

**FOR-PROFIT  
SOCIAL ENTERPRISE MODELS  
UNDERSTANDING THE LEGAL LANDSCAPE**

**INDEPENDENT SECTOR**

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BY

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# LEGAL LANDSCAPE OF FOR-PROFIT SOCIAL ENTERPRISE

By  
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## INTRODUCTION

This paper reviews the landscape of for-profit hybrid vehicles that may be used for social enterprise.

This paper does not talk about: (1) nonprofit tax-exempt forms of social enterprise<sup>1</sup> or (2) traditional for-profit legal forms such as corporations and limited liability companies, forms that are already well known. This paper focuses instead on the newly emerging “hybrid” forms of for-profit corporations and limited liability companies, with which readers may be less familiar. This is not to say, however, that one cannot operate a social enterprise effectively and efficiently through a traditional corporation or limited liability company, as many organizations already do.

The following information is presented in question and answer format.

### **Part A: Basic Questions.**

**1. What is a social enterprise?** There is no legal definition of a social enterprise. Further, there is no commonly accepted, non-legal definition. Consider two similar, but by no means identical, definitions:

- A social enterprise is any entity that uses earned revenue to pursue a double or triple bottom line either alone (in a private sector or nonprofit business) or as significant part of a nonprofit’s mixed revenue stream that also includes philanthropic and government subsidies.<sup>2</sup>
- Social enterprises are businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental, and human justice agendas. A social enterprise addresses an intractable social need and serves

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<sup>1</sup> The author has written on this subject. See, “Using Hybrid Legal Forms -- *Three Case Studies, Four Questions, and a Bunch of Analysis*” *Exempt Organizations Tax Review* (January, 2012); “Effective Social Enterprise – a Menu of Legal Structures” *Exempt Organizations Tax Review* (June, 2009) “Social Enterprise – a Legal Context” *Exempt Organizations Tax Review* (December, 2006). Tax Management Portfolio 489-1st on Social Enterprise, by Brewer, Minnigh, and Wexler (2014).

<sup>2</sup> See The Institute for Social Entrepreneurs, “Social Enterprise Terminology,” available at [www.socialent.org/Social\\_Enterprise\\_Terminology.htm](http://www.socialent.org/Social_Enterprise_Terminology.htm).

the common good, either through its products and services or through the number of disadvantaged people it employs. Its commercial activity is a strong revenue driver, whether a significant earned income stream within a nonprofit's mixed revenue portfolio, or a for-profit enterprise. The common good is its primary purpose, literally "baked into" the organization's DNA, and trumping all others.<sup>3</sup>

**2. What is a hybrid?** The term "hybrid" is used in two different ways by tax-exempt organizations. It is used, by some, to describe tandem relationships in which a nonprofit entity and a for-profit entity work together and share resources and usually intellectual property. We are not talking about these types of hybrids during our session. See *Operating in Two Worlds: Tandem Structures in Social Enterprise*, The Practical Lawyer, Fall 2011, by Ingrid Mittermaier and Joey Neugart, for a discussion of this type of hybrid. The second use of the term hybrid, and the focus of our discussion, involves a single for-profit legal entity that serves both a business and a social or charitable mission.

**3. What types of hybrids exist today?** Hybrid legal entities come in two basic flavors, the limited liability company (LLC) and the corporation. The hybrid form of the LLC is known as the L3C or the benefit LLC, and the hybrid forms of corporations include the benefit corporation, the social purpose corporation, and the public benefit corporation, which draws from both the benefit and social purpose corporation.

**4. Is a B corporation a hybrid form?** No. B Corporation is a certification mark, similar to the Green Business mark, and it is monitored and issued by B Labs Company, a 501(c)(3) entity. It is available to L3Cs, social purpose corporations, and benefit corporations, as well as other "non-hybrid" corporations that satisfy certain tests showing that they are socially responsible. I often advise my clients to consider B Corporation status, but it is not a form of legal entity. (See [www.bcorporation.net](http://www.bcorporation.net)).

**5. What is an L3C?** All 50 states and the District of Columbia authorize the formation of limited liability companies ("LLCs"). LLCs are popular because they provide liability protection like corporations, but unlike corporations they also offer complete flow-through tax treatment, and contract-like flexibility in organization and operation. Further, most states' LLC statutes permit an LLC to be formed for "any lawful purpose", which is very unlike most business corporation statutes that require any lawful "business" purpose.<sup>4</sup> For these

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<sup>3</sup> See Social Enterprise Alliance, "What's a Social Enterprise?" available at: [www.sealliance.org/why#whatsasocialenterprise](http://www.sealliance.org/why#whatsasocialenterprise).

