

BEYOND TAXATION

A GUIDE TO SOCIAL ENTERPRISE VEHICLES

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"Social enterprise" is a hot topic these days, both inside and outside the exempt organization practitioner's world. The social enterprise literature is growing by leaps and bounds—a recent search for the phrase "social enterprise" turns up almost 2.5 million hits on Google. Yet uncertainty remains.

Background

One issue is definitional—just what is social enterprise? There have been many different responses,¹ for the simple reason that the answer is not simple at all. Different players advance different meanings. Depending on who is attempting to define the term, varying emphasis may be given, for example, to whether a social enterprise operates for private profit and, if so, to what degree.

To further complicate matters, the definition of "social enterprise" differs internationally. In the United States, the term broadly encompasses enterprises that seek to achieve their primary social or environmental missions using business methods (the definition adopted by the Social Enterprise Alliance, a sort of trade association for social entrepreneurs), while in continental Europe the phrase often has a narrower meaning, sometimes conditioned on the presence of specific attributes in the enterprise with less emphasis on its business aspects.² Faced with this state of affairs, one prominent practitioner and leading light in the field advises his audiences to stop arguing about how to define social enterprise, and just get on with doing it.³ Social enterprise is about change and innovation, which is usually messy, and while this makes most legal practitioners

uncomfortable it is a fact of life accepted by social entrepreneurs themselves.

Another significant segment of the legal literature on social enterprise examines various legal forms and funding sources available for conducting social enterprises, not only here in the U.S. but around the world.⁴ More so than in many areas of law, social enterprise is international in practice. Different national legal regimes—themselves in different stages of development—have responded more or less quickly and in a variety of ways to the challenge of creating new legal constructs for operating activities that are not quite business as usual, nor charity as usual, nor even social change as usual.

In the United Kingdom, social entrepreneurs may incorporate their enterprises as "community interest companies," a special form of entity similar to a normal limited company but tied to a social mission. They may soon have another option, the "social enterprise limited liability partnership" (SELLP), a proposed form of social-enterprise entity based on partnership law. Italy introduced a legal form of social cooperative in 1991 that has seen significant use. Belgium created the *société finalité sociale* ("social purpose company," or SFS), a statutory label for otherwise ordinary legal forms of enterprise that meet certain special criteria, including having a central social purpose and not being operated for shareholder profit. France offers the *société coopérative d'intérêt collectif* ("collective interest social cooperative," or SCIC), a form of cooperative society with multiple stakeholders (including its employees) and a social mission corresponding to local needs. Other countries, such as Finland, have established special registers of companies organized as social enterprises.

This journal has published a number of articles focusing on the roles and uses of specific

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EXHIBIT 1.

Comparing U.S. Legal Forms for Social Enterprise.

	<i>Business Corporation</i>	<i>LLC</i>	<i>Flexible Purpose/ Benefit Corporation</i>	<i>L3C</i>	<i>Charity (Nonprofit Corporation)</i>
Emerged	Sometime in the late Middle Ages	1985 in Wyoming	2010 in Maryland	2008 in Vermont	Sometime in the late Middle Ages
Availability	All 50 states	All 50 states	2 states by July 2011	7 states, 2 tribes	All 50 states
Purposes	For-profit only (may consider constituencies other than shareholders in some states)	For profit, subject visions in Operating Agreement	Dual purpose (social/profit)	No purpose for profit permitted (but profit on activities OK)	Charitable purpose only (but profit on exempt activities or unrelated business activities OK)
Equity	Shares	Member interests	Shares	Member interests	None
Tax on Profit (Rev>Exp)	Yes, at corporate level	Yes, at member level	Yes, at corporate level	Yes, at member level	No, except on unrelated business
Management and control	Board elected by shareholders	Per Operating Agreement	Board elected by shareholders	Per Operating Agreement	Board of directors, chosen by members, designators, or self-electing
Tax-Deductible Contributions	No	No	No	No	Yes
Foundation Grantors	Yes, with expenditure responsibility	Yes, with expenditure responsibility	Yes, with expenditure responsibility	Yes, with expenditure responsibility	Yes
Capital sources	Sell shares, debt	Sell membership interests, debt	Sell shares, debt	Sell membership interests, debt	Loans, tax-exempt bond financing
PRIs	Yes	Yes	Yes	Yes	Yes
Certifiable as B corporation	Yes, if formed in state w/constituency statute	Yes, w/provisions in Operating Agreement	Yes	Yes	No

