CORPORATE GOVERNANCE IN HYBRID BUSINESS ENTITIES
- A Legal Analysis of new Directors’ Duties in Community Interest Companies in the United Kingdom and the Benefit Corporations in the United States

Peik Stenlund

Thesis in Corporate Law, 30 credits
Examiner:
Stockholm, Spring term 2015
The introduction of new legal entities: Community Interest Companies (CIC) in the United Kingdom (UK) and the Benefit Corporations in the United States (US) suggest that we may be at the brink of a new era in corporate governance and responsibility. This paper examines the rules for corporate governance and more specifically the directors’ duties for these two emerging legal entities in the Social Enterprise Sector. On one hand, directors in these social enterprises have received expanded freedom to consider a range of stakeholders in their decision making. On the other hand, not only are the directors permitted to consider stakeholder, directors of these social enterprises actually face a new duty to consider stakeholder interests. The paper aims at investigating the scope of new directors’ duties and whether there is room for improvement for the accountability framework for directors of these social enterprises. This paper does not only review this from a legal duty perspective, but also look at the board accountability from a larger perspective and analyses the enforceability of the new directors’ duties. On a more legal theoretical note, the paper also scrutinizes the principal-agency theory and stakeholder theory in this context.

The first chapter is a brief background to the emergence of the social enterprise sector in both UK and US. The second chapter covers the topic of corporate governance historical debate and particularly examines the stakeholder theory in social enterprise. The fourth and the fifth chapter focuses on directors’ duties, to begin with in general and then specifically for the CIC and Benefit Corporation. While the most relevant duties in a social enterprise context are briefly presented, this paper focuses the analysis of the directors’ duties at obligations that are additional and new when it comes to Community Interest Companies and Benefit Corporations. A brief analysis at the end concludes the paper with a discussion on the scope of the directors’ duties in social enterprises and how they differ from what is known from mainstream business. The conclusion also consists of commentary on what may further advance the enforceability of the duties in the future.

Method

The construction of an appropriate legal entity with accurate framework for governance and director accountability involves fearless legal pioneering and seamless collaboration and dialogue
between a multitude of interest groups and practitioners. I believe the Anglo-American case law context has proven to be a progressive environment for experimenting of different types of entities for social enterprise. Therefore, in this paper I have chosen to analyze the Benefit Corporation and the Community Interest Company. The two business entities have shown excellent potential to make a real difference and are widely used across industries already. There is an element of comparative analysis to allow analysis of strength and weaknesses and to shed light at how these legal entities can evolve further. Some difficulties have been faced to expand the comparative elements to the degree intended. The case law for social enterprises is still limited and the research in the legal aspects of social enterprise is still quite narrow. The analysis of directors’ duties in this paper is limited to cover such duties that are particular when it comes to Community Interest Companies and Benefit Corporations.

I have decided to limit the analysis within Anglo-American context even though future research could aim at interpreting the Anglo-American social enterprise sector and potentially adapt and apply legal tools for a Scandinavian or Pan-European implementation of social enterprise legislation in line with the rules concerning Community Interest Companies and Benefit Corporations.

The ambition of my work has been to complement the legal analysis of directors’ duties with a broader interdisciplinary background to allow the reader to see the directors’ duties and the specific social enterprises in a larger societal perspective. Ideally, this allows the reader to understand the driving forces, motivations and challenges in creation of the legislation. Social sciences with ideas from economic theory offer a contextual frame for the legal corporate governance analysis, while the analysis is also supported by a historical background to the corporate governance debate. A corporate governance theory gives depth to the understanding of the dynamics of the different actors that have stakes in a corporation. The interplay between these stakeholders are most important for the hybrid legal form, which by nature is there to balance several interest against each other. For understanding the reasoning behind the priorities of the legislator, the debate of conflict of interest between principal-agent is of key importance.
Summary of conclusions

Social Enterprise legislation aims at mitigating some of the gaps that exists for the limited corporation from a social responsibility perspective. The new legislation aims at removing unclarity when it comes to director liability for considering non-shareholder interests in both day to day operations but also in particular cases where a takeover situation may rise. Moreover, the legislation aims at fixing a framework for so called mission accountability.

The Community Interest Test allows the regulator to assess whether the CIC is pursuing the defined benefit for the community. This test carries similarities to the Business Judgement Rule, while it is adapted to a social enterprise context.

Consideration of stakeholders is mandatory for a director in a social enterprise, while it does not create a fiduciary duty towards the beneficiary of the defined benefit. The accountability framework allows only shareholders to enforce the duty of consideration of stakeholder interests. Also, the directors are accountable to a third-party auditor and shall account for its performance on the defined mission to the greater public audience in an annual report.

Mainstream directors’ duties are focused on procedural obligations, while the director duties in social enterprise may be open for an approach that focuses on the substance delivered due to the duty. Benefit Corporation legislation requires directors to create 'material, positive impact' to a general and specific public benefit, but at the same time material, positive impact is vaguely defined in the law. It is further discussed whether a duty of obedience, which is more common in the non-profit sector could be applicable on directors’ duties in the social enterprise sector. We will have to wait for new case law to emerge in this sector for understanding the extent of the substantive elements of the new duties.

The lack of proven enforceability may leave the director with fewer arguments to protect stakeholder interest. A personal monetary liability for a director of a social enterprise should be introduced to increase the enforceability of the social enterprise general and specific benefit purposes. Also a requirement for clear definition of the corporate objectives would improve director accountability.
TABLE OF CONTENTS

Introduction

1. Social Enterprise – The Background

1.1. Community Interest Companies in the United Kingdom
1.2. The Emergence of Benefit Corporations in the United States

2. Shareholders versus Stakeholders?

2.1. The classic corporate governance dispute
2.2. Corporate Governance Scandals and the Revitalized Debate
2.3. Towards Stakeholder Inclusion
2.4. Stakeholder Theory in Social Enterprise
2.5. Democratic Ownership
2.6. Stewardship Approach

4. Directors’ Duties

4.1. Duty of Care
4.2. Duty of Loyalty
4.3. Business Judgment Rule
4.4. The UK Companies Act 2006
   4.4.1. Duty to Act within Powers
   4.4.2. Duty to Promote the Success of the Company
5. Directors’ Duties in Community Interest Companies and Benefit Corporations

5.1. Community Interest Companies
   5.1.1. Directors’ Duties in Community Interest Companies
      5.1.1.1. Community Interest Test
   5.1.2. Stakeholder Inclusion
   5.1.3. Asset Lock

5.2 Benefit Corporations
   5.2.1. Corporate Purpose, accountability and transparency
   5.2.2. Directors’ Duties in Benefit Corporations
      5.2.2.1. Duty to Consider Stakeholder Interests
      5.2.2.2. Duty of Care and Loyalty
      5.2.2.3. Duty of Obedience
   5.2.3. The Benefit Enforcement Proceeding
   5.2.4. The Benefit Director
   5.2.5. Annual Benefit Report
   5.2.6. Third Party Audit and Mission Accountability

Conclusion
1. Social Enterprise - The Background

Due to the pluralism of different kind of social enterprises it makes it hard to define, but naturally there are also certain ingredients that they have in common, while one can also try defining them:

“*A social enterprise is a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximize profit for shareholders and owners.*”\(^1\)

Ingredients that characterize the social enterprise are that they all have a defined social purpose, the engaging in trading activities, they do not distribute profits, they hold assets in trust for community/stakeholder benefit, they apply democratic principles to ownership and they are accountable to a range of stakeholders. \(^2\)

1.1. Community Interest Companies in the United Kingdom

Prior to introduction of the modern social enterprise forms we know of today, the development in Europe has sprung from having seen different types of social cooperatives provide solutions for particularly the field of work integration and services for the disabled. The European Social Enterprise movement has been focusing quite strongly in these two fields. \(^3\)

Not until recent, as of 2004, as the Community Interest Company (CIC) was introduced in the UK, Europe has broadened its perspective on the social enterprise sector beyond just work integration and other specific purposes. Stephen Lloyd, one of the leading change makers behind

---

\(^3\) Esposito, The Social Enterprise Revolution, 2013, p. 671.
the CIC, has pointed out that it seemed “complicated to embed social purposes in a legal form because there was not an off-the-shelf, simple to use legal entity ready for social enterprise unless you used the old-fashioned industrial and provident societies – the law for which has not been updated since 1965”. 4