<sup>4</sup> For example, the Delaware LLC Act, which is representative of most others, provides that a "limited liability company may carry on any lawful business, purpose or activity, whether or not for profit, with the exception of the business of banking." Del. Code Ann. Tit. 6, § 18-106(a). See also Md. Corp. & Ass'ns §4A-201 (same language). Compare, though, the Oregon LLC Act which provides: "a limited liability company formed under this chapter may conduct or promote any lawful business or purpose which a partnership, corporation or professional corporation as defined in [Or. Rev. Stat. 58.015] may conduct or promote, unless a more limited purpose is set forth in the articles of organization." Or. Rev. Stat. § 63.074. Oregon corporations must engage in a "lawful business," and an Oregon

reasons, under the law of most states, regular LLCs are uniquely suited to serve as the legal form for social enterprise and likely will continue to be so.

To date, eleven states have created unique LLC varieties that are specially tailored by statute to accommodate both a for-profit and a social mission. Specifically, nine states and two Native American tribes have enacted L3C legislation, while two states, Maryland and Oregon, have enacted benefit LLC legislation. Regardless, such unique LLCs that are formed in one state legally may conduct business in other states as foreign LLCs even if the non-domiciliary state does not itself authorize the formation of such an entity.

The first low-profit limited liability company (“L3C”) statute was passed by Vermont<sup>5</sup> in 2008. The enabling legislation was brief and uncomplicated. In fact, the entire L3C Act in Vermont is only a few pages because it merely supplements Vermont’s existing LLC Act. The eight other states with L3C legislation are: Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Wyoming,<sup>6</sup> and two Native American tribes, Oglala Sioux Tribe and the Crow Indian Nation of Montana.<sup>7</sup>

Typically, L3C statutes refer to the state’s regular LLC statute, but add language along the following lines (this is from Vermont):

“L3C” or “Low-profit limited liability company” means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements.

(A) The Company: (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) would not have been formed but for the company’s relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other

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partnership is “an association of two or more persons to carry on as co-owners a business for profit.” *See* Or. Rev. Stat. §§ 60.074(1), 67.005(7).

<sup>5</sup> Vt. Stat. Tit.11, Ch. 21, §§ 3001(23), 3005(a), 3023(a).

<sup>6</sup> 805 ILCS 180/1-5, 805 ILCS 180/1-10, 805 ILCS 180/1-26, 805 ILCS 180/5-5 (Illinois); La. Rev. Stat. Ann. §§12:1301(A)(11.1), (12), 12:1302(C), 12:1305(B)(3), 12:1306(A)(1), 12:1309(A); Me. Rev. Stat. Ch. 21, §§1502(16), 1508, 1611; Mich. Comp. Laws §450.4102(m); N.C. Gen. Stat. §§57D-2-01, 57D-2-21, 55D-20(a); R.I. Gen. Laws §§7-16-2(27), 7-16-9, 7-16-49, 7-16-76; Utah Code §§48-2c-412, 48-2c-1411; Wy. Stat. §17-29-102(a)(ix), *et seq.*

<sup>7</sup> Oglala Sioux Tribal Council Ordinance 09-23; Crow Law and Order Code §§18-5-102, 18-5-108, 18-5-705.

factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D).

(D) If a company that met the definition of this subdivision (27) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit LLC, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company. The name of the company must be changed to be in conformance with subsection 3005(a).

These provisions are taken directly from Section 4944 of the Internal Revenue Code for program-related investments, which we discuss a bit later. The presence of this language is no coincidence since the L3C was initially set up in order to attract program-related investments.

**6. What is a benefit limited liability company?** Maryland and Oregon permit a benefit LLC,<sup>8</sup> rather than an L3C. The requirements of the Maryland and Oregon benefit LLC law essentially mirror the respective requirements for a Maryland or Oregon benefit corporation, as summarized below. In the author's opinion, these vehicles are not going to be widely used. Their rules are substantially similar to the benefit corporation rules adopted in Maryland and Oregon, but with the LLC legal form and tax treatment.

**7. What is a benefit corporation?** As of August 1, 2014, the District of Columbia and at least 26 states have adopted benefit corporation legislation. For a current list see [www.benefitcorp.net/state-by-state-legislative-status](http://www.benefitcorp.net/state-by-state-legislative-status).

Benefit corporation legislation varies significantly among the enacting states, but each state's law generally is based upon one of two approaches: the so-called "Model Benefit Corporation Legislation"<sup>9</sup> drafted by B Lab (the "Model Act") or the recently-enacted Delaware version (the "Delaware Act")<sup>10</sup>, which derives in part from the Model Act.

