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When Social Enterprises Fail

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WHEN SOCIAL ENTERPRISES FAIL

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I. INTRODUCTION

WHAT becomes of a social enterprise that fails? In the extensive scholarship produced on recently developed "social enterprise" legal entity forms, the issue of financial failure receives little attention.[1] Perhaps this should be of no surprise: bankruptcy is often perceived to be a "gloomy and depressing subject," whereas social enterprise is a decidedly feel-good one.[2] The concept of a business organization that blends for-profit enterprise with a social mission has been heralded as both a new way of doing business and a new business form.[3] A majority of states have recently adopted legislation enabling the creation of "benefit corporations," "public benefit corporations," or "social purpose corporations," business organization forms that require the pursuit of socially-beneficial objectives to accompany the pursuit of pecuniary gain.[4] And an increasing number of businesses have chosen to adopt these forms, including high-profile brands like Patagonia, King Arthur Flour, Kickstarter, Method, and Plum Organics.[5]

But as an increasing number of businesses elect to operate as social enterprises, it is only a matter of time before some of them fail. When

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1. There is no single, universally-accepted definition of the term "social enterprise." Professor Cassidy Brewer states that "[p]opularly defined, social enterprise means using traditional business methods to accomplish charitable or socially beneficial objectives." Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2011). Social enterprises may be characterized as measuring success by a "double bottom line" of "profitability and serving a public good" or a "triple bottom line" of "people, profit, and the planet." *See* Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 4–5 (2010) (citing JOHN ELKINGTON, CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS (1999)). For a discussion of competing definitions of the term, see Alicia E. Plerhoples, *Representing Social Enterprise*, 20 CLINICAL L. REV. 215, 223–25 (2013) and J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 4 n.4 (2012).

2. *See* CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 3 (1935).

3. *See* Smiddy, *supra* note 1, at 6.

4. *See infra* Section II.A.

5. *See FAQ*, BENEFIT CORP., http://benefitcorp.net/faq [https://perma.cc/WP9C-XM5H] (last visited Feb. 18, 2017).

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they do, difficult positive and normative questions will be raised as to how the unique legal characteristics of a social enterprise affect creditors' rights and interact with bankruptcy law. Do directors' duties to take into account societal and stakeholder interests conflict with the recognized fiduciary duties owed by an insolvent firm's directors to its creditors? Should considerations about preservation of a firm's social mission—considerations that drive much of the appeal for social enterprise legislation—necessarily be thrown out the window in a time of financial distress, or is there a path for preserving a social mission through a restructuring? And, when a bankruptcy proceeding causes negative consequences for a debtor's customers, employees, or local community, should it matter that the debtor was formed with a purpose of protecting the interests of those same stakeholders?

This Article identifies the conflicts between social enterprise legislation and bankruptcy law and presents a normative argument for a legal regime that would harmonize the two. Focusing on benefit corporations, the most widely adopted social enterprise form, this Article observes that existing law leaves uncertainty as to the role of directors at a time of financial distress and will produce outcomes that are at odds with the core goals of social enterprise legislation. Then, drawing on academic proposals for contract-based systems of bankruptcy, this Article argues that just as a firm may opt out of a corporate governance norm of pure shareholder wealth maximization through the selection of the benefit corporation form, a firm should be permitted to opt out of a bankruptcy norm of pure creditor wealth maximization through that same selection. A firm and its creditors could thus effectively contract into a unique bankruptcy regime for benefit corporations. Looking to the distinctive treatment of nonprofits and railroads in bankruptcy as precedent, this Article proposes a regime in which the same stakeholder interests that must be considered by the directors of a solvent benefit corporation would be required to be considered by such directors, and by the court, in a bankruptcy proceeding.

Finally, this Article argues that the availability of such a regime as a default rule for benefit corporations would on the whole produce more efficient bankruptcy outcomes. Investors in benefit corporations exhibit a preference for trading off some degree of wealth maximization in exchange for the in-kind returns associated with reducing the negative externalities, and increasing the positive externalities, of corporate behavior. By opting into a stakeholder-friendly bankruptcy system, investors could similarly trade off some degree of wealth maximization, by virtue of a higher cost of debt, in order to reduce the negative externalities and increase the positive externalities of financial failure. By better aligning bankruptcy outcomes with such preferences, the proposed regime would on the whole result in greater efficiency and societal wealth.

This Article proceeds as follows. Part II assesses the origins of social enterprise legislation, the key components of benefit corporations and related social enterprise forms, and the academic debate as to the necessity of such legislation. Part III explores why bankruptcy law matters for benefit corporations and argues that existing law and scholarship provide unsatisfactory guidance as to both the application of existing law and the normative question of what should happen to benefit corporations in bankruptcy. Part IV finds theoretical support for a unique set of bankruptcy rules for benefit corporations in the rich academic literature regarding the theoretical underpinnings of bankruptcy law. Part V draws from the bankruptcy law of nonprofits and railroads to propose specific amendments to both the Bankruptcy Code and benefit corporation statutes so as to implement a unique bankruptcy regime for benefit corporations.[6] Then, it analyzes the ex ante efficiency implications of such a regime.

II. SOCIAL ENTERPRISE LAW AND THEORY

A. *Social Enterprise Legislation*

Starting with Vermont's passage of the first "low-profit limited liability company" statute in 2008, a majority of states have now passed legislation recognizing one or more "social enterprise" legal forms.[7] Twenty-seven states and the District of Columbia have enacted benefit corporation statutes, three states have enacted public benefit corporation statutes, three states have enacted social purpose corporation statutes, eight states have enacted "low profit liability company" statutes, and three states have enacted "benefit limited liability company" statutes.[8] These legal forms are designed to facilitate a business model in which directors need not prioritize profits at the expense of a firm's other stakeholders, including employees, customers, local communities, and, on a larger scale, the environment and society as a whole. Social enterprise statutes generally require that corporate decision-making take into account the interests of such stakeholders, in addition to the interests of shareholders.[9] Except where noted otherwise, this Article focuses on the "model" benefit corpo-

6. *See* 11 U.S.C. §§ 1101–1174 (2012). This portion of the Bankruptcy Code is commonly referred to as "Chapter 11."

7. *See* Robert Lang & Elizabeth Carrott Minnigh, *The L3C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 19 (2010) (noting "Vermont became the first state in the country to adopt the L3C" in 2008).

8. *See Status Tool*, SOC. ENTERPRISE L. TRACKER, http://socentlawtracker.org [https://perma.cc/8YWS-RBZ9] (last visited Feb. 18, 2017).

9. *See* WILLIAM H. CLARK ET AL., THE NEED AND RATIONALE FOR THE BENEFIT CORPORATION: WHY IT IS THE LEGAL FORM THAT BEST ADDRESSES THE NEEDS OF SOCIAL ENTREPRENEURS, INVESTORS, AND, ULTIMATELY, THE PUBLIC, BENEFIT CORP. 7–14 (2013), http://benefitcorp.net/sites/default/files/Benefit_Corporation_White_Paper.pdf [https://perma.cc/8V3M-6PC5] [hereinafter BENEFIT CORPORATION WHITE PAPER] (discussing legal rationale for benefit corporation legislation). While all social enterprise statutes embody such a requirement, the low-profit limited liability company form is unique in that it is specifically designed to attract and facilitate "program related investments" from private foundations.

ration statute promoted by B Lab, the most widely adopted and visible social enterprise form.[10] Generally, the same considerations discussed in this Article apply to benefit corporation statutes that differ from B Lab's model approach and to other related social enterprise statutes. There are certain important distinctions that are addressed further in Sections II.D. and V.B.3.

B. *The Shareholder Wealth Maximization Debate*

While benefit corporation statutes and their brethren are a relatively new phenomenon, they are designed to address an unsettled question that has been debated in legal academia for nearly a century: does, and should, corporate law embody a "shareholder wealth maximization norm," where the sole objective of a corporation's directors is maximizing shareholder wealth?[11] Professor Stephen Bainbridge has observed that the debate over this question flares up roughly every twenty years, positing that it is a perennial problem "on which each new academic generation . . . feels obliged to puts its stamp."[12] In the 1930s, professors Adolf Berle and E. Merrick Dodd debated the issue in a series of *Harvard Law Review* articles.[13] Berle argued that corporations function like trusts, with directors acting as trustees of property on behalf of shareholders, while Dodd argued that a corporation is "an economic institution" with "a social service as well as a profit-making function."[14] In the 1950s, in large part in response to the New Jersey Supreme Court's decision to uphold a corporation's large donation to Princeton University in *A.P. Smith Manufacturing Co. v. Barlow*,[15] Berle and others "revisited the debate."[16] In the 1970s, when a debate emerged regarding corporate social responsibility,[17] economist Milton Friedman famously stated, "[t]here is only one social responsibility of business—to use its resources and engage in activities designed to increase its

10. See *infra* notes 45–48 and accompanying text for background on B Lab and its model benefit corporation statute.

11. *See* Murray, *supra* note 1, at 5–9 (summarizing history of academic debate regarding shareholder-wealth maximization norm).

12. *See* Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1435 n.40 (1993).

13. *See* Robert T. Esposito, *The Social Enterprise Revolution in Corporate Law: A Primer on Emerging Corporate Entities in Europe and the United States and the Case for the Benefit Corporation*, 4 WM. & MARY BUS. L. REV. 639, 650 (2013) (summarizing debate between Berle and Dodd).

14. *Compare* Adolf A. Berle, Jr., *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1073–74 (1931), *with* E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1148 (1932).

15. 98 A.2d 581 (N.J. 1953).

16. *See* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the Modern Corporation*, 34 J. CORP. L. 99, 133–34 (2008) (describing Berle's role as advocate in *Barlow* and his shifting view on debate in following years); *see also* Bainbridge, *supra* note 12, at 1435 n.40.

17. *See* Bainbridge, *supra* note 12, 1435 n.40.

profits."[18] In the early 1990s, Professor Ronald Green argued for a "multi-fiduciary stakeholder perspective" that takes into account non-shareholder constituents, with Bainbridge responding with a defense of the shareholder wealth maximization norm.[19] Further, in the late 1990s, professors Margaret Blair and Lynn Stout advanced a "team production theory," conceptualizing a corporation as a collaborative team with directors allocating profits and losses among various shareholder and non-shareholder constituents so as to reward their contributions to the team.[20]

Neither case law nor statutes provide a clear answer as to whether traditional corporate law actually mandates a strict shareholder wealth maximization norm. Professor Ian Lee observes that both advocates and critics of the norm "exaggerate its claim to describe accurately the state of corporate law" and that "[t]he legal situation is, in fact, persistently ambiguous."[21] Many state statutes require directors to act in the best interests of "the corporation" or of "the corporation and its shareholders,"[22] but it is by no means clear that such standards strictly conform to a shareholder wealth maximization norm.[23] In fact, certain of the same states have in place "constituency statutes," laws most commonly passed in the 1980s that "*permit* the board of directors to consider the interests of non-shareholder constituencies."[24] Constituency statutes appear to go a long way in qualifying the primacy of the shareholder wealth maximization norm. However, they are missing in several states, including Delaware, and even where adopted, they have been criticized by some social enterprise proponents as

18. *See* Milton Friedman, *The Social Responsibility of Business Is to Increase Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 32.

19. *Compare* Bainbridge, *supra* note 12, at 1446, *with* Ronald Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1419 (1993).

20. *See* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250–51, 269–70, 276–81, 291–92 (1999).

21. *See* Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 33 (2005). Lee observes that "[i]n the all-important state of Delaware, there remains no statutory statement of the entity or individuals to whom directors owe their duty of loyalty," and that "the common law duty is articulated as one of 'undivided and unselfish loyalty to the *corporation*.'" *Id.* at 34 n.118 (citing Guth v. Loft, 5 A.2d 503, 510 (Del. 1939)).

22. *See, e.g*, CAL. CORP. CODE § 309(a) (West 2016) (requiring directors to act "in the best interests of the corporation and its shareholders"); 805 ILL. COMP. STAT. ANN. 5/8.85 (LexisNexis 2016) (requiring directors to act in "best long term and short term interests of the corporation"); NEV. REV. STAT. ANN. § 78.138(1) (LexisNexis 2016) (requiring directors to act in "the interests of the corporation"); N.J. STAT. ANN. § 14A:6-1(2) (West 2016) (requiring directors to act in "best interest of the corporation"); N.Y. BUS. CORP. LAW § 717(b) (Consol. 2016) (requiring directors to act in "the long-term and the short-term interests of the corporation and its shareholders").

23. *See* Lee, *supra* note 21, at 33–34.

24. *See id.* at 34 (emphasis added).

providing inadequate guidance as to the extent to which constituents' interests can actually be taken into account.[25]

C. Dodge v. Ford, eBay v. Newmark, *and Ben & Jerry's*

Advocates for social enterprise legislation have honed in on two high-profile cases, *Dodge v. Ford*[26] and *eBay Domestic Holdings, Inc. v. Newmark*,[27] as well as the takeover of Ben & Jerry's by Unilever, as evidencing the constraints of the shareholder wealth maximization norm and the necessity of new corporate forms that reject it.[28]

Dodge v. Ford, a 1919 Michigan Supreme Court case, is often cited by legal scholars as a seminal authority for the shareholder wealth maximization norm.[29] Henry Ford, president of Ford Motor Company, had adopted a company policy not to pay any special dividends, declaring it his ambition "to spread the benefits of this industrial system to the greatest possible number" by "putting the greatest share of our profits back into the business."[30] Minority shareholders John and Horace Dodge objected, arguing that the shareholders were entitled to a share of the company's surplus that far exceeded the regular dividends they had been receiving on its authorized capital stock.[31] They ultimately brought a lawsuit demanding payment of a significant dividend.[32]

The Michigan Supreme Court found for the Dodges.[33] As Lynn Stout notes, the decision included a "remark that is regularly repeated in corporate law casebooks today"[34]:

> There should be no confusion . . . . A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice

25. *See, e.g.*, William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 831 (2012) (stating lack of case law and context "makes it difficult for directors to know exactly how, when, and to what extent they can consider [constituent] interests").

26. 170 N.W. 668 (Mich. 1919).

27. 16 A.3d 1 (Del. Ch. 2010).

28. *See, e.g.*, BENEFIT CORPORATION WHITE PAPER, *supra* note 9, at 6, 11–13; Clark, Jr. & Babson, *supra* note 25, at 826–28, 837–38; MODEL BENEFIT CORP. LEGISLATION § 301 cmt. (B LAB 2016) ("By requiring the consideration of interests of constituencies other than the shareholders, the section rejects the holdings in *Dodge v. Ford* . . . and *eBay Domestic 584 Holdings, Inc. v. Newmark* . . . that directors must maximize the financial value of a corporation." (citations omitted)).

29. *See, e.g.*, Bainbridge, *supra* note 12, at 1423; Clark, Jr. & Babson, *supra* note 25, at 825–26; *but see* Lynn A. Stout, *Why We Should Stop Teaching* Dodge v. Ford, 3 VA. L. & BUS. REV. 163, 174–76 (2008).

30. *See Dodge*, 170 N.W. at 683.

31. *See id.* at 672.

32. *See id.* at 673.

33. *See id.* at 685.

34. *See* Stout, *supra* note 29, at 165.

> of means to attain that end, and does not extend to a change in the end itself . . . .[35]

Despite the court's clear language affirming the primacy of shareholder wealth maximization, *Dodge v. Ford* has been dismissed by some commentators as irrelevant, an anomaly, and even a mistake, not to mention, nearly 100 years old and from a state court without a prominent role in corporate law jurisprudence.[36]

Far more recently, in *eBay*, the directors of craigslist enacted "rights plans" to prevent minority shareholder eBay from gaining control of the company, arguing that "eBay's acquisition of control . . . would fundamentally alter craigslist's values, culture and business model, including departing from [craigslist's] public-service mission in favor of increased monetization of craigslist."[37] The Delaware Chancery Court sided with eBay, stating that "[p]romoting, protecting, or pursuing nonstockholder considerations must lead at some point to value for stockholders," and that "[d]irectors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law."[38] While *eBay* has been cited by both social enterprise proponents and corporate traditionalists as supporting the shareholder wealth maximization norm, others have observed that the holding was limited to the heightened scrutiny context of takeover defenses and would not control in the context of general day-to-day corporate decision making.[39]

Finally, although never litigated, the takeover of Ben & Jerry's has been touted as the iconic example of the need for benefit corporation

35. *Dodge*, 170 N.W. at 684, *as stated in* Stout, *supra* note 29, at 165.

36. *See generally* Stout, *supra* note 29, at 166–72 (arguing shareholder wealth maximization doctrine articulated in *Dodge* was "mistake" lacking sound foundation in actual corporate law, as well as outdated dictum "from a state court that plays only a marginal role in the corporate law arena"); *see also* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 773 (2005) (observing that Michigan Supreme Court stated that profit-seeking is "primary" corporate objective, but not exclusive one); Nathan Oman, *Corporations and Autonomy Theories of Contract: A Critique of the New* Lex Mercatoria, 83 DENV. U. L. REV. 101, 135–36 (2005) (arguing *Dodge* decision was not based on "some generalized duty to maximize share value, but rather, because of the right of dissenting minority shareholders to be free from unreasonable oppression" (citing *Dodge*, 170 N.W. at 684)).

37. eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 32 (Del. Ch. 2010) (citing Defs.' Post-Trial Answering Br. 54).

38. *Id.* at 33.

39. *See, e.g.*, BENEFIT CORPORATION WHITE PAPER, *supra* note 9, at 11–13 (relying on *eBay* while advocating for benefit corporation legislation); Leo E. Strine, Jr., *Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 151 (2012) (arguing "consternation" about *eBay* holding reflects naiveté about true nature of corporations); *see also* Murray, *supra* note 1, at 14–15.

legislation.[40] In 2000, Ben & Jerry's was sold to Unilever instead of a competing group of investors, which included co-founder Ben Cohen, that had made a bid to take the company private.[41] Specifically, "Cohen thought that the company could better protect its social mission if it stayed [private]," but he stated that the board believed it was legally required to accept the higher offer.[42] However, as noted by J. Haskell Murray, commentators have expressed "serious doubt as to whether Ben & Jerry's *had* to sell to Unilever," even under "the enhanced scrutiny applied in the takeover context."[43] Significantly, Vermont already had a constituency statute in place expressly permitting directors to consider the interests of non-shareholder constituents.[44]

D. *B Lab Certification, Benefit Corporations, and Related Social Enterprise Forms*

The nonprofit organization B Lab is largely responsible for the creation of the benefit corporation form. In 2007, prior to the enactment of any social enterprise legislation, B Lab began certifying businesses as "B Corporations" (or "B Corps"),[45] a designation based on an assessment of a business's social and environmental performance, accountability, and transparency.[46] B Corporation (B Corp) status is not a legal form; rather, B Lab likens it to the certification of coffee as "Fair Trade."[47] Observing that corporate law appeared to prohibit public companies from adopting the kind of mission necessary for B Corp certification, B Lab soon began advocating for a legal form that would be consistent with its certification

40. *See, e.g.*, BENEFIT CORPORATION WHITE PAPER, *supra* note 9, at 6 (stating fears of traditional corporate framework constraining ability to pursue social mission are "exacerbated by cautionary tales of investor-led board takeovers of private companies and stories like the iconic forced sale of Ben & Jerry's to Unilever"); *see also* Kevin Ercoline, Note, *Beyond Puffery: Providing Shareholder Assurance of Societal Good Will in Crowdfunded Benefit Corporations*, 64 AM. U. L. REV. 169, 174–77 (2014); Clark & Babson, *supra* note 25, at 837–38.

41. *See* Constance L. Hays, *Ben & Jerry's Takeover Is Seen Close*, N.Y. TIMES (Apr. 12, 2000), http://www.nytimes.com/2000/04/12/business/ben-jerry-s-takeover-is-seen-close.html [https://perma.cc/G8R3-Z8VM].

42. *See* April Dembosky, *Protecting Companies That Mix Profitability, Values*, NPR (Mar. 9, 2010, 12:00 AM), www.npr.org/templates/story/story.php?storyId=124468487 [https://perma.cc/2UTY-U9EL]; Murray, *supra* note 1, at 36 (citing Dembosky, *supra*).

43. *See* Murray, *supra* note 1, at 16 (citing Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211, 233–42 (2010)).

44. *See id.*; Lang & Minnigh, *supra* note 7, at 19.

45. *See About B Lab, Our History*, B LAB, http://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps/our-history [https://perma.cc/X7PP-DNY9] (last visited Feb. 18, 2017).

46. *See What are B Corps?*, B LAB, https://www.bcorporation.net/what-are-b-corps [https://perma.cc/TZ5V-KL3S] (last visited Feb. 18, 2017).

47. *See id.* ("B Corp is to business what Fair Trade certification is to coffee . . . ."); *see also* Murray, *supra* note 1, at 21.

and promulgated the Model Benefit Corporation Legislation (MBCL), drafted by William H. Clark, Jr.[48] The commentary to the MBCL explicitly states that its goal is to create a corporate form that rejects the shareholder wealth maximization norm:

> This chapter authorizes the organization of a form of business corporation that offers entrepreneurs and investors the option to build, and invest in, a business that operates with a corporate purpose broader than maximizing shareholder value and that consciously undertakes a responsibility to maximize the benefits of its operations for all stakeholders, not just shareholders.[49]

The central "distinctive features of a benefit corporation" under the MBCL, as compared to a traditional corporation, are that

> (1) it has a corporate purpose to create a material, positive impact on society and the environment; (2) the duties of its directors are expanded to require consideration of interests in addition to the financial interest of its shareholders; and (3) it is required to report each year on its overall social and environmental performance using a . . . third-party standard.[50]

The second feature is accomplished by requiring directors to consider the effects of any action or inaction upon "shareholders," "employees," "customers," "community and societal factors, including those of each community in which offices or facilities of the benefit corporation, its subsidiaries, or its suppliers are located," "the local and global environment," "the short-term and long-term interests of the benefit corporation," and "the ability of the benefit corporation to accomplish its general public benefit purpose and any specific public benefit purpose."[51] Additionally, directors are permitted to consider any other interests that are cited in the relevant state's constituency statutes and any "other pertinent factors or the interests of any other group that they deem appropriate."[52] However, unless otherwise expressly provided in the corporation's charter documents, the stakeholders embodying the nonfinancial interests listed above do not have direct legal rights. Claims or actions for violations of statutory duties or standards, termed "benefit enforcement proceedings," may be brought *only* "directly by the benefit corporation" or "derivatively" by a "director," shareholders owning two percent or more of the corporation's

48. *See* Susan Adams, *Capitalist Monkey Wrench*, FORBES (Mar. 25, 2010, 1:20 PM), http://www.forbes.com/forbes/2010/0412/rebuilding-b-lab-corporate-citizenship-green-incorporation-mixed-motives.html [https://perma.cc/TPQ9-ZFZK] (reporting that B Lab found that in nineteen states company could not obtain B Corp certification without running afoul of directors' duty to put shareholders first). For the Model Benefit Corporation Legislation, see *supra* note 28.

49. MODEL BENEFIT CORP. LEGISLATION § 101 cmt. (B LAB 2016).

50. Clark & Babson, *supra* note 25, at 818–19.

51. MODEL BENEFIT CORP. LEGISLATION § 301(a)(1).

52. *See id.* § 301(a)(2).

equity or five percent or more of a parent corporation's equity, or "other persons" indicated in the charter documents.[53]

In 2010, Maryland became the first state to pass benefit corporation legislation, and other states quickly followed.[54] As of February 2017, thirty-two states and the District of Columbia have enacted legislation for either benefit corporations or the related forms public benefit corporations or social purpose corporations, and four more have introduced proposed legislation that is under consideration.[55] Most state statutes have largely followed the approach of the MBCL with some modifications. Delaware, in response to certain criticisms of the MBCL, instead created a distinct form called a public benefit corporation, with Colorado and Minnesota later taking the same approach.[56] Similarly, California adopted its own unique statute creating a form originally called a "flexible purpose corporation" and later renamed a social purpose corporation[57] (in addition to adopting a benefit corporation statute based on the MBCL),[58] and Washington and Florida followed suit.[59]

The most notable distinction between these forms for purposes of this Article is that benefit corporations, public benefit corporations, and social purpose corporations take different approaches regarding the specificity of a social enterprise's public benefit. A benefit corporation under the MBCL must have the purpose of creating a general public benefit, which is defined broadly and uniformly for all benefit corporations, and may additionally elect to adopt one or more other specific public benefits in its charter.[60] The purpose of a public benefit corporation, on the other

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53. *See id.* §§ 102, 305.

54. *See* Murray, *supra* note 1, at 22 (citing MD. CODE ANN., CORPS. & ASS'NS §§ 5-6C-01-5-6c-08 (West 2016)).

55. *See Status Tool*, *supra* note 8.

56. *See* DEL. CODE ANN. tit. 8, § 362 (West 2016); *see also* COLO. REV. STAT. ANN. § 7-101-503 (West 2016); MINN. STAT. ANN. § 304A.102 (West 2016).

57. *See* CAL. CORP. CODE §§ 2500–3503 (West 2016). The flexible purpose corporation statute in California gave directors the flexibility to consider the interests of various stakeholders without requiring them to do so (hence the word "flexible"), but as of January 1, 2015 was amended and retitled the "social purpose corporation" statute to require directors to take into account the specific social purposes set forth in the corporation's charter. *See* S.B. 1301, 2014 Gen. Assemb., Reg. Sess. (Cal. 2013–2014).

58. *See* CAL. CORP. CODE §§ 14600–14631 (West 2016).

59. *See* WASH. REV. CODE ANN. §§ 23b.25.005–23b.25.150 (West 2016); *see also* FLA. STAT. ANN. §§ 607.504–607.513 (West 2016). In addition, Texas enacted a statute permitting for-profit corporations to adopt a "social purpose," but unlike social purpose corporation statutes, it does not authorize the creation of a new corporate form. *See* TEX. BUS. ORGS. CODE ANN. §§ 1.002(82-a), 3.007, 21.101, 21.401 (West 2016).

60. *See* MODEL BENEFIT CORP. Legislation § 201. "General Public Benefit" is defined as "[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation." *Id.* § 102. A "Specific Public Benefit" is defined as including both a menu of six potential benefits that are expressly listed, as well as any

hand, includes only whatever specific public benefit is elected in its charter.[61] Falling somewhere in between those two standards, a social purpose corporation must have a general public benefit that is chosen from a set menu of broadly defined purposes listed in the statute,[62] and may additionally elect to adopt one or more other specific public benefits.[63]

E. *Benefit Corporation Debate*

While proponents of benefit corporations have been quite successful in enacting legislation, the necessity and wisdom of the benefit corporation as a legal form remains the subject of academic debate. As noted above, proponents have argued that benefit corporation legislation is necessary to free businesses from the shackles of the shareholder wealth maximization norm and avoid the outcomes of *Dodge v. Ford*, *eBay*, and the Ben & Jerry's takeover.[64] Critics, on the other hand, have argued that existing legal forms provide sufficient flexibility for directors to pursue goals other than increasing shareholder value. In some cases, critics have argued that the existence of the benefit corporation form is both unnecessary and harmful, with one going so far as to deem social enterprise legislation a "con" designed to "enable purportedly social and stakeholder-focused enterprises to tug on unwitting equity investors' heartstrings in order to loosen their purse strings."[65] A number of other commentators have ar-

other "particular benefit on society or the environment" a benefit corporation may choose that is not expressly listed. *See id.*

61. *See* DEL. CODE ANN. tit. 8, § 362. Some criticize the "general public benefit" approach of the MBCL and argue that the Delaware approach is "superior," although not as effective as an even more flexible approach. *See* J. William Callison, *Benefit Corporations, Innovation, and Statutory Design*, 26 REGENT U. L. REV. 143, 157–58 (2013); *see also* Murray, *supra* note 1, at 32–33.

62. A Washington social purpose corporation must "promote positive short-term or long-term effects of, or minimize adverse short-term or long-term effects of, the corporation's activities upon any or all of (1) the corporation's employees, suppliers, or customers; (2) the local, state, national, or world community; or (3) the environment." *See* WASH. REV. CODE ANN. § 23b.25.020. A California social purpose corporation may choose from a similar set of general public benefits or alternatively may be organized for "[o]ne or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out." *See* CAL. CORP. CODE § 2602(b)(2)(A) (West 2016). A Florida social purpose corporation must have a purpose of creating

> a positive effect, or the minimization of negative effects, taken as a whole, on the environment or on one or more categories of persons or entities, other than shareholders in their capacity as shareholders, of an artistic, charitable, economic, educational, cultural, literary, religious, social, ecological, or scientific nature, from the business and operations of a social purpose corporation.

FLA. STAT. ANN. § 607.502(6) (West 2016).

63. *See* CAL. CORP. CODE §§ 2602(b)(1)(A)–(B); FLA. STAT. ANN. § 607.502; WASH. REV. CODE ANN. §23b.25.030.

64. *See supra* note 28 and accompanying text.

65. *See* David Groshoff, *Contrepreneurship? Examining Social Enterprise Legislation's Feel-Good Governance Giveaways*, 16 U. PA. J. BUS. L. 233, 234, 240 (2013) (arguing social enterprise advocates have advanced "deceptive maze of needless [social

gued that traditional corporate law already provides most of the flexibility social enterprise proponents seek, but that benefit corporation legislation is nonetheless advisable due to the pervasive perception, accurate or not, that the shareholder wealth maximization norm ties directors' hands,[66] or due to the practical benefits of creating a focal point and institutional structure "around which socially minded players can align their interests."[67]

Moving beyond the question of the necessity of benefit corporation legislation, commentators have also ventured into assigning a deeper theoretical framework to the benefit corporation form. The American Bar Association's (ABA) Corporate Laws Committee describes benefit corporation legislation as a shift away from a "property model" of corporate law to an "'entity model'" because it provides for a corporation that does not solely "serve the interests" of its owners.[68] This theory is consistent with popular descriptions of benefit corporations and their directors serving "three masters instead of one."[69] A competing view is that benefit corporations actually embrace a property model and, in fact, serve only their shareholders, with the unique legal form serving as a contract between directors and shareholders who wish to receive both a "monetary return" and an "in-kind" return in the form of the satisfaction resulting from "investing in socially responsible companies."[70] This view draws on a theoretical model developed to explain why public companies often sacrifice shareholder value by making charitable contributions, which proposes that such investors are being offered a composite financial product con-

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enterprise legislation] using ethically-questionable marketing" in order to allow managers to engage in value-destructive behavior that would expose them to liability under traditional corporate law); *see also* Justin Blount & Kwabena Offei-Danso, *The Benefit Corporation: A Questionable Solution to a Non-Existent Problem*, 44 ST. MARY'S L.J. 617, 663, 669–70 (2013) (arguing benefit corporation legislation is unnecessary and that, "[b]y requiring managers to pursue multiple objectives and consider all stakeholders' interests equally, the benefit corporation makes it more likely that none of these objectives will be fulfilled"); Kennan El Khatib, Comment, *The Harms of the Benefit Corporation*, 65 AM. U. L. REV. 151, 152, 181–86 (2015) (arguing benefit corporation form is primed for abuse and "green-washing" and creates "harmful dichotomy with traditional for-profit companies" by which companies will be "evaluate[d] [ ] based on legal status instead of business practices").

66. *See* Murray, *supra* note 1, at 52.

67. *See* Regina Robson, *A New Look at Benefit Corporations: Game Theory and Game Changer*, 52 AM. BUS. L.J. 501, 504, 533–41 (2015); *see also* Joseph W. Yockey, *Does Social Enterprise Law Matter?*, 66 ALA. L. REV. 767, 769 (2015).

68. *See* Corp. Laws Comm., ABA Bus. Law Section, *Benefit Corporation White Paper*, 68 BUS. LAW. 1083, 1083–84 (2013).

69. *See, e.g.*, Daniel Fisher, *Delaware 'Public Benefit Corporation' Lets Directors Serve Three Masters Instead of One*, FORBES (July 16, 2013, 2:06 PM), http://www.forbes.com/sites/danielfisher/2013/07/16/delaware-public-benefit-corporation-lets-directors-serve-three-masters-instead-of-one/#7ab6788c215a [https://perma.cc/2566-GFB8].

70. *See* Jacob E. Hasler, Note, *Contracting for Good: How Benefit Corporations Empower Investors and Redefine Shareholder Value*, 100 VA. L. REV. 1279, 1304–05, 1311 (2014).

sisting of "both the economic return and . . . the warm glow" derived from contributing to charity.[71]

III. WHY BANKRUPTCY LAW MATTERS

As outlined above in Part II, benefit corporation statutes aim to depart from the perceived shareholder profit maximization norm. They do so primarily by regulating the respective rights and obligations of a corporation and its directors, on the one hand, and its shareholders, on the other hand, through provisions requiring directors to consider the impact of decisions on non-shareholder stakeholders. However, benefit corporation statutes are silent on how the rights of creditors are implicated by such stakeholder provisions, leaving unanswered questions as to how benefit corporation statutes would affect bankruptcy proceedings under existing law.[72] Similarly, the increasingly vast amount of scholarship on social enterprises has paid little attention to issues of financial failure, leav-

71. *See id.* at 1282, 1306 (internal quotation marks omitted) (citing Joshua Graff Zivin & Arthur Small, *A Modigliani-Miller Theory of Altruistic Corporate Social Responsibility*, 5 J. ECON. ANALYSIS & POL'Y 1 (2005)).