In 2001, The British government established a so called Social Enterprise Unit which had to ‘identify barriers to the growth of the social enterprise sector… and to develop strategies to overcome these obstacles.’5 In addition to creating policy to foster the growth of social enterprise the industry was stimulated by a £10 million fund for investment in the social enterprise sector. Besides the investment fund resources were invested in developing improved metrics for valuing the social benefits produced by social enterprise.6 Finally the British parliament decided to follow the recommendation put forward by the Social Enterprise Unit to create a corporate entity specifically designed for social enterprise. The Community Interest Company was authorized by the Parliament as part of the 2004 Companies Act. 7 1st of July 2005 the legislation came into force.8

Before the coining of the term “social enterprise” similar sort of activities were carried out in different forms of philanthropic activities and the cooperative movement emerged in the late nineteenth and early twentieth century. In the British context it is argued that the decline of the welfare state has stimulated the rise of social enterprise as a tool for delivering public services in society. At the same time entrepreneurship and innovation has provided flexible solutions to meet the demand for a range of challenges faced by today’s society, this has further inspired regulators, policymakers and community leaders to look for structural change that can facilitate these type of activities in a constructive manner. Social enterprises operate in the gaps and lack of service which were left after the withdrawal of the State. Social enterprises empower local communities to take immediate action themselves and deliver much needed products and services. This sort of

5Ibidem p. 674.  
7Companies Act, 2004, c. 27, § 26 (UK).  
8Community Interest Companies – Information Pack Community Interest Companies, Regulator of the Community Interest Companies, 2010, p.4.
development is often grass-root and demand driven.  

Later developments, at the brink of 21st century, have further showcased the qualities of the social enterprise movement in the UK. The social enterprise movement fosters entrepreneurial thinking in tackling societal challenges. In contrast with the non-profit sector the social enterprise are not restricted in their operations and often use trade as a tool for fundraising. The social enterprise sector emphasizes management skills in a similar manner as the business world and focuses on creating sustainable organizations that do not depend on donations and government grants, the aim is often set at gradually becoming self-sustaining through organic growth of the operation. Moreover, the social enterprise diverted from what had been seen in the non-profit sector in terms of its flexibility to distribute surplus. Earnings are often reinvested in the operations in order to grow the impact over time, while it is also possible to distribute the earnings towards primary, pre-defined stakeholder groups. Social enterprise often find financing solutions in strategic partnership with local government which further drives the emphasis towards creating triple-bottom line strategies to serve the needs of the local communities, the environment, as well as the financial performance of the organization over longer term.  

In the wake of the financial crisis the social enterprise sector in the UK was facing a challenging time on one hand due to less availability of financing. On the other hand these troubled times increased the need for services provided by these organizations. One could argue that social enterprises may increase the resilience of a society and its capacity to cope with financial downturns. According to UK government statistics in 2010 the social enterprise sector had a turnover £27 Billion and makes over £8 billion to the UK economy per annum.  

1.2. The Emergence of Benefit Corporations in the United States

---

10 Ibidem, 286.
11 Mason, Choosing sides: contrasting attitudes to governance issues in Social Firms in the UK", 2010 p. 7f.
In the late 1980s and 1990s an increasing number of socially responsible companies became more visible in the United States, among them were companies like The Body Shop or Ben & Jerry’s. The movement was driven by entrepreneurs and initiatives such as the Social Venture Network and Business for Social Responsibility took form.

These were companies that operated with a double bottom line combining for-profit business with a mission, the companies simply contributed some of their profits to educational, environmental or charitable purposes. Around the same time many States took initiative to introduce legislation, which allowed directors to take into consideration a broader set of stakeholders in their business decisions.12

As the first wave of responsible companies 1980s and 1990s focused their activities on serving “Profit and Planet”, the next generation of responsible companies brought in a third dimension, the triple bottom line was later well captured in the phrase “People, Planet, Profit”, which turned part of the attention to how these companies ensured “fair and equitable business practices” towards employees and the broader community in the location the business operation is situated.13 This can be seen as the strong comeback of the Corporate Social Responsibility agenda.

From here the emergence of a fourth sector sprung as government and social sector, non-profit organizations started adapting business practices and revenue models as a way to acquire necessary capital to sustain their social missions. As the business community is spending an increasing amount of resources on social and environmental causes the sectors that traditionally have been very far from each other started to blend and new innovative hybrid organizational models entered the scene.

A common factor for them all was that they combined social mission while engaging in business activities. Simultaneously, more aware consumers and impact driven investors drove the sector

---

12 See Chapter 2.3. Towards Stakeholder Inclusion.
13 Mickels, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p. 275.
forward and The Fourth Sector Network gathered a group of scholars, lawyers and practitioners at the Aspen Institute in 2006 which resulted in ideas of launching a specific “B certification” aimed at these hybrid organizations as well as a new corporate form namely the Low- Profit Limited Liability Company, L3C. Soon after the process initiated the work that later became the hybrid organization Benefit Corporation, which ambitiously links private interest and public benefit into one corporate entity.\textsuperscript{14}

The legal entity, Benefit Corporation, has been praised for its level of innovation. Like other emerging entities within social enterprise sector this entity seeks to ensure that both social and financial goals are accommodated in decision-making at the board level of companies.\textsuperscript{15} The Benefit Corporation has got widespread implementation in State legislation in the US. In 2015 twenty-seven States had enacted the legislation and is under progress in fourteen more States.\textsuperscript{16}

The Benefit Corporation owes thanks to the lobbying efforts of the B Labs, a non-profit organization dedicated supporting the creation and further development of social enterprise sector. B Labs also introduced the certification of social enterprises. Important to note that this is their own private certification for “B Corporations” and therefore it has no connection to the State corporate legislation that regulates the Benefit Corporations.\textsuperscript{17}

\textsuperscript{14} Mickels, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p. 279-281.
\textsuperscript{15} Esposito, The Social Enterprise Revolution, 2013, p. 695.
\textsuperscript{16} http://benefitcorp.net/
\textsuperscript{17} Esposito, The Social Enterprise Revolution, 2013, p. 695. B Labs has certified 639 B Corporations across tens of industries in March 2013.
2. Shareholders versus Stakeholders?

In the Anglo-American legal context officers and directors of both public and private companies owe fiduciary duties to shareholders alone, this is a long established legal tradition that is much influenced by economic theory as well. The Shareholder theory is advocating the interest of the shareholder and concerned of the information asymmetry that exist between the executive management and the owners of the firm. According to one of its main proponents Milton Friedman companies exists merely to maximize the profit of the shareholders.\(^{18}\) Essentially, the managers of the firms are agents (Principal - Agent theory) for the owners of the same and shall carry out their responsibilities in the best interest of the Principal and make wise decisions for the management of their assets. Any action from managers to promote community interests would be seen as misconduct and solely an action for the agent to promote their own strength and prestige.

These thoughts can be traced back to political economist Adam Smith who argued that if business acts in self-interest the market-place would regulate itself, and also provide social benefit through self-regulation (the invisible hand).\(^{19}\) However, in his earlier work The theory of Moral Sentiments from year 1759 Smith recognizes the need for “morality and compassion” in running commercial and governmental affairs.\(^{20}\)

The Shareholder theory was also subject for debate in the days of the influential professors Dodd and Berle among others debating the *reason de etre* of the corporation and whether corporation owned a duty of ‘trusteeship’ to other stakeholders.

2.1 The classic corporate governance dispute

Berle published the Modern Corporation and Private Property in 1932, which later came to be known as the cornerstone of corporate governance debate. In his work he highlights the division

---

\(^{18}\) *See further* Stout., Why We Should Stop Teaching Dodge v. Ford, 2008. This author questions the existence of legal obligation in line with shareholder wealth maximization.

\(^{19}\) Perez Carrillo, Corporate Governance: Shareholders' Interests and Other Stakeholders' Interests, 2007, p. 96-98.

of ownership and control. The image of the shareholders was groundbreaking. The shareholders were no longer seen as the 'legal owner' of the collective capital, it was rather the legal entity which appeared in that role and it had complete decision-making power of it. This way, shareholders became clearly disassociated from the active management, shareholders were simply seen as passive holders of wealth. In fact, Berle stated that shareholders cannot make any demand from a group of controlling managers and expect the demands to be met. Therefore it was important to seek legal tools that would protect shareholders interest from excessive control of the executive management.  