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<sup>8</sup> Md. Corp. & Ass'ns §§4A-1101 -1108; H.B. 2296-A, 77<sup>th</sup> Or. Leg. Assembly (2013), available at: <http://www.leg.state.or.us/13reg/measures/hb2200.dir/hb2296.en.html>. Note, though, that the Oregon benefit LLC statute, as well as Oregon's benefit corporation statute, is effective on January 1, 2014

<sup>9</sup> References to the "Model Act" are to the December 12, 2012, version available at [http://www.benefitcorp.net/storage/documents/Model\\_Benefit\\_Corporation\\_Legislation.pdf](http://www.benefitcorp.net/storage/documents/Model_Benefit_Corporation_Legislation.pdf). B Lab is a Pennsylvania-based nonprofit that certifies "B Corps." See I, B, 3, above, for a discussion of "B Corps" and the B Lab certification process.

<sup>10</sup> Del. Code Ann. Tit 8, §§361-368.

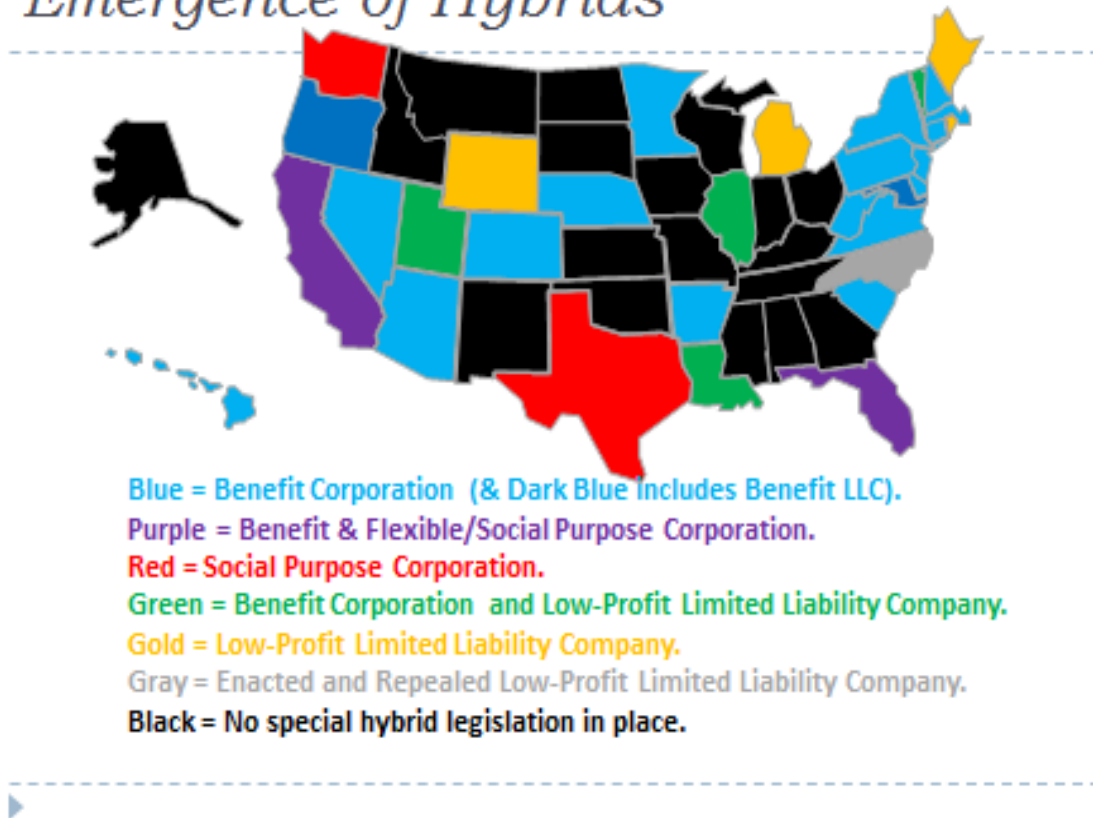
Generally speaking, Benefit Corporations are required to have:

- a. *Purpose*: a corporate purpose to create a material positive impact on society and the environment;
- b. *Accountability*: expand fiduciary duty to require consideration of the interests of workers, community and the environment; and
- c. *Transparency*: publicly report annually on overall social and environmental performance against a comprehensive, credible, independent, and transparent third party standard. ([www.bcorporation.net](http://www.bcorporation.net))

**8. What is a social purpose corporation?** A social purpose corporation, which was formerly known as the “flexible purpose corporation” in California, is similar in some ways similar to a benefit corporation, and different in others. Like the benefit corporation, it is designed to allow a corporation to take into account alternative purposes that do not involve pure profit making. Unlike the benefit corporation, it requires the corporation to only consider the specific alternate purposes that are articulated in the corporation’s Articles of Incorporation, rather than general public benefit, including the impact of decisions on purposes that may not be listed in the Articles, such as the environment, the community, creditors, and suppliers.

