP study shows that in Ghana, the DRC, and Madagascar, the most important effect on market building has come from greenfield MFI investment in staff training and development while playing a pioneering role in expanding access to financial services. See, Earne, Jansson, Koning, and Flaming (2014).

Applying a market development perspective raises questions about this exit strategy: does the DFI continue to add value at the holding company level (as many sponsors seem to believe)? Were lessons about the business model and performance widely shared with the market to ensure demonstration effects? Would the market impact have been greater if the DFI had sold its shares to a suitable private investor instead of the holding company? Should the proceeds be re-invested in other frontier markets? These questions merit further discussion among development finance professionals.

SECTION 4

Responsible Exits: Looking Ahead

The aim of this paper is to explore the issues of responsible investing during equity sales and stimulate debate without prescribing practice, which we consider premature. However, as exits start to accelerate, we hope that the four key decisions—when, to whom, how, and how much—will provide a useful framework for development-oriented investors to use in evaluating their exit options. In addition, we see a number of specific areas that warrant further exploration.

Active governance of MFIs through to exit. Active and balanced engagement in MFI governance by social investors is widely reported to be a weak spot overall (McKee 2012). Most of those interviewed for this paper felt that among the governance areas that need strengthening, boards need to pay more attention to the specific goal of responsible exit and how to best achieve it. Waiting until exit is imminent to raise the question at the board level is unlikely to optimize the outcome for the selling investors, the MFI, or the other stakeholders. Further discussion and exchange of experience is needed on the role of new ownership models and shareholder agreement provisions, along with further analysis of alternative governance models that rely on independent or minority control to sustain an MFI's social mission.

Exploring new equity investing models. The first generation of equity investing is carried out mainly by fixed-term funds, and with a governing minority stake for most investors including the DFIs. Over time, this model has had positive effects in creating strong institutions serving the poor. Some shortcomings are also coming into focus, however. Fixed-term funds do not offer the flexibility that is required in an evolving sector where market conditions can still be unpredictable. However, some investors are showing interest in taking majority stakes. Other models that prioritize delivering dividend yield rather than capital gains are also gaining traction. Other equity investing models merit further analysis since they could reduce exit trade-offs.

Balanced returns and reasonable growth. The microfinance investment sector is currently involved in a lively debate about how best to balance the financial bottom line with one or more social or development objectives. While the concepts of and emerging metrics for "balanced returns" and "reasonable growth" extend well beyond the specific issues surrounding responsible exit, the four exit decisions explored in this paper are deeply rooted in the double bottom line nature of MFIs and their owners. Each investor has its own goals preferences that it seeks to achieve at exit, and the market would benefit from improved articulation of those preferences and how best to advance them.

APPENDIX A

Accion Investments: Selling an Entire Portfolio

In late 2009, the board of Accion Investments (AINV) was pondering its future. The larger investments were beginning to outgrow the fund, while the less mature investments required continued financial and governance support. Recapitalization was possible but not necessarily desirable. Some of the fund's investors wanted to sell their entire stake. Others were willing to remain but wanted an external sale to provide a reality check on how the market valued the fund's investments.

AINV was one of the first equity funds in microfinance, created when MFIs desperately needed equity and the commercialization of MFIs was just emerging. By design, as the portfolio of AINV grew, it came to include a mix of established MFIs in South America, younger ones in Central America, and recent start-ups in Africa.

When the fund's board tasked its managers to present the available exit options, they named a set of principles that should be followed: any transactions should leave portfolio companies with solid shareholding structures, be fair and transparent and coordinated with co-investors, and provide fund investors with a profitable return.

The managers identified four options for an exit: floating the company on a small stock market, recapitalizing the fund, selling it whole to a like-minded investor, or selling individual MFIs. Among these, a stock flotation seemed of limited value—AINV was relatively small and too globally diversified. The diversity of the fund also posed a challenge to finding a single investor that would be interested in all the company's assets. A case-by-case sale seemed the most likely strategy, allowing management to find the right kind of buyer for each MFI or group of MFIs. However, such an approach posed its own risks—larger, more mature investments could sell quickly, leaving the fund with smaller, less profitable companies that would be more costly and take longer to sell. Moreover, microfinance is a small, interconnected world. The process would not stay quiet for long and could lead to difficult questions: how would Accion International (AINV's sponsor) explain its disengagement from Latin American partners, for example?

Thus, when an AINV shareholder, Bamboo Finance, expressed interest in the entire portfolio in June 2011, management and board were immediately intrigued. Bamboo was an established global private equity group with years of experience in microfinance investing. Surely, a sale to a single investor would come with fewer complications, and as a longstanding actor within the microfinance ecosystem, Bamboo easily met the test of a like-minded investor. As an existing investor in AINV, Bamboo was familiar with its portfolio companies making for a simpler due diligence process and a faster sale. It also helped that in most of these investees, AINV held a relatively small stake, meaning that an exit did not entail a strategic shift in ownership of its MFIs.

