Social Enterprise Choice of Entity: Benefit Corporation, Flexible Purpose Corporation, and the L3C

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It may be rare, but some nonprofit organizations actually generate more income than their operating costs. These "profits," however, may not be sure enough or substantial enough to attract the initial capital contributions needed to start new nonprofit organizations; they may not be sufficient to sustain an existing organization. For years, public charities have engaged in joint ventures with for-profit businesses to fund and operate charitable activities. Private foundations, on the other hand, are subject to excise taxes that essentially prohibit their involvement in for-profit joint ventures – except in the form of program related investments.

Recent legislation has proffered three next entities meant to facilitate joint ventures between non-profits and for-profits – the low-profit limited liability company, the benefit corporation and the flexible purpose corporation. Each offers distinct operational advantages, and together they open the door for "businesses that measure their success by a double bottom line – achieving profitability and serving a public good."[4]

With this article in hand, you will be able to talk with clients about the advantages and disadvantages of each new entity and help them decide if one of these " businesses that do well by doing good"[5] is the right choice.

Program Related Investment Rules as Guidelines

To understand the development of social entrepreneurship, we must start with the private foundation concept of program related investments ("PRIs"). PRI is a private foundation concept, but it is the primary source of information about how the IRS views and evaluates joint ventures between nonprofits and for-profits. Public charities consequently look to the PRI Regulations and related rulings for guidance.

A private foundation is required to spend 5% of its previous year's assets in furtherance of its charitable purposes. This is usually done by making grants to publicly

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[4] Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*. 35 Vt. L. Rev 3 (2010).
[5] *Id*.

supported charities. Alternatively, a private foundation can invest some or all of the 5% in a for-profit business that serves the foundation's charitable purposes. To qualify as a PRI, the investment must satisfy three tests. First, the primary purpose of the investment is the accomplishment of a charitable purpose[6] -- that is, the investment would not have been made but for the relationship between the investment and the accomplishment of the charitable purpose.[7] Second, return on the investment is not a significant purpose of the investment[8] -- although the fact that an investment actually produces significant income is <u>not</u> conclusive evidence that production of income was a significant purpose of the investment.[9] And, third, the investment will not influence legislation or participate in political campaigning.[10]

The PRI concept has been part of the rules since 1969, but private foundation PRIs are uncommon; they generally account for less than 1% of all distributions from private foundations.[11] If it turns out that an investment does not qualify as a PRI, then the foundation (and potentially its managers) face four excise taxes: one for failing to distribute 5% annually,[12] another for making a taxable expenditure,[13] a third for owning too much of a business,[14] and the final one for making a jeopardy investment.[15] Foundations and their managers have proven extremely unwilling to run these risks. And although foundation can ask the IRS for a letter ruling confirming that an investment will qualify as a PRI, it is a costly and lengthy process; foundations and their managers have chosen not to use it.

<u>L3Cs</u>

The advent in Vermont in 2008 of the new legal structure called the low-profit limited liability company ("L3C") has been heralded as "a watershed moment for individuals and organizations that are dedicated to achieving social change."[16] Nine states and two federal jurisdictions have followed Vermont's lead, including Michigan, Wyoming, Utah, Illinois, North Carolina, Louisiana, Maine, Rhode Island, the Oglala Sioux Tribe and the

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[6] IRC § 4944(c).
[7] Treas. Reg. § 53.4944-3(a)(2)(i).
[8] IRC § 4944(c).
[9] Treas. Reg. § 53.4944-3(a)(2)(iii).
[10] Treas. Reg. § 53.4944-3(a)(2)(i).
[11] The Foundation Center, *Aggregate Data by Private Foundation Type, 2006* (released 2008).
[12] IRC § 4942.
[13] IRC § 4945.
[14] IRC § 4943. Generally, a private foundation cannot own more than 20% of a business; although the threshold increases to 35% in some circumstances.
[15] IRC § 4944. A jeopardy investment happens when foundation managers make an investment and fail to exercise ordinary business care and prudence in providing for the foundation’s short- and long-term financial needs to carry out its exempt purposes.
[16] Cassady V. Brewer and Michael J. Rhim, *Using the L3C for Program-Related Investments*, 21 Taxation of Exempts 19 (2009).

Crow Indian Nation of Montana. L3C legislation is pending in 15 more states, including California.[17] Even though the entity does not exist in California yet, Californians can form L3Cs in other states and conduct business in the state using them. Current estimates suggest that nearly 500 L3Cs have been formed since 2008.[18]

In very general terms, an L3C is a limited liability company with an operating agreement designed to satisfy the PRI requirements. The entity generates different returns on investment for different types of members. Nonprofit members will receive relatively small returns, while for-profit members will receive higher but probably still less than market rate returns. In effect, private foundation investments become startup capital for the business. As the venture capitalist, the private foundation bears more risk, but even if it expects to receive very little return, *any* return will be better than a grant for similar purposes because there is at least a possibility that the invested principal will be returned to the foundation with some amount of growth (making more available to the foundation down the road). For-profit investors will bear less risk and may earn lower than normal returns, but the arrangement should be attractive to investors who "have a primary goal of performing a socially beneficial purpose not earning money."[19]

A fairly intense debate is under way about the actual need for such a structure and whether it fulfills its promises. Just consider the title of some recent articles about this new structure: *The Low-Proft LLC (L3C): Program Related Investment by Proxy or Perversion*[20] or *L3Cs: Less There Than Meets The Eye*[21] or *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*[22] or *Practitioners Denounce Low-Profit LLC Entity as "Trap for the Unwary."*[23] Despite this debate, nonprofits hope this new structure will encourage private foundations to make investments in a social enterprise rather than making grants to support purposes similar to the mission of the social enterprise. However, those questioning the need for a specific structure raise an important point. A private foundation should not rely solely on the fact that a business is an L3C; instead, it should not invest in the business unless its managers conduct their own due diligence and independently conclude that the investment will qualify as a PRI.