**9. What states have these various forms?** See chart on the next page.

## *Emergence of Hybrids*



Picture from Professor Cassady V. Brewer, University of Georgia School of Law.

**10. What are the specific differences between social purpose and benefit corporations?** There are two charts that follow that may be of use. The first chart compares the benefit corporation and the social purpose corporation in California. The second is a broader comparison of these corporations around the country.

## Chart I -- California

Subject Area	Regular Corporation	Constituency Statute	California Social Purpose	California Benefit
Corporate purposes	A corporation is generally set up for businesses purposes. Some states are more flexible about allowing the founders to include alternative purposes in the Articles. We have found that California has not been flexible.	A corporation in a constituency statute state will generally still have standard business purposes in its Articles	<p>Can engage in any lawful business purpose PLUS (i) one or more enumerated charitable or public purpose activities that could be carried out by a nonprofit public benefit corporation <b>and / or</b> (ii) the purpose of promoting positive short-term or long-term effects or minimizing adverse short-term or long-term effects upon any of the following: employees, suppliers, customers, creditors, the community, or the environment.</p> <p>Whatever the alternative purposes, they must be spelled out in the Articles. Changes can be made only by at least a 2/3 vote of each class of outstanding shares.</p>	<p>Can engage in any lawful business purpose PLUS must provide a general public benefit, which means a material positive impact on society and the environment, taken as a whole, as measured by a third-party standard.</p> <p>In addition, it can have one or more specific public benefit purposes, which does not limit the obligation to create a general public benefit. Specific public benefits include: (A) providing low income or underserved individuals or communities with beneficial products or services; (B) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business; (C) preserving or improving the environment; (D) improving human health; (E) promoting the arts or sciences or the advancement of knowledge; (F) increasing the flow of capital to entities with a public benefit purpose; and (G) the accomplishment of any other identifiable benefit for society or the environment.</p> <p>Changes can be made only by at least a 2/3 vote of each class or series of outstanding shares.</p>



Subject Area	Regular Corporation	Constituency Statute	California Social Purpose	California Benefit
Director's duties	Standard duty of care and loyalty requires directors to act in the best interests of the corporation, employing the judgment of an ordinary person, with the ability to rely on experts when needed.	<p>In addition, constituency statutes generally provide that a director, in determining what the director reasonably believes to be in the best interests of the corporation, shall consider the interests of the corporation's shareholders and, in the director's discretion, may consider any of the following:</p> <p>(1) The interests of the corporation's employees, suppliers, creditors, and customers;</p> <p>(2) The economy of the state and nation;</p> <p>(3) Community and societal considerations;</p> <p>(4) The long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation. (Ohio)</p> <p>In some states the constituency rules only apply to decisions made in connection with selling the assets of the corporation or merging or being acquired, but not on day to day decisions.</p>	<p>In addition to the normal duties of care and loyalty, in discharging his or her duties, a director may consider those factors, and give weight to those factors, as the director deems relevant, including the short-term and long-term prospects of the social purpose corporation, the best interests of the social purpose corporation and its shareholders, and the purposes of the social purpose corporation as set forth in its articles.</p> <p>The special duties of directors are specifically linked to special purposes actually articulated in the Articles, not to a broad array of social benefits.</p>	<p>In addition to the normal duties of care and loyalty, the director:</p> <p>(1) must consider: the employees and workforce of the benefit corporation and its subsidiaries and suppliers; the interests of customers to the extent they are beneficiaries of the general or specific public benefit purposes of the benefit corporation; community and societal considerations, including those of any community in which offices or facilities of the benefit corporation or its subsidiaries or suppliers are located; the local and global environment; and the long-term and short-term interests of the benefit corporation;</p> <p>(2) may consider any other pertinent factors or the interests of any other group that the director determines are appropriate to consider;</p> <p>(3) shall not be required to give priority to the interests of any particular person or group referred unless the benefit corporation has stated its intention to give priority to interests related to its specific public benefit purpose in its articles of incorporation; and</p> <p>(4) shall not be subject to a different or higher standard of care when an action or inaction might affect control of the benefit corporation.</p>