Still, there were complications. AINV held strategic (i.e., larger) stakes in some portfolio companies, while other investees required more technical support than Bamboo could provide. The solution was to carve out less mature MFIs in Africa and sell them jointly to Bamboo and Accion International, thus ensuring ongoing support from Accion International's capacity-building operation. Additionally, as an anchor shareholder of BancoSol in Bolivia, Accion International agreed to buy AINV's interest in that MFI.

Given AINV's close relationship with Accion International and Bamboo's existing stake in the fund, conflicts of interest were inevitable. This was recognized early on, and the fund engaged a legal specialist in conflict of interest to guide management and the board. This meant taking steps to clearly differentiate buyers from sellers: those AINV directors who held roles at Accion International or Bamboo recused themselves from all board decisions related to the sale.

While the final negotiations took place among three parties—AINV, Bamboo, and Accion International—the number of stakeholders in the transaction was far greater. MFI boards and management had to be apprised of the plans, and regulators in each of the countries were informed of the potential transaction, which also involved engaging local legal counsel in each of the relevant countries.

Completion of the transaction required 18 months as the result of cooperation needed from over a dozen institutions and their boards, as well as regulators, outside investors, and other microfinance equity funds.

APPENDIX B

Equitas: Separating Governance from Ownership

In mid-2010, when Aavishkaar-Goodwell was considering selling part of its stake in the South Indian MFI Equitas, it found itself in a rather peculiar position. Aavishkaar-Goodwell views itself as an early-stage investor, yet here it was contemplating an exit, just two years into its investment as a founding investor. Equitas had grown so quickly that Goodwell was becoming too small to maintain a significant share in the company. Moreover, Equitas' development was outpacing the type of close advisory and governance involvement that Goodwell normally seeks to provide portfolio companies.

The other peculiar position for Aavishkaar-Goodwell is that its search for an appropriate investor proved perhaps simpler than it might have been. After all, this was during the height of the microcredit bubble, just months before the SKS IPO. Bids from venture capital funds seeking quick gains in what was then seen as a quick path to an IPO were easy to come by. But Equitas was different in many ways.

Like most of its peers in microfinance, Equitas was a nonbank financial company (NBFC). What sets it apart are some highly unusual governance and social commitments, which are enshrined in the company's initial Articles of Incorporation:

- **Majority independent board**. The board is composed of a majority of independent directors, chaired by an independent and nonexecutive director—all of whom are well-known and accomplished individuals with backgrounds mainly in finance and development.

- **No controlling shareholder**. During the initial subscription round, no shareholder was allowed to own more than 15 percent of the company, and the board can reject any transactions that would result in a stake of more than 24 percent.

- **Explicit social commitments**. Equitas enshrined several substantial commitments to its social mission, including donating 5 percent of its profits to pay for children's education, as well as a commitment to employ one corporate social responsibility staff for every 10 branches, whose job would be to conduct medical and skill development camps.

- **Financial return ceiling**. Equitas capped its ROE at 25 percent and set a minimum capital adequacy of 20 percent (including off-balance sheet transactions).

Together, these steps limit the financial returns of investing in Equitas (though at a rather competitive level), while keeping in place the financial downside of fixed profit allocations to charitable activities. Meanwhile, by vesting independent directors—themselves selected on the basis of their professional independence—with final say over the company's affairs, Equitas has made it effectively impossible for investors to alter those original commitments.

While these embedded commitments create a self-selecting pool of potential investors who are comfortable with such limits, Aavishkaar worked with the Equitas team to select the most appropriate buyer from among the bidders. Their final choice was Canaan Partners, a traditional U.S.-based venture capital firm focused entirely on financial returns.

For Canaan, Equitas was in many respects a departure from the norm—it is the only investment in India in which Canaan does not have a board seat, and it is the only one with explicit social commitments and an earnings cap. However, in this structure, as well as in the company's focus on efficiency and quality of execution, Canaan saw the prospects of solid, but stable returns over the long term—the very opposite of the high-return, but also high-risk deals that were taking place in other Indian MFIs at the time.

Clearly, the unusual self-perpetuating governance and mission focus at Equitas did not limit its ability to tap commercial capital, but in fact may have helped maintain the company on the kind of stable footing that many of its competitors had lost during the go-go years of Indian microfinance.

APPENDIX C

KfW: Selling Back to the Holding

With an equity portfolio amounting to close to US$950 million, KfW may well be the largest single investor in MFIs and small banks. It has also never fully exited from any of its positions in retail financial service providers, with one notable exception: KfW has already completed seven exits in ProCredit banks around the world.