72. The Connecticut benefit corporation statute arguably provides a limited exception in that it speaks to the consequences of a benefit corporation's dissolution under certain circumstances. *See* CONN. GEN. STAT. ANN. § 33-1355(b) (West 2016). The Connecticut statute largely follows the MBCL, but it is unique in that it permits benefit corporations to adopt, via a unanimous shareholder vote, a "legacy preservation provision" intended to preserve the entity as a benefit corporation in perpetuity. *See id.* § 33-1355(a). In addition to prohibiting an acquisition by or merger into any entity other than a benefit corporation that itself has adopted a legacy preservation provision, it requires that a "dissolved benefit corporation" must distribute its "remaining property" only to charitable organizations or other benefit corporations that have adopted legacy preservation provisions. *See id.* § 33-1355(b). While at first blush this may appear to have implications for bankruptcy, a "dissolution" is a corporate event that is distinct from and may be, but need not be, accompanied by a bankruptcy proceeding. A dissolved corporation continues its corporate existence with limited capacity to carry on any business except that business appropriate to winding up and liquidating its business and affairs. *See* CONN. GEN. STAT. ANN. 33-884 (West 2016). Further, the statute speaks solely to how "remaining" property is distributed, without any further definition. *See id.* § 33-884(a). This could be interpreted as referring to all property of the corporation that remains immediately prior to dissolution or to all property of the corporation that remains after assets have been applied to pay all claims of creditors in full. The nonprofit organization that promoted and helped draft the legacy preservation provision in the Connecticut benefit corporation statute, reSET—Social Enterprise Trust—has stated that "[t]he provision . . . requires the company, if liquidated, to distribute all assets *after the settling of debts* to one or more benefit corporations or 501(c)(3) organizations with similar social missions." *See* James Woulfe, *H.B. 6356 and Legacy Preservation*, RESET (Feb. 20, 2013), http://www.socialenterprisetrust.org/blog/2013/02/20/h-b-6356s-legacy-preservation-provision [https://perma.cc/A5RN-LXVE] (emphasis added). While not dispositive as to statutory interpretation, this commentary indicates that the provision was intended only to govern the disposition of assets remaining *after* creditors are paid in full, in which case the statute would not speak to the critical issues pertaining to benefit corporation bankruptcies discussed in Part III.

ing normative questions about the implications of financial distress for the goals of social enterprise legislation unanswered.[73]

This Part argues that the treatment of benefit corporations in bankruptcy is a critical issue for their constituents. First, the obligations of directors mandated by benefit corporation statutes conflict with the well-established principle that directors of an insolvent corporation have fiduciary duties to the corporation's creditors. Left unresolved, this conflict creates uncertainty that is problematic for both directors and creditors of benefit corporations. Second, as a normative matter, a bankruptcy regime that ignores stakeholder interests would be inconsistent with the rationale for investment in benefit corporations.

A. *Benefit Corporation Statutes Conflict with Duties to Creditors in Insolvency*

The fiduciary duties of a firm's directors in bankruptcy support a norm of creditor wealth maximization that closely resembles the shareholder wealth maximization norm outside of bankruptcy. Although not expressly provided in the Bankruptcy Code, case law has established that a bankruptcy trustee has a duty to maximize the value of the bankrupt estate.[74] As a debtor-in-possession enjoys the rights of a trustee and must fulfill the duties of a trustee, it too is obligated to maximize estate value.[75] Further, a debtor-in-possession's directors continue to owe fiduciary duties to the firm, but its creditors effectively become the principal beneficiaries of such duties and may enforce them by derivative actions.[76] The Delaware Supreme Court recently articulated the principle as follows:

> It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent,* those duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is *insolvent,* however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value . . . . The corporation's insolvency "makes the creditors the

73. As discussed further *infra* notes 78–79 and accompanying text, practitioners have written about the question of whether social enterprise statutes and bankruptcy law principles create conflicting fiduciary duties for directors. *See* Alec P. Ostrow, *Inversion of Supremacy? LC3s and Benefit Corporations: Can Changes to State Law Control Conduct of Bankruptcy Cases?*, 34 AM. BANKR. INST. J. 36 (2015); Gary M. Schildhorn & Brya M. Keilson, *The Unresolved Dilemma of Creditors' Vs. Stakeholders' Rights*, 32 AM. BANKR. INST. J. 58 (2013).

74. *See, e.g.*, Commodity Futures Trading Comm'n v. Weintraub, 471 U.S. 343, 352 (1985); Myers v. Martin (*In re* Martin), 91 F.3d 389, 394 (3d Cir. 1996).

75. *See, e.g.*, La. World Exposition v. Fed. Ins. Co., 858 F.2d 233, 246 (5th Cir. 1988).

76. *See, e.g.*, Prod. Res. Grp., L.L.C. v. NCT Grp., Inc., 863 A.2d 772, 792 (Del. Ch. 2004).

principal constituency injured by any fiduciary breaches that diminish the firm's value."[77]

Benefit corporation statutes add an obvious wrinkle to this framework: directors of a benefit corporation are required by statute to consider the effects of any action or inaction upon the interests of other stakeholders, not just the corporation's shareholders. Two articles penned by bankruptcy law practitioners in the *American Bankruptcy Law Institute Journal* have identified this as presenting directors of insolvent benefit corporations with conflicting legal mandates. Gary Schildhorn and Brya Keilson observe that benefit corporation statutes conflict with the fiduciary duties of the directors of an insolvent company in the context of a sale of a debtor's assets under § 363 of the Bankruptcy Code.[78] Alec Ostrow observes that benefit corporation and other social enterprise statutes conflict with such fiduciary duties generally, citing asset sales as an example.[79] In a bidding process for an asset sale under § 363 of the Bankruptcy Code, courts generally hold that the best bid is the one that yields the greatest return to creditors.[80] However, if a debtor is faced with two bids, one that is higher in dollar amount but another that is more favorable in its treatment of stakeholders, its directors' legal obligation "to consider the interests of stakeholders" conflicts with the principle that they are obligated to maximize the estate value for the benefit of their creditors.[81]

The interaction of these two conflicting legal mandates could be interpreted in very different ways. One interpretation is that when a corporation becomes insolvent, its duty to maximize the estate value for the benefit of its creditors supersedes all of its pre-insolvency fiduciary duties, including its duties to consider the interests of other stakeholders. Alternatively, creditors could be viewed as merely stepping into the shoes of shareholders, and directors would therefore be required to balance the interests of creditors and other stakeholders just as they would be required, pre-insolvency, to balance the interests of shareholders and other

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77. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007) (quoting *Prod. Res. Grp., L.L.C.*, 863 A.2d at 794 n.67).

78. *See* Schildhorn & Keilson, *supra* note 73, at 59, 86 (arguing that to resolve such conflict, § 363 "bidding procedures" should be "carefully considered" and benefit corporations should "permit[ ] directors of insolvent benefit corporations to give considerable weight to the interests of creditors").

79. *See* Ostrow, *supra* note 73, 89–90 (concluding that "[w]ithout a clear direction from Congress . . . [resolution] of this conflict may vary along with the facts of each case").

80. *See, e.g.*, *In re* Integrated Res., Inc., 135 B.R. 746, 750 (Bankr. S.D.N.Y.) ("When a debtor desires to sell an asset, its main responsibility, and the primary concern of the bankruptcy court, is the maximization of the value of the asset sold." (citing *Bankruptcy Court Is Newest Arena for M & A Action*, N.Y.L.J., June 3, 1991, at 8)).

81. *See* Schildhorn & Keilson, *supra* note 73, at 58.

stakeholders.[82] The argument could even be made that directors must disregard the interests of creditors altogether, as in almost all cases benefit corporation statutes "exclude[ ] creditors from the list of stakeholders" whose interests must be considered.[83]

The uncertainty posed by this dilemma presents directors of an insolvent benefit corporation with a quandary. If they make decisions serving the interests of non-creditor stakeholders to the detriment of their creditors, they risk the prospect of creditors asserting a breach of fiduciary duties. On the other hand, if they make decisions solely serving creditors at the expense of other stakeholders, they risk the prospect of shareholders or other qualified constituents bringing a benefit enforcement proceeding.[84] The uncertainty is problematic for creditors, as well. A lender's financing decisions are informed, in part, by its expectations of return in a downside scenario.[85] Uncertainty as to the primacy of creditor-return maximization in bankruptcy makes lending to a benefit corporation less attractive, which should be expected to result in a higher cost of financing for benefit corporations.[86] Of course, if the legal standard were clarified in a manner unambiguously adverse to creditors, that would also be unattractive to lenders. However, certainty would at least illuminate the trade-offs associated with the benefit corporation form and help inform decisions as to the desirability of its use. Uncertainty, on the other hand, increases the overall transaction costs associated with a benefit corporation incurring debt.[87]

B. *Bankruptcy Outcomes Matter for Socially-Conscious Benefit Corporation Investors*

This Section argues that at no time do the concerns that motivate investment in a benefit corporation matter more than during financial distress. In most bankruptcies, the assets of the bankrupt estate will be insufficient to pay all creditors in full, and therefore, the interests of the equity holders, which rank behind creditors' claims, will likely be wiped out en-

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82. Significantly, the MBCL "excludes creditors from the list of stakeholders" that must be considered by a benefit corporation's directors in making decisions. *See id.* at 59.

83. *See id.* at 58–59 (observing drafters of MBCL intentionally excluded creditors "because existing state law is already available to creditors to protect their interests" and arguing that "unintended consequence" may include § 363 sales that "disregard[ ] the rights of creditors" altogether).

84. *See* MODEL BENEFIT CORP. LEGISLATION § 305 (B LAB 2016).

85. *See* Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1813 (1998).

86. *See* Schildhorn & Keilson, *supra* note 73, at 59.

87. *See, e.g.*, Richard E. Levy & Robert L. Glicksman, *Agency-Specific Precedents*, 89 TEX. L. REV. 499, 574 (2011) ("For private parties, legal uncertainty increases information costs, requires additional planning, and creates risk.").

tirely.[88] One could argue, then, that an equity investor in a benefit corporation with a low prospect of recovery on its investment has little at stake in the outcome of a bankruptcy. However, a key rationale for the benefit corporation form is to assure investors that a company is committed to being, and will in fact continue to be, socially responsible. There is perhaps no more critical time for testing this than in a time of financial distress. Further, a bankruptcy proceeding itself can cause massive disruption to a company's employees, customers, and community. Presumably an investor who sought a corporate form specifically designed to consider the needs of such stakeholders would want them taken into account not only when the company is financially viable, but also in a time of financial distress when the fate of such stakeholders may depend on how such distress is resolved.

C. *Financial Distress Is a Key Moment for the Preservation of a Benefit Corporation's Commitment to Social Responsibility*

It is possible for traditional corporations to act in a socially responsible manner, but the traditional corporate form does not assure investors that a corporation will in fact do so. A central rationale for the existence of benefit corporation legislation, if not *the* central rationale, is the notion that such assurance is valuable to a significant number of investors. Benefit corporation supporters argue that the statutes' legal mandates prevent "green-washing," such as when a firm insincerely and misleadingly touts an environmentally or socially-beneficial mission.[89] As noted in Part II, prior to the enactment of benefit corporation legislation, the majority of states already had constituency statutes that *permit* directors to consider certain non-shareholder constituents when fulfilling their fiduciary duties.[90] What sets benefit corporation statutes apart is the *requirement* that they do so.[91] The notion of locking in a company's social mission is thus integral to the benefit corporation paradigm.

Investors motivated by a benefit corporation's social mission should be concerned about potential outcomes of financial distress, above and beyond the obvious concern of potentially losing the financial value of

88. Pursuant to the absolute priority rule in § 1129 of the Bankruptcy Code, a junior class of claimants may not receive any payment under a Chapter 11 plan of reorganization until all higher-ranking classes are repaid in full, unless the higher-ranking classes agree to be paid less. *See* 11 U.S.C. § 1129(b)(2)(B) (2012) (stating that "the holder of any claim or interest that is junior to the claims of [the impaired] class [must] not receive or retain under the plan on account of such junior claim or interest any property" in order for plan of reorganization to be confirmed over dissent of impaired class).

89. *See FAQ*, *supra* note 5 ("The 'general public benefit' purpose helps prevent abuse of this legislation by corporations interested in green-washing.").

90. *See* Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 1989, 2040 tb1.6 (2009); William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 35–36.

91. *See* BENEFIT CORPORATION WHITE PAPER, *supra* note 9, at 10–11.

their investments. Just as the prospect of acquisition threatens the continuation of a firm's mission, so does the prospect of financial failure.[92] A bankruptcy filing means that in all likelihood a business or its components will be owned by different parties coming out of the proceeding than going in. In a Chapter 7 proceeding, the company's assets will be liquidated to pay off creditors. In a Chapter 11 proceeding, the company will be restructured through a plan of reorganization or a sale of substantially all of its assets, in either case typically resulting in wiping out all of the company's equity.[93] Thus, any bankruptcy of a benefit corporation is likely to result in a change in ownership with no guarantee that the new owners will have any commitment to the social mission that led investors to put their money in the business in the first place.

D. *Financial Distress Itself Impacts the Stakeholders That Benefit Corporation Statutes Seek to Protect*

Bankruptcy is often a devastating event for many constituencies involved, not just a company's shareholders and creditors. As summarized in Part IV below, bankruptcy scholars have long debated whether the bankruptcy process should protect the interests of non-investor stakeholders affected by financial distress, such as employees, customers, and the community at large, or instead serve the single purpose of enhancing returns to creditors. Even those scholars taking the latter position recognize that bankruptcies often do, in fact, have a huge impact on other stakeholders. Douglas Baird and Thomas Jackson, leading proponents of a law-and-economics conceptualization of bankruptcy that rejects non-creditor stakeholder considerations, acknowledge that "[t]he economy of an entire town can be disrupted when a large factory closes. Many employees may be put out of work. The failure of one firm may lead to the failure of those who supplied it with raw materials and those who acquired its finished products."[94]

A benefit corporation investor should therefore care about bankruptcy outcomes not only as they relate to the survival of the company's social mission, but also as they relate to the impact that a bankruptcy *itself*

92. As discussed *supra* note 28 and accompanying text, the prospect of an acquisition scenario similar to the sale of Ben & Jerry's is frequently cited by benefit corporation proponents as evidence of the necessity of benefit corporation statutes.

93. *See supra* note 88 and accompanying text.

94. Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 101 (1984) (citing PETER J. COLEMAN, DEBTORS AND CREDITORS IN AMERICA: INSOLVENCY, IMPRISONMENT FOR DEBT, AND BANKRUPTCY, 1607–900 13 (1974)); Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 MICH. L. REV. 336, 355 (1993) ("Business closings affect employees who will lose jobs, taxing authorities that will lose ratable property, suppliers that will lose customers, nearby property owners who will lose beneficial neighbors, and current customers who must go elsewhere.").

could have on the stakeholders who were intended to be protected by virtue of the election of the benefit corporation form. The application of bankruptcy law will determine whether the business will remain as a going concern or be liquidated, which parties will end up owning the restructured business or liquidated assets, and a host of other critical consequences. Benefit corporation statutes require that directors consider the effects of any action or inaction on interests including "employees," "customers," and the "community" in which the corporation is located.[95] Investors who choose to invest in a benefit corporation presumably have some degree of interest in what happens to these stakeholders—otherwise they would have not accepted the tradeoffs associated with departing from the shareholder wealth maximization norm. When a company is successful, it is likely to be easier to serve all these varying interests while also serving the pecuniary interests of shareholders. It is precisely when a company is in financial distress that there are hard choices to be made and there is most likely to be significant negative impact on these stakeholders, depending in large part on the outcome of the bankruptcy proceeding.

IV. BANKRUPTCY THEORY AND BENEFIT CORPORATIONS

Part III showed why bankruptcy matters to the benefit corporation investor and why the treatment of benefit corporations in bankruptcy proceedings should be resolved. This Part explores the theoretical underpinnings of a bankruptcy regime that would recognize the stakeholder interests identified in benefit corporation statutes. First, it summarizes the academic debate over the role of societal interests in bankruptcy proceedings, which mirrors the shareholder wealth maximization debate summarized in Section II.B. Then, it argues that contractual models of bankruptcy offered by law and economics scholars offer a theoretical framework for a bankruptcy regime that recognizes the unique characteristics of benefit corporations.

A. *Bankruptcy Theory of Creditor Wealth Maximization Versus Stakeholder Interests*

Just as corporate governance scholars have long debated the shareholder wealth maximization norm, bankruptcy scholars have long debated whether the sole purpose of bankruptcy is to maximize value for creditors, to which the Article will refer as the "creditor wealth maximi[z]ation" norm.[96] The two norms and the corresponding debates closely mirror each other. In a typical law and economics view of corporate governance, shareholders are the residual claimants to the corporation's assets, direc-

95. *See* MODEL BENEFIT CORP. Legislation § 301(a) (B LAB 2016).

