How Should Benefit Corporation Directors Make Decisions?

By Keith Paul Bishop on October 17, 2011

As discussed in this post from last week, Governor Brown has signed into law two bills that each allow for-profit corporations to have purposes that have been historically pursued by non-proft corporations. AB 361 (Huffman) adds a new part to the Corporations Code relating to "benefit corporations".

Subdivision (b) of new Corporations Code §14620 will *require* directors of benefit corporations to consider the impacts of any action or proposed action on *all* of a long list of interests and constituencies, including the shareholders, employees, and the interests of customers as beneficiaries of the general or specific public benefit purposes of the corporation. Subdivision (d) of the same statute provides that in discharging their duties, directors will not be required to give priority to any particular factor or the interests of any particular person or group identified in subdivision (b) unless the corporation has stated its intention to give priority to a specific public benefit purpose identified in the articles. How, then, is a director supposed to reach a decision?

No Losers Rule

One approach that at least has the virtue of applying a consistent rule of decision would be to require that all actions be Pareto efficient.[1] An action is considered Pareto efficient if at least one interest or constituency is made better off and no interest or constituency is made worse off.

Strict Equality Rule

One consequence of following a Pareto efficient rule is that it does not require allocative equality. This means that a decision may satisfy the requirements of Pareto efficiency if it benefits one interest greatly and all other interests only slightly. Consequently, some may argue that decisions must be fair. Under such a rule of decision, no action could be taken unless all of the statutory listed interests and constituencies would be benefitted equally.

Creating The Most Social Welfare

A serious objection to a rule based on either Pareto efficiency or allocative equality is that either rule allows boards to make decisions that do not necessarily result in the greatest social welfare. Another problem with Pareto efficiency is that there may be many possible outcomes that satisfy its criterion but the rule doesn't tell directors which outcome they should choose.

Why The Benefit Corporation Law Is Flawed

The new benefit corporation law departs from traditional corporate law in that it mandates directors to take into account a disparate group of interests and constituencies and yet fails to prescribe a rule of decision. Directors are only told that they need not prioritize among these interests and constituencies. Without a prescribed rule of decision, there can be no accountability to the shareholders or the other enumerated interests and constituencies.

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[1] Pareto efficiency is named for the Italian economist Vilfredo Federico Damaso Pareto. He lived from 1848 – 1923. In his later years, he occupied a villa in Céligny, Switzerland with a clowder of 18 Angora cats.

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