While an important part of its investment strategy, these seven transactions are in some ways closer to an internal institutional reorganization of an ownership stake than a full exit. KfW has a dual interest in ProCredit: as a direct investor in many ProCredit subsidiaries around the world, as well as one of the anchor investors in ProCredit Holding. Part one of KfW's strategy involves investing in new ProCredit subsidiaries and staying closely involved in the retail institution's governance—an involvement that demands extensive time from KfW's staff. In response, part two of KfW's strategy aims to rationalize its resources, by selling the ProCredit subsidiary back to ProCredit Holding at some point, while continuing to support the latter with additional capital investments as needed.

The decision to exit is based primarily on assessment of the subsidiary's sustainability and ability to maintain and further develop institutional capacity, while generating moderate annual growth of 5–10 percent using retained earnings. The subsidiary must also demonstrate that it adheres to its mission, acts as a market standard-setter, and promotes healthy (but not excessive) competition.

To avoid the potential for conflict of interest of selling to a related institution in the form of the holding company (and one in which KfW has a major stake), the valuation and pricing is calculated by an external party, and the premium tends to be modest. Even after these sales, KfW continues to promote a supportive environment in which the subsidiary (and other market players) can have lasting positive impact, including by developing credit bureaus, deposit insurance schemes, and other financial sector infrastructure improvements.

APPENDIX D

Arohan: A Distress Sale

It was spring 2012, and the Hyderabad-based fund manager Caspian faced a dilemma. One of its holdings, Arohan Financial Services in Calcutta, was losing money fast. During the prior 18 months since the start of the crisis in Andhra Pradesh, Arohan had shrunk to a third of its peak size, losing nearly half of its equity.

As a manager whose two funds owned a combined 55 percent stake in Arohan, Caspian felt the problem acutely—the MFI was continuing on a downward spiral and may not have survived without an infusion of new equity. To make matters worse, the dominant position—40 percent of Arohan—was held by Bellwether, Caspian's oldest fund that was set to mature in two years.

The trouble afflicting Arohan was shared by many small- and mid-sized MFIs throughout India. Since the start of the Andhra Pradesh crisis in late 2010, Indian banks, which at the time, constituted the primary source of the sector's funding had either turned off or greatly restricted lending to all but the largest and most stable MFIs.

The situation at Arohan was especially acute. On the eve of the crisis, Arohan had embarked on a growth surge aimed at doubling its portfolio by March 2011, and it had just doubled its branches and staff. With the onslaught of the crisis, bank funding was frozen; not only was portfolio growth impossible, but Arohan was forced to severely curtail its lending. By spring 2012, Arohan's portfolio shrank to less than half its peak size.

Expecting the market to recover, Arohan had retained most of its staff and branches. When the market failed to stabilize, Arohan had to face substantial losses. Besides eroding equity, the losses had two additional impacts on Arohan: first, they further exacerbated its liquidity predicament, given that banks were even less willing to lend to a loss-making institution. Second, the losses eroded the value of the enterprise, making the exit from Arohan still more difficult sell. Arohan faced an additional hurdle: its share of foreign ownership was already near its legal limit of 75 percent. Any investment would thus have to come from local sources—many of whom were already burned by exposure to Indian MFIs.

Many rejected the offer—from private equity funds and from other MFIs. But Arohan's star was not so easily extinguished. Intellecap, the investment firm hired by Caspian, was affiliated with Intellecash, which prior to the crisis had served as an incubator for aspiring microfinance start-ups, providing them with the full suite of tools to start and operate an MFI. Intellecash also managed its own small microfinance operation in an area adjacent to Arohan.

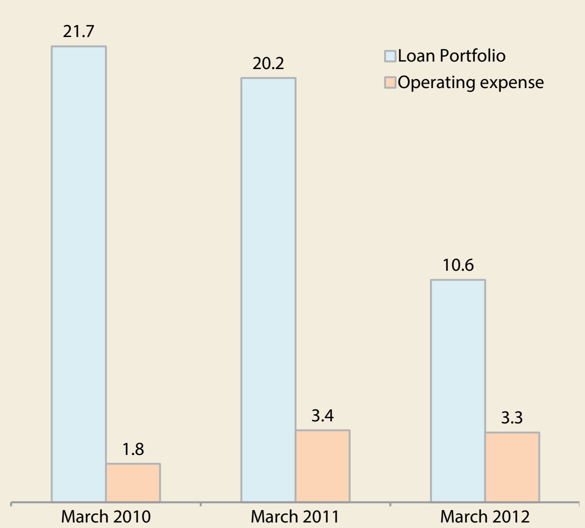
At the time Intellecap was seeking out potential Arohan investors, Intellecash had just embarked on a new acquisition-based strategy. Here was an organization looking for exactly the kind of challenge that Arohan presented, and through its strong ties to the Aavishkaar-Goodwell fund, it could raise sufficient capital to both buy out Bellwether's stake and infuse Arohan with the capital it required.