Subject Area	Regular Corporation	Constituency Statute	California Social Purpose	California Benefit
Director liability	<p>Normally, directors who act in good faith and with normal prudence are protected by the business judgment rule. In a typical corporation, directors do, from time to time take into account issues other than the financial interests of the company and its shareholders.</p> <p>Corporations make grants and engage in corporate social responsibility. While directors in a traditional corporation clearly have some leeway under the business judgment rule, it is not clear how far they could go in pursuing activities that might be deemed to jeopardize profits.</p>	<p>Case law is not clear whether directors have a more lenient standard if they consider purposes beyond financial ones to any great degree.</p>	<p>Directors are subject to liability just like directors in a normal for-profit corporation, except that the law makes it clear that they do not owe a duty to outside parties because of the enhanced social mission.</p> <p>The law provides that “Nothing in this section, express or implied, is intended to create or grant or shall create or grant any right in or for any person or any cause of action by or for any person, and a director shall not be responsible to any party other than the social purpose corporation and its shareholders.”</p> <p>In performing their duties above, the statute makes it clear that the director “shall have no liability based upon any alleged failure to discharge the director’s obligations as a director.”</p>	<p>A director is not liable for the failure of a benefit corporation to create general or specific public benefit.</p> <p>But the law does provide a special provision for “benefit enforcement proceedings” which does not appear to impose liability on individual directors: The law says:</p> <p>(a) A benefit enforcement proceeding may be commenced or maintained only as follows:</p> <p>(1) Directly by the benefit corporation.</p> <p>(2) Derivatively by any of the following:</p> <p>(A) A shareholder.</p> <p>(B) A director.</p> <p>(C) A person or group of persons that owns beneficially or of record 5 percent or more of the equity interests in an entity of which the benefit corporation is a subsidiary.</p> <p>(D) Other persons as have been specified in the articles or bylaws of the benefit corporation.</p> <p>(b) A benefit corporation shall not be liable for monetary damages under this part for any failure of the benefit corporation to create a general or specific public benefit.</p> <p>(c) If the court in a benefit enforcement proceeding finds that a failure to comply with this part was without justification, the court may award an amount sufficient to reimburse the plaintiff for the reasonable expenses incurred by the plaintiff, including attorney’s fees and expenses, in connection with the benefit enforcement proceeding.</p>

<b>Subject Area</b>	<b>Regular Corporation</b>	<b>Constituency Statute</b>	<b>California Social Purpose</b>	<b>California Benefit</b>
Shareholder rights	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits.	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits.	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits. Shareholders have special approval rights on electing into or out of FPC status, including being able to require the corporation to purchase dissenting shares at fair market value. Shareholders must approve changes in the special purposes.	Shareholders can vote to remove directors, elect different directors, and in some cases bring law suits. Shareholders have special rights for electing into or out of Benefit corporation status, including being able to require the corporation to purchase dissenting shares at fair market value.
Third party rights	None, except government	None, except government.	None, except government.	Not clear, but likely none except government.
Disclosure & Monitoring	Shareholders receive reports. Public companies make SEC filings.	Shareholders receive reports. Public companies make SEC filings.	Shareholders receive extensive reporting on the special purposes. Reports shall be made public.	Shareholders receive extensive reporting on the general and specific public benefits pursued by the corporation. Reports shall be made public.  The board must state in the annual report whether, in its opinion, the corporation failed to pursue its general, and any specific, public benefit purpose during the reporting period.

**Chart II -- United States**  
**Prepared by Professor Cassady Brewer**  
**University of Georgia School of Law**  
**A version of this chart appears in Bloomberg BNA Tax Management Portfolio 489-1**

<b>Principal Feature</b>	<b>Benefit Corporation Model Act</b>	<b>Public Benefit Delaware/Colorado</b>	<b>Social Purpose Cal; Washington; Texas</b>
<b>Purpose</b>	Must have purpose of creating a “general public benefit.” Must so state in its articles. May elect to pursue one or more specific public benefits in its articles of incorporation, but cannot do so in derogation of creating a “general public benefit.”	Intended to produce a “public benefit” or benefits <sup>11</sup> and to operate in a “responsible and sustainable manner,” and must adopt one or more “specific public benefits” <sup>12</sup> in its certificate of incorporation.	FP: Specific, special purposes to be set forth in articles, rather than a general public benefit. <sup>13</sup> SP: Same as FP but may identify additional special social purposes. <sup>14</sup>
<b>Mandate to Directors</b>	Directors must manage by considering impact on shareholders and specified stakeholders (i.e., employees, subsidiaries, suppliers, customers, community at large, environment, and short- and long-term interest of benefit corporation, including possibility that benefit corporation should remain “independent”).	Directors must manage by following tripartite mandate: Must balance the stockholder’s “pecuniary” interests, the best interests of “those materially affected by the corporation’s conduct” (i.e., stakeholders), and the “public benefit(s)” identified in its certificate of incorporation.	Directors must manage in accordance with “best interests of corporation and shareholders,” but unless otherwise required by articles, consideration of the specific, special social purpose is not mandatory (but may be considered).