96. *See* Ann Wardrop, *Theorising About Insolvency Law and the Public Interest in the Context of Insolvent Utilities: An Australian Perspective*, 29 BANKING & FIN. L. REV. 435, 459 (2014) (collecting sources and summarizing theoretical debate over purposes of bankruptcy and whose interests it should serve).

tors are agents of the shareholders, and therefore maximization of shareholder value is the singular goal of corporate decision-making.[97] Similarly, in a typical law and economics view of bankruptcy, residual claims to the corporation's assets shift primarily or exclusively to creditors upon insolvency as a consequence of there being little or no equity. Therefore, maximization of creditor wealth becomes the primary, if not singular, fiduciary duty of the directors and goal of the bankruptcy proceeding.[98] Further, just as an opposing camp of corporate governance scholars argues that corporate decision making in fact can, and should, take into account the interests of other stakeholders, an opposing camp of bankruptcy scholars argues that bankruptcy law in fact does, and should, take into account the interests of employees, customers, communities where firms operate, and other constituencies.[99]

1. *Law and Economics Theories of Bankruptcy*

Since the Bankruptcy Reform Act of 1978, law and economics scholars have been at the forefront of attempts to create a theoretical account of bankruptcy.[100] The central normative claim of law and economics theories is that the sole policy objective of bankruptcy law should be the enhancement of creditors' collection efforts with a view to maximizing creditors' wealth, which in turn contributes to overall economic efficiency.[101]

Within the overall rubric of creditor wealth maximization lie different law and economics-oriented theories of bankruptcy. The most influential of these is Thomas Jackson's "creditors' bargain model," which imagines "bankruptcy as a system designed to mirror the agreement one would expect the creditors to form among themselves were they to negotiate such an agreement from an ex ante position."[102] Jackson posits that such creditors would agree to a collective proceeding resembling the existing bankruptcy system on the basis that it better minimizes debt collection costs as compared to a non-collective system in which creditors are left to avail

97. *See, e.g.*, Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 305–16 (1976).

98. *See* JANIS SARRA, CREDITOR RIGHTS AND THE PUBLIC INTEREST: RESTRUCTURING INSOLVENT CORPORATIONS 40–41 (2003) (analogizing dominant law and economics models of corporate governance for solvent and insolvent firms).

99. *See infra* Section IV.A.3.

100. *See* Wardrop, *supra* note 96, at 446 (collecting sources and summarizing history of such theoretical accounts).

101. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 1–6 (1986); Barry E. Adler, *Finance's Theoretical Divide and the Proper Role of Insolvency Rules*, 67 S. CAL. L. REV. 1107, 1107–11 (1994); Frank H. Easterbrook, *Is Corporate Bankruptcy Efficient?*, 27 J. FIN. ECON. 411 (1990); Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159, 1159–65 (1994).

102. Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 860 (1982).

themselves of state law remedies.[103] By implication the model accounts only for consensual creditors, leaving out "nonconsensual creditors, including tort claimants."[104] Further, it leaves out non-creditor parties who may be impacted by the outcome of a bankruptcy proceeding, including employees, customers, and suppliers. It follows from such a model that the purpose of bankruptcy is to serve the interests of creditors only.[105]

While accepting the general maxim of creditor wealth maximization, other law and economics theorists have argued for the replacement of the existing bankruptcy system with more market-based approaches.[106] Among these are proposals to permit parties to contract for their own insolvency system, which will be addressed in more detail in Section IV.B.[107] A common thread through the creditors' bargain model and subsequent law and economics theories is an emphasis on overall efficiency through maximization of creditor returns as the goal of bankruptcy law,[108] and often a criticism of Chapter 11 as inefficient.[109]

2. *Criticism of Law and Economics Theories of Bankruptcy*

A varied group of academics and practitioners, sometimes referred to as "traditionalists," has criticized the primacy of the creditor wealth maximization norm as articulated by law and economics scholars.[110] They argue that theories like the creditors' bargain model, although coherent and easily quantifiable, rest on "untested assumptions" and, while "purport[ing] to avoid . . . normative and empirical issues," are in fact "driven

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103. *See id.* at 869.

104. *See* Donald R. Korobkin, *Contractarianism and the Normative Foundations of Bankruptcy Law*, 71 TEX. L. REV. 541, 555, 580 n.172 (1993).

105. *See id.* at 555 ("The outcome of the creditors' bargain model, like any other outcome emerging from a hypothetical choice situation, effectively mirrors the interests and concerns of those persons who have chosen it.").

106. *See, e.g.*, Barry E. Adler, *A Theory of Corporate Insolvency*, 72 N.Y.U. L. REV. 343 (1997); Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51, 53–54 (1992); Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1808–09 (1998).

107. *See, e.g.*, Rasmussen, *supra* note 106, at 53–54; Schwartz, *supra* note 106, at 1808–09.

108. *See supra* note 101 and accompanying text.

109. *See, e.g.*, Adler, *supra* note 106, at 343–44 (critiquing efficiency of bankruptcy law's ex post approach of preserving economically viable firms); Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, 15 J. LEGAL STUD. 127, 128 (1986) (arguing there is little justification for availability of corporate reorganizations, as opposed to liquidations); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043, 1048 (1992) (arguing "Chapter 11 almost certainly reduces social welfare" by "permit[ting] managers to make suboptimal managerial decisions").

110. *See, e.g.*, Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 577 (1998).

by normative values and empirical assumptions."[111] They observe that the creditors' bargain is essentially a circular model devised to produce economic outcomes that suit those who are chosen to sit at the hypothetical bargaining table—solely rational, wealth-maximizing contract creditors.[112] Finally, they observe that a simplified model that boils bankruptcy down to a maximization of creditor returns does not comport with the nuanced system of bankruptcy law that exists in the real world.[113]

3. *Traditionalist Theories of Bankruptcy*

Under a traditionalist view, "bankruptcy law plays a special role in our legal system and advances substantive goals" aside from efficient debt collection.[114] An example of this view is the "belie[f] that bankruptcy law serves an important purpose in rehabilitating firms that, but for bankruptcy protection, would fail," taking into account the effect that firm failure can have on jobs, communities, and other societal interests.[115] Douglas Baird, a self-described "proceduralist," a term that in Baird's delineation of the two schools of bankruptcy theory roughly corresponds with the law and economics school, contrasts the fundamental axioms of traditionalists and proceduralists as follows:

> In short, the traditional bankruptcy experts believe that: (1) the preservation of firms (and therefore jobs) is an important and independent goal of bankruptcy; (2) contemplation of the rights and needs of the parties before the court matters more than the effects on incentives before the fact; and (3) bankruptcy judges should enjoy broad discretion to implement bankruptcy's substantive policies. The proceduralists, on the other hand, believe that: (1) the preservation of firms is not an independent good in itself; (2) ex ante effects are important; and (3) the judge, after controlling for the biases and weaknesses of the parties and resolving the legal disputes, must allow the parties to make their own decisions and thereby choose their own destinies.[116]

A key aspect of traditionalist theories of bankruptcy is the notion that the interests of non-creditor stakeholders should, to some degree, be considered in a proceeding.[117] As a result, traditionalists emphasize "the value of preserving firms."[118] In the 1980s, Elizabeth Warren posited that

111. *See, e.g.*, Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 800, 812 (1987).

112. *See supra* note 105.

113. *See* Warren, *supra* note 111, at 812–13.

114. *See* Baird, *supra* note 110, at 576 (collecting sources and describing "traditionalist" camp).

115. *See id.* at 577.

116. *Id.* at 579–80.

117. *See id.* at 578.

118. *See id.* at 579.

stakeholders such as employees, customers, and suppliers are valid subjects of bankruptcy law because they are already recognized by the Bankruptcy Code to a limited degree.[119] Warren points to legislative history to argue that the 1978 Bankruptcy Code, which gives a failing firm the opportunity to reorganize under Chapter 11, was adopted "specifically to ameliorate [some of the] harmful effects" of business closings, thereby "redistribut[ing] the benefits that would stem from creditors' collection rights to other parties."[120] Warren argues that bankruptcy law should, and does, protect the interests of constituencies including "[t]he older employee, the regular customer, the dependent supplier, and the local community" of the debtor because of the "deeper social implications of business failure in a highly integrated society."[121]

Warren's analysis rejects what has been dubbed the search for a "deep structure" of bankruptcy, instead offering a "dirty, complex, elastic, interconnected view of bankruptcy."[122] Other traditionalists have offered meta-theories that compete with the law and economics creditor-centered theories. Daniel Korobkin, drawing on the paradigm of the hypothetical choice situation developed by John Rawls, imagines bankruptcy as mirroring a hypothetical bargain among *all* persons who would be affected by financial distress, not just shareholders and creditors; under the "veil of ignorance," unaware of their respective legal positions, these persons would be expected to design a fair system.[123] Lynn Lopucki, adopting Blair and Stout's team production theory, argues that a model in which "a bankruptcy firm should honor its obligations to all ["team members"] who made firm-specific investments at the invitation of the firm," even if those investments were not directly contracted for, is "superior to the [c]reditors' [b]argain [t]heory" as both a positive and normative matter.[124]

Other traditionalist scholars have proposed significant changes to the Bankruptcy Code in order to give non-creditor stakeholders a more direct and active role. In her 1997 book, *Failure and Forgiveness: Rebalancing the Bankruptcy System*,[125] Karen Gross proposes that if a community affected by a bankruptcy can show a nexus with the bankruptcy that causes substantial and redressable injury, the community should have a right to be heard in

119. *See* Warren, *supra* note 94, at 355.

120. *See id.* (acknowledging, however, that such stakeholder interests are indirect and derivative, and that such stakeholders "have no specific right to be heard in the bankruptcy case").

121. *See* Warren, *supra* note 111, at 788.

122. *See id.* at 811; *see also* David Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1357 (1987).

123. *See* Korobkin, *supra* note 104, at 560, 571 n.150.

124. *See* Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 745, 770 (2004).

125. KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM (1997).

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the proceeding.[126] Any plan of reorganization must then take into account the interests of such a community, unless the balance of equities clearly favors denying those interests.[127] Similarly, Nathalie Martin has proposed expanding the scope of parties with standing in bankruptcy cases beyond "person[s] with a pecuniary interest in the debtor or its assets."[128] Martin suggests that those with "[s]ubstantial nonpecuniary interests" involving a bankruptcy case should have standing to be heard in the adjudication of "major events in a case" including "plan confirmation, the sale of all or substantially all of a debtor's assets, and the rejection of an executory contract or unexpired lease."[129]

Scholars outside of the United States have likewise advocated for greater recognition of stakeholder rights in other bankruptcy regimes. Janis Sarra, also drawing from Blair and Stout's team production theory, has proposed a conceptual framework for reconciling stakeholder interests in Canadian bankruptcy proceedings. Sarra attempts to avoid a vague balancing standard by re-conceptualizing the purpose of bankruptcy as "enterprise value maximization," with enterprise value taking into account not just equity and debt, but also equitable investments, such as human capital investments, costs of environmental harm, costs to communities from lost trade, and any other "spin-off economic effects of firm failure."[130] Sarra suggests that the values of these investments are capable of rough measurement, although Sarra provides little guidance as to how they actually should be calculated.[131] In the United Kingdom, Vanessa Finch has argued that power in insolvency law requires "democratically legitimate objectives (or mandates)," and, therefore, must address broader communitarian concerns in addition to creditor concerns.[132] Finch articulates a set of explicit values, including "efficiency, expertise, accountability, and fairness," as the "benchmarks with which to evaluate" bankruptcy systems.[133]

4. *Criticisms of Traditionalist Theories of Bankruptcy*

Law and economics scholars have criticized traditionalist theories recognizing stakeholder interests on several grounds. One of the more compelling arguments is that traditionalists fail to explain adequately why

126. *See id.* at 227–31.

127. *See id.* For a criticism of Gross's proposal, see Barry S. Schermer, *Response to Professor Gross: Taking the Interests of the Community into Account in Bankruptcy—A Modern-Day Tale of Belling the Cat*, 72 WASH. U. L.Q. 1049, 1050–52 (1994) (arguing bankruptcy judges could not practically weigh community interests).

128. *See* Nathalie D. Martin, *Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In*, 59 OHIO ST. L.J. 429, 432 n.8 (1998).

129. *Id.* at 502–03.

130. *See* SARRA, *supra* note 98, at 90.

131. *See id.* at 96.

132. *See* VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 53 (2002).

133. *See id.* at 56, 65.

certain non-legal rights of stakeholders and distributional considerations should be observed in bankruptcy if they may be ignored outside of bankruptcy. For example, a solvent firm need not consult the local community were it to decide to close down and move overseas, causing distress to the workers who lose their jobs and the local economy.[134] Critics argue that it is not the job of bankruptcy law to address "distributional concerns" of such nature if they are not otherwise legally recognized and that doing so "invites troublesome forum shopping."[135] Law and economics scholars have further criticized specific proposals to give greater "recognition of community interests" in bankruptcy on the grounds that reorganizing firms for the community's benefit inequitably imposes costs on creditors and shareholders, that more efficient outcomes would result if communities wishing firms to remain in place paid subsidies for them to do so, and that the imprecise standards of "balancing" approaches would lead to "ad hoc intervention by bankruptcy judges."[136]

B. *Applying Bankruptcy Theory to Benefit Corporations*

The debate in corporate governance literature over the primacy of the shareholder wealth maximization norm mirrors the debate in bankruptcy literature over the primacy of the creditor wealth maximization norm. In both cases, scholars have disputed both the extent to which existing law already permits recognition of the interests of other non-shareholder or non-creditor stakeholders and the extent to which the law should recognize these interests as a normative matter. However, the corporate governance debate is unique in that critics of the shareholder wealth maximization norm actually produced legislative change to break away from the norm. First, in the 1980s, proponents of constituency statutes sought to alter, or at least clarify, the understanding of the shareholder wealth maximization norm as a matter of general applicability for all corporations.[137] Then, in recent years, proponents of benefit corporation statutes took a much different tact. Rather than reform corporate governance law generally, they sought to create an opportunity for founders and investors to opt into a different corporate governance regime in the event it more closely matches their preferences.[138] In essence, the passage of benefit corporation legislation transformed the shareholder wealth maximization norm from a mandatory rule to a default rule that parties may contract out of by electing a social enterprise legal form.

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134. *See* Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 815, 829 (1987).

135. *See id.* at 818–19.

136. *See* Marjorie L. Girth, *Rethinking Fairness in Bankruptcy Proceedings*, 73 AM. BANKR. L.J. 449, 473–75 (1999); *see also* Schwartz, *supra* note 106, at 1817–18.

137. *See supra* note 24 and accompanying text.

138. *See supra* Section II.D.

Similar legislative change has not occurred in the post-1978 bankruptcy context.[139] This may be explained in part by contrasting notions of what reform means in academic debates over the shareholder wealth maximization norm and the creditor wealth maximization norm, respectively. Critics of traditional corporate law argue that the law should become less shareholder-centric. On the other hand, since the Bankruptcy Reform Act of 1978, the debate in bankruptcy academia has largely been between law and economics critics arguing that bankruptcy law does not do enough to support a strict creditor wealth maximization norm, and traditionalists defending the nuances of the existing legal regime.[140] Nevertheless, there has also been a vocal group of critics who could be categorized as traditionalist but advocate for reform and argue that bankruptcy law should move further away from creditor wealth maximization toward a system that better recognizes the needs of multiple stakeholders.[141] These critics could benefit from taking a page out of the book of the social enterprise movement and attempt to turn the bankruptcy regime's creditor wealth maximization norm, such as it is, into a default rule that may be contracted out of.

1. *Law and Economics-Based Proposals for Contract-Based Bankruptcy Systems*

Reforming bankruptcy law to allow parties to contract out of a pure creditor wealth maximization norm finds theoretical support, ironically, in the proposals of certain law and economics bankruptcy theorists. Robert Rasmussen proposes that parties should have flexibility "to choose [the] bankruptcy scheme" that will apply to them on the basis that different bankruptcy schemes may be superior under different circumstances.[142] He argues that, contrary to the existing legal regime, most bankruptcy law should consist of default, rather than mandatory, rules.[143] Under his proposed system, a firm would be required to select from a defined menu of bankruptcy systems upon its formation, and by designating that choice in its charter, the firm and its consensual creditors would effectively contract into a particular bankruptcy regime.[144] Consensual creditors would make lending decisions in part on the basis of which "menu option" is chosen,

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139. See *supra* notes 119–21 and accompanying text regarding the progressive nature of the Bankruptcy Reform Act of 1978.

140. The moniker "traditionalist" is telling.

141. *See, e.g.*, *supra* notes 125–26 and accompanying text; *see also* Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5, 26–33 (1996).

142. *See* Rasmussen, *supra* note 106, at 53–54, 112.

143. *See id.* at 67.

144. *See id.* at 100–07. Rasmussen proposes four options: the first would "enable [a] firm to commit to never filing a bankruptcy petition under federal bankruptcy law", the second "would enable [a] firm to file a Chapter 7 petition only," the third "would stay all creditors except for [a] financing creditor," and the fourth would "allow [a] firm to create its own bankruptcy regime, subject to the restraint that it [cannot alter the rights of] nonconsensual creditors." *Id.*

offering a higher or lower interest rate depending on their expected return given the chosen bankruptcy system.[145] The rights of nonconsensual creditors, on the other hand, would be set by mandatory rules.[146]

With a similar focus on increasing the efficiency of bankruptcy outcomes through a system of default rules, Alan Schwartz proposes a system of ex ante bankruptcy contracting akin to Rasmussen's menu approach but with greater flexibility in certain respects.[147] Schwartz argues that setting a chosen bankruptcy system in a firm's charter "may founder . . . because the optimality of a [given] system is state-dependent [and] . . . time-dependent," and "corporate charters are inconvenient to amend."[148] Instead, Schwartz proposes a system in which firms contract with creditors as to choice-of-bankruptcy systems directly in their lending agreements.[149] When entering into a lending agreement, a firm and its creditors would choose from among three contract types, each with a different approach to designating, or not designating, the choice of bankruptcy system.[150] To account for changes over time as to which system may be preferable, Schwartz proposes that a debtor's last lending agreement negotiated before bankruptcy will be binding on all other creditors—e.g., it will automatically convert all previous agreements to the same construct.[151] To account for conflicts among creditor preferences, Schwartz argues that strict enforcement of the absolute priority rule should address most conflicts because most creditors will be aligned to maximize overall returns, and the risk of trade creditors favoring reorganization even when it is inefficient overall would be addressed by a majority vote rule aggregating all creditors.[152]

145. *See id.* at 101–19.