Intellecash brought more than just capital to the table. Its experience working with many different MFIs made it in many ways the perfect partner in a merger, while its strong ties to the banking community in India was critical when it came to helping pull Arohan out of its liquidity squeeze. The heads of both Arohan and Intellecash both had competencies and interests that supported a positive partnership. Finally, the financial engineers at Intellecap were able to structure the transaction in a way that greatly reduced Arohan's foreign-ownership share, thus greatly improving its prospects for future investment.

What looked promising at the outset has not disappointed. In the half-year since the merger, Arohan has returned to profitability and has begun to grow. By all accounts, the man-

FIGURE AD-1

Cost Basis Rises as Portfolio Shrinks



aging team is functioning well—an item of some importance when the merger involves the company's founder. And most importantly, Arohan seems to have succeeded in escaping its liquidity squeeze.

However, given that Arohan had no other interested buyers besides Intellecash, it is hard not to conclude that the sale and its subsequent success owe much to sheer luck. With its partnerships in capital markets via Intellecap, and its explicit acquisition-focused strategy backed by the Aavishkaar-Goodwell fund, Intellecash was a unique organization that had positioned itself to play the very role it was now undertaking in Arohan's turnaround.

But by all accounts, the offer from Intellecash was unexpected by both Caspian and Arohan. So one has to wonder—what if there had been no Intellecash? Did Arohan have any other options?

Not many. Its existing investors (Bellwether, The Dell Foundation, and Caspian's other fund, the India Financial Inclusion Fund) all wanted Arohan to survive and were willing to pursue a Plan B—an infusion of limited equity, just enough to keep the organization afloat, but critically, probably not enough to pull it out of its liquidity squeeze. Under this scenario, Bellwether would have maintained (but not increased) its stake, essentially buying time and hoping that the India microfinance sector would recover sufficiently to sell Arohan in the next two years. But certainly, there were no guarantees, and infusing more equity was simply beyond the capacity of its existing shareholders.

APPENDIX E

Edyficar: An NGO Selling to a Bank

In summer 2008, the management of CARE was facing a choice: should it sell its single largest asset, Edyficar?

A decade earlier, CARE created Edyficar as part of its poverty fighting program in Peru. Now, it was a thriving enterprise, the third largest MFI in Peru, employing a thousand staff, serving 180,000 borrowers, and accounting for over 20 percent of all of CARE's total assets. That same year, Edyficar transitioned from a microenterprise lender (an EDPYME) to a *Financiera* (an NBFI), under the Superintendency of Banks.

CARE is an NGO focused on fighting poverty around the world. While a large part of that includes financial services for the poor—mostly through the promotion of village savings and loan associations (VSLAs)—full-service banking had never been part of CARE's domain of activities. Yet that's where Edyficar was heading, and moreover it would not be long before Edyficar would grow to be larger than its parent.

It was also clear that the VSLA model, which targeted far poorer rural residents in countries poorer than Peru, was a closer match to CARE's mission than Edyficar was, whose loans at that point were averaging about $1,000 per client.

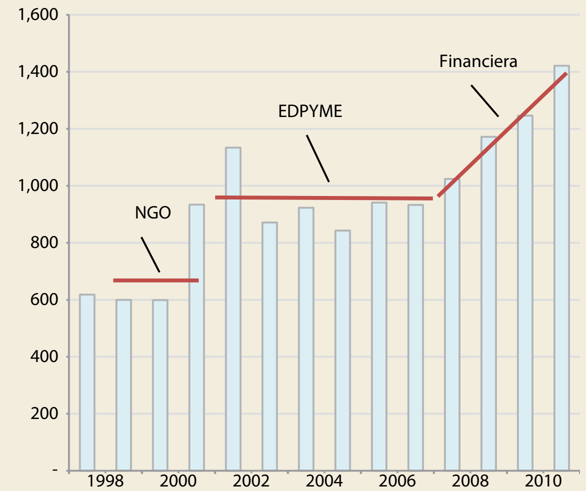
Those same elements that distanced Edyficar from CARE also meant that CARE was increasingly less able to support the MFI on its journey. Further growth meant more capital and deeper expertise—something CARE would have been hard-pressed to come up with.

