Date of Hearing: June 9, 2014

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Roger Dickinson, Chair
SB 1301 (DeSaulnier) – As Amended: May 29, 2014

SENATE VOTE: 36-0

SUBJECT: Corporate Flexibility Act of 2011: Social Purpose Corporations Act.

SUMMARY: Changes all references to a flexible purpose corporation (FPC) to a social purpose corporation (SPC). Specifically, this bill:

1) Authorizes a corporation formed (pursuant to the Corporate Flexibility Act of 2011) before January 1, 2015, to elect to change its status from a FPC to a SPC by amending its articles of incorporation.

2) Requires that any reference to SPC be deemed a reference to FPC, for any FPC formed prior to January 1, 2015, that has not amended its articles of incorporation to change its status to a SPC.

3) Requires in the case of a change of status to a SPC that the corporation shall:

   a) Modify the name of the corporation, revise the statement of purpose, and make such other conforming changes as may be necessary or desired; and,

   b) Be approved by the affirmative vote of at least two-thirds of each class, or a greater vote if required in the articles, of outstanding shares of that changing corporation.

4) Requires the directors of a SPC to consider and give weight to those factors the director deems relevant, including the short- and long-term prospects of the corporation, the best interests of the corporation and its shareholders, and the purposes of the corporation as set forth in its articles of incorporation.

5) Allows shareholders of a SPC to maintain a derivative lawsuit to enforce the requirements.

6) Makes several changes that are intended to make technical corrections, fix drafting errors, resolve unintended confusion, and insert language that was unintentionally omitted from the 2011 bill that created FPCs (SB 201, DeSaulnier, Chapter 740):

   a) Clarifying that the term "domestic other business entity" includes, but is not limited to, a limited liability company, partnership, or social purpose corporation."

   b) Requiring the articles of incorporation of a SPC to enumerate the specific purposes the corporation has been formed to further.

   c) Providing dissenters' rights to the shareholders of a SPC whose shareholders vote to convert to a domestic corporation or other business entity, or which is the disappearing

corporation in a corporate merger with an entity that is not a SPC.

d) Changing the approval threshold for a SPC to abandon a proposed transaction to sell, lease, convey, exchange, transfer, or otherwise dispose of all or substantially all of the assets of the corporation to two-thirds of the outstanding shares rather than to all of the outstanding shares.

e) Clarifying that the principal terms of a reorganization must be approved by at least two-thirds, or a greater vote if required in the articles of incorporation, of the outstanding shares of any class of a social purpose corporation that is a party to a merger or reorganization, if holders of shares of that class receive shares of the surviving or acquiring social purpose corporation having different rights, preferences, privileges, or restrictions than those surrendered.

EXISTING LAW

1) Provides for the formation and regulation of corporations. [Corporation Code, Section 100 et seq.]

2) Provides for the formation and regulation of non-profit entities. [Corporation Code, Section 5000 et seq.]

3) Requires each FPC to list its flexible purposes in its articles of incorporation. These flexible purposes may include any of the following:

   a) One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out; and,

   b) Promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of the FPC's activities on the FPC's employees, suppliers, customers, and creditors; the community and society; and/or the environment.

4) Provides that each FPC's articles of incorporation may include the following: a provision limiting the duration of the FPC's existence to a specified date; a provision limiting or restricting the business in which the FPC may engage or the powers that the FPC may exercise, or both, provided these restrictions are consistent with the purpose(s) of the FPC; and a provision requiring shareholder approval for any corporate action.

5) Establishes that each existing company wishing to become an FPC through conversion or reorganization of an existing corporate entity requires an affirmative vote of at least two-thirds of each of its classes of shareholders, or a higher vote threshold, if required in its articles of incorporation. The same vote threshold is required to amend an FPC's articles of incorporation, or to create or dissolve an FPC through merger or acquisition. The only type of action involving the formation or dissolution of an FPC, which is not intended to require a two-thirds or higher vote, is the merger of one FPC into another FPC with a similar special purpose.