forms of vehicles or investments in social enterprise, such as the low-profit limited liability company or the program-related investment, examining its advantages and disadvantages, addressing technical concerns, providing a detailed how-to guide, or giving examples of how it might be used in typical situations.⁵ The discussion below is broader, providing a map, from thirty thousand feet, of the landscape of social enterprise vehicles currently available in the U.S. The discussion is based on Exhibit 1 on page 38.

Each column in the chart represents a legal form (most already existing, but some still only a twinkle in a legislator's eye) frequently mentioned in the social enterprise sector literature.⁶ Each row presents a characteristic across which the chart compares the various vehicles. The selection of what characteristics are included is, admittedly, somewhat arbitrary. Characteristics made the cut if, in the author's experience, they are either especially useful for differentiating among vehicles, or seem to be the subject of misunderstandings or interesting debates.

The legal forms

The business corporation has been around for centuries. The limited liability company (LLC) has been around only for a few decades. Both, however, are entirely familiar to the readers of these pages.

In the far right column, "charity" is intended as shorthand for another ancient yet familiar form. Here it refers specifically to the form into which the charity has evolved in the U.S.—the Section 501(c)(3) organization, formed as a

nonprofit corporation⁷ and qualifying as a public charity rather than a private foundation.

The two newest forms, which are also the least widely available, bear further explanation.

L3C. The low-profit limited liability company, generally known by the confusing⁸ acronym L3C, is available or has been approved in seven states and two tribal areas as of this writing. Essentially, an L3C is an LLC (thus offering limited liability and pass-through tax treatment) that is required under the L3C statute to include additional requirements in its governing document. These requirements include significantly furthering charitable or educational purposes, having no significant purpose of producing income or the appreciation of property, and not being organized to accomplish any political or legislative purpose.

Once an LLC satisfies these requirements, it becomes an L3C, and as such it may have profit-making only as a secondary purpose. In other words, its social mission must come first. This reverses the default rule under LLC statutes, which usually apply traditional fiduciary duties, including the duty of care in avoiding waste and the duty of loyalty to investors above all other constituencies, absent provisions to the contrary in the LLC's operating agreement. By qualifying instead as an L3C (where that form is available) these concerns are avoided because the L3C statutory provisions within LLC statutes expressly contemplate and require a primary social purpose for the entity.

Protecting a social enterprise's managers from liability was not the primary goal of creating the L3C form, however. Even without L3C provisions, LLC laws, unlike corporation laws,

¹ See, for example, the extended discussion of the meaning of the alternate term "social entrepreneurship" in Martin and Osberg, "Social Entrepreneurship: The Case for Definition," *Stanford Social Innovation Review* (Spring 2007), page 29.

² See, for example, the extensive definition presented in Defourny and Nyssens, "Social Enterprise in Europe: Recent Trends and Developments," 4 *Social Enterprise Journal* 3 (2008), page 202 at 227-28 (2008). It includes criteria based on the nature of goods and services delivered, the number of paid workers, the identity of the people who launch the enterprise, and whether decision-making power is extended beyond capital owners. The different meanings given to the term "social enterprise" in the United States and in Europe are addressed at length in Kerlin, "Social Enterprise in the United States and Europe: Understanding and Learning from Our Differences," 17 *Voluntas* 247 (2006).

³ Venture philanthropist Jeb Emerson, in numerous public speeches, most recently in Hong Kong on 10/28/10.

⁴ See, e.g., Wexler, "Effective Social Enterprise—A Menu of Legal Structures," 63 *Exempt Org. Tax Rev.* 6 (June 2009) at 565; Kelley, "Law and Choice of Entity on the Social Enterprise Frontier," 84 *Tulane L. Rev.* 337 (December 2009) (discussing forms of U.S. legal entities available for social entrepreneurs); Defourny and Nyssens, *supra* note 2.