By 2008, its management recognized the difficult decision they had to make: they would have to sell Edyficar. After some deliberation, they also recognized that a partial sale would not work—they had to sell the whole thing. Since its transformation to a *financiera*, the evolutionary path for Edyficar was leading it ever further away from CARE's core mission (see Figure AE-1 for a look at Edyficar's fast-rising average loan amount starting in 2008). Selling a partial stake and retaining significant say in governance would simply serve to slow that evolutionary process, and would serve neither party well.

As a global NGO with many stakeholders, CARE took a methodical approach to preparing for the sale, seeking internal consensus, including buy-in from Edyficar's senior management. It also maintained close consultation with minority shareholders, as well as with the Banking Superintendency. Recognizing its own limited knowledge of the process, CARE retained Morgan Stanley, which had expertise in both mergers and acquisitions and microfinance, along with a strong ground presence in Peru.

FIGURE AE-1

Edyficar's Legal Status Reflects on Average Loan Size ($)



In time, it had fielded four serious offers, all from local or regional organizations, including banks and other MFIs. Among these, CARE selected Banco de Credito del Peru (BCP) as the winning bidder. BCP offered $96 million for buying out all of Edyficar's shareholders, representing a P/B valuation of 2.5 times. This was high by both global and country standards, but considering its profitability (30 percent average ROE during 2007–2009), the price was in fact well below that of its peers, which by JP Morgan estimates should be 3.5 times P/B for that ROE level (CGAP and JP Morgan 2011).

Nevertheless, from CARE's perspective, the price was not the driving factor in its decision. Rather, the main reason was a qualitative one: BCP's strategy was to keep Edyficar as it was. During the due diligence period, BCP was especially respectful of Edyficar's management and staff, and it committed to keep existing branding, management, and the mission all in place. To demonstrate that commitment, BCP agreed to sign one-year contracts with Edyficar's most senior executives as part of the transaction.

As both CARE and Edifycar understood at the time, BCP's perspective was guided by a recognition that microfinance was very different from banking. Some years before, BCP had tried and failed to launch its own microfinance operation. That experience and its lessons were encapsulated by something one of BCP's directors said during the negotiations: "If we were to try to do what Edyficar did, we would fail."

This is not to say that selling to BCP entailed no change. Both parties understood that back-end operations, IT systems, regulatory reporting, and other relevant services would be either merged or leveraged in some way. And as one of the leading banks in Peru, BCP could also unlock access to the capital markets as well as its own balance sheet. In short, BCP would be the partner that could fulfill the potential Edyficar had gained by becoming a *financiera*, and do so without undermining Edyficar's internal ethos.

These expectations have largely proved correct. Edyficar continues to be led by the same general manager as before, and it continues to focus on microenterprise lending. It has also continued on its rapid growth path, with the portfolio chalking up a 44 percent cumulative annual growth rate (CAGR) for the three years since the sale. And while this also reflects an increase in average loan size, that's in many ways less a reflection on Edyficar's new owner, than on the changing market landscape in Peru, where average MFI loan amounts exceed those of Edyficar. Deposits have also expanded enormously, from $30 million at the time of sale to over $500 million now, though this consists almost exclusively of very large private and institutional accounts, averaging $300,000. Savings products for Edyficar's microfinance clients have not yet been rolled out.

Edyficar today is far from the organization that CARE founded 15 years ago. It has charted its own path, and BCP has proven the right partner to join it for the past three years and walk with it into the future. Meanwhile, CARE was able to put the proceeds to work combating poverty both in Peru and around the world.

APPENDIX F

Sathapana: A Multi-Stakeholder Exit

Sathapana is in many ways the quintessential MFI story. Founded in 1995 as an NGO focused on providing health and education services to the poor of Cambodia, it quickly found its way to microfinance. During the early 2000s, it was supported by GTZ and the World Bank. In 2003 it had transformed into a commercial enterprise and established a credit relationship with Triodos Investment Management and Blue Orchard. The original shareholders included the founding NGO and the staff association. In 2004, it received its first equity investment—from ShoreCap—and in 2006, welcomed FMO and Triodos-Doen[8] as additional equity investors.

In 2009, it received a nonbanking deposit license and saw its first equity sale, when Developing World Markets (DWM) bought ShoreCap's stake. By 2012, the MFI had assets of $150 million, deposits of $67 million, and a CAGR that averaged 51 percent over the 12 years since 2000. ROE since its first commercial investment from ShoreCap averaged 25 percent.

Since about 2008, Sathapana held the position of the fourth largest MFI in the country, with a market share of about 5 percent. However, in many ways, Sathapana stood apart from the field. Its focus had been shifting toward the SME sector, and by 2011, over 25 percent of its portfolio was in SME loans, averaging $8000—nearly 10 times the sector average.

