WHICH LEGAL STRUCTURE IS RIGHT FOR MY SOCIAL ENTERPRISE?

A GUIDE TO ESTABLISHING A SOCIAL ENTERPRISE IN THE UNITED STATES

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This Guide does not provide legal information on all corporate forms available and is current as at May 1, 2016 only. Although we hope and believe the handbook will be helpful as background material, we cannot warrant that it is accurate or complete, **particularly as circumstances change after publication**. This Guide is intended to convey only general information; therefore it may not be applicable in all situations and should not be relied or acted upon as legal advice.

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FOREWORD

The Thomson Reuters Foundation launched TrustLaw Connect in July 2010, a global pro bono service that amplifies the impact of NGOs and social enterprises by connecting them with the best lawyers around the world. Our mission: spread the practice of pro bono worldwide to drive social change.

It has always been a priority for us to support innovative organisations that have the potential to address many of the world's environmental, humanitarian and social problems. As the social enterprise and social investment sector becomes increasingly sophisticated around the globe, we believe these efforts are especially key to having a large-scale impact on society, but their effectiveness may be impeded by lack of legal resources.

How a social enterprise is legally structured can greatly influence the types of capital available to it and how the organisation can operate and grow. Whether you are just beginning to formulate your entrepreneurial idea or are already working in an established social enterprise, this Guide will give you a clear overview of the various legal structures available to you and includes a decision tree to help guide your way.

We are grateful to Morrison & Foerster for producing this Guide as well as a similar one for social enterprises operating in England and Wales.

Although this research is comprehensive, you may still need a lawyer to complete the actual registering, structuring or restructuring of your organisation, but we hope this Guide will help you navigate the myriad structures available to social enterprises in the US.

M. Villa

-- MONIQUE VILLA, CEO, Thomson Reuters Foundation

INTRODUCTION

This Guide is intended to help social entrepreneurs navigate through the array of legal structures that are available for them in the United States. The burgeoning field of social enterprise and the rise of impact investing have moved well beyond the dichotomy of for-profit and not-for-profit legal structures. For many social entrepreneurs, generating revenue (and sometimes profit) from their enterprises is a key driver, ensuring financial sustainability, generating returns for investors and avoiding the need to rely on charitable donations or grants. However, many such entrepreneurs also wish to pursue a mission outside of profit maximization, specifically focused on the promotion of non-monetary social, humanitarian and/or environmental goals.

Legal structure can have a material impact on an entity's pursuit of this dual mission of profit and social value. The legal structure that an organization adopts sets the framework and governing rules under which it operates. Each organizational form has certain advantages and disadvantages in this respect, the materiality and applicability of which vary depending on the characteristics of an organization.

For example, the legal structure a social enterprise assumes will have a significant impact on the sources of funding available to it. Certain social enterprises require a large upfront investment - for instance, to fund research and development, to invest in an infrastructure project or to manufacture and distribute a product or service. Such enterprises may not have access to the capital they need if operated as traditional non-profit organizations, as financing options available to charities or NGOs from foundations, individual donors or government agencies can be too small, risk-averse or inflexible to meet the needs of many such organizations. Instead, the best way to access such capital is often through a loan (debt) or equity investment. This sort of investment may not be available on favorable terms to the same degree to all legal structures, affecting the ability of such entities to commence, continue or scale their operations.

As companies and governments innovate and develop new corporate forms to meet the varied strategic needs of social enterprises, the marketplace has become open to new legal structures and the choices for new social entrepreneurs have become increasingly complicated and difficult to understand, particularly for the non-lawyers among us. Further, the misinformation dissemination by some organizations promoting one brand or form for their financial benefit has confused the press and entrepreneurs alike. In addition to financing, there are other considerations which will determine the right legal structure for a social enterprise, including set-up costs, size, growth, location, tax and liability considerations, corporate governance issues, investor motivations and goals and whether the entity has employees. Finding the right organizational structure is a critical first step toward operating and growing a successful social enterprise that maximizes business opportunities and social goals.

The Guide

This Guide is designed to clarify the existing options for setting up a social enterprise in the United States and the important strategic considerations related thereto. While the availability and certain elements, restrictions and other attributes of the corporate structures vary from state to state, this Guide is designed to give an overview relevant across the whole country. Legal advice should be sought in relation to the applicable statutes of the state in which an entity is incorporated and operates to identify differences from the information provided in this Guide and additional considerations or layers of complexity. At the beginning of this Guide, we have included a decision tree to assist entrepreneurs in choosing the most appropriate structure for their social enterprises. While this decision tree is not designed to cover all potential issues and considerations that factor into choosing an organizational structure, we suggest that social enterprises considering which structure or structures might be most suitable for them begin with this decision tree and then turn to the full description of each of the corporate forms contained in Part 2 and Part 3 of the Guide.

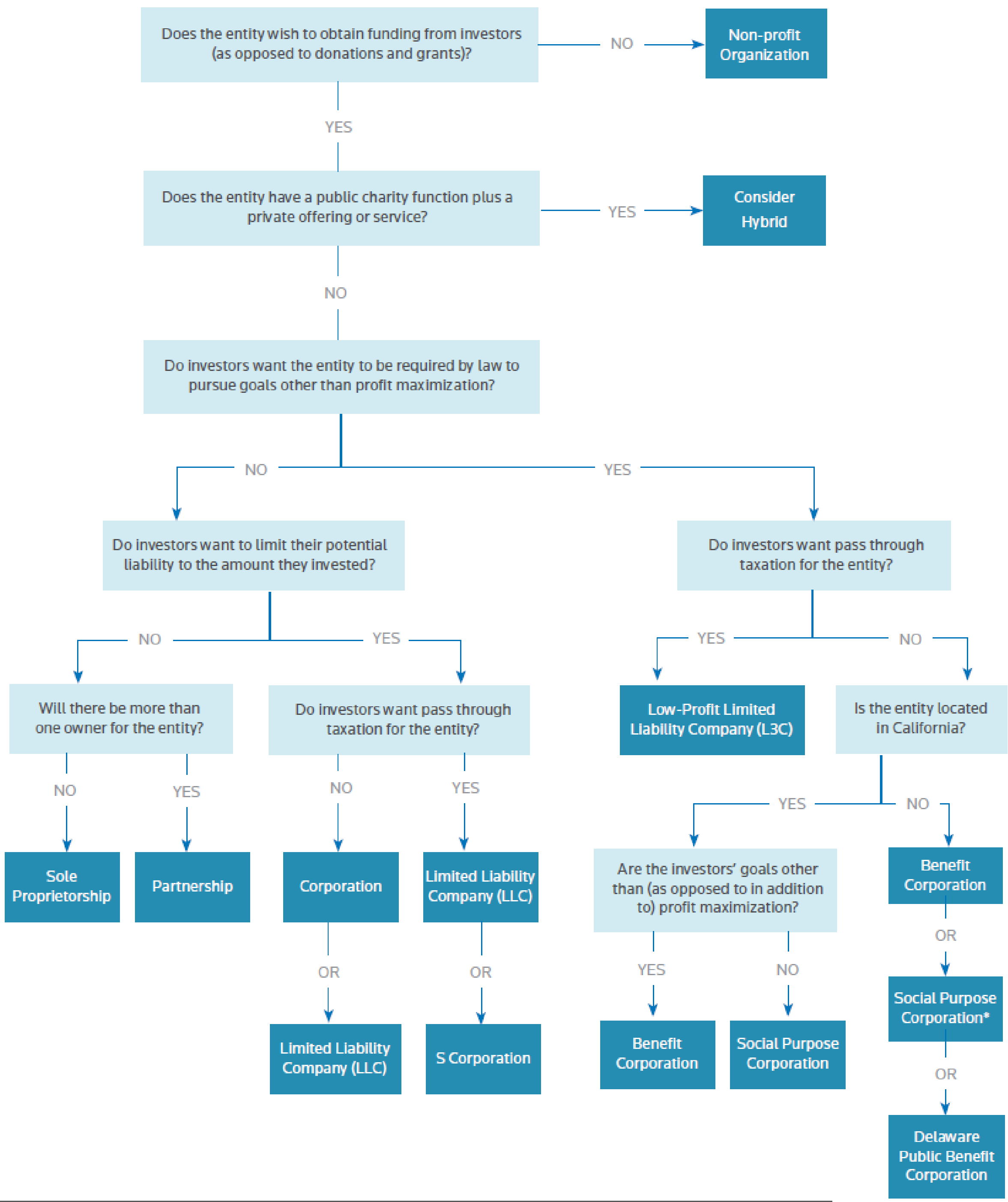
We have arranged the structures in order of complexity, from the simplest type of structure through to the more complex structures, including those that have been designed specifically for social enterprises. Each description contains a list of the main advantages and disadvantages, together with relevant case studies and details about organizational structure, establishment costs and documentation, liabilities, governance considerations, regulatory obligations, tax treatment, and implications for financing.

We have also included a brief overview of certain ratings agencies and ratings systems have been developed to provide stakeholders, investors, consumers and other interested parties with a mechanism by which they can assess the social impact of a particular social enterprise in Part 4 of the Guide. In addition, we have included links to additional resources in Part 5 of the Guide.

Please note that non-profit organizations are not covered in this Guide but will be covered in the separate guide that is anticipated to be published by the Thomson Reuters Foundation shortly following publication of this Guide (the “Charitable Organization Guide”). Non-profit organizations are legal structures often used by social enterprises due to their tax benefits.

They are, however, subject to extensive state and federal regulation. In determining which type of legal structure is right for a social enterprise, we suggest that both guides are read in conjunction to get a more complete understanding of the structures available and which is likely to be best suited in the circumstances.

1. WHICH TYPE OF SOCIAL ENTERPRISE IS RIGHT FOR ME?



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* Washington and California have adopted "social purpose corporation" legislation (which differs in certain key areas from benefit corporation legislation adopted in many other states).

2. LEGAL STRUCTURES AVAILABLE TO ALL ENTERPRISES

2.1 SOLE PROPRIETORSHIPS

Key advantages/disadvantages

ADVANTAGES

- Easy to start up; low or no start-up costs
- No formation and reporting requirements

DISADVANTAGES

- No limited liability for the individual; individual is responsible for the debts and obligations of the business
- Limited to a single owner
- Not suitable for raising outside capital

Case study

FICTIONAL EXAMPLE

Soledad Prosepina owns and operates a sole proprietorship that offers sustainable design consulting services. She specializes in advising on environmentally-sensitive structures and sustainable solutions for the built environment. She sees overall energy and environmental performance as a core goal and attempts to integrate sustainable design principles and strategies into all aspects of a project. Her mission is to help clients identify new sources of business value while benefiting the environment and the communities in which these developments are located.

(a) Overview

Sole proprietorships are the oldest, simplest, and most common form of business enterprise. More than 22 million sole proprietorships were operating in the United States in 2008, outnumbering corporations and partnerships combined by a factor of three.[1]

Many types of businesses may be run as sole proprietorships. The predominant quality that defines a sole proprietorship is that it does not have any legal status or structure separate from its owner. The proprietor and the business are inseparable and indistinguishable in the eyes of the law, which impacts nearly all aspects of how the business is formed, structured, operated, regulated and taxed.

A sole proprietorship may only have one owner, who must be an individual. The introduction of additional owners will automatically and by definition change the business into a partnership. Thus, a sole proprietorship is not a viable business form for individuals who wish to have partners or business associates to help them manage or run the enterprise. Also, this means that sole proprietors do not have the option to issue ownership interests in the business to investors in exchange for funding without adopting a different form of business enterprise.

Sole proprietorships have certain structural benefits such as:

- SIMPLICITY – The sole proprietorship is the most basic and inexpensive type of business entity to form and operate, with minimum startup costs and few formal requirements.
- FLEXIBILITY AND CONTROL – The owner has complete control and authority to manage the business and its finances.
- PASS-THROUGH TAXATION – For tax purposes a sole proprietorship is not treated as an entity separate from its owner. Thus, the owner reports the income, gains, deductions, losses and credits of the proprietorship directly on his or her personal income tax returns.

Sole proprietorships also face significant drawbacks, including:

- UNLIMITED PERSONAL LIABILITY – Owners of sole proprietorships are personally liable for the obligations of the business.

[1] http://www2.census.gov/library/publications/2011/compendia/statab/131ed/tables/12s0744.xls.

– DIFFICULTY RAISING CAPITAL – Sole proprietors are greatly limited in their access to financing.

Another attribute of sole proprietorships is that they lack continuity. The enterprise is so closely bound to and dependent upon its owner that its existence is more precarious than other business forms. When the sole proprietor dies, the enterprise will terminate. Even if the proprietorship assets are assumed by the heirs of a deceased owner who continue to operate the business under the same name, the business has legally ended and a new enterprise has been formed by the new owner or owners. Similarly, if the sole proprietor sells the assets of the business, the sole proprietorship ceases and a new business is formed by the buyer. By contrast, when a shareholder of a corporation dies, or transfers or sells his or her stock, the business may continue to exist and operate without disturbance. The lack of continuity of a sole proprietorship is a disadvantage in that the enterprise might not communicate a sense of stability or assurance to third parties who may be hesitant to become involved with a company that could end abruptly. The potential risk of sudden termination could deter lenders from extending credit to the business and prevent the enterprise from attracting qualified employees.

(b) Organizational Structure

There is no formal structure required for a sole proprietorship, since the owner is the sole decision maker for the business with full power to control all aspects of how the business is operated and how any money is handled. The simplicity of the business form allows the owner to spend more time building and running the enterprise and less time tied up with paperwork or other formalities. In contrast, corporations, LLCs and partnerships must abide by or set up various structural guidelines for how the business is managed, how decisions are made, and which individuals are entitled to engage in such management and decision making. The sole owner has complete discretion in a sole proprietorship, thus business planning and organizational arrangements such as operating agreements or bylaws are not required.

