



## **L3C vs. B-Corps: What is Best for Your Social Venture?**

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Social entrepreneurs have the unenviable challenge of: 1) launching a sustainable business; 2) that solves or alleviates global afflictions; and 3) doing so while operating on a razor-thin profit margin. Severally, each of these elements create a difficult hurdle for all start-up to overcome; collectively, they yield what seems like insurmountable odds. Fortunately, start-up social ventures can avoid some of the classic operational and financial obstacles that come with such entities by choosing a legal designation that best promotes their vision.

Historically, federal and state statutes have viewed charitable and for-profit entities as mutually exclusive organizations whose mission statements rarely, if ever, overlapped. This legal distinction has been wholly rejected by a new class of up-and-coming entrepreneurs that believe companies can pursue profit *while* advancing social causes. In response to the need for a legal designation that straddles the line between for and non-profits, the US government and a growing number of states have recognized a new class of business entities that allows for the creations of such enterprises. The two most popular are low profit limited liability companies (L3C) and Benefit Corporations (B-Corp).

L3C is a newly recognized business entity that allows companies to achieve modest profits while operating under a business model that emphasized impact over profits. L3Cs were specifically designed to help social entrepreneurs raise capital from a much broader range of investors than are typically attracted to traditional NPOs.

L3Cs are structured under a “tranching” system that appeals to investors ranging from risk-averse entities like NGOs to aggressively managed hedge funds. Tranching allows a flexible ownership structure that allocates risk unevenly among its members based on their risk tolerance and ROI requirements. L3Cs will typically offer three levels of tranches designed to accommodate variations in investor needs. The lowest tranche is reserved for contributors like program related investments (PRI) that are willing to be junior claim holders and absorb below market rates. Investors placed in the lowest tranche provide the ability for L3Cs to attract the significant capital needed from larger, profit-driven investors placed in higher tiers. The middle tier, or “mezzanine” tier, provides L3Cs with access to socially conscious investors that consider the realization of social impact a component of their expected ROI and, as such, are willing to accept returns slightly below market rates. Lastly, offers an attractive investment opportunity for endowments and other contributors wishing to fund socially conscious projects while receiving market rate returns. Most importantly, the senior tier allows L3Cs to gather the substantial contributions that are typically unavailable to traditional NPOs.

Under *Treas. Reg. § 1.501(c)(3)*, L3C designated entities must: 1) significantly further the accomplishment of one or more charitable or educational purposes identified under *26 C.F.R. § 170(c)(2)(B)*; 2) have been formed for the purpose of furthering said charitable or educational purposes; 3) not strive for the attainment of revenues or property as their primary purpose; and 4) not be organized to further any legislative or political purposes. Some states have passed legislation recognizing L3Cs and several more are considering following suit. Kentucky and Indiana’s state legislature failed to pass L3C bills introduced during each state’s 2011 legislative session.

Lastly, it should be noted that L3Cs operate as a “pass through” entity for federal tax purposes, allowing the tax burden to be pass along to its members and paid as personal income tax.

A popular alternative to L3Cs for companies wishing to operate under a standard of social accountability is the increasingly recognized Benefit Corporation. Benefit Corporations are distinct from L3Cs because they are required to operate under specific standards set forth by B-Lab, a non-profit organization founded by Benefit Corporation visionary Jay Gilbert. Benefit Corporations are required to draft or amend their articles of incorporation to include the following five provisions:

*Purpose* — shall create general public benefit defined as the material positive impact on society and the environment, as measured by a third party standard shall have the right to name specific public benefit purposes the creation of public benefit is in the best interests of the Benefit Corporation.

*Accountability* — directors duties are to make decisions in the best interests of the corporation directors and officers shall consider effect of decisions on shareholders and employees, suppliers, customers, community, environment (together the “Stakeholders”). Shall have an independent Benefit Director accountable for statement in annual Benefit Report whether Board acted consistent with obligation to create general and any specific public benefit purposes, and considered effects of decisions on stakeholders.

*Transparency* — shall publish an annual Benefit Report in accordance with recognized third party standards for defining, reporting, assessing social and environmental performance, including assessment of successes and failures in achieving general and specific public benefit purpose and in considering effects of decisions on stakeholders. Benefit Report delivered to: 1) shareholders; 2) to public website with exclusion of proprietary data; and 3) Secretary of State with exclusion of proprietary data.

*Right of Action* — only shareholders and directors have right of action. No third party right of action if Benefit Corporation is a subsidiary, >5% owners of parent have right of action. Right of Action can be for 1) violation of or failure to pursue general or specific public benefit; 2) violation of duty or standard of conduct.

*Change of Control/Purpose/Structure* — shall require 2/3 majority vote.

Companies that operate under these standards are legally protected and obligated to pursue social benefits before profits. This obligation guarantees to investors that management will operate the business in a way that furthers their interest in social improvement.

Until recently, Benefit Corporations were merely voluntary certifications that provided investors peace of mind and a set of standards for management to pursue. This changed in 2010 when the state of Maryland became the first to recognize Benefit Corporations as a designated legal structure, thus conferring legal protection for company officers to make decisions that seek to provide social benefits over profit.

Today, Benefit Corporations are a recognized corporate structure in 10 states and the District of Columbia with an additional 16 states considering similar legislation. Unfortunately, the Kentucky and Indiana legislatures do not have statutes recognizing B-Corp entities or proposals for enactment of such legislation. Companies created in states like Kentucky that do not recognize Benefit Corporations are limited to voluntarily conforming their company to the standards set by B-Lab to receive Benefit Corporation Certification, which is periodically renewed contingent upon the company's conformity with B-Lab standards.

Conversely, businesses created in states that recognize Benefit Companies can register their company as such and must operate in accordance with the state's applicable statute(s). While such legal entities are not required to maintain "Benefit Corporation Certification" from B-Lab *per se*, nearly all require the Benefit Corporation to meet similar third party standards.

While both L3Cs and B-Corps offer solutions important to emerging social entrepreneurs, both designations fail to address the challenges addressed by the other — L3Cs do not offer the transparency and legal protections of B-Corps, while B-Corps will not receive the broad capital market access enjoyed by L3Cs. Ultimately, the decision must be made by weighing the importance of generating capital (L3C) or the legal obligation that demands management make every operating, financing, and investing decision based primarily on pursuit of a social cause (B-Corp).

Check out the links below for more information on L3Cs or B-Corps:

L3C:

<http://www.intersectorl3c.com>

<http://www.americansforcommunitydevelopment.org>

B-Corps:

<http://www.benefitcorp.net>

<http://www.bcorporation.net>

Sources:

Treas. Reg. § 1.501(c)(3)-1

<http://www.socialenterprisetrust.org/pdf/legal-structure-and-social->

enterprise.pdf

Practical Tax Strategies, THE L3C LOW-PROFIT LIMITED LIABILITY  
COMPANY: INVESTMENT OPTION FOR SOCIETAL IMPACT, 86  
PRACTXST 66

<http://www.bcorporation.net>

<http://www.benefitcorp.net>