In 2012 the shareholders approved a new strategic plan that envisioned transforming Sathapana into a commercial bank, broadening its products and services, and positioning it for a potential regional expansion. The plan also entailed a significant capital increase, with a further equity infusion envisioned within a few years. FMO and Triodos had been hands-on investors: both held board seats, were actively engaged in governance, and supported training programs. However, it had now been six years since their investment, and Sathapana had reached a new level of maturity in terms of performance, footprint in the market, risk management, and governance. They considered the timing appropriate for an exit for these reasons as well as their desire to reduce their Cambodia exposure (both also held stakes in other Cambodian MFIs). In light of Sathapana's new strategy, the time was ripe to bring in a new strategic shareholder that shared Sathapana's vision and had the resources and capacity to help implement it.

FIGURE AF-1

Growing MFI in a Growing Market

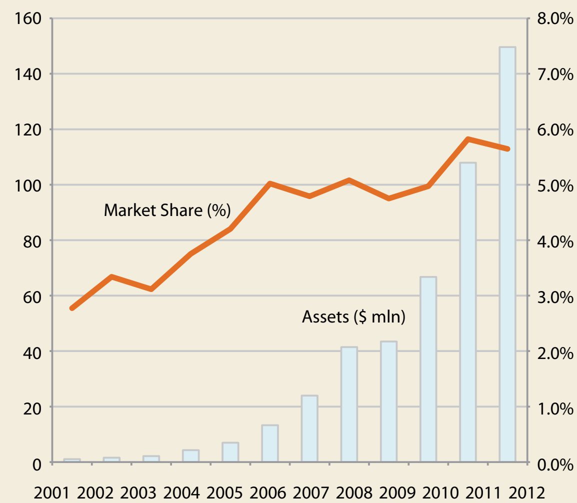
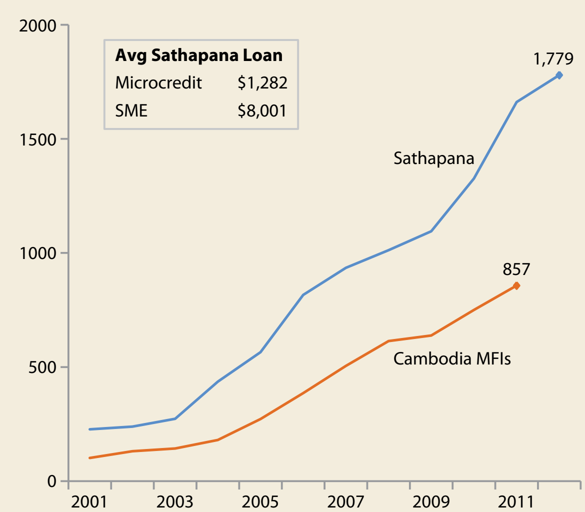


FIGURE AF-2

Average Loan Amounts (USD)



8. Triodos-Doen Foundation (Triodos Doen) was launched in 1994 by the DOEN Foundation and Triodos Bank. Since December 2013 it has been operating as Triodos Sustainable Finance Foundation, under the exclusive management of Triodos Investment Management and without active involvement of the DOEN Foundation.

When FMO and Triodos decided to sell, they informed Sathapana's other shareholders, senior management, and the board of their decision. In these discussions, it became apparent that the sale would have to be done on a cooperative basis—FMO and Triodos together held 40 percent of Sathapana, in other words, a major but noncontrolling stake. However, selling a controlling stake could yield significantly more interest and potentially a better price from the type of strategic investor they were seeking. The other shareholders—including DWM, which owned the largest stake (35 percent)—also held tagalong rights, which gave them the right to sell their shares alongside those of FMO and Triodos. The sellers thus had to seek a buyer willing to buy these additional shares.

For the tagalong shareholders, the sale was a significant opportunity. Although DWM had only recently invested in Sathapana, it recognized that joining in a strategic sale would likely produce a better outcome than retaining its shares. Besides providing a higher price, the bid also met DWM's strategic objective to develop deeper links among its partner MFIs and the broader financial systems within which they operate. For the staff association, comprised mainly of middle- and lower-middle-income Cambodians, this was an unusual opportunity to monetize their shares, and the shareholders, through their M&A adviser, sought to make sure the staff association was fully informed about the consequences of joining the sale or retaining their shares. Finally, for the founding NGO the sale presented an opportunity to monetize part of its stake, while retaining a voice in post-sale governance.

However, the presence of tagalong rights had consequences. DWM and its tagalong partners had the flexibility of participating (or not) in the sale, but with fewer obligations than FMO and Triodos, which had initiated the process and were ultimately responsible for carrying out the deal. Over the course of the transaction, this mix of different rights and responsibilities increased the complexity of the process.