Dodd argued in his famous contribution to the debate "To whom are corporate managers trustees?" that directors should consider a broader range of constituencies such as creditors, employees and consumer interests in their decision making. In contrast, Berle promoted the model whereas directors duties where only to consider towards the shareholders. He saw shareholder-director relationships as a trust relationship rather than a principal-agency structure, which also meant that shareholders where to regard as beneficiaries. The difference between the concepts is to be found in the control mechanisms. In a principal-agency relationship the principal always stays in control of the agent, in professor Berle's model the shareholder remained a passive and vulnerable beneficiary, which may also need to be protected with regulatory means. This view of the relationship meant that role of shareholder participation in decision-making was somewhat outplayed.

2.2. Corporate Governance Scandals and the Revitalized Debate

A much later debate arose after the corporate governance scandals of Enron and Worldcom in the US in the 1990s and more recently the aftermaths of the global financial crisis. The scandals raised the question of which responsibility the shareholder have in these sorts of scandals? Seeing

---


22 Berle later concluded that business shall not run only to maximize profit but are actually ‘recognised in law to be administrators of a community system’. See further Mickels, Alissa, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p. 273.
Commentators regard the short term interest of some shareholders as a threat to companies. It can be seen as a change of attitude from debating protection of shareholders in the 1930s to rather debate the protection of the corporation itself from shareholders or protection of shareholders from other shareholders with conflicting interests. Much of the new regulation that has been set in place in the US and UK to prevent from future scandals focuses on regulation for shareholder protection to mitigate such unseen abuse of managerial power which was seen in the scandals.

There were two major sides of it. On one hand protecting shareholder rights or on the other hand increasing shareholder influence by increased participatory rights in strategic decision-making. The Sarbannes-Oxley Act of 2002 in the US was made to protect investors by enhancing accuracy and reliability of corporate disclosed governance data made available in reporting to the public. The Act does not bring forward any greater possibilities to shareholders to take part in the corporate governance though, many commentators were asking for greater opportunities for shareholders to influence the director election process.23

2.3. Towards Stakeholder Inclusion

One can also see tendencies of that the shareholder centered legal tradition might be breaking up, in 1983 Pennsylvania was the first State to adopt that authorized directors may consider other interest besides the ones of the shareholders.24 Many are the States that have followed the example and now allow directors to take into account the interests of employees, suppliers, customers, and the local community in their decision making process. Some of the States includes the interest of other stakeholder groups as the long term interest of the shareholder. Generally though, it can be said that the statutes expand the room for wider set of consideration,

---

23 One might think that the US legislation grants great powers to shareholders but in comparison to the UK tradition it is not very strong. In the UK, shareholders hold rights to amend corporate constitutions, assemble shareholder meetings and power to appoint or remove directors in the shareholder meetings. The post crisis response in the UK, also argued for increased shareholder democracy and participation23. More recently, in the United States, shareholder empowerment through increased participatory rights, has gained traction while the old-school agenda for shareholder protection has moved aside. For example, The Securities and Exchange Commission adopted changes to the federal proxy rules 14a-11 which grants certain larger and long-term (had hold shares for longer than 3 years) access to companies’ proxy materials a non-binding right to vote on director remuneration and increased possibility to nominate and elect directors to the management board.
when directors making their business decisions. In the United Kingdom similar set of rules were introduced in the Companies Act in 2006.

Breaking the shareholder primacy culture has not come without struggle. As early as in 2004, after 7 years of advocacy, California and Minnesota tried enacting a bill that would hinder directors from making decisions which would cause severe effects on environment, human rights, public health and safety. Directors would still have had a duty to make money for shareholders while not at the expense of these stakeholder interests. The so called Hinkley’s Amendment was rejected by governor in California after approval in Assembly and Senate in 2008. Even though the bill was rejected at the end the governor had opened up for investigating ‘alternative models of corporate governance’ which may have paved the way for the pioneering of the legislation of Benefit Corporation in the State of California. At the same time many states have brought forward new forms of hybrid organizational forms such as the Social Responsible Corporation in Hawaii and Minnesota in 2007 and Non-Profit Limited Liability Company of Tennessee and Kentucky, and the L3C in North Carolina and Vermont. Finally, Maryland and Vermont became the first States to introduce the more ambitious legal from the Benefit Corporation in 2010, which includes a duty to consider stakeholder interests.

Historically, the track record of legal cases which allow directors to pay attention to other constituencies than the shareholders, seem to be very limited and appear only in certain specific circumstances. Michigan Supreme Court ruled in Dodge vs. Ford Motor Co and concluded that directors were allowed to reduce customer prices at the expense of shareholder dividends and that this decision by the directors did not sacrifice the interest of the shareholders. The Supreme Court of Delaware has allowed directors to take account of the impact on creditors, customers, employees, and the local community. In Revlon Inc v. MacAndrews & Forbes Holdings Inc it was defined that the directors has to find some benefit for the stockholders in doing so. It seems like most of the traditional case law is uniform with the State statutes which merely pays attention to stakeholder interest in very limited cases, where it can be clearly aligned with the

25 Mickels, Alissa, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p. 297-300
long term interest of the shareholders. The question is how the social enterprise legislation in many US states and the UK can be seen in this light, are the new emerging social enterprise legal forms a step closer to acknowledgment of stakeholder theory in practice?

2.4. Stakeholder Theory in Social Enterprise

According to corporate governance theory stakeholders are ‘Any identifiable group or individual who can affect the achievement of an organization’s objectives, or who is affected by the achievement of an organization’s objectives’ for example creditors, owners, suppliers, employees, directors, government or the community in which the company operates or draws resources from. The Stakeholder theory was much contributed by economic theorist R. Edward Freeman in his book Strategic Management: A Stakeholder Approach in 1984. The core idea of his work was that organizations that pay attention to managing their stakeholder relationships will survive longer and perform better. The stakeholder theory emphasizes that organizations also have certain responsibilities towards these groups.

There is variety of criticism towards this theory primarily from theorist who would support the view of a corporation merely as a nexus of property rights. The criticism ranges from economical, moral to legal aspects. For instance, stakeholder theory is said to be incompatible with corporate governance since it requires accountability to several groups. On one hand, some critical voices say that if directors are obliged to take into account other public or social interests this alone becomes an uncontrollable power in the hands of the managers, which eventually needs to be restricted by public control. On the other hand, it can also be argued that the hypothetical interests of all shareholders shall be met regardless of whether these interests are maximization of share value or whether it is an environmental agenda that is driven by a community of activist shareholders or large institutional shareholder. In principal, taking into account other interests

---

28Perez Carrillo, Corporate Governance: Shareholders' Interests and Other Stakeholders' Interests, 2007, p. 96f.
than maximization of share value are still in line with and compatible with shareholder theory, as long as the other interests are driven by shareholders.\textsuperscript{31}

It is brought up as an apparent risk that accountability is diluted in social enterprises if you add many stakeholder groups that directors need to prioritize. It is argued that it is likely to be more effective if focusing on delivering value for just one stakeholder group than to multiple ones. Obviously, it needs to be clear to whom directors are to be held accountable to. \textsuperscript{32}

I would argue that this criticism does not subvert the stakeholder theory, it rather stresses how important it is to identify different stakeholders and to clearly define priorities in a social enterprise, or the so called normative base of the social enterprise. Thus, this sort of definition provides a scope for a directors’ duty and accountability is in a social enterprise very much in line with an agent–principal relation.\textsuperscript{33} Ideally a board of directors involves representatives from the multitude of stakeholders that need to be served. The principal must constitute of a multitude of stakeholders, which speak with one voice, having had the chance to debate and find compromising solution in a board room. It is often argued also outside the social enterprise sector that a diverse board of directors serves the long-term interest and stability of any organization. After all, maximization of impact or profit for one stakeholder creates misbalances over long term that will have to be corrected sooner or later.