146. *See id.* at 67.

147. Schwartz's approach includes only two alternative bankruptcy systems to chose from, but is more flexible in the sense that choices may be state-dependent and time-dependent. *See infra* text accompanying notes 148–52.

148. *See* Schwartz, *supra* note 106, at 1811.

149. *See id.* at 1811, 1823 (stating "[t]wo bankruptcy system options are assumed to exist," with one much like Chapter 11 and another providing for sale of insolvent firms or their assets at auction).

150. The first, termed a "renegotiation proof contract," authorizes the firm to keep a negotiated portion of the monetary return that would be generated by whatever bankruptcy system it chooses, thereby bribing the debtor to choose the more efficient system by aligning its interests with its creditors. *See id.* at 1827–30. The second, termed a "renegotiation contract," does not specify a given bankruptcy system and the debtor is free to choose the bankruptcy system it prefers. *See id.* at 1830. The third, termed a "partially renegotiation-proof contract," would designate the preferred bankruptcy system on the basis of an outside signal and could be renegotiated if the signal fails to predict an appropriate system. *See id.* at 1830–31.

151. *See id.* at 1834.

152. *See id.* at 1838.

2. *Contract-Based Bankruptcy System for Benefit Corporations*

There are several possible approaches for allowing parties to opt out of the creditor wealth maximization norm into a more stakeholder-friendly regime. Following the Rasmussen model, corporations could designate in their charters that they elect to be subject to a specified stakeholder-friendly regime, thereby effectively contracting with all future consensual creditors by putting them on notice. This choice may be tied to a corporation's decision to be a benefit corporation, or it could be entirely disconnected from its corporate form, recognizing the possibility that a firm could prefer a stakeholder-friendly bankruptcy regime without wanting to be a benefit corporation, or vice-versa. Or, following the model advocated by Schwartz, corporations could expressly contract with creditors in lending agreements as to their choice of regime in this respect. This choice would not necessarily have to be confined to two possible regimes but could extend to a range of bankruptcy systems with varying treatments of stakeholders.

Although a more nuanced system for contracting around issues of stakeholder rights in bankruptcy has some theoretical allure, the most feasible and justifiable system is to tie this election directly to benefit corporation status. First, a firm's identity as a benefit corporation makes the choice of bankruptcy regimes far more salient both to the firm itself and to its creditors. The decision of whether to incorporate as a benefit corporation is an opportunity for founders and investors to deeply consider the various legal implications of their choice, including issues of stakeholder rights in bankruptcy. While financial creditors should in theory perform the diligence required to understand the bankruptcy implications of a borrower's charter provisions in any event, a borrower's status as a benefit corporation is a highly identifiable signal to all consensual creditors that it is a firm with unique legal characteristics that may affect creditors' rights. Second, more complex systems risk a host of logistical issues that could challenge the application of a theoretical model to practice.[153] Finally, there is a strong normative argument for tying post-bankruptcy filing stakeholder rights to pre-bankruptcy stakeholder rights, and vice-versa. A central tenet of law and economics arguments is that pre-bankruptcy entitlements should be maintained in bankruptcy.[154] One of the strongest criticisms of proposals to extend additional rights in bankruptcy to stake-

153. For a criticism of Schwartz's contract system focusing on complexities of applying the theory to practice, see Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317, 326 (1999) and Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 DICK. L. REV. 267, 279–85 (2001).

154. *See* Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857, 871 (1982) ("The creditors' bargain model, then, provides a satisfying theoretical explanation of why bankruptcy law should make a fundamental decision to honor negotiated non-bankruptcy entitlements.").

holders is that there is no justification for why such rights may be legitimately ignored outside of bankruptcy—for example, in the hypothetical scenario of a solvent firm shuttering its local operations and moving overseas. However, a stakeholder-friendly bankruptcy regime for benefit corporations would flip the argument on its head. Such a system would award special rights to stakeholders in bankruptcy precisely *because* they enjoy similar rights pre-bankruptcy.

A remaining consideration is whether the election of a stakeholder-friendly bankruptcy regime should be tied to benefit corporation status as a mandatory or default rule. A mandatory rule would provide for stronger signaling power. If all benefit corporations are subject to the same rules, consensual creditors should be aware of the implications of lending to a benefit corporation without a need for any further investigation. However, a mandatory rule is at odds with the liberal spirit of social enterprise legislation, which aims to give firms and their investors greater choice by allowing them to opt out of the shareholder wealth maximization norm.[155] Certain benefit corporation investors may prefer a more traditional bankruptcy regime in order to avoid potentially higher debt costs associated with a stakeholder-friendly regime. Put differently, they may have a preference for a benefit corporation legal framework that recognizes stakeholder interests only during times of financial viability. A mandatory rule would risk discouraging such a subset of investors from choosing the benefit corporation form in the first instance. Further, a stakeholder-friendly regime can be expected to result in more overall efficiency so long as investors exhibit a preference for accepting the prospect of higher debt costs in exchange for producing more stakeholder-friendly bankruptcy outcomes.[156] However, for any investors who do not prefer to make that tradeoff, a mandatory rule could result in a misalignment of investor preferences with bankruptcy outcomes and therefore potentially inefficient results. For these reasons, the more optimal approach is to subject benefit corporations to a stakeholder-friendly bankruptcy regime as a default rule that may be opted out of by a charter provision.

Tying a firm's identity as a benefit corporation to a default rule of a stakeholder-friendly bankruptcy regime provides a path to a traditionalist-minded bankruptcy reform that is grounded in a law and economics contract-based theoretical model. It addresses much of the law and economics criticism that is otherwise levied towards proposals to make bankruptcy more community- and stakeholder-friendly. Traditionalist proposals have

155. *See* J. William Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, 2 AM. U. BUS. L. REV. 85, 103 (2012) (arguing "benefit corporation conception . . . starts down the right path [of promoting liberalism] by facilitating choice," but that MBCL is "insufficiently liberal" because it requires all benefit corporations to adopt same general public benefit). The term "liberal" is used in this Article in its classic philosophical sense, not in its contemporary political sense.

156. See *infra* Section V.C.2 for a more detailed discussion of efficiency issues.

been criticized for inequitably shifting costs to creditors, but in a benefit corporation-linked system, consensual creditors will be on notice of the altered bankruptcy regime and, therefore, price their financing accordingly.[157] They have been criticized as inefficient on the basis that efficient outcomes benefiting communities and stakeholders would be more accurately reached through communities and stakeholders paying subsidies, rather than judges weighing interests and placing costs on creditors. But in a benefit corporation-linked system, the corporation's investors should be expected to value the benefits to communities and stakeholders accurately by accepting higher debt costs in exchange for such benefits.[158] They have also been criticized for changing pre-bankruptcy entitlements, but as demonstrated above, a benefit corporation-linked system would, in fact, seek to preserve the indirect pre-bankruptcy entitlements of stakeholders.[159] The most difficult criticism to address is that proposals for stakeholder rights are vague and leave judges without standards in balancing various interests. Part V of this Article will attempt to address this point by discussing instances in which bankruptcy courts have already been tasked with balancing creditor and stakeholder interests and that serve as a basis for constructing a plausible system for benefit corporation bankruptcies.

3. *Consent Issues Associated with a Contract-Based Bankruptcy System for Benefit Corporations*

Before proceeding with an analysis of what an altered bankruptcy regime for benefit corporations might look like, the theoretical model of such a regime as a contracted-into system warrants a closer examination. So long as a creditor is on notice of a company's status as a benefit corporation and the attendant bankruptcy implications of that status, the altered regime of creditor rights is effectively one component of a

157. See *infra* Section IV.B.3 for a discussion of nonconsensual creditors under such a system.

158. See *infra* Section V.C.2 for a more detailed discussion of efficiency issues.

159. A notable exception is that, in such a system, stakeholders would be afforded indirect entitlements in bankruptcy that they would not necessarily be afforded in the context of debt enforcement outside of bankruptcy. A secured creditor can typically exercise remedies upon default that include the ability to satisfy the debt by taking possession of and selling a borrower's assets or potentially the borrower itself. Any concerns about a benefit corporation's mission being abandoned as a result of a change of ownership through bankruptcy apply equally to a change of ownership through the exercise of such non-bankruptcy remedies, yet creditors exercising such remedies would not be required to do so in a manner that takes into account stakeholder interests. However, a benefit corporation could potentially contract around this mismatch to some extent by negotiating for stakeholder-friendly protections in its credit documents. Further, a benefit corporation in default and facing the prospect of a seizure of collateral would always have the option of filing a voluntary petition and availing itself of the protections of the Bankruptcy Code. Protections include the automatic stay of enforcement and, assuming it did not opt out, the stakeholder-friendly provisions of the proposed benefit corporation bankruptcy regime.

bargained-for set of terms comprising the contractual arrangement between the company and the creditor.[160] To the extent a creditor views the regime as decreasing the expected value of its return in a downside scenario, the creditor may demand a higher interest rate or other creditor-favorable terms, or simply choose not to transact with the benefit corporation. This justification holds for true consensual financial creditors but breaks down for nonconsensual creditors, consensual creditors who cannot be expected to be on notice of benefit corporation status and its bankruptcy implications, and creditors who extend credit prior to a company's conversion to a benefit corporation form without such creditors' consent.

A creditor intending to lend any material amount can be expected to perform basic due diligence on the borrower's legal status. If a company's status as a benefit corporation is not already immediately apparent, a lender and its counsel would soon learn of it through legal due diligence as they review the company's charter.[161] It is conceivable that a lender could extend credit without learning of such identity or appreciating its significance for purposes of creditors' rights, but that should hardly excuse the consequences of such failure. A financing creditor is generally expected to mitigate these risks through due diligence and requiring contractual representations from the borrower.

In contrast, insofar as a unique bankruptcy regime for benefit corporations alters the treatment of a nonconsensual creditor in bankruptcy, it cannot be seen as an ex ante bargain between the firm and the nonconsensual creditor. An individual hit by a truck owned by a benefit corporation does not choose to have a claim against a benefit corporation, as opposed to a traditional corporation, and does not bargain for a different set of legal rights. Certain non-financial consensual creditors are more difficult to categorize. Theoretically, a customer with a small contract claim is a consensual creditor, but it may not be reasonable to expect such a creditor to know that a company is a benefit corporation or appreciate the legal significance of that corporate status. Finally, any transaction between a creditor and a traditional for-profit corporation that later becomes a benefit corporation, absent the creditor's consent to the conversion, cannot be viewed as an ex ante bargaining regarding the legal implications of benefit corporation status.

There are two possible approaches for addressing the challenge of creditor consent to a benefit corporation's bankruptcy regime. The first is

160. This presupposes that benefit corporation forms do not supplant traditional corporate forms entirely and that for-profit businesses remain subject to the rules of the existing bankruptcy regime.

161. A lender would in all likelihood be aware of a borrower's status as a benefit corporation even before commencing standard legal due diligence, given that such status would likely be marketed by the company. *See* Dana Brakman Reiser, *Benefit Corporation—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 622 (2011) (citing branding as one key reason to adopt social enterprise form).

to design a bankruptcy regime with different treatment for creditors that depends on whether a creditor should have been, or in fact was, aware of a company's status as a benefit corporation and the implications thereof. Such an approach would preserve the integrity of the ex ante bargaining theoretical justification in all circumstances, but it would likely prove too complex and unwieldy to be workable. Determining whether a creditor should have been aware of certain facts and their legal implications requires either fact-specific inquiries that are ripe for dispute or bright-line rules that risk arbitrariness. Looking instead to whether a creditor was aware of certain facts would prove even more challenging and create a perverse incentive for creditors to be willfully ignorant. Even drawing a bright line between all consensual creditors and nonconsensual creditors would vastly complicate benefit corporation bankruptcy proceedings, effectively resulting in the claims of nonconsensual creditors becoming senior to other unsecured claims in a limited respect.[162]

The better approach is for the rules not to distinguish between creditors on the basis of whether they should have been, or were, aware of a debtor's benefit corporation status. Such an approach does not perfectly fit an ex ante bargaining model, but it is far simpler to administer and is consistent with existing rules regarding nonprofit and railroad bankruptcies. The hypothetical nonconsensual creditor injured by a truck may end up with significantly different returns in bankruptcy depending on whether the truck was owned by a for-profit supermarket, a nonprofit hospital, or a railroad company.[163] Similarly, consensual creditors like vendors and customers may be entirely unaware of the bankruptcy implications of a transaction with, for example, a nonprofit hospital versus a for-profit hospital. These differences are not justified by a theoretical model of different bankruptcy laws serving as an ex ante bargain among parties, but that is not the only possible justification for the rules. The Bankruptcy Code provides special rules for nonprofits and railroads because of recognized policy objectives protecting the public interest, and those objectives outweigh any concerns about unbargained-for disparate treatment of creditors.[164] Putting entity type aside, nonconsensual creditors face widely different outcomes based on factors entirely outside of their control.[165] The appropriate treatment of nonconsensual debtors in bankruptcy is outside the scope of this Article and is the subject of exten-

162. Rasmussen's menu option model acknowledges the issue of nonconsensual creditors and concludes that, unlike consensual creditors, they should be subject only to mandatory bankruptcy rules. *See supra* note 106 and accompanying text. However, Rasmussen does not address how to account for the different outcomes for nonconsensual creditors that may indirectly result from bargaining for different bankruptcy systems.

163. *See infra* Section V.A.

164. *See id.*

165. For example, a tort claimant may receive no return from a debtor with secured debt exceeding the debtor's enterprise value or may receive a substantial return from a debtor with little consensual debt.

sive academic debate.[166] It suffices to say that the unbargained-for disparate treatment of nonconsensual creditors is not unique to the system proposed for benefit corporations in this Article, but it is a hallmark of existing bankruptcy law.

On closer inspection, a system that ignores issues of consent may produce fewer inequitable results than might otherwise be assumed. Nonconsensual creditors typically account for a relatively small portion of the claims in a business bankruptcy. When they play a larger role, it is often in the case of a mass tort situation—for example, a bankrupt company with large asbestos liability. In such a case, the stakeholder mandates of benefit corporations may actually benefit such creditors. The MBCL requires "community and societal factors" to be taken into account in all decisions, which could potentially result in more favorable treatment for tort creditors where the claims are aligned with general societal concerns about public safety.[167] Similarly, to the extent non-financial consensual creditors are employees or customers, they too would benefit from the application of the MBCL's stakeholder provisions in bankruptcy.

Finally, the issue of companies converting to benefit corporation status after a consensual debt has already been incurred can be protected against contractually. Credit agreements for large lending transactions typically contain covenants restricting borrowers from amending their charter documents in a manner that is adverse to their lenders, provisions that could, depending on their formulation, bar a conversion to benefit corporation status if it were to implicate a less creditor-friendly bankruptcy regime. To the extent such provisions are not currently universal for all lending transactions, a unique bankruptcy regime for benefit corporations would likely result in lenders demanding such protections more frequently.

V. PROPOSAL FOR BENEFIT CORPORATION TREATMENT IN BANKRUPTCY

Section IV.B developed a theoretical framework for benefit corporations and their creditors to effectively contract into a stakeholder-friendly bankruptcy regime as a default rule. This Part will set forth a proposal for the rules of such a regime. First, this Part will review instances where the Bankruptcy Code currently gives special consideration to public interest concerns with respect to certain types of debtors, reviewing the treatment

166. *See, e.g.*, Henry Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1902 (1991) (proposing unlimited shareholder liability for tort claims, combined with priority of both secured and unsecured consensual claims over tort claims); David W. Leebron, *Limited Liability, Tort Victims, and Creditors*, 91 COLUM. L. REV. 1565, 1643–49 (1991) (proposing that tort claims take priority over all consensual claims); Christopher M.E. Painter, Note, *Tort Creditor Priority in the Secured Credit System: Asbestos Times, the Worst of Times*, 36 STAN. L. REV. 1045, 1080–83 (1984) (proposing that tort claims take priority over all consensual claims).

167. *See* MODEL BENEFIT CORP. LEGISLATION § 301(a)(1) (B LAB 2016).

of nonprofits and railroads in bankruptcy. Then, it will propose specific amendments to both the Bankruptcy Code and benefit corporation statutes to implement a unique stakeholder-friendly bankruptcy regime for benefit corporations. Finally, this Part will analyze the ex ante efficiency implications of such proposal.