In view of this complex and intensive process, FMO and Triodos engaged ShoreBank International (SBI)[9] as the M&A adviser right from the beginning. In addition, Sathapana's CEO was actively involved, providing input on the initial list of potential investors who had already demonstrated interest (this included the winning bidder) and facilitated close communication with the National Bank of Cambodia, which had to provide regulatory approval for both the transaction and the buyer.[10] The selection criteria for the bidders focused on three key areas: strategic fit with Sathapana and its mission, financial capacity, and a competitive price.

The auction was competitive, attracting local, regional, and international institutions. Ultimately, the sellers selected Maruhan Japan Bank (MJB), a local commercial bank established in 2008 that was already lending to multiple Cambodian MFIs, including Sathapana. In addition to offering the highest bid, MJB also had a regional growth strategy aligned with Sathapana's—both saw Cambodia as a home base for what would ultimately be broader operations in Southeast Asia. Because MJB had only a single branch and no overlap with Sathapana's client base, integrating operations was also not a significant factor. Plus, MJB was favored by Sathapana's management, whom the buyer sought to retain by extending employment contracts with the CEO and his key staff.

However, along with its strong strategic fit, MJB also posed a dilemma: in addition to owning banks across the ASEAN region, MJB's parent company, Maruhan Corporation, operates a large number of slot machine-type parlors (Pachinko) across Japan.[11] To resolve this dilemma, the sellers asked for special assurance—a request to the parent company for a specific undertaking that the scope of its Cambodian operations would remain limited to the banking sector. This helped separate the positive aspects of MJB from the concerns posed by its owner's gaming business. As social investors, the sellers wanted to ensure that Sathapana's social and developmental mission would continue following the sale. To that end, they led the amendment of the MFI's charter (to which MJB became a signatory) to clearly spell out its commitment to provide financial services to the poor. In addition, MJB agreed to accommodate the founding NGO's request to sell only half of its shares while contracting options to exercise the remainder at a later time. This allowed the NGO to retain its board seat, through which it could help maintain Sathapana's mission focus after the sale.

The offer from MJB also met the expectations of the tagalong shareholders, all of whom joined the sale. Though these tagalong rights divided the shareholders and may have complicated the process, they did not change what ultimately was a positive outcome for all. In the end, MJB acquired 95.1 percent of Sathapana's shares, with the remaining 4.9 percent retained by the founding NGO. With this, Sathapana had closed its social investor chapter, setting forth on a new path.

9. SBI was a part of the ShoreBank group to which Sathapana's earlier investor, ShoreCap, had belonged, and thus were also well-acquainted with Sathapana and the Cambodia market. As of October 2013, SBI is operating as Enclude.
10. The transaction faced greater regulatory scrutiny because the buyer was deemed influential according to Cambodian law, meaning it would own more than 20 percent of the financial institution. Such investors face greater obligations toward the regulator, which may enjoin influential shareholders to increase the company's capital until solvency standards are met.
11. While gambling is illegal in Japan, Pachinko is not, in part because it can be also used as a recreational arcade game. Historically, Pachinko has been a widely accepted activity in the country.

APPENDIX G

Focus Group on Social vs. Financial Return

The following scenario was presented to a group of investors. Participants, all representatives of microfinance equity funds, were divided into four groups and asked to choose which offer they would accept. Three groups chose the local commercial bank, even though two of them recognized that the holding company held out higher social return (one investor described the choice as "going with my mind, not my heart"). One group chose the holding company, citing mission alignment as the reason. No investors chose the private equity investor as a viable option, due to its lack of fit with the MFI's mission, though some did mention that it was a painful choice, given that they were giving up substantially higher financial returns.

Consider the following scenario

You are a 30 percent shareholder in an MFI that you invested in five years ago. Now, it has a $90 million portfolio and almost 90,000 borrowers. Two years ago it acquired a banking license, and now has 30,000 deposit accounts at $15 million total raised. The remaining 70 percent of the MFI's portfolio is funded via debt, mostly from foreign sources. For the past five years, the MFI has been growing at 30 percent CAGR.

One of the MFI's goals is to broaden its loan offerings (currently 93 percent of its portfolio is in microenterprise loans, 4 percent in housing, and 3 percent in emergency loans). On the savings side, it has set a goal of depositors surpassing borrowers in three years and deposits reaching 70 percent of loan portfolio. However, it has had trouble keeping deposit accounts active (40 percent of the deposit accounts have negligible balances; two-thirds of deposits come from the largest 500 accounts, averaging $20,000 each). The MFI needs an additional $10 million in equity to continue its growth.

Five years ago, the fund you manage invested $3.2 million in this MFI, which at the time was just two years old (your original 40 percent share has since been diluted to 30 percent). Since the beginning, you've played a leading role in governance and were the driver behind the MFI's transformation into a bank and its push for savings. Another three smaller investors (combined 50 percent stake) have indicated that they would probably sell together with you, thus a total of 80 percent could be sold (the rest is mostly management shares, some local wealthy investors, and a stake in an employee stock ownership plan).