(c) Establishment and Documentation

A sole proprietorship is simple and inexpensive to start compared to other business forms. Unlike a corporation or LLC, no formation documents are required to be filed with the state when forming a sole proprietorship. This can save a business from filing fees as well as from the expense associated with preparing such formation documents. To bring a sole proprietorship into existence, the owner simply needs to begin conducting business. In fact, many individuals run sole proprietorships without even realizing it; independent contractors, consultants, and freelancers are all sole proprietors simply by virtue of doing their jobs.

The sole proprietor should obtain any and all registrations, licenses and permits required from the federal, state and local government to run the business and make it legitimate. For example, a business enterprise may require a state or local sales tax permit if it intends to sell retail merchandise, a health permit if it is handling food or a liquor license if it plans to dispense alcohol. Sole proprietors are also often required to register with local tax authorities and pay at least a minimum tax in exchange for a business license or tax registration certificate. Banks may require a sole proprietor to show such a business license or sales tax license when opening a new business bank account.

Additionally, a sole proprietorship may be required to obtain a federal employer identification number, or EIN, from the Internal Revenue Service if it has employees, a qualified retirement plan, or files returns for excise, alcohol, tobacco, or firearms taxes.[2] A sole proprietor may elect to apply for an EIN even if one is not required for his or her business. Otherwise, the sole proprietor may simply use his or her social security number for tax reporting.

FICTITIOUS BUSINESS NAMES

A sole proprietor may do business under his or her own legal name. For instance, if John Smith opens a mechanic shop, he may simply operate as "John Smith Auto Repair." Alternatively, John may select a different business name like "Big City Auto Repairs." Such a business name is referred to as a trade name, fictitious name or "DBA," which stands for "doing business as."

A sole proprietor will first need to ensure that the fictitious business name he or she has selected is available, meaning that the name isn't the same as or overly similar to a name already being used by another entity in a way that could prevent the sole proprietorship from adopting such name. In the example above, if Mike Jones owns "Big City Auto Repair" across town from where John opens his new business, Mike may accuse John of infringing on his trademark rights in an attempt to force John to change the name of his shop or even pay monetary damages. Whether Mike is successful will depend on how likely it is that one business will be confused for the other: the resemblance of the names, similarity between the types of business operated and relative locations are all factors to be considered in such a determination. A sole proprietor can do diligence on name availability by conducting

[2] The EIN is obtained by filing a form SS-4, which may be completed by mail, online, fax or over the phone. See, e.g., https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employer-ID-Numbers-EINs.

a screening search using an online search engine, reviewing state or local fictitious name databases, and searching federal and state registered trademark databases.

After a sole proprietor has verified that the selected fictitious business name is available, he or she must comply with any state and local requirements to register such name. Such requirements may vary from state to state.[3] For example, New York requires the filing of an Assumed Name Certificate with the county clerk's office where the business is located, and all businesses operating under a fictitious name in Florida must register with the state Division of Corporations.[4]

(d) Liabilities

One of the primary disadvantages of a sole proprietorship is that a sole proprietor is personally liable for the obligations incurred by the business. Unlike a limited liability company or corporation, where the business is a separate entity that shields its owners from liability, the sole proprietorship and the sole proprietor are one and the same, and the liabilities of the business are not separate from its owner. This means that if the sole proprietorship cannot meet all of its obligations, the assets of the owner, including his or her bank account, car, or even home, can be accessed to satisfy such obligations.

Sole proprietors are subject to all unmet obligations of the business, including unpaid debts to contract creditors (such as suppliers or lenders who the business has contractually agreed to pay back) as well as judgment creditors (such as tort plaintiffs who bring successful legal proceedings against the business). Moreover, a sole proprietorship, and thus the sole proprietor, is liable for the obligations created by its employees in the course of employment.

The exposure to personal liability should be considered carefully when deciding on a form of business entity. In particular, if the contemplated business enterprise involves a moderate or high degree of risk or is in an industry with a reputation for litigation, a sole proprietorship may not offer adequate protection against the potential liabilities associated with such business. In such cases, the business owner may want to consider forming a corporation or limited liability company to protect his or her personal assets. Additionally, a sole proprietor should obtain adequate insurance coverage to provide protection against liabilities.

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[3] See http://www.sba.gov/content/register-your-fictitious-or-doing-business-dba-name for a guide to registration requirements by state.

[4] https://efile.sunbiz.org/ficregintro.html.

(e) Governance and Regulatory Obligations

The sole proprietorship does not impose any internal governance obligations on its owner. The sole proprietor has complete ownership and thus complete control over how the business is run without the approval of any committee or requirement for any vote. No formal records are required by law, though a sole proprietor should still take it upon him or herself to set up proper business records and financial statements. While the informality, and thus simplicity, of sole proprietorships may be an advantage that makes them attractive to their owners, the lack of structure and financial controls may lead to the failure of a small business. Moreover, inadequate record-keeping could pose a challenge for calculating income taxes and could deter potential customers, suppliers and lenders alike from engaging with the business. In addition, sole proprietorships must comply with all federal, state and local tax filings and must follow all procedures to keep any regulatory filings (such as business licenses and permits) up-to-date.

(f) Tax Treatment

A sole proprietorship is not treated as an entity separate from its owner for tax purposes; in tax parlance, the sole proprietorship is “disregarded” for tax purposes. Thus, the owner reports the income, gains, deductions, losses and credits of the proprietorship directly on his or her personal income tax returns.

A sole proprietorship does not pay separate income taxes, and, accordingly, only one level of tax applies to the income and gains of the business. Conversely, deductions, losses and credits of the sole proprietorship often are usable by the owner to offset income generated by the owner elsewhere, subject to certain limitations. Moreover, because the sole proprietorship is disregarded, cash or other property generally can be moved in and out of the sole proprietorship (for example, in and out of its bank accounts) with no tax consequences.

Under some circumstances, use of a sole proprietorship also simplifies, and thereby reduces the costs of, tax reporting because the income, gains, deductions, losses and credits are not reported separately from the tax returns of the owner. At the same time, the interaction of the tax items of a sole proprietorship with the other tax items of the owner can become complicated, particularly if the proprietorship uses special methods of accounting for the business. Furthermore, an owner cannot be an employee of his or her sole proprietorship for income tax purposes. Thus, owners generally will have to pay periodic estimated taxes throughout the year (rather than having taxes withheld from paychecks or other cash received by the owner) and will have to pay self-employment taxes on income (in effect, both the employer and employee portions of Social Security and Medicare taxes, subject to a deduction for half of such taxes).

It is important to note that sole proprietorships may not be eligible to take advantage of business incentives enacted under tax laws applicable to certain loss deductions, benefit plans and similar matters.

Keep in mind that, like all businesses, the owner of a sole proprietorship is also responsible for any other applicable taxes in addition to federal income taxes, such as excise taxes, employment taxes and any state or local taxes, including sales taxes and property taxes.[5]

(g) Financing

Another drawback of running a sole proprietorship arises in the context of raising capital. Most sole proprietorships start with limited funds pulled together from the owner's personal wealth, loans from family and friends, or consumer loans from banking institutions. This initial capital may be enough to begin running a business and generating a stream of income, and a sole proprietor may choose to reinvest any or all of such income back into the enterprise. As a business grows and expands, however, larger amounts of capital may be needed to buy more equipment, hire new employees or rent larger operating space. Though the need for funding for a sole proprietorship may increase over time, the sources of available funding remain limited due to its organizational structure.

Partnerships, limited liability companies and corporations may issue ownership interests in the form of partnership interests, membership interests or capital stock in exchange for funding. In contrast, a sole proprietorship can only have one owner; thus a sole proprietor is inherently precluded from issuing any type of equity interest to raise capital. When a second person becomes an owner of the business, the organization is by definition transformed into a partnership (described in Section 2.2), and has the advantages and disadvantages associated with that type of enterprise. Often at this point sole proprietors will choose to form a limited liability company or corporation, as opposed to defaulting to a partnership structure.

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[5] See http://www.sba.gov/content/learn-about-your-state-and-local-tax-obligations for a listing of state and local tax obligation resources.

(h) Resources

For additional information, visit:

http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Sole-Proprietorships

http://www.sba.gov/content/sole-proprietorship-0

https://www.ftb.ca.gov/businesses/bus_structures/soleprop.shtml

2.2 PARTNERSHIPS

Key advantages/disadvantages

ADVANTAGES

- Simple and inexpensive to establish and maintain
- Has advantages of sole proprietorship but permits multiple owners of enterprise

DISADVANTAGES

- No limited liability for general partners; each partner is responsible for the debts and obligations of the business
- Generally not suitable for accessing outside capital

Case study

BRIGHTPATH CAPITAL PARTNERS, LP

Brightpath Capital Partners, LP (BCP) is a Delaware limited liability partnership that invests in talented management teams and high-growth businesses creating jobs, wealth, and sustainable environments. BCP provides innovative investment solutions rooted in in-depth research and a disciplined investment process. BCP is focused on generating both economic and social value in the San Francisco Bay Area, California and the Western United States. BCP's investment team consists of seasoned investors with deep entrepreneurial and operating experience, and an extended network of partners and relationships. As such, BCP is positioned to serve the distinct needs of private, undercapitalized companies which endeavour to positively impact their communities as they build successful enterprises. For more information, please visit http://www.brightpathcapitalpartners.com/wp2/.

(a) Overview

A partnership is a form of business structure whereby two or more parties, or partners, agree to form and carry on a business. Each partner in a partnership provides funding, assets, labor or skill, and receives a share in the profit and losses of the partnership.

There are several forms of partnership structures, with the most prevalent forms being:

- General partnership
- Limited partnership
- Limited liability partnership, or LLP
- Limited liability limited partnership, or LLLP

A general partnership is the simplest form of partnership. Absent specific agreement to the contrary, each partner in a general partnership generally (i) has equal rights, responsibilities, powers and obligations in the management and governance of the business, (ii) shares equally in the profits and losses of the business, (iii) is personally liable for the liabilities of the partnership, and (iv) has the ability to dissolve the partnership. No formal state filing or documentation is typically required by law to form a general partnership in its most basic form.

A limited partnership consists of one general partner and one or more limited partners. The general partner manages the limited partnership and has similar rights, responsibilities, obligations and liabilities to a partner in a general partnership. The limited partners are passive investors who contribute capital (or other assets) to the partnership, typically do not participate directly in the management of the business and generally have limited liability up to their individual investment amount. A formal state filing is required to form a limited partnership.

An LLP is similar to a general partnership except that (i) a formal state filing is required for formation and (ii) its partners enjoy limited liability protection. State laws regarding LLPs vary, particularly in regard to the types of entities that are allowed to operate as LLPs (if any) and the extent of limited liability coverage provided. Use of LLPs is often restricted to certain professions, such as accountants and attorneys, and as such this type of structure is inapplicable to many types of businesses.

An LLLP is similar to a limited partnership except that the liability of a general partner in a limited liability limited partnership is typically limited in a manner similar to that of partners in an LLP.[6] The LLLP is a relatively new structure and only half of the states have laws enabling the creation of LLLPs. As a result, use of the LLLP structure is not prevalent, particularly for organizations that operate in multiple states, as it is often unclear if states other than the state of organization will recognize the limited liability protection of the LLLP.

As explored in greater detail below, certain attributes are fairly uniform across partnership structures, such as the ability to elect for pass-through taxation. Further, in comparison to other forms of business structures, partnerships generally have greater management, governance, distribution and ownership flexibility and fewer statutory formalities and requirements. However, other attributes, including (i) the liability of members, (ii) required documentation and corporate formalities and (iii) structure and governance, vary from among partnership structures and from state to state.

(b) Organizational Structure

The governance, management, distribution and ownership structure of a partnership is flexible and can be tailored to an organization's desired structure. Many states set forth default background rules relating to such topics. However, unlike with a corporation (and similar to an LLC), in most cases, such rules and requirements can be adjusted by agreement for a partnership.[7] As such, this structure is typically set forth in reasonable detail in the partnership's partnership agreement.

GOVERNANCE AND MANAGEMENT STRUCTURE

One important area of flexibility for a partnership relates to its governance and management structure. Unlike a corporation, which is governed by its board of directors and managed by its officers (rather than directly by its shareholders), a partnership is governed and managed directly by its partners or by a subset of partners. Absent agreement to the contrary in the partnership's partnership agreement, such management rights are shared equally by all partners, each partner has the ability to bind the partnership in dealings with third parties, and most important management decisions are to be made by the majority of the partners. Further, partnerships also have the option to appoint officers such as a chief executive officer or chief financial officer to run the day-to-day operations of the

[6] See e.g., Delaware Limited Partnership Act §17-214. Cf. http://www.ftb.ca.gov/businesses/bus_structures/LLLpartner.shtml (California does not have an enabling statute for the creation of a California LLLP, but requires foreign LLLPs to register in the state prior to transacting business and pay certain annual fees).

[7] Certain background governance rules cannot always be modified or eliminated. See, for example, Delaware Revised Uniform Partnership Act § 15-103(b) and California Uniform Partnership Act of 1994 § 16103(b).

partnership, or can leave such duties to the partners directly or to a subset of partners. Even if the organization is governed or managed by a smaller group of individuals, partners of the partnership will generally have the ability to vote on certain fundamental decisions for the partnership absent specific agreement to the contrary.

DISTRIBUTION AND OWNERSHIP STRUCTURE

A second important area of flexibility for a partnership relates to its distribution and ownership structure. Partnership ownership interests are called "partnership interests" and entitle partners to certain corporate (e.g. voting and management) and capital (e.g. distribution, income, and appreciation) rights. Partnerships have wide latitude to allocate the relative corporate and capital rights of partnership interests and can structure corporate approvals, processes and procedures as well as the economic rights in a manner that suits the partnership's goals. For example, if one investor in a partnership is interested more in the operating profits and losses of the partnership, while another investor is interested more in the appreciation of the partnership and its assets, the parties could structure an operating agreement that entitled the former partner to a larger share of the partnership's operating income and the latter partner to a larger share of the partnership's capital appreciation.