⁵ See, for example, Dana, "Structuring Separate and Subsidiary Entities for Private Operating Foundations," 22 *Exempts* 1 (Jul/Aug 2010), page 33; Chernoff, "L3Cs: Less Than Meets the Eye," 21 *Exempts* 6 (May/Jun 2010), page 3; Joseph, "Program-Related Investments and You—Perfect Together?" 21 *Exempts* 5 (Mar/Apr 2010), page 10; Joseph and Kosaras, "New Strategies for Leveraging Foundation Assets," 20 *Exempts* 1 (Jul/Aug 2008), page 22.

⁶ Co-operative organizations, or co-ops, have been mentioned among the panoply of social enterprise forms, but are not covered here because they come up only rarely, and would only be suitable candidates for conducting a social enterprise in a very narrow set of circumstances.

⁷ Charities also occur in trust form, and the chart will be accurate with respect to their tax characteristics. The management and control structures in charities formed as trusts, however, and the financing options available to them, differ from incorporated charities, and are beyond the scope of this overview.

⁸ "Confusing" because the author believes that every exempt organization law practitioner in the U.S. has, on countless occasions, corrected clients who refer to their organizations as "501-3-Cs."

typically give entrepreneurs great structural and governance flexibility, and are broad enough to permit the LLC to focus primarily on a charitable mission. L3Cs, rather, were designed to facilitate investment in social enterprise by private foundations, in the form of program-related investments, or PRIs.

PRI. PRIs are exceptions to the prohibition, found in Section 4944, on jeopardizing investments by private foundations.⁹ A debt or equity investment by a private foundation that does not generate returns (whether in the form of interest, dividends, or capital appreciation) high enough to justify the investment as prudent in light of the level of risk it represents (in the context of the foundation's overall portfolio), exposes the foundation, and the foundation managers who approved of the investment, to potential liability. If that investment, however, had as its primary purpose the accomplishment of charitable goals, had no significant purpose to produce income or appreciation, and had no purpose of legislative lobbying or participation in candidate elections, it will qualify as a PRI and thereby avoid having to meet a prudent investment standard. The L3C statutes are tailored specifically to impose these PRI requirements on L3Cs in their governing documents, at least as long as the entity retains its L3C status.

L3C promoters have asked the IRS to issue guidance that L3C investments are presumptively PRIs, but the IRS has declined to do so. One IRS official stated that "[a]t the federal level, no one has really signed off" on the use of the L3C for PRIs and the issue was still being studied.¹⁰ As a result, private foundations may not rely on the L3C status of the recipient to make an automatic determination that a partic-

ular investment qualifies as a PRI. So, while formation as an L3C would facilitate the due diligence needed by a private foundation (or its legal counsel) before it may safely make a PRI (or issue a legal opinion that a particular proposed investment qualifies as a PRI), it has not yet proven to be the easy solution to the complexities of making a proper PRI that its promoters may have hoped.¹¹

More troubling, some of the publicity surrounding the L3C form has exaggerated the difficulties of making PRIs to other forms of entity¹² or has even suggested that L3Cs automatically qualify for PRIs.¹³ The fact is that PRIs may be, and often have been, made in business corporations, access to PRI funding does not depend upon the legal form a social enterprise may choose, and a private foundation wishing to make a PRI to an L3C must go through the same due diligence as for a PRI to any other form of entity.¹⁴

Flexible purpose/benefit corporation. The very newest vehicle is found in the middle of the chart. It actually encompasses two different legal forms viewed by the author as virtually identical in certain essential ways. The benefit corporation exists (as of this writing) only in Maryland and Vermont;¹⁵ the flexible purpose corporation has been proposed and is expected to be adopted shortly in California.

The key characteristics of a benefit corporation, per its governing statute, are that it must create public benefit (and may designate specific public benefits to be created), and that creating such benefits is by definition in the corporation's best interests. The fiduciary duties of directors of benefit corporations are correspondingly adjusted to allow the directors to

⁹ See Joseph and Kosaras, *supra* note 5, for a more detailed explanation of PRIs.

¹⁰ See "The L3C Status," *Nonprofit Times* (9/1/09), available at www.nptimes.com/09sep/npt-090901-3.html.

¹¹ See Chernoff, *supra* note 5, for a general debunking of the various incorrect statements that have been made about the L3C form.