<sup>11</sup> A positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities, or interests (other than stockholders in their capacity as such).

<sup>12</sup> “Specific” benefits are not defined, but the definition of “public benefit” includes, but is not limited to, “effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature.”

<sup>13</sup> The specific alternative purpose may be (i) one or more enumerated charitable or public purpose activities that could be carried out by a nonprofit public benefit corporation and/or (ii) the purpose of promoting positive short-term or long-term effects or minimizing adverse short-term or long-term effects upon any one or more of the following: (a) its employees, suppliers, customers and creditors, (b) the community and society, and/or (c) the environment. This chart refers to only the California version of the flexible purpose corporation statute. This chart does not yet take into account the Texas flexible purpose corporation.

<sup>14</sup> MUST contain this statement: “The mission of this social purpose corporation is not necessarily compatible with and may be contrary to maximizing profits and earnings for shareholders, or maximizing shareholder value in any sale, merger, acquisition, or other similar action of the corporation.”

<b>Principal Feature</b>	<b>Benefit Corporation Model Act</b>	<b>Public Benefit Delaware/Colorado</b>	<b>Social Purpose Cal; Washington; Texas</b>
<b>Transparency</b>	Annual report sent to each shareholder, posting of report on company's website, and filing with Sec. of State. No distinguishing name or initials required.	Delaware: Only biennial reports to stockholders unless certificate/bylaws require otherwise. Further, unless certificate/bylaws require otherwise, the report is not required to be made public. Colorado: Frequency of report not clear, but the report must be made public. Both: Under Delaware and Colorado law, however, a distinguishing name or initials is required for a public benefit corporation: "PBC."	FP: Annual report sent to shareholders, posting of report on its website. <sup>15</sup> SP: Annual social purpose report posted to website. FP: Must have "FPC" in name.
<b>Third Party Standard</b>	Annual report must consist of assessment of performance against a "comprehensive, independent, credible, and transparent" third-party standard.	Delaware: No such third-party standard required. Board sets its own standards against which to report; however, the certificate can require adoption of a third-party standard if desired. Colorado: The standard must be from an organization not controlled by the benefit corporation or an affiliate.	FP: None. SP: None.
<b>Enforcement and Remedies for Failure to Pursue Benefit or Social Purpose</b>	A "benefit enforcement proceeding" may be commenced by: the benefit corp., under normal rules for derivative actions, a 2% or greater shareholder, a director, 5% or greater shareholders of parent corp. (i.e., certain indirect shareholders), or other persons specified in governing documents. As a result of the benefit enforcement proceeding, a court may enjoin the corporation from acting or require reconsideration of a decision.	Only 2% or greater stockholders (or, if less than 2%, \$2 million in value if shares are publicly traded) may bring derivative suit to enforce benefit purposes. Otherwise, normal Delaware or Colorado enforcement and remedy rules and procedures apply just as they would to any Delaware or Colorado corporation.	FP: Traditional derivative lawsuit. SP: Traditional derivative lawsuit.

<sup>15</sup> The superior court of the proper county shall enforce the duty. In any action or proceeding w/ respect of failure to produce reports, court may award reimbursement amount, including attorney's fees, to shareholders, in connection with the action or proceeding.

Principal Feature	Benefit Corporation Model Act	Public Benefit Delaware/Colorado	Social Purpose Cal; Washington; Texas
<b>Limitations on Director Liability</b>	Except as otherwise provided in articles, directors and officers are not liable for monetary damages for failure of the benefit corporation to pursue or create general public or specific public benefit. Otherwise, normal director duties and standards imposed under adopting state's law apply. Duties run only to shareholders. No duties to nonshareholder stakeholders. Indemnification permitted under normal state law.	Normal duties and standards apply (including business judgment rule), but directors have no duty to mere stakeholders and have no liability to stockholders for decisions balancing the "tripartite" purposes (see note 1 above) as long as the decision is informed and disinterested, and is not one that no person of ordinary, sound judgment would approve. Otherwise, indemnification of directors and officers is permitted as normally allowed under Delaware law.	FP: Only responsible to FP corp and shareholders, not stakeholders. If acting in good faith and reasonably, no liability based upon alleged failure to discharge obligations as director. Liability for monetary damages may be eliminated or limited by articles; however, cannot limit liability for willful misconduct or fraud. SP: Not liable to stakeholders. Otherwise, normal duties/standards to shareholder