PARTNERSHIP AGREEMENT

Through its partnership agreement, a partnership can set forth who, how, and in what manner the partnership will be owned, governed or managed, and how a partnership's profits and losses will be allocated and distributed, including, among other things:

- Who will govern and manage the partnership (e.g. all partners, a select group of partners, separately appointed officers).
- How such individuals will be appointed and removed.
- The rights, powers and responsibilities such individuals have.
- The indemnification rights such individuals will have.
- Who is entitled to vote on major governance, management, distribution and ownership issues.
- The relative weight of votes.
- The procedures that will be followed for decisions.
- The level of approval needed for general issues.
- Whether any issues require specific higher levels of approval or approval of specific parties.
- Whether any partners or groups of partners have special rights, privileges or preferences.

- The fiduciary duties partners owe to each other and to the partnership.
- The current ownership structure of the partnership.
- The forms of investment (e.g. cash, property, services) allowed in the partnership.
- Restrictions imposed upon, and procedures required, to raise future internal and external capital.
- How profits and losses are allocated among the partners.
- How, when and in what amount distributions will be made among the partners.
- How the proceeds from a sale or liquidation of the partnership will be distributed among the partners.
- The restrictions, if any, relating to the transfer of partnership interests.
- What occurs on the death, withdrawal or removal of a partner or the liquidation of the partnership.
- Any penalties if partners fail to act in accordance with the partnership agreement.

IMPACT OF STATE LAW

If substantive and procedural rules governing the partnership are not addressed in the partnership's partnership agreement, many state statutes governing partnerships set background default rules. For example, if the partnership's partnership agreement does not specify specific voting rights, generally (i) each partner (regardless of such partner's contribution to a partnership) generally has an equal vote in matters, (ii) the consent of a majority of partners is required for many decisions and (iii) the consent of all partners is required for certain key events such as a merger of the partnership.[8] Further, if the partnership agreement is silent regarding the circumstances in which the partnership will dissolve, generally each partner has the unilateral right to dissolve the partnership.[9] While these default rules may provide some guidance if such issues are not addressed in the partnership's partnership agreement, such rules often vary from state to state in terms of scope, detail, procedure and substance and may not reflect the parties' desired structure. Social entrepreneurs should consult with legal advisors to obtain further information on rules in specific states.

[8] See e.g., Delaware Revised Uniform Partnership Act § 15-401(f), California Uniform Partnership Act of 1994 § 16401(f), Delaware Revised Uniform Partnership Act § 15-902(b) and California Uniform Partnership Act of 1994 § 16911(a).

[9] See e.g., Delaware Revised Uniform Partnership Act § 15-801 and California Uniform Partnership Act of 1994 § 16801.

IMPACT OF FLEXIBILITY

The flexibility afforded to partnerships to restructure state default rules[10], together with the variations of the default rules themselves, can serve to remove restrictions regarding corporate actions and limit the rights of partners. This can be an advantage for an organization that wants to make decisions quickly by allowing it to streamline the decision-making process regarding certain corporate actions by removing procedural hurdles such as the consent of partners. However, these attributes can also serve to raise issues for minority investors who may have fewer rights available to protect their interests[11] if the partnership agreement removes background rights or explicitly provides certain partners with more favorable rights. As protection against abuses of power, certain state statutes do provide limited partners in a limited partnership with the right to initiate derivative suits on behalf of the partnership.[12] However, due to the flexibility partnerships have in structuring governance duties and responsibilities, the opportunities for such actions may be limited in certain cases.

(c) Establishment and Documentation

DOCUMENTATION

The documentation requirements for the formation and operation of partnerships differ among the different partnership forms and from state to state. All partnerships will typically:

- Apply for federal and state employer identification numbers.
- Draft a partnership agreement.
- Complete other standard documents (such as employment agreements) necessary or desired to run the business.

Additionally, limited partnerships, LLPs and LLLPs will also likely need to:

- File a short charter document in the partnership's state of organization (often called a Certificate of Limited Partnership or Certificate of Limited Liability Partnership).
- Qualify to do business in any states in which the partnership will transact business.
- File federal and state securities filings related to the issuance of partnership interests.

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[10] State default rules are the background rules of law that are established by state law.
[11] Including voting rights or the right to financial and ownership information regarding the partnership.
[12] See e.g., Delaware Limited Partnership Act §17-1001 *et. seq.*

CHARTER DOCUMENTS AND QUALIFICATIONS TO DO BUSINESS

Partnerships must comply with the requirements of their state of formation, which is generally the state in which the enterprise or its owners is located. General partnerships are typically not required to file a formal charter document in their state of organization. Many states, such as Delaware and California, allow for a permissive filing[13] of a charter document for a general partnership (called a Certificate of Existence), but do not require such filing.[14] A general partnership may want to make such a filing to substantiate to a third party the existence of the partnership or a partner's authority to act on behalf of the partnership.[15]

Each state has a slightly different form and requirements for a partnership's charter document and documents related to qualifying to do business in such state. However, these documents are typically fairly simple and straightforward. Through the charter document, the partnership selects a name (which usually must contain the name "limited partnership", "LP", "L.P." or "LTD" (for limited partnerships) and a "limited liability partnership", "LLP" or "L.L.P." (for LLPs)), sets forth the name and address of its registered agent in the partnership's state of organization, sets forth the name and address of its general partner(s), and may be required to provide certain other information such as the partnership's business address, the partnership's business purpose, the names of the partners and the duration of the partnership (i.e. if perpetual or for a limited number of years). The partnership must also provide similar information in filings (typically annually) in each state in which the partnership transacts business.

PARTNERSHIP AGREEMENT

As described above, the principal organization document for any form of partnership is a partnership agreement. Although a written partnership agreement is not generally required by state law, the partnership agreement is generally advisable. Absent a partnership agreement, the partnership's structure is dictated by default rules under state law, which may not cover all pertinent issues or reflect the parties' desired allocations of rights, privileges, preferences and obligations. For example, absent agreement to the contrary, the general background rule in many states is that, notwithstanding such member's differing investment amounts in the partnership, each partner (i) has equal rights in the management and conduct of the partnership, (ii) is entitled to an equal share of partnership profits, (iii) is chargeable with an equal share of the partnership's losses, and (iv) has no preemptive right to subscribe to any

[13] Permissive filings are filings that an entity can but is not legally required to make.
[14] Delaware Revised Uniform Partnership Act §15-202 and California Uniform Partnership Act of 1994 § 16303.
[15] See e.g., Delaware Revised Uniform Partnership Act §15-303.

additional issue of partnership interests.[16] If a partnership wishes to be governed by different principles or allocate profit and losses other than equally among the partners, a partnership agreement will be required.

OTHER FILINGS AND AGREEMENTS

In addition to these partnership specific agreements, a partnership will also typically enter into standard agreements relating to the conduct of its business at the time of formation such as employment agreements, proprietary information and invention assignment agreements and consulting agreements, as well as make federal, state and local tax and regulatory filings, and, in the case of limited partnerships, LLPs and LLLPs, securities filings.

OTHER CONSIDERATIONS

Any form of partnership can be established with two or more members. In the case of a limited partnership or LLLP, at least one partner must be a general partner and at least one partner must be a limited partner.

COST

The cost for establishing a partnership varies. The main cost components include attorney fees for the preparation of documents; any accounting related fees for taxation-related advice and services and, in the case of limited partnerships, LLPs and LLLPs, state filing fees for organization, qualification and securities filings, and statutory representation fees for the partnership's agent for service of process. Attorney fees are affected by the type of partnership, the complexity of the partnership's management, governance, distribution and ownership structure (as reflected in the partnership's partnership agreement) and the number of additional documents required to set the partnership up for business (e.g. employment agreements, securities and regulatory filings). For limited partnerships, LLPs and LLLPs, state filing and statutory representation fees are affected by the numbers of states and specific states in which the entity organizes, transacts business or sells securities. State filing fees vary from state to state. Organization and qualification-related fees typically range from $50 to $500; however, certain states charge a fee

[16] See e.g., Delaware Revised Uniform Partnership Act §15-401 and California Uniform Partnership Act of 1994 § 16401.

per partner or have publication requirements that can increase fees for domestic or foreign limited partnerships, LLPs or LLLPs substantially.[17]

SELECTING A STATE OF ORGANIZATION

When selecting a state of organization for a partnership, many factors should be considered, including:

- The organization's principal place of business and states in which it transacts business.
- Flexibility and predictability of state statutes and legal precedent.
- State taxation issues.
- State filing fees, including organization and annual maintenance fees (franchise tax and secretary of state).
- Nature of limited liability protection (for limited partnerships, LLPs and LLLPs).

The lowest cost option for partnerships is typically to organize in the state in which the partnership's principal place of business is located, which may help reduce attorney fees (as the partnership will likely be subject to certain of such state's laws regardless of where it is organized), and, in the case of limited partnerships, LLPs and LLLPs, may help the partnership avoid duplicate state filing fees and additional statutory representation fees.

However, cost alone should not dictate the state of organization. Initial and annual costs need to be weighed against strategic considerations. For example, many parties prefer the predictability and familiarity of Delaware as a state of organization. Further, some states have more limited legal precedent relating to partnership specific issues and disputes or have unique aspects in governing statutes which may not be suitable for a particular organization. In addition, the degree of limited liability protection for limited partners in a limited partnership and partners in an LLP and LLLP vary by state; many states strictly limit the types of business that can operate as LLPs and many states do not allow for the creation of LLLPs.[18] Social entrepreneurs should consult with legal advisors to understand the best state for their particular enterprise.

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[17] See https://direct.sos.state.tx.us/help/help-corp.asp?pg=fee for an example of a state that charges a fee per partner; See New York Revised Limited Partnership Act § 121-201 and New York Registered Liability Limited Partnership Act § 121-1502 for an example of a state that has a publication requirement.

[18] See New York Registered Liability Limited Partnership Act § 121-1500 and California Uniform Partnership Act of 1994 §16101(8) for examples of state restrictions on the types of businesses that can operate as LLPs.

(d) Liabilities

The liabilities of a partner in a partnership vary by partnership structure. The general rules for each type of structure are briefly described below.

GENERAL PARTNERSHIP

Partners in a general partnership are personally liable for the debt, obligations, actions and liabilities of a partnership. This means that if the liabilities of the partnership exceed the partnership's assets, a party can seek damages from the personal assets of each partner. Thus, unlike shareholders of a corporation or members of an LLC, a partner in a general partnership can be held liable for damages above and beyond such partner's investment in the partnership. With limited exceptions (such as liabilities incurred before a party's admission as a partner), this liability is generally joint and several[19] for all liabilities that a partnership sustains.[20] This means that a party can seek damages from the individual partner responsible for the liabilities of the partnership, or from any one or more of the other partners in the partnership (even if they did not participate in the creation of the liabilities).

LIMITED PARTNERSHIP

General partners in a limited partnership have similar liability to partners in a general partnership. Limited partners, in contrast, typically enjoy limited liability. This means that if a limited partnership's debts or liabilities exceed its assets, each general partner of the limited partnership can be held liable for damages above and beyond such general partner's investment in the partnership, while each limited partner will generally only stand to lose such limited partner's investment in the partnership and will generally not be held personally liable for such debts.[21] Such limited liability typically does not apply to the extent that a limited partner actively participates in the control or management of the business, with respect to acts or omissions of the limited partner (e.g. fraud or receiving distributions from a limited partnership in contravention of state law or the limited partnership's operating agreement), or with respect to personnel guarantees or contractual obligations by the limited partner either in the limited partnership's partnership agreement or with a third party (e.g. if a

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[19] Joint and several liability means that each party is liable for the entire liability and a person who is harmed by such parties could bring a potential claim against any or all such parties for the full amount of such liability.

[20] See e.g., Delaware Revised Uniform Partnership Act §15-306 and California Uniform Partnership Act of 1994 § 16306.

[21] See e.g., Delaware Limited Partnership Act §17-303 and §17-403 and California Uniform Limited Partnership Act of 2008 §15303 and §15404. Please note that the limited nature of such limited liability varies by state (see Thomas A. Humphreys, Limited Liability Companies and Limited Liability Partnerships (2nd ed. 2011)).

limited partner personally guarantees a limited partnership's bank loan or other obligation).

LLP AND LLLP

Partners in an LLP, similar to shareholders of a corporation or members of an LLC, typically enjoy the benefit of limited personal liability for the business debts, judgments and actions of the LLP.[22] There are certain exceptions to this rule. Such limited liability typically does not extend to acts or omissions of a partner or personal guarantees or contractual obligations by a partner in either the partnership agreement or with respect to a third party.

While state statues vary, liability for general partners in an LLLP is typically limited in a manner similar to that of partners in an LLP, while liability for limited partners in an LLLP is typically limited in a manner similar to liability for limited partners in a limited partnership. One exception is that many state statues provide that the carve out from limited liability described above for limited partners in a limited partnership regarding active participation in the management of the partnership's business does not apply to limited partners in an LLLP.[23]

Please note that due to the (i) relatively new nature of LLPs and LLLPs; (ii) lack of legal precedent; (iii) variance among governing statutes; (iv) lack of enabling statutes in many states (for LLLPs), and (v) ability of parties to expand, diminish or eliminate protections afforded by statues (such as fiduciary duties), the limited liability of partners of an LLP or LLLP may be much less predictable and complete than for shareholders, officers and directors of a corporation.[24]

As with a corporation and LLC, the scope of the exceptions to limited liability for limited partners in a limited partnership, partners in an LLLP and partners in an LLP can be reduced through prudent planning and attention to corporate formalities. In addition, as with other entity structures, the partnership itself will remain liable for all company liabilities.

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[22] See e.g., Delaware Revised Uniform Partnership Act § 15-306 and California Uniform Partnership Act of 1994 § 16306(c).
[23] See e.g., Delaware Limited Partnership Act §17-214.
[24] Thomas A. Humphreys, Limited Liability Companies and Limited Liability Partnerships (2nd ed. 2011).