In the social enterprise context it is often argued that it makes business sense to integrate stakeholders that depend on or supply for your business activity. This is a rather pragmatic view at it, while the undertone in many cases is also strongly moral and ethical. A social enterprise can be formed to serve a greater cause, but to offer clearer guidance for the director duties and create a stronger normative base for the activity the organization can formulate its specific mission and prioritize its stakeholders more clearly.\textsuperscript{34}


\textsuperscript{33} More about the same topic in Chapter 6.2.1. Duty to Consider Stakeholder Interests.

\textsuperscript{34} Murray, J. Haskell, Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes,
It is clear that the tracking of the impact of the social enterprise becomes crucial. The link between the normative base and the empirical evidence of activity for delivering impact shall be crystal clear and measurable, this is how the social enterprise can showcase and maintain the legitimacy of the operation and provides proof of cost-efficiency and ultimately provides stakeholders with fundamental information of the organization’s use and ultimately the directors management of the company resources. This sort of information also indicates whether the social enterprise is in line with its mission and whether it addresses the needs of the stakeholders. The social enterprise can end up delivering something different from what the stakeholder requires due to poor management or circumstances that can be hard to predict. To prevent from these situations it is now normal to set up service level agreements prior to any project implementation.\textsuperscript{35}

Some theorist view the corporation as a social institution whereas stakeholder interest are naturally aligned with the interest of the firm, since the firm is seen as a natural part of society rather than something separate from it. Therefore governance structures shall also facilitate stakeholder interests.

3.1. Democratic Ownership

Fair and equitable participation across different stakeholders provides ownership and creates room for democratic decision-making in business organizations. From a societal point of view it can be seen as an expansion of democratic ideas in a corporate dimension. In organizational theory it is argued that abuse of power is less likely to appear if relevant stakeholders gain legal ownership in the organization also known as democratic ownership. Access to oversight of the

board work also increases the transparency which in turn should enhance the accountability of the board.

Allowing corporate governance structures serve a wider set of interests than just the interest of the shareholders, can be seen as an alternative way of ensuring efficiency in decision-making - a way that focuses more on long-term stability than short-term profits. There exist apparent risks for conflict of interest for other groups that are affected by the operation of the firm. Suppliers, employees and local government, natural ecosystems may not benefit from the same activities as a shareholder would directly benefit from.

These ideas are not entirely new and the emergence of the labour right's movement in the 19th century Europe show certain practical application of stakeholder inclusion by entrepreneurs who supplied health and education benefits for their workers and shortened the weekly working hours to protect the interest of their employees. This may just be seen as a long-term investment in securing human resources for the operation which results may highly depend on the workers availability, motivation and capacity – which does not undermine benefits for the shareholders at least not over longer term. In the USA pharmaceutical companies such as Merck developed Codes of Conduct which stressed the companies purpose to serve Public Health. In today's world, according to my opinion, this examples is comparable to social enterprise initiative of Danone, which developed a nutrient yogurt for the benefit of children suffering from malnutrition in third world countries, it creates meaningful impact and therefore motivate employees and still made business sense since it allowed the company to tap into an emerging market - an excellent strategic entrance to a growing mass-volume market at the base of the pyramid.

3.2. Stewardship Approach

In discourse on social enterprise governance a Stewardship approach has been advocated for as an alternative to Agency Theory. The Agency Theory in corporate governance focuses very much on the economic aspects of relationships in an organization while a Stewardship Approach gives more room for non-economic factors that influence management. Psychological and situational factors play an evident role in management activity regardless of economic driving forces.

36Perez Carrillo, Corporate Governance: Shareholders' Interests and Other Stakeholders' Interests, 2007, p. 96f.
According to the Stewardship approach a manager is trustworthy and drives the best interest of the organization as their own interest are in line with the organizations’ interest. This requires a relationship of trust between the manager and the principal, hence the manager will drive the interest of the principal.  

This resonates with the ethos of the social enterprise sector; directors in this sector are often members or strongly committed to a certain community that it serves. This helps to align the organization/managers decision-making with the needs of that community. Still, the Stewardship Approach also runs along with idea of that social enterprise sector will mature and become more streamlined towards business efficiency. This would allow a broader skill-set in board level with less focus on inclusive representation. I would still argue that it is not necessarily a trade-off in business efficiency to maintain strong stakeholder participation at board level.

---

37 Ibidem, p290.  
38 Ibidem, p290.  
4. Directors’ Duties

There are two basic duties that are central to the directors’ duties in American legislation, namely the duty of Care and Duty of Loyalty, while in the UK a longer list of duties was codified in the Companies Act in 2006, from much of the duties having been previously recognised in the Common Law. By duty in this chapter we understand legal duty that is enforceable in a court. Since some areas may lack case law the concept of duty also covers some areas of duty that may not be enforceable in a court at least yet. The ethical perspective of duty may offer complementary argumentation for legally unclear situation. It may also offer guidance in choosing between several legally acceptable alternatives.\(^\text{40}\)

4.1. Duty of Care

The Duty of Care relates to the agency-principal relationship and is there to ensure directors invest sufficient time and diligence into their role as managing the company. The rule is obviously there to protect the principal from a situation where the agent carelessly mismanages the assets of the company. This duty can mean a variety of practical matters such as establishing information and monitoring systems, supervision of the operations. It can also mean that the manager possesses required skills and experiences for his function.\(^\text{41}\)

4.2. Duty of Loyalty

The Duty of Loyalty commits directors to act in good faith and to do this in their understanding of what is the best interest of the company. The duty is also there to ensure that the personal interest of the director will not conflict with the interest of the company. This is highly important in particular cases where a director might have a personal material interest or directly benefit

\(^{40}\) Sjåfjell, Beate & Anker-Sørensen, Linn, Directors’ et all, Duties and Corporate Social Responsibility (CSR) - Boards of directors in European companies – reshaping and harmonising their organisation and duties, 2013, p.9f.

\(^{41}\) Ibidem p. 6f.
from a transaction of the company. The concept of the interest of the company is central, still hard to define the exact boundaries of that. It is argued that the boundaries of that are rarely tested in practice due to the strong social norm of shareholder primacy in board rooms.42

4.3. Business Judgment Rule

The Business Judgment Rule is used by courts in the US to determine whether a director in his decision-making or day to day running of business operations has or has not violated his duty to act according to the best interest of the corporation. The presumption is that the director acts well-informed, in good faith and with honest belief that his action serves the best interest of the company. Therefore the burden of proof lies on any counterpart. A shareholder will have to proof that a director has acted deliberately against his or her duty of care or loyalty, in a way which is not aligned with the best interest of the corporation. Bad faith is also a requisite. Bad faith is 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’43 In practice, a court can find valid reasons for sound business judgment as long as there is a rational purpose for the specific decision.44 In case of decisions that serve other constituencies it is also less likely that a court finds a self-interested motive in such business judgment.45

The US state corporate laws46 permits directors to take into account stakeholder interests even at the expense of the shareholders. Generally, it can be said that directors must take into account the best interest of the corporation as a whole, including the interest of stakeholders. For the long-term benefit of the corporation the directors can make use of tools such as called poison pills, shareholder rights plans, staggering of board elections or other means to prevent from hostile take

43 Walt Disney Co. Derivative Litig., 906 A.2d 27, 67 (Del. 2006).
45 Ibidem p.284, also see Jackson, "Towards a Stakeholder-Shareholder Theory of Corporate Governance: A Comparative Analysis, 2011, p.37, This author argues that directors may even be able to approve transactions with self-interest, as long as the procedural requirements are met. These sort of transactions can be made possible if a number of disinterested directors approve and the matter is disclosed to the extent needed.
46 A majority of states have implemented constituency statues for taking into account non-shareholder interest. See further Mickels, Alissa, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p.290f.
overs. Even though for example Delaware legislation allows directors to take into account interests of many constituencies and the fiduciary duties are owed to the corporation as a whole, only shareholders may enforce those duties through derivative suits. Thus, directors are permitted to consider stakeholder interests in their business judgment, while there is no duty to consider them.

4.4. The UK Companies Act 2006

The general directors’ duties in the UK Companies Act Section 171-177 are listed and according to the Act directors have a duty to act within powers, to promote the success of the company, to exercise independent judgment, to exercise reasonable care, skill and diligence, to avoid conflicts of interest, not to accept benefits from third parties and finally to declare interest in proposed transaction or arrangement.