The offers

Local commercial bank	Holding company	Private equity investor
Background	**Background**	**Background**
The third largest bank in the country, seeking to expand its down-market presence. It has previously tried to build its own microfinance lending program, which was unsuccessful. The bank would like to keep MFI operations separate, integrating only main back office functions and MIS. It agrees to sign a one-year contract with current management.	A moderate-size holding company with six MFIs in its portfolio, mostly in the same region. It has developed an especially strong savings methodology (five of its MFIs have more savers than borrowers, and portfolios mostly funded by deposits). Deposits average $400–600. The holding company wants to keep the CEO (who holds the holding company in high regard). It will bring two of its savings experts to align the MFI's savings program to its methodology.	Foreign private equity fund active in the region. Has made several recent investments in consumer finance companies in nearby countries. Most of its investments are resold in 3–4 years. Other finance companies have sought partnerships with large household retailers. Also offers short-term loans to wage-earners (payday loans), at prices slightly above MFI rates for comparable products. Offers management significant options as part of the deal. Management is interested.

Continued

Local commercial bank	Holding company	Private equity investor
Social Mission No explicit mission, but regulator (Central Bank) is well-run and includes requirements such as standard pricing disclosure and has expressed concerns about avoiding market overheating. It's clear the bank is mostly interested in growing the high-yield MFI portfolio, though larger clients will be able to access the bank's broader offerings. It has a broad ATM network and money transfer service, but has very few deposit accounts below $500.	**Social Mission** Primary mission to expand savings and credit services to the poor. Focus less on microenterprise lending and more on financial inclusion, including low-income wage-earners. Loan portfolios of other MFIs include up to 10 percent in housing loans and as high as 25 percent in consumption loans. Has engaged a rating agency to conduct Smart Certification for one of its MFIs. Plans to roll out to others in time. Partners with research institutions to evaluate its level and quality of outreach, but largely uninterested in client impact analysis.	**Social Mission** No social mission. Regulator (Central Bank) is well-run and includes requirements such as standard pricing disclosure and has expressed concerns about avoiding market overheating.
Price $13.9 million, or 2.1 P/B. Extends same offer to the other investors, conditional upon your sale.	**Price** $10.6 million, or 1.6 P/B. Prefers to buy just your stake, plus $10 million in fresh shares. Agreed to sign a three-year buy-out option with other investors, who are comfortable with offer.	**Price** $17.8 million, or 2.7 P/B. Extends same offer to the other investors, conditional upon your sale.

Which one will you accept and why?

APPENDIX H

List of Interviewees

Name	Organization
Sushma Kaushik	Aavishkaar
Mary Chaffin John Fischer	Accion
Anne-Marie Chidzero	Africap Microfinance Fund
Marcus Fedder	Agora Microfinance
Anne Contreras	Arendt & Medernach
Shubhankar Sengupta	Arohan
Ximena Escobar de Nogales Xavier Pierluca	Bamboo Finance
Melchior de Muralt	BlueOrchard
Alok Mittal	Canaan Partners
Laté Lawson Peter Buijs	CARE
Vishal Bharat	Caspian Advisors Private Limited
Fernanda Lima Brad Swanson	Developing World Markets
Ana Maria Zegarra	Edifycar
Edvardas Bumsteinas	EIB
Laurie Spengler Ian Callaghan Jesse Fripp	Enclude (formerly ShoreBank International)
PN Vasudevan	Equitas
Arno de Vette	FMO
Els Boerhof	Goodwell Investments
Paul DiLeo	Grassroots Capital Management
Martin Holtmann	IFC
Dina Pons	Incofin IM
Anurag Agrawal	Intellecap
Manoj Nambiar	IntelleCash Microfinance Network Company
David Munnich	Investisseurs & Partenaires
Matthias Adler Martin Hagen	KfW
Ira Lieberman	LIPAM International, Inc.
Kaspar Wansleben	Luxembourg Microfinance Development Fund (LMDF)
Geeta Goel	Michael & Susan Dell Foundation
Doug Young	MicroVest
Fernando Campero	MIF
Stefan Harpe Frank Rubio	Oikocredit
Alex Silva	Omitrix
Jean-Gabriel Dayre Elodie Parent	Proparco
Michael Fiebig Henry Gonzalez	responsAbility
Mildred Callear	SEAF
Frank Streppel	Triodos
Mark van Doesburgh Luis Guerra	Triple Jump
Judith Mayer	University of Munich
CJ Juhasz	WWB Asset Management

APPENDIX

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