(e) Governance and Regulatory Obligations

GOVERNANCE OBLIGATIONS

Many of a partnership's ongoing governance obligations are determined internally by the partnership through the partnership's partnership agreement. As a general rule, there are fewer statutory governance requirements for a partnership than for a corporation or LLC and most decisions can be made informally. Those requirements that do exist often provide for a choice by the partnership or provide explicitly that such requirements can be contracted around through the partnership's partnership agreement.

Partners generally owe fiduciary duties of loyalty and care to other partners.[25] Limited partners in a limited partnership or LLLP generally do not have any fiduciary duties to fellow partners except for the requirement to exercise their rights and discharge their duties consistently with the obligation of good faith and fair dealing.[26] While the boundaries and enforceability of such modifications vary from state to state, the explicit right many state statutes provide to modify such fiduciary duties provides more flexibility for partnerships than for corporations in this respect.[27]

REGULATORY OBLIGATIONS

Partnerships, like other entities, are subject to federal, state and local regulatory requirements applicable to the type of business they operate. Regardless of the type of business, the partnership will have certain ongoing federal, state, and possibly local, filing requirements. Depending on the states in which the partnership operates, its business and its tax elections, such filings can include:

- Federal, state and local income and employment tax-related filings.
- Federal state and local regulatory filings (e.g. environmental permits, manufacturing licenses).
- Additionally, if the partnership is a limited partnership, LLP or an LLLP, the partnership may have:
- Annual state informational filings (with the secretary of state in the state of the partnership's incorporation and any state in which the partnership is qualified to do business).

[25] See e.g., Delaware Revised Uniform Partnership Act § 15-404 and California Uniform Partnership Act of 1994 § 16404.

[26] See e.g., California Uniform Limited Partnership Act of 2008 §15-903.05.

[27] See e.g., Delaware Revised Uniform Partnership Act § 15-103(f). Please note that certain states place greater limitations on a partnership's ability to modify or eliminate such duties (see, for example, California Uniform Limited Partnership Act of 2008 §16013).

- Annual state franchise tax filings (with the franchise tax board in the state of the partnership's incorporation and any state in which the partnership is qualified to do business).
- Federal and state security filings (relating to the issuance of partnership interests).

The exact filings, format, timing, substance and cost will vary based on the type of business operated, the state in which the partnership is organized, and the states (or states) in which the partnership transacts business. For example, certain states consider limited partnership, LLP and LLLP interests to be securities, while others do not take that position.[28] As such, partners should carefully review the applicable rules and regulations in states in which the partnership solicits investors and operates.

(f) Tax Treatment

A partnership typically can elect to be treated either as a pass-through entity or corporation for income tax purposes. Absent an affirmative election otherwise, a partnership automatically will be taxed as a pass-through entity for federal income tax purposes. A partnership treated as a pass-through entity is not subject to a separate tax on its income. Instead, owners of the partnership will report and pay tax on their share of the partnership's income, gains, deductions, losses and credits on their personal income tax returns.[29] In addition and subject to certain limitations, distributions of cash or other property from the partnership to the partners generally are not subject to a separate tax.

On the one hand, pass-through treatment can prove advantageous in many circumstances through the avoidance of double taxation and the ability to deduct losses of the business on the tax returns of the partners (subject to certain limitations). On the other hand, pass-through taxation can lead to cash flow issues for partners, as each partner's share of the partnership's taxable income is taxable to that partner whether or not actually distributed by the partnership to such partner. In addition, partners generally cannot be employees of their partnership (partners will have to pay periodic estimated taxes in lieu of being subject to wage withholding) and taxable income allocated to partners of a partnership often is subject to self-employment (i.e., Social Security and Medicare) taxes. Further, historically

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[28] Thomas A. Humphreys, Limited Liability Companies and Limited Liability Partnerships (2nd ed. 2011).

[29] See Internal Revenue Code § 704(b) and Treasury Regulation § 1.704-1(b) *et seq.* While partnerships generally have flexibility to determine how the partnership's tax items are allocated among the partners, such allocations must have substantial economic effect or otherwise must be in accordance with the partner's economic interest in the partnership. *See* Internal Revenue Code § 704(b) and Treasury Regulation § 1.704-1(b) *et seq*.

corporations have enjoyed advantages with respect to certain business incentives enacted in the US federal tax code.

Notwithstanding a partnership's pass-through treatment for federal income tax purposes, certain states, such as California, may still impose annual taxes, such as franchise and gross receipts fees, on the entity itself. In addition, a partnership, like other businesses, must pay other forms of tax, such as sales and use, excise, employment, property and transfer taxes.

Under some circumstances, a partnership may wish to affirmatively elect to be taxed as a corporation, including if the partnership:

- has foreign or tax-exempt partners that want to avoid being treated as engaged in a trade or business in the United States;
- has foreign partners resident in a country with whom the United States has a treaty under which distributions from a corporation would be subject to reduced or no withholding taxes;
- is more than 80-percent owned by a corporation that wants to include the partnership as a corporation within its consolidated return; or
- is owned by partners that want to avoid being treated as doing business in a state or being subject to taxation in such state.

If a partnership elects to be treated as a corporation, generally it will be taxed in accordance with the discussion under *Tax Treatment* for corporations below.

(g) Financing

The attributes of partnerships often make them attractive structures for small, tightly-knit groups of partners that do not anticipate needing to raise additional outside capital, as such partners can choose to allocate the relative corporate and capital rights of contributors with great flexibility. Further, subject to compliance with federal and state securities laws and any restrictions contained in the partnership's partnership agreement, partnerships have few formal restrictions on financing and raising funds.

However, certain factors greatly limit the types of investors interested in investing in partnerships. Most sophisticated investors consider general partnerships too risky given the lack of limited liability. Tax exempt and venture capital investors are less inclined to invest, or may be contractually prohibited from investing, in operating partnerships with pass-through taxation as this can lead to unrelated business income for such entities. Further, venture capital and sophisticated angel investors may shy away from partnership investments due to issues relating to (i) the complexity of addressing multiple rounds of funding or a diverse ownership structure in a partnership's partnership agreement, (ii) complications relating to transferring partnership interests and survivorship issues,[30] and (iii) reduced flexibility in offering employees standard equity incentive awards[31] (crucial for many high-growth companies in which such investors invest). Also, partnership interests do not qualify as "qualified small business stock", and do not receive the favorable tax treatment such stock can provide to investors under the US Internal Revenue Code, and it is very challenging (although not impossible) for a partnership to conduct an initial public offering and become a public company.[32] In addition, in the case of limited partnerships, such investors may want to play an active role in the governance or management of the business, which can potentially impact the limited liability protection a limited partnership provides limited partners.

For these reasons, and the simple fact that many investors are more experienced and comfortable with investing in Delaware "C" corporations, many outside investors (notably venture capital investors) simply may not be willing to invest in the partnership or may require the partnership to convert to a corporation prior to investing which can lead to additional legal fees and tax issues for current owners. As a result, a partnership likely is not a good fit for organizations that anticipate raising meaningful amounts of outside capital or want flexibility in future fundraising.

(h) Resources

http://www.irs.gov/Businesses/Partnerships

http://www.sba.gov/content/partnership

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[30] Many state statutes provide that certain partnerships can be dissolved by the will of any partner or, in certain cases, by the specific events such as the death, bankruptcy or incapacity of a partner. See, for example, Delaware Revised Uniform Partnership Act § 15-801. Further, a partnership may terminate for tax purposes notwithstanding that the partnership continues under state law if (i) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners or (ii) fifty percent (50%) or more of the interest in partnership capital and profits are sold or exchanged within a twelve (12) month period (see Internal Revenue Code § 708(b)).

[31] While partnerships can adopt equity compensation plans to incentivize employees, partnerships, like LLCs, cannot issue incentive stock options and the structure and terminology of such plans may be unfamiliar to prospective employees.

[32] Internal Revenue Code § 1220.

2.3 CORPORATIONS

Key advantages/disadvantages

ADVANTAGES

- Separate legal entity providing for limited liability of shareholders for the debts of the corporation
- Perpetual existence with easily transferable ownership interests
- Generally regarded as most suitable legal structure for raising capital (debt or equity)
- Relatively simple to provide equity compensation for employees
- Can rely on business judgment rule to promote social and/or environmental mission that is in the long- or short-term best interests of the corporation

DISADVANTAGES

- Complicated formation process with prescribed procedures
- Formalities in formation and management must be adhered to
- Competitive market pressures and concerns regarding duties to maximize shareholder value may discourage corporations from pursuing social or charitable purposes
- Prohibited or restricted in certain instances from prioritizing social or environmental purposes that negatively impact shareholder value
- Constituency statutes designed to allow for additional considerations outside of shareholder value lack accountability and disclosure and often conflict with other provisions governing corporations

Case study

REVOLUTION FOODS, INC.

Founded in 2006, Revolution Foods, Inc., a Delaware corporation, provides fresh, healthy meals and offers nutrition education programs to students nationwide. Revolution Foods' mission is to lead the conversation on childhood health and improve the lives of hundreds of thousands of students every single day. Revolution Foods is committed to making an impact by

providing healthy meals and offering nutrition education programs designed to encourage healthier eating decisions. Revolution Foods also promotes family nutrition through a retail product offering which will be launched in the summer of 2013 and is a certified B Corporation (see Section 4). For more information, please visit http://revolutionfoods.com

(a) Overview

A corporation is a distinct legal entity, or artificial "person", formed and existing under state law. As such, corporations are subject to the business corporation laws set forth by the states in which they are incorporated. A corporation is legally separate from its owners and those who manage it, allowing it to enter into agreements, own and dispose of property, incur liabilities and pay taxes like a natural person.

The corporate form affords businesses with certain benefits such as:

- The owners of a corporation are not responsible for the debts and obligations of the business and are generally shielded from sharing in downside risk beyond their investment in the company.
- A corporation is designed with a built-in organizational structure that clearly separates oversight, daily management and ownership into three bodies: the board of directors, officers and shareholders of the company.
- Corporations may attract investors with their ability to issue stock. Moreover, the legitimacy afforded to a corporation through its formal structure can be appealing to creditors and equity investors alike.

Likewise, certain drawbacks are inherent with the formation of a corporation including:

- Forming and maintaining a corporation involves the preparation and filing of various legal documents along with the payment of state filing fees, which can be both time-consuming and expensive.
- A corporation is required to observe various formalities to ensure that it is truly being run as a separate legal entity warranting limited liability treatment.
- Corporations taxed under subchapter C of the United States Internal Revenue Code generally are taxed separately from their owners, which can lead to double taxation on corporate earnings intended for distribution as dividends to shareholders (as opposed to reinvestment). Such corporations are often referred

to as "C" corporations. However, under certain circumstances corporations can elect treatment under subchapter S of the Internal Revenue Code (i.e., "S" corporations).

Corporations also enjoy perpetual existence due to their independent status, unlike sole proprietorships or partnerships, which may be forced to terminate upon the death or withdrawal of an owner.[33] This means that a corporation may exist indefinitely, regardless of changes in management or ownership. Thus, if an owner, or shareholder, dies or no longer wants to be involved with the business, their ownership interest can be transferred to another individual or entity without disturbing the continuity of the company. Perpetual existence affords corporations increased stability that makes them more attractive to potential creditors and investors.

(b) Organization Structure

A corporation is governed by its board of directors and owned by its shareholders (often referred to as stockholders). The daily management of the corporation is entrusted to the corporation's officers, who are appointed by the board of directors. Although the board of directors is responsible for managing a corporation's business affairs, the approval of shareholders is required for certain corporate actions such as the sale of the business or amendment of charter documents.

This structure provides for discrete functions for each role, though the individuals occupying such roles may overlap. Indeed, in most states, a single individual may serve as the sole director, officer and shareholder of a corporation, though his or her duties and responsibilities will change in each role. While the formal structure of a corporation serves to neatly and automatically separate duties within a business, such rigidity may be cumbersome for a smaller business that could benefit from the simplicity of a sole proprietorship, partnership or LLC.

BOARD OF DIRECTORS

The directors comprising a corporation's board of directors are elected by the corporation's shareholders. Generally, each corporation must have at least one director,[34] though a corporation's charter document and bylaws may require that the corporation have more. The powers, duties and responsibilities of the board of directors are outlined in the bylaws of the corporation, which typically provide the

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[33] See e.g., California Corporations Code §200(c).

[34] See e.g., Delaware General Corporation Law §141(b); note, however, that the governing laws of the state in which the corporation is incorporated may require the corporation have more than one director in certain circumstances.

board with the power to approve major decisions and transactions (although shareholder approval may also be required), appoint officers, and establish corporate policies and goals. Depending on the corporation's bylaws, the board of directors may act by unanimous written consent or by adopting resolutions at board meetings.[35] The timing of regular meetings of the board of directors is set forth in a corporation's bylaws, though special meetings may be called as needed. The laws of the state of incorporation and the corporation's charter document also set forth certain powers, duties and responsibilities of directors of a corporation.

OFFICERS

Unlike the board of directors, which makes high-level decisions on the management of the corporation, officers oversee and are responsible for the daily operations of the business. Thus, officers have the authority to act on behalf of the business and may legally bind the business in obligations such as employment agreements, loan documents or customer contracts. Each state's corporate laws set forth the required officer positions a corporation must fill, which typically include a president or chief executive officer, treasurer or chief financial officer, and secretary.[36] In most states, it is permissible for a single individual to simultaneously occupy all requisite officer positions for a corporation.

SHAREHOLDERS

The shareholders are the owners of a corporation and hold share of capital stock of the corporation evidencing their stake. Ownership of a corporation may be concentrated in a single shareholder who manages the entire entity or dispersed across millions of shareholders. Shareholders are not personally liable for the obligations of a corporation and their risk of loss is generally capped at the amount of their investment. Ownership entitles the shareholders to any dividends distributed by the corporation as well as any appreciation in their ownership stake resulting from the success of the corporation. Shareholders are also charged with electing the corporation's board of directors and may vote on certain important matters such as the approval of a merger or sale of the company. Subject to the limitations of state and federal securities laws, shareholders may terminate their ownership by selling or transferring their stock to a new owner or another existing owner, thereby allowing the corporate entity to continue operating without disturbance.