**Part B: Why Would A Nonprofit Corporation That Is Tax-Exempt Under Section 501(C)(3) Think About Forming A New Hybrid For-Profit Entity?**

**1. Why would a 501(c)(3) think about setting up a new hybrid form?** An existing 501(c)(3) corporation may want to set up a new entity for at least the following reasons:

- a. It wants to use its existing know-how, trademarks, patents or other intellectual property to engage in a business activity. As an example, a job training nonprofit that operates a restaurant in which it trains disabled individuals for employment decides to use its expertise to open up restaurants that employ a wide range of individuals, not just disabled individuals or members of another "charitable class". If it operated the new venture within its current nonprofit framework, it would generate unrelated business income. If the business activities began to overwhelm the charitable activities, it might risk losing its exempt status.
- b. It wants to engage in an activity that it might be able to do within its existing 501(c)(3) framework but that requires outside investors to build and/or grow and it needs a for-profit vehicle for that investment. As an example, the same restaurant described above wants to expand. It will continue to focus on job training for the disabled, but it needs capital investment that it is not able to raise through grants and donations, in order to expand.

**2. How should a charity think through the question of what type of entity to establish?** Preliminarily, the 501(c)(3) should decide: whether it needs a new legal entity at all and whether that entity needs to be a for-profit taxable entity. These two questions often overlap. Assuming the charity has considered issues such as liability, ease of administration, whether it needs investors, whether it needs stock to offer to employees, and other key issues and decides that it indeed wants (1) a new entity and (2) a new entity that is for-profit, it has the following choices:

- For-profit corporation;
- Pass-through entities (e.g., partnerships and limited liability companies); and
- Other, including cooperatives, trusts, and unincorporated associations.

Normally, the analysis boils down to two choices: LLC or corporation. Even before the charity gets to the question of whether to use a new hybrid form, it must make the basic decision of LLC or corporation.

**3. What is the difference between an LLC and a corporation?** Normally in considering between a corporation and an LLC, one considers several factors: limited liability, management structure, and taxation.

Although treatises have been written – and continue to be written – on these factors, as a practical matter, both the LLC and the corporation, if properly set up and maintained will provide protection against liability.

As to management and control, it is often said that the LLC affords more flexibility because the management, ownership, and control structures are established in the LLC operating agreement, which makes them essentially a matter of contract, whereas the corporate law of most states provides a body of rules that corporations must follow. In a corporation, the shareholders will elect a board of directors that will manage the organization. In reality, in an entity with a limited number of owners, creative corporate lawyers can use different classes of shares and voting agreements to achieve largely the same results in a corporate structure as in an LLC structure. In a larger entity, the corporate structure is going to be less flexible, but that is not necessarily a bad result. Also, in our experience, more institutional investors and venture capitalists prefer the corporate structure, particularly if the entity is to go public or to be sold later on.

In our experience, most decisions between the LLC or the corporate form are based on tax considerations. LLCs do have the option of electing to be taxed as pass-through entities, avoiding the corporate level tax. With limited exceptions, the LLC form is generally not advantageous to tax-exempt investors.<sup>16</sup>

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<sup>16</sup> One exception involves a tax-exempt entity forming a single member LLC to hold property, such as real estate, in an attempt to shield its other assets from potential liability. Another situation involves an LLC that is clearly related to the tax-exempt entity's tax-exempt purpose, such as an LLC to operate low-income housing and sell tax credits.

Consider the following results for an LLC owned in part (but not entirely) by a charity and a corporate subsidiary of a public charity. We assume that the LLC is not wholly owned by a charity, since a wholly owned LLC is disregarded for tax purposes. We also assume that the charity is not a private foundation because a private foundation cannot own more than 20% of a business enterprise (Section 4943) with some exceptions.

a. Normal operations

	<b>Taxable Income</b>	<b>Distributions</b>	<b>Interest, Rent, Royalties</b>
LLC owned in part by PC	LLC income is allocated to its members (including the charity) on a Schedule K-1 and members owe taxes, whether or not they receive distributions.	LLC members generally do not pay additional taxes on cash distributions.	If a charity member receives additional payments of interest, rents or royalties under a separate contract with the LLC, it pays tax on the net income if it owns more than 50% of the profits interests.
Corp owned by PC	Corporate subsidiary pays taxes on its own net income.	Tax-exempt public charity shareholder pays no taxes on dividends.	A tax-exempt shareholder that owns more than 50% of a subsidiary pays UBIT on interest, rent and royalties that it receives.

b. Winding up

<b>CASE</b>	<b>Sale of Stock or LLC Interests</b>	<b>Sale of Assets</b>	<b>Dissolution</b>
LLC	Charity would not be taxed on capital gains from selling its LLC interests.	If the LLC sells its assets, it will allocate any gain from the sale to its members. Charity members will not pay tax on capital gains.	Generally no taxes.
Corp	A tax-exempt charity will normally not pay tax on the net gain from the sale of its subsidiary stock.	The corporate subsidiary will pay tax on any gains from sale.	A deemed sale of subsidiary assets will result in tax to the subsidiary, which may not have cash to pay the tax.