¹² For example, L3C Advisors, itself an L3C that was launched to promote the form, explained at one point that an L3C was "a perfect vessel for PRI investment without the need for IRS private letter rulings," implying that private foundations need to obtain a private letter ruling from the IRS when making a PRI, which is not the case. See "L3C and Economic Development," page 1, available at <http://classic.cof.org/files/Documents/Conferences/LegislativeandRegulatory03.pdf>.

¹³ See, for example, Krasney, "Foundations Listen Up: Why PRI's and L3C's Matter," *The Life & Wealth Balance* (9/4/09), available at <http://richiericher.wordpress.com/2009/09/04/foundations-listen-up-why-pri-and-l3cs-matter>, stating that

"L3Cs automatically qualify as 'Program Related Investments' (or PRIs) for foundations."

¹⁴ There is much debate concerning why more private foundations do not make PRIs. In the author's view, making a PRI often carries a substantial legal compliance cost. More importantly, most private foundations do not have the infrastructure in place to support making PRIs. For example, foundation staff with expertise in traditional grantmaking typically lack the background to employ debt and equity strategies in furtherance of philanthropic ends.

¹⁵ Vermont enacted a benefit corporation statute in May 2010, allowing incorporation there as a benefit corporation (or conversion to that status) effective 7/1/11.

¹⁶ See Patel, "Facilitating Stakeholder-Interest Maximization: Accommodating Beneficial Corporations in the Model Business Corporation Act," 23 *St. Thomas L. Rev.* 135, 146-47 and fn. 65 (2010) (discussing and listing constituency statutes); Hale, "Corporate Law and Stakeholders: Moving Beyond Stakeholder Status," 45 *Ariz. L. Rev.* 823, 833 and fn. 78 (2003) (same).

consider and weigh, as they deem appropriate, the interests of various stakeholders in determining what is in the corporation's best interests. A benefit corporation is required to report annually to the public and its shareholders on its creation of public benefit and social and environmental value, and its shareholders and directors have standing to enforce these public benefit requirements. Ending benefit corporation status, or a change in control, each requires a two-thirds shareholder vote. (The concept of the benefit corporation as a new legal form was developed by B Labs, a Section 501(c)(3) organization that also advocates for passage of benefit corporation legislation. B Labs is the same organization that promulgates standards for, and certifies, "B Corporation" status. This is not the same as incorporating as a benefit corporation, and is the final characteristic on the chart, discussed below.)

The flexible purpose corporation is still only a legislative proposal. It was developed by a self-appointed working group of members of the California bar to facilitate the creation of companies with combined profit and social or environmental purposes in California. Once the statute is enacted, a flexible purpose corporation would have to specify at least one "special purpose" in its articles of incorporation in addition to traditional corporate profit-maximizing purposes. The special purpose (and flexible purpose corporation status) could be changed only with a two-thirds vote of shareholders. Its directors would be protected from claims of breach of fiduciary duty for trading off profits against achieving the corporation's special purpose. Flexible purpose corporations would have to provide annual impact reports, to the public and their shareholders, to facilitate enforcement of their special purposes.

The proposed flexible purpose statute addresses several technical issues beyond those considered in benefit corporation statutes, and takes a somewhat different approach in some particulars, but the thrust of the two regimes is very similar, which is why they have been combined in a single column in the chart.

Constituency statutes. Finally, the chart refers to business corporations having constituencies beyond their shareholders, and to "constituency statutes." Such statutes began appearing in the late 1980s, and have been adopted in nearly two-thirds of the states as of this writing.¹⁶ Typically, these statutes modify the fiduciary duties of directors under corporate law, allowing them (and in some

cases requiring them) to consider more than just the immediate impacts on shareholders in approving corporate actions. Specifically, they can (or must) consider (1) the impacts on such constituencies as employees, customers, suppliers, or the local community, in addition to shareholders, and (2) long-term as well as immediate impacts on shareholders.