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[35] See e.g., Delaware General Corporation Law §141(f).
[36] See e.g., California Corporations Code §312(a).

(c) Establishment Costs and Documentation

DOCUMENTATION

To form a corporation in any state, incorporation documents must be filed in the business filing office of that state. Fees for such a filing vary depending on the state of incorporation. Corporate filing information can typically be obtained at the state's filing office website, which usually also contains fee information and provides various corporate forms. Generally, establishing a corporation requires several state and federal filings and the drafting of certain organizational and governance documents, including:

- Filing a short charter document (often referred to as Articles of Incorporation or Certification of Incorporation) in the corporation's state of incorporation.
- Applying for federal and state employer identification numbers.
- Qualifying to do business in any states in which the corporation will transact business.
- Drafting the bylaws of the corporation.
- Filing federal and state securities filings related to the issuance of securities to shareholders.
- Completing other standard documents (such as employment agreements) necessary or desired to run the business.

STATE OF INCORPORATION

An initial consideration when forming a corporation is selecting the state of incorporation. A corporation may be formed in any state, not just the state in which its business is located (sometimes referred to as the "home" state). Many corporations are formed in Delaware, especially large public companies, even though they transact little or no business in Delaware due to the fact that Delaware has made a concerted effort to create a landscape that is attractive to corporations with low fees and less restrictive regulations. As a result, Delaware has a developed and sophisticated body of corporate law. Thus, there may be less uncertainty in certain aspects of operating a Delaware corporation.

For a small, privately held corporation, however, it may not make sense to incorporate outside of its home state. To do business in a state other than the state of incorporation, where it is a "domestic" corporation, a corporation must be qualified as a "foreign" corporation.[37] Thus, a corporation must either incorporate or qualify to do

[37] See e.g., California Corporations Code §2105.

business in its home state. The costs and requirements of foreign qualification in a corporation's home state may be nearly as cumbersome as the incorporation itself, leading to additional burdens on formation. Further, each state requires a corporation to designate a registered agent for service of process.[38] If there are no business operations and no corporate presence located in the state of incorporation, the corporation must use the services of a third party registered agent service which adds an additional cost and inconvenience. Social entrepreneurs should consult with legal advisors to understand the best state for their particular enterprise.

CORPORATE CHARTER

A corporation's existence begins with the filing of the requisite formation document, or charter, and payment of a filing fee with the appropriate state filing office, usually the Secretary of State. In most states, the charter is referred to as either the Articles of Incorporation or Certificate of Incorporation. The filing fees accompanying a corporation's charter range from as low as $50 in Iowa to up to $250 in Connecticut.[39] As a point of reference, the filing fee in Delaware is at least $89 and $100 in California. The statutory requirements regarding the information that must be included in the charter also varies from state to state, though generally a corporation must provide (i) its corporate name, (ii) the name and address of its registered agent for service of process (iii) the nature of the business, (iv) the number of authorized shares of capital stock the corporation may issue and (v) the name and address of the incorporator.[40] Once a corporation is formed, the incorporator may appoint initial directors and resign as the incorporator of the corporation.

BYLAWS

Unlike the charter, the bylaws of a corporation are not filed with the state (and thus are not a public document) though they still serve an important role in governing the operation of a corporation. Usually, the bylaws describe such matters as the frequency of regular meetings of the board of directors and shareholders of the corporation, the voting and notice requirements related to such meetings and the roles of various corporate officers. Corporate bylaws generally also provide for the method of electing and removing directors to and from the board and may establish special committees with designated responsibilities and authority. The rules set forth in a corporation's bylaws are also subject to the limitations of state law and provisions of the corporation's charter.

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[38] See e.g., Delaware General Corporation Law §132.

[39] See https://sos.iowa.gov/business/FormsAndFees.html; compare with http://www.sots.ct.gov/sots/lib/sots/commercialrecording/allforms/cert_of_inc_-_stock_corp.pdf.

[40] See e.g., Delaware General Corporation Law §102.

INITIAL BOARD MEETING

To complete the incorporation process, a corporation should hold its first meeting of its board of directors to establish certain important initial governing matters. Typically, a board will approve the bylaws, appoint corporate officers, establish a bank account and take other actions to allow the business to begin to operate. The actions taken by the board during such meeting should be recorded in meeting minutes to be filed in the corporate minute book.

(d) Liabilities

One of the most important aspects of the corporate form is that it affords shareholders protection against the liabilities of the corporation. A corporation is a separate legal entity that is liable for its own debts, claims, torts and other liabilities. Its directors, officer, employees and shareholders are generally shielded against such obligations. The personal assets of a shareholder are not subject to the liabilities of a corporation if the corporation is unable to satisfy those obligations. Thus, an individual shareholder’s exposure is generally limited to the amount of their investment into the corporation.

EXCEPTIONS TO LIMITED LIABILITY

The protections afforded by limited liability are not absolute. For example, if a shareholder personally guarantees a loan or other commitment of the corporation, he or she agrees to be personally accountable for the underlying liabilities in the event that the corporation cannot meet its obligations. Creditors often require personal guarantees from owners to protect their interests when lending to new and therefore potentially risky businesses. Directors, officers and shareholders of a corporation may also be liable for certain unpaid federal and state taxes owed by the company. Further, in situations where a corporation has committed fraud or disregarded corporate formalities, courts have on occasion “pierced the corporate veil,” ignoring the protection of the corporate entity to hold directors or active shareholders personally liable for harm done to third parties.

Personal liability arising from such exceptions can be avoided with thoughtful planning and awareness of necessary corporate formalities and obligations. As some best practices, timely payment of corporate taxes should be a priority of a corporation, personal guarantees should be considered carefully and granted only when necessary, and complete corporate records should be maintained by the corporate record-keeper.

FIDUCIARY DUTIES

Under applicable state law, directors, officers and shareholders with certain controlling ownership interests owe fiduciary duties to the corporation and its shareholders. That is, these individuals are in positions of power with respect to the corporation and therefore have the obligation to act in a manner consistent with the best interests of the corporation and its shareholders. Although the scope of the fiduciary obligations of directors, officers and controlling shareholders varies by state, generally, directors, officers and controlling shareholders meet their fiduciary duties if they act in good faith with due care and refrain from engaging in acts of self-dealing.[41] When a corporation is subjected to particular circumstances such as insolvency or a potential sale of the company, the standards governing these responsibilities may change or expand.

One area deserving particular attention for social entrepreneurs is the prevailing view in the United States that directors of a corporation have a duty to maximize shareholder value, particularly in the context of a strategic transaction such as the sale of the business. This view of the corporation and the role of the board of directors restrict the ability or willingness of social enterprises to consider other values over maximizing shareholder wealth under certain circumstances. It may also have the effect of inhibiting directors from taking actions that could support other values in addition to profit maximization even when those actions could be considered permissible, for example when making operational decisions. As a result, social enterprises may view the corporate structure as overly limiting. In response to this concern, a number of states have adopted legislation providing for the formation of "benefit corporations", and California and Delaware have enacted legislation providing for the formation of "social purpose corporations" and "public benefit corporations" respectively Each variation of the corporate form explicitly permits corporations satisfying certain conditions to promote purposes other than the maximization of shareholder value. See Sections 3.1,3.3 and 3.5 below.

However, we note that the primary duties are viewed by courts together with the business judgment rule. The business judgment rule provides protection for liability for boards and management to consider social and environmental goals that are in the best interest of the corporation, not specifically defined by shareholder value or stock price. It is actually legal factors apart from form – e.g. quarterly reporting, stock options – that drive many profit-maximization corporate actions.

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[41] See e.g. *In re Walt Disney Co. Derivative Litigation,* 906 A.2d 27 (Del. 2006).

NON-SHAREHOLDER CONSTITUENCY STATUTES

In response to the slightly misguided view that the duty of a corporation's board of directors is to maximize shareholder wealth, a number of states have adopted non-shareholder constituency statutes.[42] These statutes are intended to permit or in some cases require corporate directors to consider non-shareholder interests, such as the interests of the community, employees, customers and suppliers, when making business decisions, particularly when considering a strategic transaction such as the sale of the business. Notably, neither California nor Delaware, two of the most popular states of incorporation, have adopted such statutes.

There is very little legal guidance as to how non-shareholder constituency statutes should be interpreted, and there is considerable debate regarding whether such statutes provide sufficient protection to directors relying upon them, particularly in a takeover context. Generally, these statutes do little more than authorize directors to consider non-shareholders when making decisions.[43] Specifically, they lack any (i) guidance regarding weighting of goals, (ii) mechanism for transparency, or (iii) means for assuring accountability. As a result, corporations and corporate directors should carefully consider whether to rely on such statutes. Social entrepreneurs choosing to establish a corporation may find that forming a social purpose corporation, public benefit corporation or benefit corporation would provide more flexibility and protections for their directors and officers.

(e) Governance and Regulatory Obligations

After a corporation has been properly formed, there are certain ongoing requirements that it must comply with in order to comport with corporate formalities and maintain good corporate status.

GOVERNANCE

Particular attention must be paid to corporate formalities in order to ensure that the full protections of the corporate form and its limitations on liability are available to an entity. For example, copies of all board and shareholder consents and minutes of important board and shareholder meetings should be kept in a minute book by the corporate record-keeper to properly document issues contemplated and decisions made by the board and shareholders. These records are important legal documents that demonstrate compliance with corporate formalities and respect for the corporate

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[42] See e.g. Conn. Gen. Stat. § 33-756; Ind. Code Ann. § 23-1-35-1; Minn. Stat. Ann. § 302A.251; Wis. Stat. Ann. § 180.0827.

[43] See e.g., http://www.malegislature.gov/Laws/GeneralLaws/PartI/TitleXXII/Chapter156D/Section8.30.

form. In the event that a corporation is subjected to an audit or lawsuit, such documentation can serve to chronicle appropriate oversight and deliberation by the board of directors, evidence requisite approval of corporate actions by the shareholders, and ensure that all parties are acting within their respective ambits of authority.

REGULATORY OBLIGATIONS

Besides keeping current with state and federal tax obligations, corporations must make regular reports to their respective state corporate filing offices. Such reports require a small filing fee and contain general information such as the address of a corporation's principal office and the names and addresses of its officers, directors and registered agent for service of process.[44] This allows a state to ensure that it has up-to-date records on each of the corporations formed in that state. For example, Delaware requires that its corporations electronically file an Annual Report and pay a $50 filing fee every year. In California, a Statement of Information must be filed within 90 days of incorporation and annually thereafter, accompanied by a $25 fee. It should be noted that a corporation may also need to file such reports in each state in which it is qualified to do business. California's qualified foreign corporations are required to file an annual Statement of Information and pay the associated $25 fee like a domestic California corporation, while the filing fee for a foreign corporation Annual Report is $125 in Delaware.[45] In New York, a Biennial Statement must be filed and a $9 filing fee must be paid by domestic and foreign corporations alike every two years.[46] In addition, corporations must pay franchise taxes that are imposed by the state of incorporation and the states in which they conduct business. For example, corporations doing business in California are required to pay a minimum franchise tax of $800 per year, even if it operates at a loss during the year.

(f) Tax Treatment

As distinct legal entities, corporations are taxed separately from their shareholders (subject to discussion below regarding S corporations), which can lead to both favorable and unfavorable tax consequences depending on the nature of the business contemplated. Although only federal income tax provisions are summarized below, corporations are also subject to state income and other tax laws.

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[44] See e.g., http://www.sos.ca.gov/business-programs/business-entities/filing-tips/filing-tips-corp/.

[45] http://www.sos.ca.gov/business-programs/business-entities/forms; http://www.corp.delaware.gov/frtax.shtml.

[46] New York Business Corporation Law §408; http://www.dos.ny.gov/corps/fees_corp.html.

C CORPORATIONS

Because corporations are separate taxable entities for tax purposes, double taxation of corporate income can result for corporations taxed under subchapter C of the Internal Revenue Code (i.e., corporations that have not elected, or that are not eligible to elect, treatment under subchapter S of the Internal Revenue Code). First, double taxation occurs when profits are taxed at the corporate level and then distributed to shareholders as dividends, which are taxed at the shareholder level. Second, double taxation can occur when a corporation is dissolved and its assets distributed to shareholders in liquidation, in which case the corporation will be subject to tax on any net gain with respect to its assets and the shareholders will be subject to tax on any net gain with respect to their shares.

Such double taxation has been mitigated in recent history by a reduction in the tax rates applicable to qualified dividends and capital gains. In addition, double taxation on a current basis (as opposed to in liquidation) only presents a problem for a corporation that has net income that will be distributed to shareholders as a dividend. Thus, the problem of double taxation will be mitigated to the extent that: (i) the corporation has no net income or intends to reinvest such income in the business; (ii) the corporation is capitalized with debt, the interest on which is deductible; or (iii) the corporation pays reasonable compensation (including bonuses) to shareholders employed by such corporation, which compensation is deductible. Corporations and their shareholders should keep in mind, however, that the deductibility of interest can be subject to limitation and any compensation paid to shareholders must be reasonable.

Despite the problems of double taxation, corporations can have certain tax advantages. For example, historically a number of business incentives, such as the reduced tax rates applicable to gains on the sale of "qualified small business stock,"[47] have been limited to corporations.