6) Shareholders of an existing corporation that decide to convert to an FPC are entitled to dissenter's rights, which are spelled out in existing law (Corporations Code Section 1300).

Dissenters' rights generally entitle dissenting shareholders to be cashed out for their shares at the shares' fair market value, as of the day before the first announcement of the terms of the proposed reorganization or merger, adjusted for any stock split, reverse stock split, or share dividend which becomes effective after that date.

7) Each FPC is required to prepare an annual report, which must be sent to its shareholders no later than 120 days after the close of the FPC's fiscal year, and at least 15 days prior to the shareholders annual meeting (35 days prior if sent via bulk mail). In addition to a balance sheet, income statement, and a statement of cashflows for that fiscal year, the annual report must also include a management discussion and analysis (MD&A) regarding the FPC's stated purpose or purposes, as set forth in its articles of incorporation. To the extent consistent with reasonable confidentiality requirements, each FPC must post its MD&A on its web site. Each FPC's MD&A is required to include the following information, at a minimum:

   a) An identification and discussion of the short-and long-term objectives of the FPC that relate to its special purpose(s), and an identification and explanation of any changes made to these special purpose objectives during the fiscal year;

   b) An identification and discussion of material actions taken by the FPC during the fiscal year to achieve its special purpose objectives, the impact of those actions, including the causal relationships between the actions and the reported outcomes, and the extent to which those actions achieved the special purpose objectives for the fiscal year.

   c) An identification of material actions, together with the intended impact of those actions, which the FPC expects to take in the short- and long-term to achieve its special purpose objectives.

   d) A description of the process for selecting, and an identification and description of the financial, operating, and other measures used by the FPC during the fiscal year for evaluating its performance in achieving its special purpose objectives, including an explanation of why the FPC selected those measures and an identification and discussion of the nature and rationale for any material changes in those measures made during the fiscal year.

   e) An identification and discussion of any material operating and capital expenditures incurred by the FPC during the fiscal year in furtherance of achieving its special purpose objectives, a good faith estimate of any additional material operating or capital expenditures the FPC expects to incur over the next three fiscal years in order to achieve its special purpose objectives, and other material expenditures of resources incurred by the FPC during the fiscal year, including employee time, in furtherance of achieving its special purpose objectives, including a discussion of the extent to which that capital or use of other resources served purposes other than, and in addition to, furthering the achievement of the special purpose objectives.

8) In addition to the annual report described above, each FPC must prepare and distribute a special purpose current report to its shareholders within 45 days of an expenditure, which is made in furtherance of its special purpose objectives, and which had or is believed likely to have a material adverse impact on the FPC's results of operations or financial condition for a

quarterly or annual fiscal period. This special purpose current report must identify the expenditure or group of related or planned expenditures, which had or was likely to have a material adverse impact on the FPC's financial condition.

FISCAL EFFECT: None.

COMMENTS:

In 2011, SB 201 (DeSaulnier, Chapter 740) codified the product of a working group of corporate law attorneys, organized in 2008 to facilitate the creation of a new corporate form intended to give companies in California greater flexibility to combine profitability with broader social or environmental purposes. SB 201 called these new corporations "FPCs." California was the first and only state thus far to enact a FPC. California was the sixth state to create benefit corporations, 15 states total have created benefit corporations. (AB 361, see below).

According to the Author, this measure is needed to "build on the framework of SB 201, adjusting certain aspects of the existing legislation to make the corporate form more workable for business owners and more effective at protecting the social mission."

According to the Secretary of State's Office, as of March 24, 2014, since FPCs and benefit corporations were created on January 1, 2012, 210 corporations have formed, with 62 considered FPCs. Of the 62 FPCs, 34 existing corporations changed their status to a FPC; therefore only 28 entirely new corporations were created as a FPC.