Without a constituency statute, case law requires a board to maximize short-term shareholder value, to the detriment of all other metrics, on pain of liability for breach of fiduciary duties. Constituency statutes have the effect of softening or diluting somewhat the laser focus of business corporations on profits and shareholder value. While they provide some justifi-

The very newest vehicle encompasses two different legal forms.

cation for directors whose decisions reflect broader values, the problem some see is that they have no teeth. They fall well short of benefit or flexible purpose corporation statutes in that constituency statutes generally do not require directors to weigh public benefit in corporate decision making, give parties standing to enforce public benefit purposes, require transparency on public benefit and social and environmental performance, or protect stated public benefit purposes from amendment, for example.

Characteristics to be considered

The key characteristic that the author used in determining the left-right order in which the columns appear was "purposes," with the vehicles arranged on the spectrum from least charitable (strictly pure profit purposes) to most charitable (no profit purpose permitted). Thus, the flexible purpose/benefit corporation, which comes closest (at least in the author's view) to truly balancing charitable and profit motives in a hybrid form, is in the middle. It is no coincidence that this form is also the newest, least available, and still untested.

Note that with the sole exception of charities, all the legal forms contemplate equity ownership, whether in the form of shares or membership interests. They consequently contemplate raising capital through the sale of such equity interests (in addition to being able to raise capital in the form of debt—although of course only charities may benefit from debt capital in the form of tax-exempt

bond financing). Similarly, all forms except charities are taxed on profits from core activities, whether at the entity or individual owner level. Charities are the only form designed to be funded with donations only, and the only form that provides its donors with a tax deduction for their gifts. Finally, charities are the only one of the legal forms that is not eligible for certification as a "B Corporation," a characteristic mentioned above and discussed further below. Thus, even with the recent introduction of several new models and forms for conducting social enterprise to fill the gap between business and charity, charities still stand apart from all the others, offering a set of burdens and benefits fundamentally different from all other options.

Having observed charities' special status in certain respects, it is also worthy of comment to note how all the forms are more or less the same in other respects. For example, legally at least, all forms may be funded by private foundation grants, albeit with private foundations being required to conduct expenditure responsibility in the case of all except charities.¹⁷ Similarly, as discussed above, despite misperceptions on this point, all the forms can legally, and do, receive PRIs from private foundations.

'B Corporation' status. The entry "B-certifiable" in the last row of Exhibit 1 refers to meeting certain standards promulgated by B Labs. To qualify for "B Corporation" certification, a company must meet a comprehensive set of performance benchmarks relating to social and environmental values. It also must explicitly incorporate consideration of the interests of employees, consumers, the community, and the environment into corporate decision making and must do so in the company's governing

documents. The exact standards depend on the number of employees and the business sector of the entity. B Labs randomly audits 20% of certified entities every two years to ensure that they continue to meet certification standards. As of this writing, there are 315 certified "B Corporations" in the U.S., Canada, and the European Union.

Some confusion has been created by the designation of a certified business as a "B Corporation" as if that is yet another legal form. It is not. That is why "B Corporation" appears in Exhibit 1 as a characteristic, not a type of entity. "B Corporation" certification is available to any form of legal entity that can meet its requirements—except charities, as noted above. At first glance, this makes some sense, since an essential point of B certification is to provide qualifying businesses with evidence of their commitment to the public good, while charities have the halo conferred by Section 501(c)(3) status. One could stretch the point and analogize B certification for businesses to IRS recognition of Section 501(c)(3) status for nonprofits. Nonetheless, B certification requires demonstration of an organization's specific practices in various operational arenas such as fair labor conditions and environmentally sustainable business practices. Even with their Section 501(c)(3) purposes and halos, many charities do not embody all the values addressed by B certification in how they operate. Therefore, in the future, it may make sense for charities to be able to seek such certification, and for B Labs to provide it, even though it is not currently available.

¹⁷ In practice, the author and her firm have found increasing willingness among private foundations to make expenditure responsibility grants in recent years. Nonetheless, reluctance to make such grants is still sufficiently widespread among foundations to warrant a disclaimer: The legal reality that any form of entity can be funded by private foundation grants is not yet reflected in real world actions. Thus, social entrepreneurs whose business models rely on private foundation grants are forewarned that obtaining grant funding as anything other than a charity will be difficult.

Conclusion

The legal world of the social entrepreneur is a rapidly changing one, so the details of this aerial view of the available options will change. Even so, the broad outline it offers can continue to serve as a map through a novel landscape. ■