S CORPORATIONS

Notwithstanding the foregoing, certain corporations may elect to be taxed under subchapter S of the Internal Revenue Code, which generally provides a form of pass-through tax treatment similar to that typically enjoyed by partnerships and LLCs.[48] The S election should be made with the Internal Revenue Service and any state in which the corporation does business that does not automatically recognize an election made for federal tax purposes. If such an election is made, each shareholder

[47] See Internal Revenue Code § 1202.
[48] See generally, Internal Revenue Code § 1362, *et seq.*

is allocated a proportionate amount of the corporation's income, gains, deductions, losses and credits based on his or her percentage of stock ownership in the corporation. The shareholders then report their share of the corporation's tax items on their individual tax returns and pay tax on their share of the corporation's taxable income or gain, if any. Conversely, the corporation does not pay tax on such income or gain and distributions of cash or other property to shareholders generally will not be subject to a separate level tax (unlike the dividends of a C corporation).

Importantly, not all states have adopted, or fully adopted, the pass-through treatment applicable to S corporations under the Internal Revenue Code. For example, California continues to apply a 1.5% tax on the net income of S corporations.

Not all corporations qualify for the S corporation election. Among other things, an S corporation generally must have solely individuals as shareholders, one class of stock and one hundred or fewer shareholders.

(g) Financing

One major benefit to the corporate form is that it offers a wide variety of options for financing and raising funds for the business. Fundamentally, a corporation can raise money through borrowing (issuing debt securities) or selling ownership interests in the company (issuing equity securities). Initial shareholders usually consist of a corporation's founders and can be expanded to a circle of their family, friends and business associates. As a company grows and additional capital is required, it must decide whether to use debt or equity to finance its operations.

DEBT FINANCING

The mechanics of corporate debt work like any conventional loan. A certain amount of money is borrowed from a creditor and must be repaid with interest at the rate and time set forth in the loan agreement. The downside risk of taking out a loan as a corporation is that it must be repaid regardless of whether or not the business is successful. Additionally, even though the owners' exposure in a corporation is usually limited to their investment, creditors often require the founders of a new business to personally guarantee a corporate loan before they are willing to extend credit. However, if the business thrives financially, the corporation is only obligated to repay the creditor the agreed-to amount of the loan and may retain any additional earnings for itself.

EQUITY FINANCING

A corporation may also issue equity as an alternative or supplement to taking on debt. Rather than extend a loan like a creditor, equity investors take an ownership interest in a corporation in the form of stock. Corporate profits may be paid out to shareholders in the form of dividends. Additionally, while interest payments on debt may generally be deducted for tax purposes, dividends to shareholders may not. Existing shareholders may have mixed feelings about issuing additional equity, as their ownership percentages in the company will be decreased with the introduction of additional owners. However, at least in theory, they will own a smaller percentage of a company that is worth more as a whole, so their stake should not be diluted. Whether or not this holds true will largely depend on how favorable the negotiated pre-financing valuation is to existing shareholders, as additional shares are issued to the new equity investors in a proportion determined by the agreed upon valuation.

Beyond choosing between traditional debt and equity financings, corporations face a myriad of other financing options and decisions. For instance, a corporation may issue a hybrid security in the form of a convertible note, a debt instrument that may be converted into stock pursuant to the conversion requirements set forth in the financing documents. A corporation may also issue warrants, entitlements to purchase capital stock at a set price, to induce creditors to enter a loan or investors to purchase equity. Further, capital stock itself may be issued in different series and structured with a variety of rights, preferences and privileges. In recent years, the SAFE (Simple Agreement for Future Equity) has become a popular financing instrument for startups. Similar to a convertible note, a SAFE converts into equity issued in a subsequent equity financing, generally at a discount. However, unlike a convertible note, a SAFE is an equity instrument and has no maturity date or interest rate and so may be advisable in circumstances in which greater flexibility is preferred.

The wealth of available choices in financing a corporation is not only a benefit of the corporate form but may also provide a source of complexity and confusion. The various risk/reward profiles of each method of financing should be carefully considered and balanced against the need and accessibility of capital.

Finally, the corporation must take great care to comply with all federal and state, securities laws when issuing its securities.

(h) Resources

http://www.irs.gov/Businesses/Corporations

http://www.sba.gov/content/corporation

http://www.sos.ca.gov/business/be/starting-a-business-types.htm

http://www.corp.delaware.gov/howtoform.shtml

2.4 LIMITED LIABILITY COMPANIES

Key advantages/disadvantages

ADVANTAGES

- Separate legal entity providing for limited liability of members for the debts of the company
- Significant management, governance, distribution and ownership flexibility
- Ability to include social mission in governing documents
- Flexibility to adjust or eliminate traditional fiduciary duties to allow for increased focus on social and environmental goals
- Ability to structure distribution waterfalls to account for differing goals among investors
- Fewer formalities in formation and management than a corporation

DISADVANTAGES

- No limited liability for general partners; each partner is responsible for the debts and obligations of the business
- Generally not suitable for accessing outside capital

Case study

PACIFIC COMMUNITY VENTURES, LLC

Pacific Community Ventures, LLC, a Delaware limited liability company, is a generalist fund investing across a wide range of industries. Its funds provide capital and resources to high growth California businesses that bring significant economic gains to low-to-moderate income employees, as well as delivering financial returns to business owners and to its investors. Pacific Community Ventures, LLC is a hands-on investor that partners with management to provide capital and expertise to ensure the long-term success of its portfolio companies. It builds, develops and maximizes the value within these organizations for the benefit of owners, management and employees. Pacific Community Ventures, LLC manages over $60 million and is currently investing out of Pacific Community Ventures Investment Partners III, LLC, a $40 million fund that closed in 2007. For more information, please visit http://pcvfund.com.

(a) Overview

A limited liability company, or LLC, is a form of business structure which incorporates elements of both a corporation and a partnership. The LLC structure is relatively new in the United States, and laws providing for creation of LLCs were not originally adopted in various forms in many states until the 1990s.[49]

The LLC structure is designed to provide owners with certain advantages, including:

- Limited liability.
- Ability to elect between federal income taxation as a corporation or pass-through entity.
- Management, governance, distribution and ownership flexibility.
- Reduced corporate formalities.

As with shareholders of a corporation, the owner or owners of an LLC (called "members") enjoy the benefit of limited personal liability for the business debts, obligations and liabilities of the LLC.[50] This limited liability means that, in general, the maximum amount that investors in an LLC may lose through their investment in the company is the amount that such investors invested in the LLC. This personal protection from liability is a significant advantage for LLC members over a general partnership structure in which each partner is personally liable for the debts and expense of the organization (even in excess of such partner's investment).

As with partners in a partnership, owners of an LLC typically enjoy the benefit of being taxed for income tax purposes as a pass-through entity (unless the owners affirmatively elect treatment as a corporation). If taxed as a pass-through entity, the owners of the LLC report their share of the LLC's income, gains, deductions, losses

[49] Thomas A. Humphreys, Limited Liability Companies and Limited Liability Partnerships (2nd ed. 2011).
[50] See e.g., Delaware Limited Liability Company Act § 18-303 and California Limited Liability Act § 17101.

and credits on their individual income tax returns.[51] Pass-through taxation can, in certain cases, have significant tax benefits to the members of the LLC in part because it avoids the double taxation burden that can apply to a corporation, as described in Section 2.3.

As with partnerships, LLCs have significant flexibility to tailor their governing documents to conform to a desired management, governance, mission, distribution and ownership structure. For example, an LLC's business profits and losses can be allocated to the LLC's members in a different manner than ownership interests and an LLC can be governed either by the LLC's members directly, or by one or more "managers" appointed by the members.[52] LLCs also typically have fewer mandatory corporate formalities and state filing requirements than do corporations (although more than a general partnership).

Although there are many advantages to operating as an LLC, certain limitations and weaknesses include:

- Potential management, governance and ownership complexity.
- Limited statutory rights and protections for members.
- Ownership transferability issues.
- Equity compensation issues.
- Fundraising limitations.

In addition, the relative newness of LLCs as compared to other entities and variation in state laws regarding LLCs may lead to uncertainty with respect to the interpretation of state law (in addition to the inherent issues that arise because of significant deviations between LLC statutes in different states) and the significance of legal precedent in the event of a dispute.

These drawbacks, which are explored further in the sections below, serve to limit the attractiveness of the LLC structure for organizations that intend to (i) have a diverse ownership base and structure, (ii) obtain capital investments from venture capital or other outside investors, (iii) attract employees through equity-based grants or (iv) become a public company.

[51] Internal Revenue Service, Publication 3402: Taxation of Limited Liability Companies (Rev. March 2010).

[52] See e.g., Delaware Limited Liability Company Act § 18-401 *et seq.* and Delaware Limited Liability Company Act § 18-501 *et seq.*

(b) Organizational Structure

The governance, management, distribution and ownership structure of an LLC is flexible and can be tailored to an organization's desired structure. Many states set forth default background rules relating to such matters. However, unlike with a corporation (and similar to a partnership), in most cases, such rules and requirements can be adjusted by agreement for an LLC.[53] As such, this structure is typically set forth in reasonable detail in the LLC's operating agreement.

GOVERNANCE AND MANAGEMENT STRUCTURE

One important area of flexibility for an LLC relates to its governance and management structure. LLCs have the ability to set their management and governance structures along a sliding scale of centralization. Unlike a corporation, which is governed by its Board of Directors and not its shareholders, an LLC can choose whether or not the LLC will be governed directly by its members, by a subset of its members, or by a centralized group of "managers". Managers can be members, non-members or a combination thereof. LLCs also have the option to appoint officers such as a Chief Executive Officer or Chief Financial Officer to run the day-to-day operations of the LLC, or can leave such duties to members directly or to the LLC's managers.[54] Even if the organization is governed or managed by a smaller group of individuals, members of the LLC, much like shareholders in a corporation, will generally have the ability to vote on certain fundamental decisions for the LLC absent specific agreement to the contrary.

DISTRIBUTION AND OWNERSHIP STRUCTURE

A second important area of flexibility for LLCs relates to its distribution and ownership structure. LLC ownership interests are called "membership interests" and entitle members to certain corporate (e.g. voting and management) and capital (e.g. distribution, income, and appreciation) rights. LLCs have wide latitude to allocate the relative corporate and capital rights of membership interests and can structure corporate approvals, processes and procedures as well as the economic rights in a manner that suits the LLC's goals. For example, if one investor in an LLC is more concerned with the operating profits and losses of the LLC, while another investor is more concerned with the appreciation of the LLC and its assets, the parties could

[53] Certain background governance rules, such as the right of members to vote on a merger or dissolution of the LLC in California (California Limited Liability Act § 17103(c)), cannot always be modified or eliminated.

[54] See e.g., Delaware Limited Liability Company Act § 18-407 and California Limited Liability Act § 17154. Please note that the appointment of officers for an LLC is optional, unlike for a corporation for which certain officers are required by law to be appointed.

structure an operating agreement that entitled the former member to a larger share of the LLC's operating income and the latter member to a larger share of the LLC's capital appreciation. Further, LLCs can also use this flexibility to specify a social or environmental related mission and, as discussed in more detail in Section 3.2 of this Guide, to create tranches of membership interests to satisfy investors with differing ultimate goals. For example, an LLC could include a mission in its operating agreement focused on social or environmental goals and also provide for separate classes of membership interests structured in tranches such that distributions from profits or the sale of the LLC flowed first to investors with a greater focus on monetary return and second to investors with a greater focus on the LLC pursuing social or environmental goals.

IMPACT OF OPERATING AGREEMENT

Through its operating agreement, an LLC can set forth who, how, and in what manner the LLC shall be owned, governed or managed, and how an LLC's profits and losses will be allocated and distributed, including:

- Who will govern the LLC (e.g. members or managers) and who will manage the LLC's operations (e.g. members, managers or officers).
- How such individuals will be appointed and removed.
- The rights, powers and responsibilities such individuals will have.
- The indemnification rights such individuals will have.
- Who is entitled to vote on major governance, management, distribution and ownership issues.
- Whether all votes count equally, or certain votes are weighted.
- The procedures to be followed for making decisions.
- The level of approval needed for certain decisions.
- Whether any matters require higher levels of approval or approval of specific parties.
- Whether any members or groups of members have special rights, privileges or preferences.
- The fiduciary duties members owe to each other and to the LLC.
- The ownership structure of the LLC.
- The forms of investment (e.g. cash, property, services) allowed in the LLC.
- What restrictions are imposed upon, and what procedures are required, to raise future internal and external capital.
- How profits and losses are allocated among the members.
- How, when and in what amount distributions will be made among the members.
- How the proceeds from a sale or liquidation of the LLC will be distributed among the members.

- What restrictions, if any, exist relating to the transfer of membership interests.
- Whether such transfer restrictions apply equally to the corporate and capital portions of membership interests.
- What occurs on the death, withdrawal or removal of a member or the liquidation of the LLC.
- What penalties exist if members or managers fail to act in accordance with the operating agreement.

Like a corporation's charter and bylaws or a partnership's partnership agreement, the operating agreement thus serves as a roadmap for the substantive and procedural rules governing the LLC.

IMPACT OF BACKGROUND LAW

As stated above, if such issues are not addressed in the LLC's operating agreement, many state statutes governing LLCs set background default rules. For example, if the LLC's operating agreement does not specify who shall manage the organization, by default, many state statutes governing LLCs provide that the LLC will be governed by the LLC's members in proportion to their ownership interest. While these background rules may provide some guidance if such issues are not addressed in the LLC's operating agreement, such rules often vary from state to state in terms of scope, detail, procedure and substance and may not reflect the parties' desired structure.

IMPACT OF FLEXIBILITY

The flexibility afforded to LLCs to restructure default rules can serve to remove restrictions regarding corporate actions and limit the rights of members. This can be advantageous to an organization wishing to make decisions quickly by allowing it to streamline the decision making process regarding certain corporate actions by removing procedural hurdles such as the consent of members. However, these attributes can also serve to raise issues for minority investors who may have fewer rights available to protect their interests (including voting rights or the right to financial and ownership information regarding the LLC) if the operating agreement removes background rights or explicitly provides certain members with more favorable rights. As protection against abuses of power, many state statutes do provide members with the right to initiate derivative suits on behalf of the LLC.[55] However, due to the flexibility LLCs have in structuring governance duties and responsibilities, the opportunities for such actions may be limited in certain cases.