**4. If the entity should be a corporation, should it adopt one of the new hybrid corporate forms, such as a social purpose corporation or a benefit corporation?** An alternative corporate form makes sense if the founders want the corporation's board to be absolutely free to consider, on a regular and unlimited basis, a social or charitable mission, without concern about failure to maximize profits. The social purpose corporation permits the founders of the corporation to establish specific and clear social purposes – purposes that are not business purposes – and the corporation is then to act in connection with those articulated purposes and to report to the shareholders specifically on its success or failure in achieving the specific purposes.

The relationship between purposes and directors' duties is less clear in the benefit corporation, where even though specific alternate purposes might be articulated, the directors also are required to consider an array of alternative issues, such as customers, suppliers, the environment, the community, and others. In addition, the directors must live up to a third party standard set by an outside standard body, but it is not clear whether a careful lawyer will advise



the board to self-evaluate under those standards or to go the extra step of seeking certification by the standard setting body.

**5. If the charity is considering an LLC, when does an L3C make sense?**

In those situations where a charity decides to use an LLC as its subsidiary, an L3C may make sense because it permits the charity to lock in the charitable purposes. Traditional investors are likely to object to an L3C whereas private foundation and angel investors may seek it.

**Part C: When Would A 501(C)(3) Tax-Exempt Entity Think About An Investment In A Hybrid Entity That Is Operated By Someone Else (Not A Subsidiary)?**

**1. Can a charity invest in a hybrid entity?** A public charity can invest in a hybrid entity under the same rules that it considers when investing in any for-profit entity. It must consider:

- Whether the investment is prudent under state law rules governing investments (e.g., the state's version of the Uniform Prudent Management of Institutional Funds Act or UPMIFA and anything in the corporate law).
- Whether the investment is consistent with the charity's investment guidelines and policies.
- If the investment is not prudent or does not fall within investment guidelines, is it being conducted for program-related purposes? Does the investment further the charity's charitable purposes?

All investments in hybrids must be considered on a case-by-case basis. There is nothing about the L3C, the benefit corporation, the social purpose corporation, or B corporation certification that automatically makes an investment appropriate. An L3C or a hybrid with a clearly articulated charitable purpose might make a program-related investment more appropriate for the charity. At the same time, one might argue that a charity cannot make a prudent, but not program-related investment in an L3C, which by law cannot have as a significant purpose the production of income or the appreciation of property.

Private foundation investors have even more rules to consider. Private foundation investors may make prudent investments and program-related investments. Prudent investments can also be socially responsible investments – investments in companies that do not do harm – or they may even be mission-related investments – investments in companies that actually further the purposes of the foundation, while making money. As an example, an environmentally focused foundation may decide to invest its money prudently in a solar company that also further its mission. Private foundations also make program-related investments.

**2. What is a program-related investment?** An investment must meet three requirements to qualify as a program-related investment (“PRI”):

- The primary purpose of the investment must be to further one or more exempt purposes of the foundation. In large measure, this is a determination specific to each foundation, its mission, and the proposed PRI.
- The production of income or the appreciation of property may not be a significant purpose of the investment.
- The PRI cannot be used to fund electioneering or lobbying activity.

The benefit of a PRI is that the investment counts as part of the foundation’s 5% annual payout obligation, the foundation can hold more than 20% of the business, and the investment does not have to be prudent. The L3C is designed to attract PRIs and if properly set up may be a solid vehicle for a PRI, but the foundation must still analyze the PRI carefully. There is nothing in particular about the hybrid corporate forms that lend themselves inherently to PRIs.

**3. What about expenditure responsibility?** Expenditure responsibility requires that any program-related investment made by a private foundation to a for-profit entity, including an L3C, a benefit corporation, or a social purpose corporation, will be subject to excise taxes under Section 4945 of the Internal Revenue Code as a taxable expenditure unless the private foundation exercises the level of due diligence and oversight called *expenditure responsibility*. Expenditure responsibility starts before the grant is made, with a pre-grant inquiry. Next, the grant must be made on specified terms and conditions, which must be embodied in a written grant agreement. The grantee must provide appropriate reports on the use of grant funds; the grantor must report the grant properly to the IRS with its annual tax return.