Washington

On June 7, 2012, the state of Washington created SPCs. In Washington, a SPC allows a corporation's shareholders and directors to put a social purpose (such as saving the environment or saving the whales) above the purpose of making a profit. The SPC in Washington closely mirrors California's FPC. Unlike California, Washington did not enact benefit corporations. Washington is the only state to have "social purpose corporations."

Arguments in Support

According to Morrison & Foerster LLP, "*the new name, Social Purpose Corporation, better captures the essence of the corporate form and reflects the fact that the corporation is at its core devoted to the special mission"*

Arguments in Opposition

According to the California Association of Nonprofits, "*the term "flexible purpose" was chosen after much consideration by the authors of SB 201 in 2011, and it is an accurate description of these corporations. The proposed term "social purpose corporation" will mislead the public into confusing such corporations with nonprofit organization, leading them to mistakenly think that these corporations are tax-exempt nonprofits. We are also concerned that the term "social purpose corporation" is confusingly similar to "socially responsible corporation" a term in high usage in the field of corporate social responsibility, where it is a descriptor that can be applied to for-profit corporations of all types that act in socially responsible ways….."*

According to an attorney who participated in the working group which created SB 201, Steven Hazen states, "*I can confirm that the choice of name for the entity was a matter of significant deliberation by the working group and by the interests of the Bar that supported enactment of the 2011 FPA. The name on which the working group settled was the FPC. While that name may not seem particularly catchy, it has several important characteristics that led to its adoption.*

1) The name of the entity gave notice of what the new Division 1.5 did: enable a corporation to have a purpose that goes beyond the economic interests of its shareholder but gives those shareholders that power to determine what that purpose would be rather than dictate to them what it had to be. …."

Previous Legislation

SB 201 (DeSaulnier, Chapter 740, Statutes of 2011) established the Corporate Flexibility Act of 2011 which created a new corporate form called a FPC. Provided that one or more natural persons, partnerships, associations, FPCs, or corporations, domestic or foreign, may form a FPC under the California Corporations Code, by executing and filing articles of incorporation with the Secretary of State (SOS).

AB 361 (Huffman, Chapter 728, Statutes of 2011) authorized the creation of a new corporate form called a benefit corporation, and provides for the rules that must be followed by these types of entities, and by other types of entities wishing to become benefit corporations.

Questions

1) While the measure makes technical changes, the significance of the bill is the name change to from FPC to SPC. The need for this change after just 18 months since FPCs were established is not clear. Those who were in the working group behind SB 201 do not have a consensus behind this name change.

2) While this measure is keyed non-fiscal, would this measure incur costs through the name change with the Secretary of State's office in regards to changing forms and adopting new forms?

3) This measure does not force existing FPCs to change their status to social purpose corporations, therefore, would CA essentially have three very similar corporate forms, benefit, FPCs and social purpose and would this create more confusion?

4) What current problems exist behind the name of a flexible purpose corporation?

Double-referral

Should this bill pass out of the Assembly Banking and Finance Committee, the measure will proceed to the Assembly Judiciary Committee.

Suggested Amendments

The committee may wish to recommend that the measure move forward without changing the name from FPC to SPC. The need for the name change is not clear.

Technical Amendments

On page 36, lines 1-6,

(4) If the flexible purpose corporation is a flexible purpose corporation subject to the Banking Law (Division ~~1~~ ***1.1*** (commencing with Section ~~99~~ ***1000)*** of the Financial Code), the articles shall set forth a statement of purpose that is prescribed by the applicable provision of the Banking Law (Division ~~1~~ ***1.1*** (commencing with Section ~~99~~ ***1000***) of the Financial Code).

REGISTERED SUPPORT / OPPOSITION:

Support

Morrison & Foerster LLP

Concerns

Hanson Bridgett LLP

Opposition

California Association of Nonprofits (CalNonprofits)
One individual

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