[55] See e.g., Delaware Limited Liability Company Act § 18-1001 *et seq.* and California Limited Liability Act § 17500 *et seq.*

(c) Establishment Costs and Documentation

DOCUMENTATION

Establishing an LLC requires several state and federal filings and the drafting of certain organizational and governance documents, including:

- Filing a short charter document (often referred to as Articles of Organization or a Certificate of Formation) in the LLC's state of organization.
- Applying for federal and state employer identification numbers.
- Qualifying to do business in any states in which the LLC will transact business.
- Drafting an operating agreement (also called a limited liability company agreement).
- Filing federal and state securities filings related to the issuance of membership interests.
- Completing other standard documents (such as employment agreements) necessary or desired to run the business.

CHARTER DOCUMENT AND QUALIFICATIONS TO DO BUSINESS

Each state has slightly different forms and requirements for an LLC's charter document and documents related to qualifying to do business in such state. However, these documents are typically fairly simple and straightforward. Through the charter document, the LLC selects a name (which usually must contain the name "Limited Liability Company", "LLC" or "L.L.C."), sets forth the name and address of its registered agent in the LLC's state of organization and may be required to provide certain other information such as the LLC's business address, business purpose, the duration of the LLC (i.e. if perpetual or for a limited number of years) or if the LLC is member or manager managed. Through qualification to do business filings, the LLC provides similar information as contained in the LLC's charter to each state in which the LLC will transact business.

OPERATING AGREEMENT

The principal organization document for an LLC is the LLC's operating agreement. Although a written operating agreement is not generally required by state law, the operating agreement, much like a partnership's partnership agreement and a corporation's charter and bylaws, outlines the LLC's management, governance, distribution and ownership structure. Absent an operating agreement, the LLC's structure is dictated by state law, which may not cover all pertinent issues or reflect the parties' desired allocations of rights, privileges, preferences and obligations. The content of the operating agreement is explored further above.

OTHER FILINGS AND AGREEMENTS

In addition to these LLC-specific agreements, an LLC will also typically enter into standard agreements relating to the conduct of its business at the time of formation such as employment agreements, proprietary information and invention assignment agreements and consulting agreements, as well as make federal, state and local tax, securities and regulatory filings.

OTHER CONSIDERATIONS

An LLC can be established with one or more members.[56] Setting up a single member LLC is often a more straightforward and streamlined process than establishing a multi-member LLC as there are typically fewer issues to resolve relating to management, governance, distributions and ownership.

COST

The cost for establishing an LLC varies. The main cost components include attorney fees for the preparation of documents; state filing fees for organization, qualification and securities filings; statutory representation fees for the LLC's agent for service of process; and any accounting-related fees for taxation-related advice and services. Attorney fees are affected by the complexity of the LLC's management, governance, distribution and ownership structure (as reflected in the LLC's operating agreement) and the number of additional documents required to set the LLC up for business (e.g. employment agreements, securities and regulatory filings). State filing and statutory representation fees are affected by the numbers of states and specific states in which the entity organizes, transacts business or sells securities. State filing fees vary from state to state. Organization and qualification-related fees typically range from $20 to $500; however, certain states, such as New York, impose additional requirements such as a publication requirement for both domestic and foreign LLCs that can increase fees substantially to upwards of $3,500.[57]

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[56] Historically, many state LLC statutes required LLCs to have two or more members. However, recent amendments in all fifty states now permit single member LLCs.

[57] See, for example, New York Limited Liability Company Law § 802.

SELECTING A STATE OF ORGANIZATION

When selecting a state of organization for an LLC, many factors should be considered, including:

- The organization's principal place of business and states in which it transacts business.
- Flexibility and predictability of state statutes and legal precedent.
- State taxation issues.
- State filing fees, including organization and annual maintenance (franchise tax and secretary of state) fees.
- Anticipated capital raising needs.
- Nature of limited liability protection.

The lowest cost option is typically to organize in the state in which the LLC's principal place of business is located, which may help reduce attorney fees (as the LLC will likely be subject to certain of such state's laws regardless of where it is organized), and may help the LLC avoid duplicate state filing fees and additional statutory representation fees. However, cost alone should not dictate the state of organization. Initial and annual costs need to be weighed against strategic considerations. For example, many investors prefer the predictability and familiarity of Delaware as a state of organization. Further, given the relatively new nature of the LLC structure, and the frequent amendments to such statutes which have occurred since original adoption, some states have very limited legal precedent relating to LLC-specific issues and disputes or have unique aspects in governing statutes which may not be suitable for a particular organization. In addition, many states prohibit certain types of businesses (such as banks, trusts and insurance companies) or certain professionals (typically including accountants, doctors or architects) from operating as an LLC.[58]

(d) Liabilities

Similar to shareholders of a corporation, members of an LLC enjoy the benefit of limited personal liability for the business debts, judgments and actions of the LLC. This means that if an LLC's debts or liabilities exceed its assets, generally each owner of the LLC will still only stand to lose such owner's investment in the LLC and will not be held personally liable for such debts. As with officers and directors of a corporation, typically this protection also applies to managers of the LLC or members participating in management and governance decisions.[59]

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[58] See e.g., California Limited Liability Act § 17002(a) and § 17375.
[59] See e.g., Delaware Limited Liability Company Act § 18-303; see also California Limited Liability Act § 17158.

As with corporations, there are certain exceptions to this rule including liabilities related to:

- Acts or omissions of a member or manager (e.g. fraud or receiving distributions from an LLC in contravention of state law or the LLC's operating agreement).
- "Piercing the veil" of the LLC (similar to as with a corporation as discussed above).
- Personnel guarantees or contractual obligations by a member or manager either in the LLC's operating agreement or with a third party (e.g. if a member personally guarantees an LLC's bank loan or other obligation).

However, as with a corporation, the scope of these exceptions can be reduced through prudent planning and attention to corporate formalities.

Managers, members and officers of LLCs have certain background fiduciary duties imposed by state statutes. While such fiduciary duties vary by state, they are typically similar to those of a corporation (see *Fiduciary Duties* in Section 2.3 above) and include duties of care and loyalty.[60] However, many state statutes provide that such background fiduciary duties can be expanded, limited, modified or even eliminated.[61] While the boundaries and enforceability of such modifications are not clearly known and vary from state to state due at least in part to the lack of legal precedent, many state statutes provide LLCs with the right to modify such fiduciary duties, which permits more flexibility for LLCs than for corporations in this respect.

Due to the (i) relatively new nature of LLCs; (ii) lack of legal precedent; (iii) variance among governing statutes; and (iv) ability of parties to expand, limit or eliminate protections afforded by such statues (such as fiduciary duties), the limited liability of managers and members of an LLC may be less predictable than for shareholders and directors of a corporation. In addition, as with other entity structures, the LLC itself will remain liable for all company liabilities.

(e) Governance and Regulatory Obligations

GOVERNANCE OBLIGATIONS

Much like a partnership, many of an LLC's ongoing governance obligations are determined internally by the LLC through the LLC's operating agreement. As a

[60] Thomas A. Humphreys, Limited Liability Companies and Limited Liability Partnerships (2nd ed. 2011).

[61] Certain background fiduciary duties, such as an implied contractual covenant of good faith and fair dealing in Delaware (Delaware Limited Liability Company Act § 18-1101(c)) or the duty of loyalty in certain states, cannot always be reduced or eliminated. The scope of such duties and the extent to which such rules can be altered varies from state to state.

general rule, there are fewer statutory governance requirements for an LLC than for a corporation and most decisions can be made informally.[62] For example, typically LLCs are not required to hold annual meetings or keep written minutes.[63] Those requirements that do exist often provide for a choice by the LLC or provide explicitly that such requirements can be contracted around through the LLC's operating agreement. However, following corporate formalities, such as keeping written copies of member or manager meetings and consents, much like in the context of a corporation, may help ensure that the full protections of limitations on liability are available to an LLC.

REGULATORY OBLIGATIONS

LLCs, like other entities, are subject to federal, state and local regulatory requirements applicable to the type of businesses they operate. Regardless of the type of business, the LLC will have certain ongoing federal, state, and possibly local filing requirements. Depending on the states in which the LLC operates, its business and its tax elections, such filings can include:

- Annual state informational filings (with the secretary of state in the state of the LLC's incorporation and any state in which the LLC is qualified to do business).
- Annual state franchise tax filings (with the franchise tax board in the state of the LLC's incorporation and any state in which the LLC is qualified to do business).
- Federal, state and local income and employment tax related filings.
- Federal state and local regulatory filings (e.g. environmental permits, manufacturing licenses).
- Federal and state security filings (relating to the issuance of membership interests).

The exact filings, format, timing, substance and cost will vary based on the type of business operated, the state in which the LLC is organized, and the state (or states) in which the LLC transacts business.

(f) Tax Treatment

An LLC generally has several options related to its tax treatment. The Internal Revenue Service does not recognize an LLC as a separate classification for federal

[62] Thomas A. Humphreys, Limited Liability Companies and Limited Liability Partnerships (2nd ed. 2011).
[63] See, for example, http://www.ftb.ca.gov/businesses/bus_structures/LLcompany.shtml.

income tax purposes. As such, an LLC, like a partnership, typically can elect to be treated as either a pass-through entity or corporation for income tax purposes.[64]

Absent an affirmative election otherwise, an LLC automatically will be taxed as a pass-through entity for federal income tax purposes. In such circumstances, an LLC with a single owner will be "disregarded" from its owner and taxed like a sole proprietorship[65] and an LLC with two or more owners will be classified and taxed as a partnership. An LLC treated as a pass-through entity is not subject to a separate tax on its income. Instead, owners of the LLC will report and pay tax on their share of the LLC's income, gains, deductions, losses and credits on their personal income tax returns.[66] In addition and subject to certain limitations, distributions of cash or other property from the LLC to the members generally are not subject to a separate tax.

On the one hand, pass-through treatment can prove advantageous in many circumstances through the avoidance of double taxation and the ability to deduct losses of the business on the tax returns of the members (subject to certain limitations). On the other hand, pass-through taxation can lead to cash flow issues for members, as each member's share of the LLC's taxable income is taxable to that member whether or not actually distributed by the LLC to such member. In addition, members generally cannot be employees of their LLC (members will have to pay periodic estimated taxes in lieu of being subject to wage withholding) and taxable income allocated to members of an LLC often is subject to self-employment (i.e., Social Security and Medicare) taxes. Further, historically corporations have enjoyed advantages with respect to certain business incentives enacted in the Internal Revenue Code.

Notwithstanding an LLC's pass-through treatment for federal income tax purposes, certain states, such as California, may still impose annual taxes, such as franchise and gross receipts fees, on the entity itself. In addition, an LLC, like other businesses, must pay other forms of tax, such as sales and use, excise, employment, property and transfer taxes.

[64] While an LLC can elect to voluntarily change its tax classification, certain limitations exist on an LLC's ability to change classifications. Such changes in classification may have tax consequences to the LLC and its members at the time of such change.

[65] However, a single member LLC treated as a disregarded entity for federal income tax purposes will be treated as a separate entity for purposes of employment tax and certain excise taxes.

[66] While LLCs generally have flexibility to determine how the LLC's tax items are allocated among members, such allocations must have substantial economic effect or otherwise must be in accordance with the member's economic interest in the LLC. See Internal Revenue Code § 704(b) and Treasury Regulation § 1.704-1(b) *et seq*.

Under some circumstances, an LLC may wish to affirmatively elect to be taxed as a corporation, particularly if the LLC:

- has foreign or tax-exempt members that want to avoid being treated as engaged in a trade or business in the United States;
- has foreign members who are residents of a country with whom the United States has a treaty under which distributions from a corporation would be subject to reduced or no withholding taxes;
- is more than 80-percent owned by a corporation that wants to include the LLC as a corporation within its consolidated return; or
- is owned by members that want to avoid being treated as doing business in a state or being subject to taxation in such state.

If an LLC elects to be treated as a corporation, generally it will be taxed in accordance with the discussion under *Tax Treatment* for corporations.

(g) Financing

As stated above, LLCs offer many advantages to investors in the form of limited liability, pass-through taxation and operational flexibility and simplicity. These attributes often make LLCs attractive structures for a single investor or for small, tightly-knit groups of investors that do not anticipate needing to raise additional capital, as such members can choose to allocate the relative rights of contributors with great flexibility. Further, subject to compliance with federal and state securities laws and any restrictions contained in the LLC's operating agreement, LLCs have few formal restrictions on financing and raising funds. Further, LLCs have the flexibility to provide in their operating agreement for separate classes of membership interests structured in tranches. This structuring flexibility could be of particular interest for LLCs with investors with differing ultimate goals and is discussed in more detail in Section 3.2 of this Guide.

However, some of these attributes may also limit the types of investors interested in investing in LLCs. For instance, tax exempt and venture capital investors are less inclined to invest, or may be contractually prohibited from investing, in LLCs with pass-through taxation, as this can lead to unrelated business income for such entities. Further, venture capital and sophisticated angel investors may shy away from LLC investments due to issues relating to (i) the complexity of addressing multiple rounds of funding or a diverse ownership structure in an LLC's operating agreement, (ii) the lack of a defined regime of legal precedent and predictability, (iii) complications relating to transferring LLC membership interests and survivorship issues, and

(iv) reduced flexibility in offering employees standard equity incentive awards[67] (crucial for many high growth companies that such investors invest in). In addition, LLC membership interests do not qualify as "qualified small business stock" and do not receive the favorable tax treatment such stock can provide to investors under federal tax laws. It is very challenging (although not impossible) for an LLC to conduct an initial public offering and become a public company.[68] Many LLCs convert to corporations at this point in the company's development.

For these reasons, and the simple fact that many investors are more experienced and comfortable with investing in Delaware "C" corporations, many outside investors (notably venture capital investors) simply may not be willing to invest in the LLC or may require the LLC to convert to a corporation prior to investing which can lead to additional legal fees and tax issues for current owners. As a result, an LLC may not be a good fit for organizations that anticipate raising meaningful amounts of outside capital or want flexibility in future fundraising.