A. *Examples of Organizations with Unique Bankruptcy Treatment*

For an indication of how bankruptcy law might give more credence to stakeholder and public interest concerns with respect to certain types of debtors, look no further than the existing provisions of the Bankruptcy Code. Nonprofits are treated differently than for-profit businesses in a number of critical ways, which is particularly significant in that the benefit corporation form is often viewed as a hybrid of nonprofit and for-profit principles.[168] Further, railroad reorganizations have their own unique treatment under the Bankruptcy Code, providing a compelling approach for recognizing stakeholder interests that is similar in spirit but distinct in method from the nonprofit approach.

1. *Nonprofits in Bankruptcy*

a. Involuntary Filings and Conversion to Chapter 7

Nonprofit organizations receive privileged treatment under the Bankruptcy Code, promoting business continuity at the expense of creditors' rights. The Bankruptcy Code does not permit creditors to commence involuntary bankruptcy cases against "a farmer, family farmer or a corporation that is not a moneyed, business or commercial corporation."[169] For the sake of simplicity, this Article refers to a "corporation that is not a moneyed, business or commercial corporation" as a "nonprofit."[170] Similarly, unlike in the case of a for-profit debtor, a bankruptcy court cannot

168. *See, e.g.*, Katherine R. Lofft, Purvi B. Maniar & Tamar R. Rosenberg, *Are Hybrids Really More Efficient? A 'Drive-by' Analysis of Alternative Company Structures*, 2012 BUS. L. TODAY 1.

169. *See* 11 U.S.C. § 303(a) (2012). Voluntary petitions for bankruptcy, on the other hand, may generally be filed by any association "that resides or has a domicile, place of business, or property in the United States," including nonprofit organizations. *See* 11 U.S.C. § 109; *see also id.* §§ 101(9)A, 101(41), 301 (2012).

170. *See* 11 U.S.C. § 303(a). The Bankruptcy Code does not define the term "corporation that is not a moneyed, business, or commercial corporation." *See id.* The legislative history of § 303 includes a statement that "churches, schools, and charitable organizations and foundations [are protected] from involuntary bankruptcy." *See* H.R. REP. NO. 95-595, at 321 (1977), *as reprinted in* 1978 U.S.C.C.A.N. 5963, 6278. Some courts have applied a "state classification rule" such that an organization qualifies if it is registered with its state of organization as a nonprofit, and others have applied a more nuanced "corporate activity rule" under which the "nature of an entity's activities" is reviewed in addition to its "classification under state law." *See* James Lockhart, *What Constitutes "Moneyed, Business, or Commercial Corporation" Subject to Involuntary Bankruptcy or Reorganization upon Creditors' Petition Under 11 U.S.C.A. § 303(a) and Predecessor Statutes*, 24 A.L.R. FED. 2d 397, §§ 7–8, 12 (2007).

convert a nonprofit debtor's Chapter 11 case into a Chapter 7 case without the nonprofit debtor's consent.[171] In combination, these rules constitute a critical difference in bankruptcy regimes for nonprofit debtors and for-profit debtors. A nonprofit debtor cannot be forced to liquidate its assets, and therefore, a nonprofit in financial distress is assured that it can survive if it so chooses.

b. Dispositions of Nonprofit Property

The law of nonprofit bankruptcies is also distinguished by the unique considerations that factor into the disposition of a charitable nonprofit debtor's property. In addition to the traditional fiduciary duties of care and loyalty, nonprofit directors are subject to a "duty of obedience," which requires "that a director act with fidelity, within the bounds of the law generally, to the organization's 'mission,' as expressed in its charter and by-laws."[172] For charitable nonprofits, these fiduciary duties may be enforced by state attorney generals, who have broad oversight over charitable organizations under the doctrine of *parens patriae*.[173] Recognizing that in such capacity attorney generals have an interest in how charitable assets are disposed, the Revised Model Nonprofit Corporation Act of 1987 (RMNCA),[174] which forms the basis for the nonprofit corporation statutes in twenty-six states,[175] requires twenty-day advance notice to the attorney general before a public benefit corporation[176] or religious corporation may sell, lease, exchange, or otherwise dispose of all, or substantially all, of its property.[177] Although direct approval of the attorney general is not required under such a provision, the RMNCA gives attorney generals

171. *See* 11 U.S.C. § 1112(c) (2012).

172. *See* Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 641 (1998) (quoting DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 21 (1988)).

173. *See* Terri Lynn Helge, *Policing the Good Guys: Regulation of the Charitable Sector Through a Federal Charity Oversight Board*, 19 CORNELL J.L. & PUB. POL'Y 1, 11–13 (2009) ("Government enforcement of charities is rooted in the English common law power of parens patriae, which imposes on the representative of the sovereign the exclusive duty to enforce charitable trusts.").

174. *See* REVISED MODEL NONPROFIT CORP. ACT (AM. BAR ASS'N 1987).

175. *See* Michael E. Malamut, *Summary of Sources of State Nonprofit Corporation Laws*, NAT'L PARLIAMENTARIAN, Second Quarter 2008, at 8, 8.

176. The *RMNCA* distinguishes between religious corporations, public benefit corporations, and mutual benefit corporations as three categories of nonprofit corporations. Religious corporations are corporations organized for religious purposes. Public benefit corporations are corporations that are exempt under § 501(c)(3) of the Internal Revenue Code or otherwise have public or charitable purposes. Finally, mutual benefit corporations encompass any other nonprofit corporations. *See* REVISED MODEL NONPROFIT CORP. ACT § 17.07. The term "public benefit corporation" has a different meaning as used in the Delaware, Colorado, and Minnesota social enterprise statutes, which is discussed *supra* in note 56 and accompanying text.

177. *See* REVISED MODEL NONPROFIT CORP. ACT § 12.02(g).

standing to seek injunctive relief for proceedings for which they are required to be given notice.[178] The New York Not-for-Profit Corporation Law[179] provides a stricter standard, requiring a charitable nonprofit proposing to dispose of all or substantially all of its assets to obtain the approval of the attorney general or applicable state court by means of a petition that sets forth, among other requirements, that "the purposes of the corporation, or the interests of its members will be promoted thereby."[180]

Prior to the Bankruptcy Code providing any specific guidance on the issue, courts recognized public interest- and mission-related considerations regarding the disposition of charitable assets when adjudicating nonprofit bankruptcies. In *In re Brethren Care of South Bend, Inc.*,[181] a nonprofit debtor "whose primary asset [was] a retirement and nursing care facility," proposed a sale of all its assets to another nonprofit.[182] The court approved the debtor's proposed sale over the objections of creditors who proposed a competing plan yielding a higher return (but possibly resulting in a for-profit corporation operating the facility), holding that "the continuing satisfaction and ongoing beneficial treatment of the residents . . . is a good business reason for the sale."[183] In *In re United Healthcare Systems Inc.*,[184] a nonprofit hospital debtor supported a sale of all its assets to a bidder chosen in a pre-bankruptcy filing bidding process, notwithstanding that there was a second potential bidder who may have been willing to pay a higher price.[185] The bankruptcy court had denied the debtor's request for approval of the sale, holding that the board of directors failed to exercise proper business judgment by accepting the offer and not providing "the opportunity to take higher and better offers."[186] The district court reversed the decision, finding that the board "exercised sound business judgment" in considering factors other than price in assessing the offer, including that the chosen bidder was the only potential bidder "committed to keeping the [ ] [h]ospital in one location and to providing $5 million in future investments."[187] Citing *In re Brethren Care*, the district court held that the bankruptcy court should have considered that the debtor was a charitable institution and that the "officers and directors of a non-profit organization are charged with the fiduciary obligation to act in furtherance of [that] organization's charitable mission."[188]

178. *See id.* § 1.70.
179. N.Y. NOT-FOR-PROFIT CORP. LAW § 511(a)(6) (Consol. 2016).
180. *See id.* § 511(a)(6) (Consol. 2016); *see also id.* §§ 510(a)(3), 511-a.
181. 98 B.R. 927 (Bankr. N.D. Ind. 1989).
182. *See id.* at 928–31.
183. *See id.* at 935.
184. No. 97-1159, 1997 WL 176574 (D.N.J. 1997).
185. *See id.* at *1–3.
186. *See id.* at *3.
187. *See id.* at *5–6.
188. *See id.* at *5.

In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) codified the deference to the public policy considerations associated with nonprofits.[189] BAPCPA enacted several new provisions in the Bankruptcy Code specifying that transfers of property by nonprofit debtors, including those in the context of plans of reorganization and 11 U.S.C. § 363 asset sales, are subject to applicable state law and other restrictions on nonprofits.[190] Further, the BAPCPA section effecting such changes contains an uncodified provision stating that "[t]he parties who may appear and be heard in a proceeding under this section include the attorney general of the State in which the debtor is incorporated, was formed, or does business."[191] Taken together, the BAPCPA nonprofit provisions expressly prioritize states' interests in subjecting dispositions of charitable assets to the oversight of attorney generals and other restrictions over the interests of creditors in disposing of assets in a manner resulting in the highest recovery on claims.[192]

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189. *See* Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered sections of 11 U.S.C.).

190. *See* 11 U.S.C. § 363(d)(1) (2012) (providing trustee may sell or lease property under subsection (b) or (c) of that section only in accordance with applicable non-bankruptcy law that governs transfer of property by nonprofit); *id.* § 541(f) (providing nonprofit exempt from taxation pursuant to § 501(c)(3) of Internal Revenue Code may transfer assets to non-exempt corporation, but only under same conditions that would apply if debtor had not filed bankruptcy case); *id.* § 1129(a)(16) (requiring bankruptcy court, in confirming Chapter 11 plan, to find all transfers of property under plan are made in accordance with applicable non-bankruptcy law that governs transfer of property by nonprofit).

191. *See* Pub. L. No. 109-8, § 1221(d), 119 Stat. at 196.

192. However, notwithstanding BAPCPA's broad language subjecting all transfers of property to non-bankruptcy law restrictions, difficult questions may arise when applying the rule to transfers sought by creditors without the debtor's consent. In *In re Machne Menachem*, the bankruptcy court held that the applicable restrictions on transfer in the New York Not-for-Profit Law applied only to voluntary transfers of assets by a nonprofit debtor and were therefore not contemplated by Section 1129(a)(16) in the context of a creditor-proposed plan. *See In re* Machne Menachem, Inc., 371 B.R. 63, 68 (Bankr. M.D. Pa. 2006). A creditor had proposed a plan of reorganization involving a transfer of assets to a third party to which the debtor objected. *See id.* at 65. The applicable New York law required approval of two-thirds of the board of directors of the nonprofit corporation for any "sale, lease, exchange or other disposition of all or substantially all, of the assets of a [not-for-profit] corporation." *See id.* at 68 (internal quotation marks omitted) (quoting N.Y. NOT-FOR-PROFIT CORP. LAW § 510 (McKinney 2006)). The court reasoned that "to read the phrase 'other disposition' as encompassing involuntary transfers of corporate property . . . . would lead to an absurd result . . . . [because] creditors could not foreclose on a not-for-profit's property" without first obtaining approval from the debtor's own board of directors. *See id.* While the decision rested on an interpretation of the specific state law restriction, rather than of Section 1129(a)(16), the court's strict reading of the state law suggests that the provisions introduced by the BAPCPA may not always protect nonprofit public policy considerations in the case of creditor-driven dispositions of property.

c. Overall Effect of Nonprofit Bankruptcy Regime

In their unique treatment under the Bankruptcy Code, nonprofits are subject to a bankruptcy regime that clearly rejects creditor wealth maximization as its sole objective. Law and economics scholars often focus on the optimality under various scenarios of collecting debts through bankruptcy versus outside of bankruptcy and of preserving a firm as a reorganized going concern versus liquidating its assets.[193] By placing the decision-making as to both outcomes entirely with the nonprofit debtor, the nonprofit bankruptcy regime favors the protection and continuation of insolvent nonprofits over economic efficiency. Similarly, the deference to mission-related considerations in the context of the disposition of nonprofit property, as codified by BAPCPA, subordinates the interests of a nonprofit's creditors to the interests of its constituents under state law in ensuring its property is applied for charitable purposes. Together, these provisions comprise a regime that values the rehabilitation and preservation of financially distressed nonprofit firms over efficient debt collection.

2. *Railroads in Bankruptcy*

a. Railroad Bankruptcies Prior to the Bankruptcy Reform Act of 1978

Railroads have long received singular treatment under bankruptcy law, reflecting a public policy goal of protecting the public interest when a railroad business fails.[194] Prior to 1933, railroad bankruptcies were brought as equity receiverships, which involved foreclosing and selling a railroad debtor's property to a new company formed for that sole purpose and generally consisting of the railroad debtor's secured creditors.[195] This process was heavily criticized on a number of accounts, although it did have the overarching benefit that "the equity receivership procedure [generally] did not interfere with railroad service to the public."[196] In 1933, bankruptcy relief was first made available to railroads pursuant to

193. *See* Lubben, *supra* note 153, at 287, 291–92 (observing many law and economics bankruptcy frameworks "ultimately boil down to proposals to liquidate the debtor" on basis of higher efficiency and critiquing theories as reflecting incomplete "understanding of Chapter 11" in practice). For further discussion of law and economics scholars focus on the optimality under various scenarios of collecting debts through bankruptcy versus outside of bankruptcy, see *supra* note 101 and accompanying text.

194. *See, e.g.*, Barton v. Barbour, 104 U.S. 126, 135 (1881) ("[T]he cessation of [a railroad's] business for a day would be a [public] injury. A railroad is authorized to be constructed more for the public good to be subserved, than for private gain . . . . It is, therefore, a matter of public right by which the courts, when they take possession of the property, authorize the receiver or other officer in whose charge it is placed to carry on in the usual way those active operations for which it was designed and constructed, so that the public may not suffer detriment by the non-user of the franchises.").

195. *See* Charles Jordon Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 21–22 (1995).

196. *See* Julie A. Veach, Note, *On Considering the Public Interest in Bankruptcy: Looking to the Railroads for Answers*, 72 IND. L.J. 1211, 1216 (1997).

Section 77 of the former Bankruptcy Act. Congress insisted that the law provide for the protection of the public interest in railroad reorganizations, and it did so by making the Interstate Commerce Commission (ICC) the arbiter of the public interest in this respect.[197] Any reorganization plan was subject to the approval of the ICC, which was required to consider the compatibility of the plan with the public interest, among other factors. The "singular treatment accorded railroads in the Act" reflected their "central role [ ] in the nation's economy" and their role as the primary means of long-distance transportation.[198] In particular, "[b]ecause one railroad's track was linked to that of another railroad," the failure of a single railroad could have a nationwide "ripple effect."[199]

In applying Section 77, courts consistently recognized the importance of promoting the public interest, with an evolving view on how to balance that goal with the interests of creditors. In the 1940s, courts held that, "regardless of the interests of creditors," rail service must "be continued for the benefit of the public."[200] In the following decades, courts "took a more moderate position."[201] In the *New Haven Inclusion Cases*,[202] the Supreme Court summarized the "two basis objectives" of Section 77 as "the conservation of the debtor's assets for the benefit of creditors and the preservation of an ongoing railroad in the public interest."[203] The case involved the proposed inclusion of the New Haven Railroad, a long-struggling railroad in a Section 77 reorganization proceeding, in "the merger of the Pennsylvania and New York Central railroads."[204] As a condition to the merger, the ICC required that the merging entities purchase the New Haven railroad so as to sustain its operations, finding that a termination of service would lead to significant distress in the region.[205] Its creditors argued that the erosion of the debtor's estate due to its continued operation in the lengthy reorganization proceeding constituted an unconstitutional taking of their property.[206] The Supreme Court disagreed, holding that the creditors "invested their capital in a public utility that does owe an obligation to the public," and that "[by] their entry into a railroad enterprise, [the security holders] assumed the risk that in any depression or any reorganization the interests of the public would be considered as well as

197. The ICC was a federal regulatory commission with oversight authority over railroads. *See* Arthur Donovan, *Intermodal Transportation in Historical Perspective*, 27 TRANSP. L.J. 317, 330 (2000). It was replaced by the Surface Transportation Board in 1995. *See id.* at 343.

198. *See* 6 NORTON BANKR. L. & PRAC. 3d § 117:2.

199. *See* GROSS, *supra* note 125, at 219.

200. *See* Veach, *supra* note 196, at 1219 (discussing cases).

201. *See id.*

202. 399 U.S. 392 (1970).

203. *See* New Haven Inclusion Cases, 399 U.S. 392, 398 (1970); Veach, *supra* note 196, at 1219.

204. *See New Haven Inclusion Cases*, 399 U.S. at 398.

205. *See id.* at 406.

206. *See id.* at 490.