4.4.1. Duty to Act within Powers

Directors are in the United Kingdom shall stay within their powers when exercising their position. Their powers shall only be used for a proper purpose. This duty is specially apparent in takeover situations. The duty to act within power can be seen as an extended duty to act in good faith, which covers situations where director acts in good faith to serve a purpose that is not in line with the assignment defined in the companies constitution.

4.4.2. Duty Promote the Success of the Company

In the UK a more stakeholder centered corporate governance model was introduced through The Companies Act of 2006. Section 172(1) of the British Companies Act allows consideration of long-term interests of the corporation much like an American version of a constituency statute.

---

47 A case where a socially-conscious company feared loss of long-term value and mission in a take-over situation by financially single-minded investors is found in the case of Ben & Jerry's was bought by Unilver, where bidder in a shareholder suit argued that the highest bid had to be accepted and founders had no right to reject the generous offer for purchase of their shares. See further Page & Katz, Freezing out Ben & Jerry, Corporate Law and the Sale of Social Enterprise Icon, 2008.


49 UK Companies Act 2006, Chapter 46, Part 10, Chapter 2 Section 172-177.

50 UK Companies Act 2006, Chapter 46, Part 10, Chapter 2 Section 171. See also legal case which was then codified in the UK Companies Act 2006:Howard Smith Limited) v. Ampol Petroleum Limited and Others.
Company’s employees, suppliers, customers, community and the environment can be taken into consideration by a director in his decision-making. 51

When the new Companies Act was introduced by the Secretary of the State for Trade and Industry, Mr Alistair Darling, he presented the Act as novel in terms of directors’ duties, which aimed to serve a broader concept of shareholder value, what he called “Enlightened Shareholder Value”. It underlines that shareholders will gain more long-term sustainable success if the company pay attention to wider range of matters. The intention was clearly to increase consideration of stakeholder interests when director promotes the success of the company. 52

From a critic’s point of view, it can be said that the directors are left unsure whether they will be held accountable for a breach of fiduciary duties to stakeholders. There is very little practical guidance given on how to react to this legislation. 53 Futhermore, the UK Companies Act has left central concepts such as measurement of social and environmental performance open, the Act is criticized for “an absence of proper guidance, rules and regulations which could serve as benchmarks for the quality and quantity of required disclosure”. These are tools that are supposed to be there to help members of the company assess how directors comply with the duty under section 172 duty to promote the success of the company. 54

While the most relevant general directors’ duties have briefly been presented here, this paper focuses the analysis of the directors’ duties at obligations that are additional and new when it comes to Community Interest Companies or Benefit Corporations.

51 UK Companies Act 2006, Chapter 46, Part 10, Chapter 2 Section 172. See also Mickels, Alissa, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p 293f.
53 Mickels, Alissa, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p 300.
5. Director Duties in Community Interest Companies and Benefit Corporations

The Directors of these social enterprises are imposed with a new duty to consider stakeholder interests. In a white paper on the “Need and Rational for the Benefit Corporation” the B Lab states as one of the main characteristics of the new legal form “an expansion of the duties of directors to require consideration of non-financial stakeholders as well as the financial interests of shareholders”.\(^5\) In this chapter the implications of this new duty will be analyzed. On the other, there is a large amount of flexibility when applying this new duty. The enforceability of the duty can be questioned. There is no fiduciary duty to stakeholders. The CIC Regulator in the UK has a range of tools to enforce a similar duty, while in the US the shareholders are given an expanded right to action to enforce the new duty to consider stakeholder interests.

5.1. Community Interest Companies

The CIC is a limited company, but subject to restrictions specifically to ensure it will serve community interests. The governance is taken care of by the board of directors primarily.

A CIC can either be limited by shares or by guarantee. If limited by guarantee, the CIC guarantees that all profits will be reinvested in the company. If limited by shares, the CIC operates like a traditional limited company. Still, CICs limited by shares are allowed to raise equity financing while profit distribution to shareholders is capped at 35% of the profits.\(^6\)

5.1.1 Directors’ Duties in Community Interest Companies

Director duties in CIC are to a large extent similar to the ones of a mainstream business, while

\(^5\)Clark, Jr. and Vranka, Need and Rationale for the Benefit Corporation, 2013, p.1.
guidelines published by the CIC Regulator on this matter clearly points out an additional responsibility, the director of a CIC shall ensure that the CIC is run in a way that it complies with the Community Interest Test. The Regulator specifically point out that this might lead to practical situations where the company may have to choose to pursue the defined community interest instead of generating financial returns for the investors of the CIC.  

The balancing act is carried out by board of directors who hold long-term strategic power and therefore should account for the results. Challenges lies not only in that the objectives are undertaken but also that they are put into evidence in order to gain legitimacy from key stakeholders. Social accounting systems are therefore a central part of the ensuring accountability at board level. At the same time the board should be focusing on ensuring competitiveness in the mainstream market, which may also be comparable to ensuring long term reoccurring social benefit.

The board of directors must monitor and manage their staff and ensure they prioritize delivering on the set social objectives, while still maintaining a business orientation and an entrepreneurial corporate culture. A strong ability to maintain accountability at board level is often directly linked to the organizations legitimacy to operate as a social enterprise and therefore enhances its position towards key stakeholders, which may be completely incremental for the long term existence of the enterprise if the relationships to stakeholders are strategic for its operations.

5.1.1.1. Community Interest test

When registering a CIC the founders must sign a Community Interest Statement, in order to define how they will deliver a ‘community purpose’. The CIC directors are thereafter responsible to submit an annual report to the CIC Regulator, which must describe how benefits provided are not being limited to the benefit of an improperly restricted group of people.

57 Office of the Regulator of Community Interest Companies: Information & Guidance Notes, Chapter 9, 2013, § 9.1.2.  
A central tool of the CIC regulation is the so called Community Interest Test which is to determine whether a ‘reasonable person might consider [the] activity [as] being carried on [by the CIC] for the benefit of the community.’ The Community Interest Test is enforced by the CIC Regulator. This is primarily to ensure public confidence in the CIC legal entity. The CIC Regulator has rather far-reaching powers to intervene in CIC operations. The CIC Regulator can order independent audits, commence civil proceedings to intervene in the CIC’s business, remove directors and appoint a manager to run the CIC in case of a director is removed.

5.1.2. Stakeholder inclusion

Inclusion of stakeholder groups in decision-making is encouraged but not required in Community Interest Companies. Nevertheless, the CICs must detail efforts made in the annual report submitted to the CIC Regulator. Among the means to encourage such inclusion we find examples such as circulating newsletters, stakeholder meetings, establishing interactive website, or even creating governance structure so that identified stakeholder groups needs to be consulted before CIC director make certain type of decisions.

5.1.3 Asset Lock

Furthermore, the CIC is also characterized by the Asset lock that it is subject to. The dividends of a CIC are caped as earlier mentioned, while the directors have a duty to ensure that the CIC obtain fair market value on the sale of any asset. This has practical relevance specially to prevent that a director gain from selling assets for below market price in order to undermine the community interest goals of the CIC or maybe even for personal gain from selling to an entity that the director owns himself. In case of dissolution of a CIC the directors are similarly

---

62 UK Companies Act, §§ 26, 43.
63 Ibidem § 44.
64 Ibidem § 46.
65 Ibidem § 47.
prevented by asset lock to prevent from selling to directors, members or equity holders.\textsuperscript{68} 

I would argue that the cap on dividends is useful to differentiate the CIC from other legal entities and also to ensure trust and public confidence in the CIC brand. To some extent the cap of dividends might drive long term value creation in the CIC rather than short term shareholder wealth as profits are reinvested in company. At the same time it may also lead to difficulties for fundraising and limit the growth of companies that develop much needed solutions within sectors that are crucial for human wellbeing.