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[17] See California Senate Bill 323 (2011-2012 session).
[18] interSector Partners, L3C, www.intersectorpartners.com (tally as of 9/16/11).
[19] Robert R. Keatinge, *Hybrid Entities*, ALI-ABA
[20] Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion*, 64 Ak. L. Rev. 63 (2010).
[21] David S. Chernoff, *L3Cs: Less There Than Meets The Eye*, 22 Taxation of Exempts 3 (2010).
[22] J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 Vt. L. Rev. 273 (2010).
[23] Amy S. Elliott, *Practitioners Denounce Low-Profit LLC Entity as "Trap for the Unwary,"* 67 The Exempt Organization Tax Review 4 (2011).

Benefit Corporations

In 2010, Maryland cut a different path by creating the benefit corporation. Since then, eleven states[24] – including California[25] – have also enacted benefit corporation legislation. Several other jurisdictions have introduced similar legislation.[26] It is important to note that each state enacts distinct versions of benefit corporation legislation.

Benefit corporation legislation effectively broadens the factors the officers and directors must consider in conducting the corporation's affairs. The corporation's governing documents must identify its socially beneficial purpose, and the directors and officers must consider the accomplishment of that purpose in conducting the corporation's affairs. The officers and directors are relieved of liability for conducting the business in a manner that furthers the beneficial purpose but does not maximize shareholder value. However, in California, a benefit corporation's stakeholders – including shareholders and beneficiaries of the corporation's socially beneficial purpose – can initiate a cause of action against the directors and officers if the stakeholders make a determination that the directors and officers are not furthering the corporation's socially beneficial purpose.

The legislation requires a benefit corporation's directors and officers to identify a third party standard for socially beneficial businesses to which the corporation's activities will be compared on an annual basis. The standard measures the corporation's accomplishment of its socially beneficial purpose and it must consider multiple stakeholders, including shareholders and beneficiaries of the corporation's socially beneficial purpose. (At present, B Lab the most well-known third party standard.[27]) The benefit corporation must produce an annual report that includes a description of how the corporation accomplished the metrics established by the third party standard. These annual reports must be made publicly available.

Flexible Purpose Corporations

In January 2012, California will become the first state to recognize the flexible purpose corporation. [28] The governing instruments of such a corporation must specify at least one charitable or public purpose that directors and officers must consider in addition to traditional shareholder economic interests when conducting the corporation's affairs.

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[24] Other states that have enacted benefit corporation legislation: Hawaii, Illinois, Louisiana, Massachusetts, New Jersey, New York, Pennsylvania, South Carolina, Vermont, and Virginia.
[25] See California Assembly Bill No. 361 (2011-2012 session), sent to Governor 9/1/11, to be effective 1/1/12.
[26] http://www.benefitcorp.net/state-by-state-legislative-status
[27] B Lab (www.bcorporation.net). It is important to recognize that classification as a "benefit corporation" describes a business's legal structure, while certification as a "B Corporation" shows that a business has voluntarily adopted standards of social performance, accountability, and transparency established by B Lab.
[28] See California Senate Bill 201 (2011-2012 session), sent to Governor for signature on 9/9/11, to be effective 1/1/2012.

Directors and officers are relieved of liability for conducting the business in a manner that furthers a special purpose but does not maximize shareholder value.

Every year, the directors and officers must establish objectives for measuring the corporation's efforts to achieve its special purpose and issue a written analysis of the previous year's efforts. This report, along with financial statements that identify receipts and disbursements related to the efforts, must be provided to the California Attorney General, the corporation's shareholders and be made publicly available. Because this entity is completely new, there is little guidance on this self-evaluation; flexible purpose corporations could seek B Corp certification, and rely heavily on this third party standard. Shareholders can exercise dissenter's rights if the board and management are not making acceptable efforts in accomplishing the special purpose.

Choosing Between an L3C and a Corporate Form

There are several factors to consider when deciding on the appropriate form for a new social enterprise. The identity of preferred investors is a threshold question.

If the goal is to attract funds from private foundations, an L3C deserves close attention because the operating agreement and management of the enterprise can be tailored specifically to satisfy PRI requirements. Control is often a pivotal question. A private foundation (or the group of private foundation investors) that can show it effectively controls the operation may feel much more comfortable asserting that it made the investment primarily for the accomplishment of a charitable purpose.

On the other hand, if the goal is to attract institutional investors, corporate form may be a wiser choice because these investors dislike the risk of phantom income inherent in pass-through entities. For exempt investors, such as pension funds, phantom income can lead to unrelated business taxable income. For foreign investors, phantom income can constitute effectively connected income or income from commercial activity, leading to either U.S. filing requirements or the loss of certain U.S. exemptions.

Choosing between a benefit corporation and a flexible purpose corporation is largely a question of deciding between enforcement regimes. A benefit corporation involves a strict comparison to a third-party certification regarding effort to achieve a socially beneficial purpose and allows stakeholders a cause of action against directors and officers in certain circumstances. A flexible purpose corporation involves self-review of such efforts and does not create a stakeholder cause of action. However, the flexible purpose corporation is unique to California and is thus new to investors both inside and outside the state. Therefore, this choice depends on the personalities of likely investors, directors and officers, ultimately making it a subjective choice.

Conclusion

The laws pertaining to socially beneficial business are rapidly changing. While several jurisdictions initially adopted the L3C, even more are embracing the greater freedom offered by the benefit corporation and, in California, the flexible purpose corporation. Although often similar, the statutes in each state are distinct. Planners should compare their organizational needs with the unique characteristics of each state's legislation before forming an entity.