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theirs."[207] Thus, the application of Section 77 came to embody a balancing of the public interest with the interest of creditors, with courts recognizing the *ex ante* implications of such approach.[208]

b. Railroad Bankruptcies After the Bankruptcy Reform Act of 1978

With the overhaul of the bankruptcy law system effected by the Bankruptcy Reform Act of 1978, Section 77 was replaced by Subchapter IV of Chapter 11 of the Bankruptcy Code.[209] The new regime maintained the emphasis on recognizing the public interest in railroad reorganizations, but it differed from its predecessor in several important respects. Most critically, it permitted liquidation of railroads, which was not available under Section 77, and it generally took the authority to enforce the public interest from the ICC and placed it in the hands of the court and the bankruptcy trustee.[210] The court, and the trustee in certain situations, is tasked with weighing the public interest[211] in railroad reorganization decisions in four discrete sections of Subchapter IV: § 1165, requiring that "the court and the trustee shall consider the public interest in addition to the interests of the debtor, creditors, and equity security holders" in applying other sections regarding railroad reorganizations; § 1169, requiring that the court order the trustee to continue operation of a railroad line subject to a rejected lease if operation by the lessor is "contrary to the public interest;" § 1170, providing that "[t]he court . . . may authorize the abandonment of . . . a railroad line if such abandonment is" among other criteria, "consistent with the public interest;" and § 1173, providing that the court will confirm a plan if, among other criteria, it is "consistent with the public interest" and, if more than one plan meets all the applicable criteria, requiring the court to confirm the plan that is "most likely to maintain adequate rail service in the public interest."[212]

The public interest provisions relating to railroad reorganizations provide a compelling counterpoint to critiques of stakeholder-centric reform proposals. The concept of bankruptcy law taking into account the public interest is not a radical notion—at least in the particular arena of railroad reorganizations, the law already expressly does so, and it has done so for some time. The long history of railroad reorganization cases con-

207. *See id.* at 491–92 (quoting Reconstruction Fin. Corp. v. Denver & R.G.W.R. Co., 328 U.S. 495, 535–36 (1946)).

208. *See id.* at 506 (noting that "the Commission struck a balance between public and private interests").

209. *See* 11 U.S.C. §§ 1161–1174 (2012).

210. *See* Veach, *supra* note 196, at 1222. Trustees are required to be appointed in all railroad reorganization cases. *See* 11 U.S.C. § 1163. The ICC, later succeeded by the Surface Transportation Board, and other agencies retain the right to appear and be heard in a railroad reorganization but have no right to appeal. *See id.* § 1164.

211. For a discussion of the meaning of "public interest" in the context of railroad bankruptcies, see Veach, *supra* note 196, at 1214.

212. *See* 11 U.S.C. §§ 1165, 1169(b), 1170(a)(2), 1173(a)(4), 1173(a)–(b).

firms that bankruptcy courts are capable of balancing various interests that extend beyond those of a debtor and its creditors. The applicability of these provisions is obviously limited, and it could be maintained that it is far easier to factor in a narrow conception of the public interest with respect to the potential discontinuation of a railroad line than a general notion of the public interest writ-large, or other stakeholders' interests, in non-railroad contexts.[213] However, as argued by Karen Gross, if the public interests associated with railroads are important enough to demand attention, then why not the public interests associated with more modern forms of transportation that affect communities, and then why not other types of organizations that affect communities in different but equally important ways?[214] While limited, the railroad reorganization provisions are nevertheless an encouraging basis on which a more broadly applied recognition of stakeholder rights could be built.

B. *A Proposed Bankruptcy Regime for Benefit Corporations*

Drawing from the examples of the Bankruptcy Code's unique treatment of nonprofits and railroads, this Section proposes a specific bankruptcy regime for benefit corporations. First, it will analyze the theoretical justifications and challenges of applying the unique bankruptcy rules relating to nonprofits and railroads to benefit corporations. Then, it will propose specific changes to the Bankruptcy Code and benefit corporation statutes and analyze how such changes would apply to different social enterprise forms.

1. *Applicability of Nonprofit and Railroad Bankruptcy Regimes to Benefit Corporations*

a. Applicability of Nonprofit Bankruptcy Regime

The bankruptcy law of nonprofits is a natural starting place in crafting a bankruptcy law of benefit corporations. Given the hybrid nature of benefit corporations, their treatment should arguably fall somewhere on the spectrum between the treatment of nonprofits and the treatment of for-profits.[215] The key distinctions between nonprofit and for-profit bankruptcy rules can be grouped into two categories. The first, the rules that exempt nonprofits from the prospect of involuntary bankruptcies or involuntary conversions from a reorganization to a liquidation proceeding, will be referred to as the "Involuntary Proceeding Exemption." The second, the rules that subject transfers of property of a nonprofit debtor to applicable restrictions under state or other law, will be referred to as the "Non-Bankruptcy Law Disposition Provisions."

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213. See *infra* Section V.B.1.c for further discussion of the challenges of applying the railroad approach to benefit corporations.

214. *See* GROSS, *supra* note 125, at 220–21.

215. *See supra* note 168 and accompanying text.

Application of the Involuntary Proceeding Exemption to benefit corporations risks encouraging the abuse of the benefit corporation form. A key distinction between a for-profit, including a benefit corporation, on the one hand, and a nonprofit, on the other hand, is that "[a] nonprofit . . . is prohibited from net earnings" to shareholders or other private owners, a feature referred to in academic literature as the "nondistribution constraint."[216] In addition, nonprofits are subject to additional reporting requirements and a host of other restrictions that are not applicable to most for-profit organizations. Yet nonprofits also enjoy significant benefits, including exemption by application from income and other taxes, the ability to receive donations that are tax-deductible for their donors in certain cases, and the Involuntary Proceeding Exemption.[217] If these benefits were available to for-profits, founders of an organization may be unlikely to choose the nonprofit form and the additional restrictions that come with it. A few academics and practitioners have called for the tax benefits applicable to nonprofits to be extended to hybrid social enterprise forms.[218] Others have persuasively argued against this proposal, in part on the basis that the flexibility of social enterprise forms would cause "difficulty in ensuring that [such entities] in fact provide meaningful public benefit" as compared to nonprofits.[219] Social enterprise forms are therefore far more susceptible to being taken advantage of by opportunists who wish to "take the tax benefits and leave the public benefit behind."[220] Similar risks apply to extending the Involuntary Proceeding Exemption to benefit corporations. An entrepreneur

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216. *See* Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 56–57 (1981). The term "nondistribution constraint" is an academic term that broadly describes certain restrictions applicable to organizations that are tax exempt under § 501(c)(3) of the Internal Revenue Code. For simplicity, the use of the term "nonprofit" in this section refers to a firm organized as a nonprofit that is also exempt from federal taxation under § 501(c)(3). As noted in Section V.A.1.a, the term used by the Bankruptcy Code does not correspond precisely to this definition, but for purposes hereof is assumed to refer to an organization that is subject to the nondistribution constraint.

217. For a description of the advantages enjoyed by nonprofits, see Anup Malani & Eric A. Posner, *The Case for for-Profit Charities*, 93 VA. L. REV. 2017, 2026 & n.22 (2007).

218. *See, e.g.*, *id.*, at 2022 (advocating "decoupling" of tax exemption from nonprofit form); Bob Solomon, *The Fall (and Rise?) of Community Banking: The Continued Importance of Local Institutions*, 2 U.C. IRVINE L. REV. 945, 979 (2012) (arguing nonperforming investments in community development financial institutions should be tax deductible); Thomas J. Billitteri, *Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach*, ASPEN INST. 6 (Jan. 2007), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf [https://perma.cc/C537-KUK7] (reporting on Aspen Institute-convened conference where "many participants . . . . advocated such steps as changing the federal tax code to accommodate new kinds of social enterprise vehicles").

219. *See* Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387, 436–38 (2014).

220. *See id.* at 438.

could choose the benefit corporation form to take advantage of ancillary benefits like the Involuntary Proceeding Exemption if such benefits increased the prospects of pecuniary gain enough to offset any decrease in pecuniary gain stemming from stakeholder-benefitting provisions. However, it is difficult to imagine the same with respect to the nonprofit form, given the nondistribution constraint and other trade-offs associated with nonprofit regulation.

The same concern does not hold for extending the Non-Bankruptcy Law Disposition Provisions to benefit corporations. An application of this concept to benefit corporations would result in respecting state law restrictions on transfers of the firm's assets occurring outside of bankruptcy inside of bankruptcy. In other words, if state law requires that the ownership of a benefit corporation or its assets cannot be transferred to a new party without considering the impact of such transfer on various stakeholders, then the same would be true in a bankruptcy proceeding. Such a rule is consistent with the purpose of a benefit corporation. As discussed in Section III.B, an investor who cares about the impact of a corporation's actions on stakeholders outside of bankruptcy should care about it in the context of bankruptcy, as well. The rule would not be an ancillary benefit of choosing the public interest and stakeholder provisions embodied by the benefit corporation form. Rather, it would be an *extension* of these provisions. It is difficult to imagine any profiteering to be had by the extension of such provisions into bankruptcy. If anything, it would decrease the prospect of returns for equity holders by reducing recoveries for creditors and thereby decreasing the likelihood of any surplus value remaining for equity.

b. Applicability of Railroad Bankruptcy Regime

The public interest mandates of the Bankruptcy Code's railroad reorganization provisions provide an instructive model for crafting benefit corporation bankruptcy rules that depart from the nonprofit model. The Non-Bankruptcy Law Disposition Provisions, by ensuring that nonprofit transfers in bankruptcy take into account state law public interest considerations, effectively give influence to state attorney generals authorized to regulate charitable organizations on behalf of the general public.[221] Railroad bankruptcy laws used to bestow the ICC with the authority to speak for the public interest. That role has since been passed to the bankruptcy court, which is tasked with determining and weighing the public interest in railroad reorganization decisions.[222] Benefit corporations, unlike charitable nonprofits, are not subject to regulation by a governmental agency that speaks for the public interest or the interests of particular, identified stakeholders. The current railroad reorganization approach of assigning

221. *See supra* notes 190–92 and accompanying text.

222. The trustee in a railroad reorganization, as the representative of the debtor's estate, is also tasked with this role. *See supra* Section V.A.2.b.

that role to the bankruptcy court offers a useful alternative where there is no obvious third party to be assigned with such a role.

c. Challenges of Applying Nonprofit and Railroad Bankruptcy Regimes to Benefit Corporation

In considering the applicability of the nonprofit and railroad bankruptcy approaches, a key distinguishing factor for benefit corporations is the relative weakness of their accountability mechanisms and the open-ended nature of the stakeholder interests protected under benefit corporation statutes. Nonprofits are subject to robust regulatory regimes designed "to ensure that they in fact pursue public benefit."[223] Railroads are not subject to similar accountability mechanisms, but, by their very nature, provide a service that courts have long viewed as vital to the public interest.[224] To the extent that public interests are given special consideration in the bankruptcy of a nonprofit or a railroad, there is a strong basis for presuming that those same interests were served by the debtor prior to bankruptcy—whether due to the strict accountability mechanisms of the nonprofit regulatory regime or due to the nature of the services that railroads provide.

Benefit corporations, on the other hand, are subject to weak accountability mechanisms. In the absence of any direct regulatory oversight, the principal means of accountability under the MBCL are reporting requirements as to a benefit corporation's social and environmental performance and the availability of derivative "benefit enforcement proceedings."[225] However, the required reporting is neither standardized nor tied to any particular benchmark, and unless otherwise elected in a charter, benefit enforcement proceedings cannot be brought by non-stockholder stakeholders, leaving such stakeholders with, at best, non-legal means of holding benefit corporations accountable.[226] Further, the public interests

223. *See* Mayer & Ganahl, *supra* note 219, at 392, 433 ("Various, primarily federal, tax rules—e.g., UBIT, penalties for excess benefit transactions, and the threat of the loss of exemption—as well as the supervisory role usually given to state attorneys general, grant authority to public representatives to keep charities faithful in their service of public interests." (citing John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 150–51 (2010))).

224. *See supra* note 194 and accompanying text.

225. *See* MODEL BENEFIT CORP. LEGISLATION §§ 102, 305 (B LAB 2016).

226. For an in-depth discussion of the challenges of accountability for benefit corporations, see Alicia E. Plerhoples, *New Directions in Community Lawyering, Social Entrepreneurship, and Dispute Resolution: Social Enterprise as Commitment: A Roadmap*, 48 WASH. U. J.L. & POL'Y 89, 134 (2015) ("Because non-stockholder stakeholders cannot bring a derivate suit against a hybrid corporation, they lack direct accountability . . . Indirect accountability is the ability to influence or shape the corporation's action or behavior through less formal means and is derived from non-legal sources such as public shaming or negative publicity from media and third-party watchdogs . . . ."); *see also* Mayer & Ganahl, *supra* note 219, at 432–36 ("[C]urrent hybrid statutes do not address the issue of how charitable is charitable enough, nor does it appear desirable for them to do so.").

purported to be served by benefit corporations are significantly broader than the public interest referred to in the context of railroads and may have no obvious connection to the benefit corporation's line of business.[227] An indiscriminate application of the nonprofit or railroad bankruptcy approach to benefit corporations therefore risks allocating more value to the stakeholder interests associated with the benefit corporation form than is warranted by a debtor's actual pre-bankruptcy behavior.

2. *Proposed Changes to Existing Law*

a. Proposed Changes to the Bankruptcy Code

As in the case of nonprofits, bankruptcy law should respect state law considerations as to the disposition of the property and ownership of benefit corporations. However, taking the same approach as the Non-Bankruptcy Law Disposition Provisions applicable to nonprofit property transfers would not be entirely effective. Unlike the law of nonprofits in most states, benefit corporation statutes do not subject transfers to objective limitations or the approval of a third party arbiter. Rather, benefit corporation statutes regulate transfers indirectly through the mandate for directors to consider stakeholder interests in making *all* decisions and directly, at least with respect to transfers of substantially all assets, through a requirement for approval by a two-thirds majority of the shareholders. As a result, a provision simply stating that transfers of property in bankruptcy must be made in accordance with non-bankruptcy law risks being both too narrow and too broad: too narrow in that stakeholder considerations would be recognized only in situations where the directors of the debtor remain involved in decision-making, and too broad in that the two-thirds shareholder vote would arguably be required in *all* situations, even for plans proposed by a creditor that would not otherwise need to be consented to by the debtor.[228]

Instead, the Bankruptcy Code should recognize the stakeholder considerations embedded in benefit corporation statutes by expressly requiring both the debtor or trustee *and* the court to take such interests into account.[229] This mirrors the railroad approach. Rather than establishing a single standard of considering the public interest, however, it would recognize that benefit corporations have heterogeneous standards for which

227. Under the MBCL, all benefit corporations are required to have a purpose of creating a "general public benefit," defined as "a material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation." *See* MODEL BENEFIT CORP. LEGISLATION §§ 102, 201(a). The MBCL also permits specific public benefits as purposes which are in addition to the "general public benefit" purpose. *See id.* § 201(b).

228. This would leave out any plan of confirmation proposed by a creditor and not consented to by the debtor, as well as any proceedings where a trustee is appointed to manage a debtor's estate.

229. This approach would depend on whether the debtor's estate is managed by the debtor-in-possession or by an appointed trustee.

stakeholder interests are represented. The bankruptcy court would have to consider applicable state legislation and the charter of a given benefit corporation, and it would defer to those standards however they may be articulated on a case-by-case basis. Following the language of § 1165 regarding railroads, this could be accomplished with a provision stating that in a case involving a benefit corporation, unless otherwise expressly provided in the benefit corporation's charter,[230] the court and the trustee or debtor shall consider "Stakeholder Interests" in addition to the interests of the debtor, creditors, and equity security holders when applying the sections of the Bankruptcy Code regarding reorganization, sales of assets, and conversion of a Chapter 11 case to a Chapter 7 case.[231] Stakeholder Interests would be defined as all interests that a director of a benefit corporation is required to consider in discharging his or her duties pursuant to state law and the benefit corporation's charter documents.[232]

230. Such a qualification is necessary for the rule to operate as a default rule.

231. *See* 11 U.S.C. §§ 363, 1112, 1129 (2012).

232. While the rule proposed in this Section accounts for non-creditor interests in a manner that may reduce creditor returns, it does not follow that such a rule is inconsistent with the absolute priority rule, which prohibits holders of any junior "claim or interest" from receiving payment under a plan of reorganization until all higher-ranking classes are repaid in full. *See* 11 U.S.C. § 1129(b)(2)(B). "Interest" in this context is generally understood to mean "equity interest." *See, e.g.*, *In re* Wabash Valley Power Ass'n, Inc. (*Wabash II*), 72 F.3d 1305, 1313 (7th Cir. 1995) (citing 11 U.S.C. § 1129(b)). In nonprofit bankruptcies, courts have grappled with how the rule may apply to plans that would allow directors, managers, or members to retain control of the debtor or "which appear to allocate going concern value of the nonprofit to pre-petition interest holders or the nonprofit itself." *See* Pamela Foohey, *Chapter 11 Reorganization and the Fair and Equitable Standard: How the Absolute Priority Rule Applies to All Nonprofit Entities*, 86 ST. JOHN'S L. REV. 31, 36 (2012). Generally, courts have found the absolute priority rule to be "inapplicable to nonprofits" on the basis that they typically "do not have 'owners' who hold 'equity interests[,]'" with "a fact-specific analysis" where a party retains an interest resembling equity. *See id.* at 37. Similarly, in the context of railroad bankruptcies, the public interest protected by the railroad reorganization provisions clearly is not comparable to an equity interest. The promotion of such public interest and adherence to the absolute priority rule are implicitly compatible goals under the Bankruptcy Code because confirmation of any railroad plan of reorganization requires both that the plan be consistent with the public interest and that it comply with the entirety of 11 U.S.C. § 1129. *See* 11 U.S.C. § 1173(a)(1) (2012). Under the rule proposed in this Section, the holders of Stakeholder Interests do not resemble equity holders nor do they hold claims against a debtor's estate entitled to payment. The requirement of taking into account Stakeholder Interests, similar to the requirement to take into account the public interest in railroad bankruptcies, potentially results in outcomes that benefit such interests at the expense of lower overall returns for creditors. But the rule does not require that the property of the estate actually be distributed to the holders of such interests, and in fact, such interests may not even have identifiable holders in the case of interests like the environment and community and societal factors. Once a plan, asset sale, or similar event is approved, duly taking into account its effects on such interests, the claims of creditors would remain the first claims entitled to payment from a distribution of property of the estate.