5.2. Benefit Corporations

The Benefit Corporation legislation addresses three shortcomings that traditional corporate form misses to address which are especially important for businesses with hybrid purposes. Firstly, it breaks through the shareholder wealth maximization norm and creates legal certainty by introducing the changes into standard internal incorporation documents and supports these legal changes with State statutory law. This alone should prevent possible litigation between shareholders and directors. Secondly, it addresses the lack of social and environmental accountability standards and helps distinguish organization that take real action from organizations that only provide empty claims on social responsibility. Thirdly, the Benefit Corporation creates mandatory reporting guidelines which enhance transparency and accountability.\textsuperscript{69}

5.2.1. Corporate purpose, accountability and transparency

Benefit Corporation statutes\textsuperscript{70} are structured around four main headings: General provisions, corporate purpose, accountability and transparency. The article of incorporation is required to include language explaining that the benefit corporation shall have the purpose of creating a ‘general public benefit’. It is defined as a ‘material positive impact on society and the environment’, measured ‘against a third party standard, from the business and operation of a

\textsuperscript{68}Esposito, The Social Enterprise Revolution, 2013 p. 676.
\textsuperscript{69}Resor, Benefit Corporation Legislation, 2012 p.105f.
\textsuperscript{70}See for example N.Y. Business Corporation Law Section 1701.
benefit corporation’. Obviously in the coming years, case law will help us understand the exact interpretation for addressing accountability and methodology. The reference to a third-party standard is most notable.\(^{71}\)

Typically the statutes for benefit corporations in US states list examples of so called ‘specific public benefits’ that can be targeted. Still, the list ends with a catch-all provision, that encourages innovation of new or more ‘specific public benefits’. Among listed examples we find ‘providing low-income or underserved individuals or communities with beneficial products or services’, ‘preserving or improving the environment’ or ‘improving human health’.\(^{72}\) It can be said that benefit corporations ‘can pursue any specific mission, but that the company as a whole is also working toward general public benefit’. This explains the need of separating general and specific public benefits.\(^{73}\)

Generally, the Statutes also contain provisions for 2/3 voting requirement in case of merger or sale, which is also applicable to amendments to the corporate purposes in the articles of incorporation. These rules are designed to ensure benefit corporations preserve their unique corporate purpose over time. Even though these requirements does not work as a complete ‘asset lock’ it may prevent from potential hostile takeovers or transactions that would separate a benefit corporation’s assets from the stated social or environmental purposes. Also for example in Vermont, it is required that the Board of directors provides an explanation why it is proposing a merger or sale in which it would no longer survive as a benefit corporation.\(^{74}\)

5.2.2. Directors’ Duties in Benefit Corporations

Logically, a court that applies the Business judgment rule, should take into account that a Director is acting in the best interest of the corporation, even when shareholder interests are set a

\(^{71}\)Ibidem, p.697f.
\(^{72}\)Ibidem, p698.
side. The Benefit Corporation’s identity is based on distinguishing itself in the market as a value-driven corporation, it may be counterproductive even from a shareholder value perspective, if the director sacrifices corporate values in favor for short term monetary gain. The non-shareholder constituencies are set as objective of the corporation in their articles of incorporation, which specifies and should offer great guidance for the directors’ decision-making process and day-to-day business operations.\textsuperscript{75} Consequently, “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.”\textsuperscript{76}

The Directors of Benefit Corporation are also protected by specific Benefit Corporation statutes. It is clearly stated that a consideration of all stakeholders shall not be seen as violation of the duties of directors while the director “may serve in good faith, in a manner the director believes to be in the best interests of the benefit corporation and with that care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances”.\textsuperscript{77}

5.2.2.1. Duty to Consider Stakeholder Interests

Directors of Benefit Corporations have a duty to consider the effects of their business decisions upon stakeholder groups. The Statues list specifically stakeholders without putting them into any specific order of hierarchy.

Most Benefit Corporation legislation stipulates that directors have no fiduciary duties to stakeholders. However, shareholders are given an expanded right of action to enforce duty to consider stakeholder interests. Thus, the benefit corporation’s compliance with stated social and environmental purposes relies on shareholder activity.\textsuperscript{78} Additionally, it is also permitted to grant specific stakeholder groups with a similar right to action or give privilege to one or more specific

\textsuperscript{75} Mickels, Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe, 2009, p. 284f.
\textsuperscript{76} Ibidem, p. 286.
\textsuperscript{77} California Corp Code § 14620(a).
\textsuperscript{78} Wexler &Lewitt, Using New Hybrid Legal Forms: Three Case Studies, Four Important Questions, and a Bunch of Analysis, p.73f.
public benefits above others. A fiduciary duty can only exist if it is specifically stated in the certificate of incorporation or by the bylaws of the benefit corporation.\(^79\)

The law does not allow the director to deprioritize a general public benefit in favor for a well-defined “specific public benefit purpose”. The danger is that the ‘general public benefit purpose’ is too vague and does not offer directors enough guidance for practical decision-making. For example, how shall a director act in a situation where he or she might harm one stakeholder while benefiting another, the environment might suffer from a decision which benefits the employees?\(^80\) The current form of the law offers no guidance and priorities for a director to prioritize the benefits. In fact, the law lists as much as 7 different causes that can be served:

“Specific public benefit, includes: providing low-income or underserved individuals or communities with beneficial products or services; promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business; preserving the environment; improving human health; promoting the arts, sciences or advancement of knowledge; increasing the flow of capital to entities with a public benefit purpose; and the accomplishment of any other particular benefit for society or the environment.”\(^81\)

It seems to me that the legislator have left it to be determined by the founders or the board of the corporation and therefore it is of great importance for any serious Benefit Corporation that they carefully define the specific benefits and the stakeholders they aim to serve in the Articles of Association.

As earlier mentioned; critics of the Benefit Corporation claim that it is a serious challenge for holding directors accountable if they must consider multiple stakeholders in every decision they make. It opens up risks for directors to make decisions that are driven by self-interests by referring to a stakeholder that serves that interest best on a case by case approach. It is argued that humans are self-interested by nature, the only way to counteract that is by providing directors very clear guidance on which objective and stakeholder is primary in the enterprise coupled with an effective enforcement mechanism. Opponents to this view say humans are able to balance be-

---

79 For example N.Y. Business Corporation Law, Section 1707 (c).
81 For example N.Y. Business Corporation Law, Section 1702 (e).
tween many priorities and it should not be of any major issue for a director to balance the interest of various corporate stakeholders.\textsuperscript{82}

There are different opinions on some central concepts in the duty to consider stakeholder interest. Some argue that a particular outcome will not be requested from a directors’ activity, rather it is important that the directors’ decision making process considers all the relevant stakeholders, while other commentators underline that the Benefit Corporation legislation requires directors to create ‘material, positive impact’ both to a specific and general public benefit. The material, positive impact is vaguely defined, we will have to wait and see when there is more case law to draw conclusions from whether this legal strategy is effective or not.\textsuperscript{83}

5.2.2.2. Duty of Care and Loyalty

In mainstream corporate governance the duty of loyalty has proven to be most efficient in lawsuits that aim at enforcing director liability. It is argued that the normal duty of loyalty lawsuits shall be available for similar cases that concern benefit corporations. We have still not seen any case law in this area though. These cases would not only cover directors that act in self-interest, but also in case a director fails to act in good faith and to advance the best interest of the corporation.\textsuperscript{84}

Similarly, The duty of care would in principle also be applicable in cases of benefit corporations. Still, this will most probably not be applicable for the Benefit Corporation for the time being since Benefit Corporations legislation already includes rules that exclude monetary liability in case of unsuccessful pursuance of the general and specific public purpose, but on the other hand scholars argue that there is no good reason not to introduce the rules for monetary liability for

\textsuperscript{82}Haskell. "Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes, 2012, p. 28, 33f.
\textsuperscript{83}Cummings, Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest, 2012, p.593 Compare Clark Jr. & Babson, How Benefit Corporations are Redefining the Purpose of Business Corporations, 2012, p. 850.
\textsuperscript{84}See case law in mainstream corporations in Delaware indicates that the duty of loyalty has a broad conception. See further Stone vs. Ritter 911 A.2d 362, 369–70 (Del. 2006).
benefit directors in the future. This would have little practical implication since lawsuits in the case of duty of care in traditional corporate law are rarely successful.\(^8^5\)

5.2.2.3. Duty of Obedience

Duty of obedience is primarily recognized in the non-profit sector, but some argue that it is also valid for business corporations and has been so for long according to case law.\(^8^6\) The duty can be described as the directors’ duty to remain faithful to the organization’s purpose and mission. In the social enterprise sector this sort of argumentation should have much application in my opinion. This duty is much like the duty to consider stakeholder interest oriented towards substance rather than just procedure. In the non-profit sector it is seen as a board’s duty to stay committed to the donors will of the use of the finances.\(^8^7\) In the same manner I argue that a Benefit Director shall stay true to the purpose defined in the Articles of Association in a Benefit corporation and the “specific public benefit purpose. A shareholder in a Benefit Corporation must to a large extent base the investment decision on the mission statement in the Benefit Corporation and shall therefore be protected from mission drift in a similar manner than a donor in a non-profit organization. It is further argued by scholars that a revival of the duty of obedience would enhance the legitimacy of the corporation in society.\(^8^8\) I also see that the UK Companies Act Section 171 Duty to act within powers as a similar duty which is very much binding for a Community Interest Company, while Benefit Corporations are left with unclear guidance in this matter.

---


\(^8^6\) Palmiter R. Alan, Duty of Obedience, The Forgotten Duty, 2010, p.461: Recent case law implies that duty of obedience might still be effective for business corporations even though it is not mentioned by name in recent legal cases.


\(^8^8\) See Palmiter R. Alan, Duty of Obedience, The Forgotten Duty, 2010, p.458, for further discussion on the duty of obedience. The duty of obedience has much diminished due to a shift in view of directors’ liabilities. The focus has no longer been set on directors being personally liable for unauthorized actions, rather the language used focuses on the directors liability of failure to act responsibly – a shift from power to duty that happened in the beginning of the 20th century. Over time this meant an abandonment of ultra vires doctrine in corporate law. Now, some commentators see signs of a revival of the duty of obedience and with it the ultra vires doctrine, specifically through the case of In re Caremark International, Inc. Derivative Litigation among others. The case concluded that a director has a duty to create and oversee compliance schemes in order to avoid illegal actions by the corporations employees. The court referred to duty of care, while it is also about corporations compliance with law and directors duty to ensure that.
5.2.3. Benefit Enforcement Proceeding (BEP)

A Shareholder of a Benefit Corporation is given a right to proceed with legal action in case the Director of the company fails to pursue the stated general or specific public benefit. There is no such right for third parties in Benefit Corporation legislation. The Benefit Enforcement Proceeding is a right to legal action specifically for shareholders, directors and other persons in case mentioned in the corporations articles of association. The legal proceeding have to be based on the defined public or specific benefit in the company’s corporate documentation.\(^\text{89}\)

“...a shareholder is expressly given the right to bring a legal action on the basis that the director failed to pursue the stated general or specific public benefits, failed to consider the interests of the various stakeholders set forth in the statute, or failed to meet the transparency requirements in the statute.” \(^\text{90}\)

The Benefit Corporation legislation does expand the right for a shareholder to bring a director to court for other reasons than the traditional scope of misconduct. Thus, consideration of stakeholders becomes mandatory, while it does not create a fiduciary duty towards the beneficiary of the defined benefit.\(^\text{91}\)

From an accountability perspective the BEP has been criticized for not being a strong enough enforcement mechanism to curb a director from misconduct for a self-interested practice for instance. Given the expanded flexibility for a director of a Benefit Corporation to consider a broader range of interests in their decision making process (not only profit for shareholder) the risk for director abuse is higher, that is why scholars have also stressed the still so important right for shareholder to elect directors, and still consider this as the main “policing mechanism”. \(^\text{92}\)

\(^{89}\)New Jersey. STAT. ANN. § 14A:18-10.
\(^{91}\)Johnson, Pluralism in Corporate From: Corporate Law and Benefit Corps. 2012-2013 p. 293.
\(^{92}\)Clark Jr. & Babson, How Benefit Corporations are Redefining the Purpose of Business Corporations, 2012, p. 850.
The BEP cannot lead to any monetary damages or personal financial liability for a director. For example California Benefit Corporation legislation excludes the Director or the corporation from monetary damages. Shareholders can request injunctive relief in case of failure by a director to pursue the defined general of specific benefits. Commentators argue that it is a heavy burden on courts to handle such injunctive reliefs, interestingly in the UK the matter has been avoided by creating the CIC regulator who oversees the activities of the CICs.

5.2.4. The Benefit Director

In a number of US States it is required that the Benefit Corporation appoints a designated Benefit Director to sit on the Board. The authorities and duties of a benefit director is the same as any other director in general. However, the primary responsibility of the Benefit Director is to prepare the Annual Benefit Report. The director shall also include a statement on whether the corporation has reached its stated Benefit goals or in case it has failed an explanation of the failures shall be added. Basically, the Benefit Director shall report on whether the duty to consider stakeholder interests has been fulfilled or not. Similar to the other directors in a Benefit Corporation the Benefit Director is not personally liable for an act or an omission to act in this capacity.

5.2.5. Annual Benefit Report

Directors of Benefit Corporations are required to submit an Annual Benefit Report to all shareholders (ABR) and according to most Statues the latest report shall be made publicly available on the company’s webpage. First of all, ABRs must include a narrative summary of how the company has pursued its general and specific public benefits and secondly if any

---

93Haskell. Choose Your Own Master: Social Enterprise, Certification, and Benefit Corporation Statutes., 2012, p. 35.
94For example, Cal. Corp Code § 14620(f).
97For example California Corp. Code § 14360.
98For example New Jersey. STAT. ANN. § 14 A: 18-11(c).
circumstances that have hindered the achievement of general and specific public benefits they need to be described and thirdly the social and environmental performance needs to be assessed or quantified.\textsuperscript{100} The ABR also has to be measured against some independent, third party standard.\textsuperscript{101}

The report addresses accountability from two angles, on one hand the process on how decision are reached and on the other hand the results of those decisions audited by third party. Therefore the Benefit Report must include (1) third-party audits, (2) board of directors’ meeting minutes which includes discussion on impact on the stakeholders of the corporation, and (3) statement from independent Benefit Director on how the board has reached decision on all matters.\textsuperscript{102}

5.2.6. Third Party Audit and Mission Accountability

Majority of the largest companies in the world make their policies public on their webpages and have also adopted codes of conduct that are often promoted by international organizations such as the UN. The most known one is the UN Global Compact that allows companies to sign up for proactively working with and publicly stipulating their social responsibility practices. Shareholder suits are argued to be an ineffective tool for corporate mission accountability. While the international structures that are set in place for mainstream businesses for social and environmental responsibility reporting and monitoring are merely covered by soft law and are not compulsory.\textsuperscript{103}

\begin{footnotesize}
\begin{tabular}{ll}
an\textsuperscript{100} & For example Maryland, \textit{CODE ANN.}, Corporations & Associations § 5-6C-08(a). \\
an\textsuperscript{101} & For example N.Y Business Corporation Law § 1702(b) \\
an\textsuperscript{102} & Cummings, Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest, 2012, p.594f. \\
an\textsuperscript{103} & Perez Carrillo, Corporate Governance: Shareholders’ Interests and Other Stakeholders’ Interests, 2007, p. 100. \\
\end{tabular}
\end{footnotesize}

The principles put forward are widely accepted standards for labour, human rights and sound environmental practices. Furthermore, the International Labour Office has produced an influential declaration of principles governing multinational enterprises. These are guidelines on employment, training, conditions of work and industrial relations. The OECD guidelines on multinational enterprises cover guidelines against child labour and other forms of forced labour as well as environmental misconduct. Apart from this there are a range of international standards and monitoring schemes such as the Social Accountability 8000, which sets standards for labour and global manufacturing operations and ISO 14000 (International Standards Organization) is an environmental management standard.
Thus, the Benefit Corporation focuses a great deal on the auditing and reporting requirements. The third-party audit is done against an independent third-party standard\(^\text{104}\) Some of the third-party standards provide strong branding opportunities. It is argued that the accountability framework for Benefit Corporations believes more in reputational sanctions than legal ones. It is cheaper and quicker to let the market guide and enforce the code of conduct. It follows a simple logic that Benefit Corporations must value their image and reputation so highly that it is forced to be transparent and true to its proclaimed mission statement and values. It is also argued from a law and economics point of view that environmental disclosures reduces information asymmetries between companies, consumers and investors and therefore prevent market failure. The Social Reporting industry also apart from just Benefit Corporation legislation has argued that the reporting is often burdensome and costly specially for small companies and it is also limited to which extent readers of the material will consume time to understand the reporting and make sense of it, also the third-party auditor is envisioned to play a role of an objective valuator, therefore the performance metrics should be “...'objective' (so consumers can trust them), standardized (so consumers can compare results across companies), and quantifiable (so they are quick and easy to understand)”\(^\text{105}\)

\(^{104}\)Third-party standards are provided by a range of organisations such as Global Reporting Initiative (GRI), International Standard Organisation (ISO), Green American, B Lab etc.