Finally, in order to account for the weak accountability mechanisms of benefit corporation statutes and the open-ended nature of the public benefits they espouse, such language should be qualified so as to recognize the degree to which a benefit corporation's Stakeholder Interests were actually served prior to filing for bankruptcy. For example, the MBCL requires directors of any benefit corporation to consider the effects of actions on "the local and global environment."[233] However, there may be wide discrepancies in the extent to which benefit corporations actually devote resources to doing so. Ideally, the legal standard would not give the same weight to environmental considerations in the case of, on the one hand, a company that exhibited a long and proven commitment to environmentally sound business practices prior to bankruptcy and, on the other hand, a company that elected the benefit corporation form for entirely different reasons and showed little interest in environmental considerations in practice. A solution would be to tie the weighing of stakeholder interests to corporate behavior exhibited prior to filing. Although imperfect, the third-party annual benefit reports required under the MBCL provide a readily available proxy.[234] The language proposed above requiring that the court and the trustee or debtor consider Stakeholder Interests could therefore be qualified with language providing that those interests must be observed only to the extent that they were observed by the debtor prior to the filing of the petition, as evidenced by the debtor's statutorily-required third party reports.

b. Proposed Changes to Benefit Corporation Statutes

Even with the above changes to the Bankruptcy Code, a benefit corporation director's duties as they are expressed by existing benefit corporation statutes would still conflict with its duties as they are understood in the context of a bankruptcy. As noted in Section III.A, benefit corporation statutes exclude creditors from the list of stakeholders whose interests must be considered by directors. Thus, a director of a bankrupt benefit corporation would still face the dilemma of navigating two legal standards that, taken at face value, appear to be in conflict: a bankruptcy regime that requires considering non-stakeholder interests along with the interests of creditors, and a state law regime that requires considering the interests of a defined group of stakeholders excluding creditors. Therefore, as suggested by Schildhorn and Keilson, benefit corporation statutes should in-

233. *See* MODEL BENEFIT CORP. LEGISLATION § 301(a)(1)(v) (B LAB 2016).

234. As discussed in the text accompanying notes 225–27, the reporting requirements of the MBCL are a weak mechanism for accountability due to the lack of standardization or common benchmark and the inability of non-shareholder stakeholders to directly hold benefit corporations accountable for deficiencies cited in such reports. But while insufficient as a means of accountability, such reports could nevertheless provide a useful evidentiary record of all of a benefit corporation's pre-bankruptcy efforts regarding social and environmental performance, including by indicating any focus on a particular subset of stakeholders.

clude a provision to the effect that upon insolvency, creditors are included in the list of parties whose interests must be taken into account by a benefit corporation and its directors.[235] Even without such an amendment a court could potentially reach the same conclusion and hold that creditors of an insolvent corporation surely must be considered stakeholders even if not called out by statute. Such a change, however, would eliminate ambiguity and potential liability concerns by clearly harmonizing the two standards.[236]

c. Applying Proposed Regime to Different Social Enterprise Legal Forms

As discussed in Section II.D, benefit corporation statutes and related social enterprise statutes are not uniform. The stakeholder interests that a bankruptcy court would be required to consider pursuant to the regime proposed above could vary significantly in degree of specificity based on the applicable statute and the applicable purposes that a social enterprise elects to adopt. A benefit corporation under the MBCL may choose to have as its purpose only the general public benefit (i.e., a material positive impact on society and the environment), with directors required to take into account the interests of a generically broad range of stakeholders.[237] In contrast, a public benefit corporation may choose to have only "a specific public benefit" as its purpose, for example to "[p]romote medical and health sciences education,"[238] with directors required to balance that specific interest against pecuniary interests "and the interests of those materially affected by the corporation's conduct."[239] A social purpose corporation could have one or more of a limited menu of broadly defined social purposes, with directors given discretion in weighing such purposes against other factors, including the best interests of the corporation and its shareholders.[240] Finally, a benefit corporation or a public benefit cor-

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235. Schildhorn and Keilson propose such a change to benefit corporation statutes as a way of resolving the conflict with traditionally understood fiduciary duties of directors of insolvent corporations. *See* Schildhorn & Keilson, *supra* note 73, at 86. However, they do not propose an accompanying change to the Bankruptcy Code. *See id.* This leaves open the question of how a bankruptcy court would apply such a provision in administering cases and whether it would actually require a court to balance the same non-creditor and creditor interests.

236. Hypothetically, as an alternative, the Bankruptcy Code standard could simply mirror the standard contained in existing benefit corporation statutes, thereby not recognizing the interests of creditors at all. However, this would lead to a nonsensical result in the application of bankruptcy law.

237. *See* MODEL BENEFIT CORP. Legislation § 201 (B LAB 2016).

238. *See* Alicia E. Plerhoples, *Delaware Public Benefit Corporations 90 Days out: Who's Opting In?*, 14 U.C. DAVIS BUS. L.J. 247, 254, 271 n.122 (2014) (citing Amended and Restated Certificate of Incorporation of Arist Medical Sciences University, Inc., filed with State of Del., Sec'y of State (Aug. 12, 2013, 1:01 PM)).

239. *See id.* at 256; *see also* DEL. CODE ANN. tit. 8, § 362 (West 2016).

240. *See, e.g.*, CAL. CORP. CODE § 2700(c) (West 2016).

poration may choose to adopt both a broad general public benefit and a specific public benefit.[241]

The different social enterprise models present different challenges to the success of a social enterprise bankruptcy regime. Specific public benefits require bankruptcy courts to weigh entirely distinct types of interests against creditor wealth maximization on a case-by-case basis. For example, a corporation with a stated purpose of providing living wages in a low-income community and a corporation with a stated purpose of bettering the environment by selling biodegradable footwear present significantly distinct considerations for a court weighing public benefit considerations against creditor wealth maximization. By contrast, a court applying the railroad reorganization provisions has the benefit of precedents that examined a single issue: how to weigh the public interest associated with maintaining railroad service against creditor wealth maximization. This presents courts with a challenge, but it is not an unprecedented one. Charitable nonprofits can have a wide range of specific purposes that fall within broader categories of permitted purposes. Under the BAPCPA, courts are required to respect state law restrictions that promote preservation of those purposes, which could lead to significantly different considerations for different nonprofits.

A benefit corporation with a purpose only of promoting the general public benefit presents a different challenge in that its purpose is so broad and its stakeholders so diffuse that it may be difficult to weigh their interests against the interests of creditors tangibly. Critics have argued that the MBCL's general public benefit provision and mandate to take into account the interests of a broad range of stakeholders are too vague, leaving directors with little practical guidance as to how to prioritize the "interests of various constituencies" and potentially inhibiting their ability to pursue legitimate specific social objectives. In the absence of more specific guidance, directors may simply fall back on prioritizing shareholder wealth maximization.[242] Similar issues could apply in a bankruptcy proceeding. For example, in assessing competing plans of reorganization for a benefit corporation having only a general public benefit purpose, how should a court compare a plan that is better for employees to a plan that is better for customers, when both groups are statutorily enumerated stakeholders? Facing such questions, a court would more likely default to creditor wealth maximization when the countervailing stakeholder interests are broad and vague rather than specifically defined. These challenges could be mitigated, however, by the rule proposed above that stakeholder interests should be observed in bankruptcy only to the extent they were actually observed pre-bankruptcy.

241. *See supra* notes 60–61 and accompanying text.

242. *See, e.g.*, Murray, *supra* note 1, at 29–33; *see also* Callison, *supra* note 155, at 107–09.

As long as there is heterogeneity in social enterprise forms, as well as flexibility under given forms to pursue a range of social objectives and pursue such objectives with varying degrees of commitment, there will inevitably be heterogeneity in the application of a social enterprise bankruptcy regime. The flexibility of the public benefit corporation and social purpose corporation statutory approach and the breadth of the MBCL statutory approach present distinct challenges that would likely result in significantly different applications of the standard proposed herein. Nevertheless, for all forms, the bankruptcy regime proposed in this Article is more likely to produce outcomes that are aligned with the considerations driving social enterprise legislation than a regime that ignores those considerations altogether.

C. *Efficiency of Benefit Corporation Bankruptcy Proposal*

1. *Simplified Law and Economics Model of Bankruptcy*

The unique bankruptcy treatment of benefit corporations proposed herein presents a lower expected value of return for creditors in bankruptcy. It may not always result in different outcomes from those of a traditional bankruptcy system, but when it does, the outcomes will take into account non-creditor interests to a greater extent and, therefore, provide lower returns to creditors. In a straightforward law and economics view of bankruptcy, such a system should be expected to have the ex ante effect of decreasing overall economic efficiency. Lenders would demand a higher rate of interest to compensate for their lower expected return in a downside scenario, and consequently, benefit corporations would face a higher cost of debt capital.[243] As a result, benefit corporations would be required to devote resources to servicing debt that may be more profitably used elsewhere. Ultimately, this results in decreased productive economic activity and, therefore, lower overall social wealth.[244]

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243. However, creditor demand for socially responsible debt investments may mute or even eliminate this effect. Regardless of whether the motivation is genuinely "doing good" or the superficial positive public relations effects associated with what is perceived to be responsible lending, there is a real demand for debt investments seen as socially responsible. Fixed income constitutes a growing portion of the "sustainable investing" market, a market that "[b]y one estimate" comprised of "$21.4 trillion of global assets under management . . . in 2014." *See* J.P. MORGAN PRIVATE BANK, DECODING THE ELEMENTS OF SUSTAINABLE INVESTING, https://am.jpmorgan.com/blob-pbstudio/1383335319956/83456/sustainable-investing-2016.pdf [https://perma.cc/F3E4-ZXB9] (last visited Feb. 22, 2017). For the same reasons that certain equity investors are willing to trade off some degree of shareholder wealth maximization in exchange for in-kind returns associated with investing in a benefit corporation, there are likely creditors willing to trade off some degree of expected financial return in exchange for in-kind returns associated with lending to a benefit corporation. This dynamic may not fully offset the countervailing lower expected financial return, but it may mitigate the increase in debt costs that would otherwise be expected under the proposed regime.

244. *See, e.g.*, Schwartz, *supra* note 106, at 1814 ("To summarize, in the economic view, the ultimate object of bankruptcy law is to help maximize social

2. *Benefit Corporations as Instruments for Efficiently Addressing Externalities*

This analysis changes if the benefit corporation form is viewed as a contract between directors and shareholders who wish to receive both a monetary return and an "in-kind" return associated with reducing the negative externalities, and increasing the positive externalities, of the firm's behavior. This view is illustrated by a hypothetical comparing the decision making of a firm that is purely profit-maximizing to that of a firm that chooses non-profit-maximizing outcomes due to societal considerations under certain circumstances.

Suppose a manufacturing firm has the option of producing its sole product using two alternative methods. The annual operating expenses associated with Method A equal $100, the annual operating expenses associated with Method B equal $200, and both methods produce the exact same product resulting in annual gross revenues of $400. Method A, however, results in environmental pollution with an annual societal cost of $600, while Method B does not. Suppose further that this pollution is not legally prohibited and does not otherwise affect the firm's operations because of negative publicity or other factors. If the firm is purely profit-maximizing, it will choose Method A, resulting in an annual net profit of $300 rather than $200. This result is a classic market failure. Because the firm is not legally or otherwise induced to internalize the cost of the negative externalities produced by its activity, it operates inefficiently when taking into account all costs of its behavior, decreasing overall societal wealth.

However, if the firm is not entirely profit-maximizing, but rather its equity investors are willing to realize less profit in exchange for producing positive societal effects or eliminating negative societal effects, the result *may* be different. Equity investors in a benefit corporation who expect its stakeholder provisions not to be completely superfluous—in other words, who expect that on some occasions the corporation may take actions that are not purely profit-maximizing on account of societal considerations—must be willing to forego some amount of profit in exchange for those societal considerations being taken into account. Otherwise, they would invest in purely profit-maximizing firms. Whatever their underlying motivation, investors are willing to pay some amount for the firm to decrease negative externalities and increase positive externalities on stakeholders. Adopting a property model in which a benefit corporation's stakeholder provisions exist to serve the partially non-profit-maximizing preferences of its shareholders and the benefit corporation's directors function as agents for the shareholders by taking into account those preferences, a benefit corporation is more likely to reach efficient outcomes than a profit-maximizing firm, as is illustrated by returning to the above hypothetical.[245]

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wealth. This object implies the instrumental goal of minimizing the cost of debt capital. This instrumental goal, in turn, is facilitated by maximizing the creditors' expected return when the firm is insolvent.").

245. *See* text accompanying *supra* notes 70–71.

Now suppose the aforementioned manufacturing firm is not purely profit-maximizing, but rather is a benefit corporation whose equity holders consider protection of the environment to be a societal interest for which they are potentially willing to forego a certain amount of shareholder wealth. Such shareholders will collectively be willing to pay, in the form of reduced profits, an annual amount equal to *G* for the firm to not engage in the environmentally harmful manufacturing method in question. If *G* is less than $100, the firm will choose Method A, as would a purely profit-maximizing firm. If *G* is above $100, the firm will choose Method B, the more efficient outcome from the perspective of overall societal wealth. Thus, assuming a world of perfect information in which investors do not pay more for an externality than the true societal cost or benefit of such externality, a firm with investors valuing societal externalities in addition to profit maximization will either produce the same outcome or a more efficient outcome than a firm that is purely profit-maximizing.[246]

3. *Benefit Corporations as Instruments for Efficiently Addressing Externalities in Bankruptcy*

This model of a benefit corporation's efficiency-maximizing behavior functions the same way in the context of the benefit corporation bankruptcy regime proposed in this Article. The lower expected value of return for creditors in such a regime is passed on to the benefit corporation in the form of a higher cost of debt financing. But it does not follow that this results in less overall efficiency. Under the system proposed in this Article, an investor in a benefit corporation who does not opt out of the stakeholder-friendly bankruptcy regime implicitly places a value on producing bankruptcy outcomes that are more stakeholder-friendly than those produced under a traditional regime. This investment implies that the regime's expected value to the investor is greater than the loss in shareholder wealth resulting from the higher cost of debt financing. If it were not, the investor would not choose to invest in a firm subject to such a regime. Assuming that the investor is not paying more for such a system than the true cost or benefit of the negative or positive externalities such a system would in fact address, such a system should result in outcomes that

246. If shareholders are willing to pay more to prevent a negative externality, or cause a positive externality, than the externality's true societal cost or benefit, an inefficient outcome could result. In the above hypothetical, if the true societal cost of the pollution is in fact $50 rather than $600, and *G* is $200, the firm will choose Method B, an overall less efficient outcome. Of course, in the real world of imperfect information, socially-minded investors may overstate the true societal value of externalities in certain circumstances. However, an inefficient outcome requires not just that the shareholders' evaluation of an externality exceeds its true value, but that the amount *they* are willing to pay to internalize it exceeds its true value. In a world of imperfect information, this is, of course, possible. However, an investor putting his or her own money on the line should be in as good a position as anyone not to overvalue an externality.

are either the same or more efficient from an overall societal wealth perspective than those of a traditional bankruptcy system.[247]

VI. CONCLUSION

Critics have persuasively argued that the aims of social enterprise legislation could be achieved through more traditional legal frameworks. Nevertheless, there is a large contingent of entrepreneurs and investors who wish to eschew the perceived norm of shareholder wealth maximization and pursue a socially conscious business model. The benefit corporation and other social enterprise forms serve as convenient platforms for them to do so.

But if the social enterprise legal movement is confined to qualifying a rule of corporate governance that may not need qualification in any event, it is a rather limited endeavor. If such entrepreneurs and investors truly wish to do business in a different way, they should widen the lens and begin to consider other aspects of what it means to be a genuinely social enterprise. Considering the implications of financial distress—a time when aspirational ideals of double and triple bottom lines clash with the hard realities of business failure and creditor claims—is an important step in that direction. Hopefully, this Article's proposals for a unique bankruptcy regime for benefit corporations contribute to a discussion of social enterprise that moves beyond the threshold corporate governance questions and explores the possibilities of just how different a "different way of doing business" can be.

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247. *See supra* note 246 and accompanying text.