\(^{105}\)Cummings, Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest, 2012, p.601.
Conclusion

Directors’ duties in social enterprises are different from the directors’ duties in traditional corporations in many aspects; firstly the Benefit Corporation legislation grant shareholders expanded right to enforce the duty to consider stakeholder interests or in the case of Community Interest Companies, gives the CIC Regulator right to enforce similar obligations. Secondly, the directors are accountable to a third-party auditor and thirdly shall directors shall account for the enterprise impact performance to the greater public audience in an annual report.

The director duties in mainstream business are mostly concerned with procedural and structural considerations rather than the substance of the effects. It could be argued that directors of non-profit organizations have a duty of stay true to the mission of their organizations. A duty which is substance oriented. This opens up for an interpretation that directors of the Benefit Corporation shall stay true to the mission expressed in the constitution of the social enterprise or the articles of association in a similar manner. Still, it is debatable, to which extent a duty of obedience has support among the law or principles that govern the non-profit sector and whether it is valid for the business corporations at all, hence it is questionable whether the duty can be applied in a social enterprise context.  

In a buyout situation, in the case of the Benefit Corporation the director is required to consider the impact of the buyout to all stakeholders not just shareholders. But more importantly, the Benefit Corporation legislation requires directors to create 'material, positive impact' both to a specific and general public benefit. The material, positive impact is vaguely defined, we will have to wait and see when there is more case law to draw conclusions from whether this legal strategy is effective or not. The definition is left open due to the fact that a too strict definition could limit market innovation in developing appropriate performance standards and might also hold back the number of willing corporations that would like to sign up for becoming Benefit Corporations if the requirements for material impact is defined too strictly.

106 Cummings, Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest, 2012, p.592 Compare Palmiter, Duty of Obedience, The Forgotten Duty, 2010, p.461 recent case law implies that duty of obedience might still be effective for business corporations even though its not mentioned by name in recent legal cases.
On the other hand, some commentators do not interpret the directors’ duties to have expanded to cover also delivery of material impact, rather just the pursuing of it and that the decision-making process takes account of stakeholders is a requirement. In the short-term, case law will indicate the level of liability for delivering actual material impact and/or measurable specific or public benefit.\textsuperscript{107}

The Community Interest Companies legal structure hands over the supervision to the CIC regulator. The Community Interest Test allows the regulator to assess whether the CIC is pursuing the defined benefit for the community. This test carries similarities to the Business Judgement Rule, while it is adapted to a social enterprise context in my opinion, once again it remains to be seen to which degree of stringency the Regulator can enforce material impact as a director duty. The lack of a similar rule for Benefit Corporations has been criticized by scholars. It is advocated for and it is envisioned that the rule would lead to that directors could potentially be held liable personally only if he or she “consciously failed to carry out her duties in good faith, knowingly violated the law, or prioritized her own self-interest.”\textsuperscript{108}

Some scholars say the Benefit Corporation should be more stringent in ensuring that directors meet their social goals. It is argued that the enforcement mechanism for director accountability in Benefit Corporations could be improved by introducing some tools that have been proven efficient in mainstream corporate governance.\textsuperscript{109} A monetary liability for directors as well as a requirement for a clear statement of the corporation’s objective are among the recommended improvements.\textsuperscript{110} Moreover, as shareholders are the only group that can file a legal claim against the director in a Benefit Corporation the accountability is too limited. On one hand anything else would be practically impossible, allowing the public to file legal suits towards the Benefit Corporations would be hard to manage and open up for a stream of more or less well motivated legal actions. On the other hand, the lack of enforceability may leave the director with fewer arguments to protect stakeholder interest and in complicated matters where a need of balancing

\textsuperscript{107} Cummings, Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest, 2012, p.593 \textit{Compare}
\textsuperscript{108} Haskell. Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes, 2012, p. 41.
\textsuperscript{110} Haskell. Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes, 2012, p. 35.
stakeholder interest up against shareholder interest the short term financial objectives might just be more enforceable and therefore be prioritized.

It has been suggested that stakeholder groups should get access to lighter legal remedies, for example such that would allow them to check upon director decisions in case the stakeholder group is able to pinpoint a harmful effect on 'legitimate interest” by a specific decision. This could prevent from situations of categorical ignorance of certain interests, but also limit the potential number of stakeholder initiated law suits (theoretically, in case they would be allowed at all) and limit the extent of liability to a reasonable level. It would be important to analyze the cost implications of such reform. The decision-making process of directors would become more complicated and might pose additional cost on the Benefit Corporations, but after all it could also push directors to carefully analyze the effects of decisions on forehand, while it could also restrict the willingness of risk and the willingness of pursuing innovative and less proven approaches to the challenges that social enterprise seek to mitigate.111

At best social enterprises nurture the capability of people and systems to maintain leadership to achieve contrasting social and business aims. The balancing act is carried out by board of directors who hold long-term strategic power and therefore should account for the results. Challenges lies not only in that the objectives are undertaken but also that they are put into evidence in order to gain legitimacy from key stakeholders. Social accounting systems are therefore a central part of the ensuring accountability at board level. Rather than seeing binding legislation in this area the matter depend also on stakeholders active claims on the social enterprises or by using frameworks that are provided by support groups that advocate the importance of accountability for the social enterprise sector.

References:

available at: http://disciplinas.stoa.usp.br/pluginfile.php/197990/mod_resource/content/1/DCO0318_Aula_0_-__Berle__Means.pdf


Clark, William H. Jr, Drinker Biddle & Reath LLP; Larry Vranka, Canonchet Group LLC, Th Need and Rationale for the Benefit Corporation, B Lab 2013, Available at http://benefitcorp.net/legislators/benefit-corp-white-paper


Lloyd, Stephen, Transcript: Creating the CIC, Vermont Law Review Vol. 35:031, 2010 Available at: http://lawreview.vermontlaw.edu/files/2012/02/13-LLoyd-Book-1-Vol.-35.pdf&sa=U&ei=b55mU9eRHYihyATxoIGoAw&ved=0CDgQFjAF&usg=AFQjCNEs3-r7ErGFiVFbc2V-nSFyDR3DQ

Mason, Chris, Choosing sides: contrasting attitudes to governance issues in Social Firms in the UK, Social Enterprise Journal, Vol. 6 Iss: 1, pp.6 – 22, 2010 http://dx.doi.org/10.1108/17508611011043020


Office of the Regulator of Community Interest Companies. Information and guidance notes, March 2013, available at www.bis.gov.uk/cicregulator


http://www.uwyo.edu/law/_files/docs/wy%20law%20review/v12%20n1/11%20resor.pdf

Sjåfjell, Beate and Anker-Sørensen, Linn, Directors’ Duties and Corporate Social Responsibility (CSR) (September 9, 2013). Hanne Birkmose, Mette Neville & Karsten Engsig Sørensen (eds.), Boards of directors in European companies – reshaping and harmonising their organisation and duties, Kluwer Law International, 2013; University of Oslo Faculty of Law, University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-26; Nordic & European Company Law Working Paper No. 10-40. Available at:
http://ssrn.com/abstract=2322680


References to Law:

United Kingdom

Companies Act (Audit, Investigations and Community Enterprise), 2004 c 27 (UK)
Companies Act, 2006 c 46 (UK)
The Community Interest Company Regulations, 2005 No. 1788, (UK)

United States

New York Business Corporation Law
California Corporations Code
New Jersey Statutes Annotated Title 14A
Annotated Code of Maryland, Corporations and Associations

References to Case Law:

Howard Smith Limited v Ampol Petroleum Limited and Others (New South Wales 1974 )
Re Caremark International, Inc. Derivative Litigation
Walt Disney Co. Derivative Litigation, 906 A.2d 27, 67 (Del. 2006)

Other References:

The Securities and Exchange Commission the federal proxy rules 14a-11

Online Resources:
http://benefitcorp.net/
www.wikipedia.org/wiki/Stakeholder_Theory
www.bis.gov.uk/assets/cicregulator/