(h) Resources

http://www.sba.gov/content/limited-liability-company-llc

http://www.sos.ca.gov/business/be/starting-a-business-types.htm

http://www.corp.delaware.gov/howtoform.shtml

https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Limited-Liability-Company-LLC

http://www.limitedliabilitycompanycenter.com/

[67] While LLCs can adopt equity compensation plans to incentivize employees, LLCs cannot issue incentive stock options and the structure and terminology of such plans may be unfamiliar to prospective employees.

[68] Internal Revenue Code § 1220.

3. LEGAL STRUCTURES SPECIFICALLY DESIGNED FOR SOCIAL ENTERPRISES

In recognition that the traditional available structures of for-profit and not-for-profit organizations may not be adequately meeting the needs of many social entrepreneurs[69], some states have recently created new forms of entities that are specifically designed for social enterprises. These entities are intended to allow companies to access a wider variety of financing options while pursuing goals that include both profits and other objectives.

While such dual pursuits are permissible in certain traditional legal structures (see, for example, the discussion of LLCs in Section 2.4 above), organizational forms such as the social purpose corporations, public benefit corporation, low-profit limited liability companies (L3C) and benefit corporation make such dual focus mandatory in varying degrees for the organization.

Use of these structures is not available in all states, and, at present, there is a great deal of variance among states regarding the structure and nature of these entities. Further, in the case of benefit corporations and L3Cs the statutes creating such organizations often are not well-integrated with existing state law regulating traditional for-profit entities, leading to potential conflicts. In addition, given the short history of many such forms, there is not an established body of precedent that organizations can rely upon in making decision, and interpreting governing law. For example, there is significant ambiguity in many states regarding the fiduciary duties of officers and directors in these new organizational forms. As a result, social entrepreneurs considering using these organizational structures should be sure to consult with legal counsel in their desired states of organization and operations.

One important note with respect to all of these organizational forms is that currently there is no special federal tax benefit for utilizing these forms of organization versus their traditional for-profit counterparts (other than for a 501(c)(3) organization that is part of a Hybrid). For

[69] Failure of existing forms is not for the most part because of issues that are intrinsic to the corporate form itself but because of other factors.

example, none of social purpose corporations, public benefit corporation, low-profit limited liability companies (L3C) or benefit corporations enjoy tax exempt status. Instead, social purpose corporations, public benefit corporations and benefit corporations have tax characteristics that mirror standard corporations and L3Cs have tax characteristics that mirror standard limited liability companies.

Further, certain of these organizational forms were designed in part to provide for-profit organizations with easier access to equity investments by private foundations. In addition to traditional investments made for purposes of generating a financial return, private foundations may make "program related investments", or investment made for exempt purposes, which are subject to strict IRS rules. [70] These new structures were intended to simplify compliance by private foundations with those IRS rules. However, there is significant disagreement on this point among practitioners in this area as to the effectiveness of this in practice. One of the main issues is that notwithstanding that a social enterprise such as an L3C may have a mission that includes objectives other than profit maximization, private foundations will still be required to ensure that they have satisfied all of the requirements applicable to program-related investments. Under the Internal Revenue Code, the test for a program-related investment looks to the foundation's intent and purposes in making the investment, not simply the purposes of the entity receiving the investment. The IRS also requires due diligence and oversight as to the actual use of the funds for exempt purposes. In fact, many critics have raised concern that these new structures may create a false sense of comfort that the private foundation can let the organization's legal structure be a substitute for legally mandated

[70] A private foundation is an organization, usually a non-profit corporation or trust, operated for charitable purposes that meets the requirements for exemption from paying federal income taxes under Section 501(c)(3) of the Internal Revenue Code. The Internal Revenue Code requires that private foundations (other than private operating foundations) make qualifying distributions of at least 5% of their investment assets each year in order to avoid incurring an excise tax. Only distributions made in furtherance of the private foundation's exempt purpose or to obtain an asset to be used directly in achieving such exempt purpose constitute "qualifying distributions". Among other things, certain types of investments, termed "program-related investments" by the Internal Revenue Code, constitute qualifying distributions.

A program-related investment is one made primarily to accomplish a charitable or other exempt purpose and not to produce income or influence legislation or political campaigns. Program-related investments often take the form of an interest-free or below-market rate loan to a non-profit organization. An investment in a for-profit entity, such as an equity investment, can also constitute a program-related investment, so long as a charitable or other exempt purpose will be primarily served by the investment. In the case of investments in for-profit entities, private foundations must take steps to ensure that the investment will be used for the intended charitable purpose, such as conducting inquiries into and executing agreements with the recipient for-profit entity and monitoring the investment. Private foundations are often reluctant to make qualifying distributions in the form of equity investments because of uncertainty with respect to whether a particular investment would qualify as a program-related investment; failure to comply with the rules can result in significant excise tax penalties. Private foundations considering making equity investments may choose to seek private letter rulings from the IRS to ensure that the investments will be considered program-related investments. However, they are not required to do so.

analysis. As a result, the degree of efficacy in streamlining such investment likely trails advocates original hopes for these structures at present. However, as the IRS' view is evolving in this area, social entrepreneurs should be sure to consult legal and tax professionals regarding a particular legal form.

3.1 SOCIAL PURPOSE CORPORATION

Key advantages/disadvantages

ADVANTAGES

- Enjoys advantages applicable to corporations generally
- Protects boards of directors and management of corporations pursuing one or more identified charitable or public purposes
- Provides boards of directors and management ability to adjust weighting of social and profit maximization focus to account for changing circumstances
- Mandatory reporting requirements will provide some measure of accountability and certainty to investors and strategic partners that the corporation is pursuing a social purpose
- Highlights and brands an organization as having a social or charitable purpose in addition to the maximization of profits
- Provides shareholders with say in determining mission of entity
- May provide access to information to third parties, consumers, strategic partners, investors and others whose interests are aligned with the corporation's charitable or public purposes

DISADVANTAGES

- The same disadvantages applicable to corporations generally also apply to SPCs
- Must comply with potentially time-consuming and potentially costly additional annual reporting requirements related to social or charitable purposes
- New form of corporation; potential impact on capital raising is unclear
- May be difficult for a corporation with numerous shareholders to transition to/from status as an SPC

Case study

KEPLERS 2020, SPC

Kepler's 2020, SPC, or Kepler's, is a community-supported bookstore organized as a California flexible purpose corporation. Kepler's was formed in 2012 and evolved from the former Kepler Corporation, which previously operated a book store in the San Francisco bay area since the 1950s. Kepler's mission is to serve as an accessible intellectual and cultural hub for public education, community dialog, and browsing and discovery of new ideas and books in order to open minds, deepen literacy, and promote critical thinking. Kepler's also strives to promote positive short-term and long-term effects of, and minimize adverse short-term and long-term effects of, such activities on Kepler's employees, authors, speakers, publishers, suppliers, customers, creditors, partners, the community and society. For more information, please visit http://www.keplers2020.com/

(a) Overview

First introduced in the fall of 2010, in October 2011, California adopted a new form of for-profit corporation, originally titled the flexible purpose corporation, or FPC, but now titled the social purpose corporation, or SPC.[71] The form underwent the name change from FPC to SPC effective January 1, 2015 as part of an amendment to the original bill designed to emphasize the socially-beneficial nature of the new form, improve uniformity with the new Delaware public benefit corporation legislation and clarify other technical provisions.

This legislation expressly permits corporations to be formed as SPCs or to convert from a corporation or other entity into an SPC in order to pursue one or more explicitly adopted social or charitable purposes, or "special purposes," in addition to the other purposes of the corporation. Directors and officers of an SPC must operate in furtherance all of the purposes to which the SPC is dedicated, including such special purposes, and must consider the special purpose or purposes in addition to traditional

[71] See California Corporations Code §2500-3503. The legislation became effective January 1, 2012. In addition, Washington has adopted a "social purpose corporation" (which is a variation of California's social purpose corporation) and several states including Delaware and Colorado have also adopted new corporate forms which resemble a mixture between benefit corporations and California's social purpose corporation.

shareholder economic interests when determining what is in the best interests of the SPC and its shareholders. Within prescribed limits, this corporate form permits directors and officers to promote one or more special purposes, even at the expense of economic value, provided that such purposes are clearly specified in the Articles of Incorporation and there is sufficient accountability and transparency (as further described below). Otherwise properly made decisions and actions of the directors and officers that consider these multiple (and even potentially competing) purposes are protected from claims of waste or other breaches of fiduciary duties.

(b) Organizational Structure

SPCs are governed by substantially the same rules regarding corporations as are applicable to other California corporations. See Section 2.3 for more information.

(c) Establishment Costs and Documentation

See Section 2.3 above for more information on the requirements for establishing a corporation in California. In addition to the requirements applicable to establishing all California corporations, to be an SPCa corporation must also comply with requirements specific to SPCs:

ARTICLES OF INCORPORATION

The Articles of Incorporation of a social purpose corporation must set forth the following:[72]

A provision stating that the purpose of the social purpose corporation is to engage in any lawful act or activity for which a social purpose corporation may be organized under the California Corporations Code for the benefit of the overall interests of the social purpose corporation and its shareholders and in furtherance of its enumerated special purposes.[73]

An additional dedication of the organization to one or more of the following "special purposes:"

1. One or more charitable or public purpose activities that could be carried out by a California nonprofit public benefit corporation; or
2. The purpose of promoting positive effects of or minimizing adverse effects of the social purpose corporation's activities upon any of the following, provided that the corporation consider the purpose in addition to or together with the financial

[72] See California Corporations Code §2602.
[73] The specific language that must be used is provided in Section 2602(b)(1) of the California Corporations Code.

interests of the shareholders and compliance with legal obligations, and take action consistent with that purpose:

a. The social purpose corporation's employees, suppliers, customers, and creditors;

b. The community and society; or

c. The environment.

The language of this special purpose is not designed to create a lowest common denominator, below which someone could not establish a social purpose corporation. Nor is it designed to create a vehicle for outside policing by third parties, other than accountability to the investors and shareholders regarding compliance with one or more special purposes and the public reporting of efforts and resources devoted to realization of the special purpose. Rather, the special purpose requirement is designed to put shareholders and potential shareholders on notice that the corporation will pursue agreed interests that may (or may not) align with profit maximization, depending upon the business judgment of the directors, taking into account the special purpose.

In addition, the Articles of Incorporation must state that the corporation is organized as a social purpose corporation under the Social Purpose Corporations Act, and the name of the corporation must include the words "social purpose corporation" or an abbreviation (SPC). Entities formed as FPCs prior to the act's amendment may, but are not required to, amend their names, Articles of Incorporation and share certificates to change from FPC to SPC.[74] Entities formed as FPCs that choose not to change their status to SPC must have language stating that they were organized as an FPC under the Corporate Flexibility Act of 2011.

CHANGES TO THE SPECIAL PURPOSE

As noted above, the SPC's special purpose(s) must be clearly identified in the SPC's Articles of Incorporation. The special purpose(s) established in the Articles of Incorporation may only be amended or eliminated by a vote of at least two-thirds of each class of voting shares held by the SPC's shareholders, or a greater vote if specified in the SPC's Articles of Incorporation.

Shareholders of California corporations have certain dissenters' rights to opt-out of certain corporate transactions. In addition to standard dissenters' rights, shareholders

[74] See California Corporations Code §2502; §2601(b)(2).

of an SPC may also have dissenters' rights in the event of any material change in the special purposes set forth in the entity's Articles of Incorporation.

CHANGE OF CORPORATE FORM TO OR FROM A SOCIAL PURPOSE CORPORATION

New entities may incorporate using the SPC form and existing for-profit corporations may convert into SPCs. However, any decision by a business entity to become an SPC requires the approval of at least two-thirds of each class of voting shares of the entity. The conversion of an SPC into another form of California domestic or foreign legal entity would also require the approval of at least two-thirds of each class of voting shares held by the SPC's shareholders. SPCs may merge with other SPCs or with other entities governed by laws that permit such mergers, and the SPCs may either survive or terminate in such mergers. However, any merger or reorganization materially altering or eliminating an existing SPC's special purposes requires the approval of at least two-thirds of each class of voting shares of the SPC, or a greater vote if specified in the SPC's Articles of Incorporation.

Shareholders of SPCs retain certain opt-out and appraisal rights in the event the required vote is obtained approving certain business combinations (particularly a merger with and into a non-SPC), or a conversion of another legal entity into an SPC or of an SPC into another legal entity and the shareholder did not vote in favor of the transaction.

(d) Liabilities

In addition to the existing rights of a corporation's directors and officers to exercise their business judgment as provided under California law, SPC directors and officers also have the ability to make decisions that specifically offset maximization of profit with the special purpose(s) set forth in the corporation's Articles of Incorporation when, in their business judgment, such a decision is necessary and appropriate. Once a special purpose is set forth in the SPC's Articles of Incorporation, its directors and officers are afforded considerable flexibility in their decisions and actions, both within and outside of the ordinary course of business, subject to reasonableness and materiality standards of existing case law. Such decisions and actions need not necessarily favor any one purpose (including enhancing shareholder value) over any other. Rather, existing case law that imposes a reasonableness and materiality standard will also apply to the prioritization by directors and managers of one or more of the stated special purposes over others, including, in appropriate circumstances, favoring the achievement of a stated special purpose over the economic interests of the shareholders.

Although the directors and officers of an SPC must consider the corporation's special purpose(s) in the course of their decision-making, the legislation affords substantial flexibility to craft the appropriate balance between profit and pursuit of the SPC's special purpose(s). Some critics have claimed that this framework is overly permissive and lacks enforceability, however, they appear to be misreading the statutory language. While third parties have no new rights to enforce an SPC's adherence to its special purposes, shareholders continue to have the right to elect and remove directors and to bring a claim for breach of fiduciary duties under California law.

(e) Governance and Regulatory Obligations

After a corporation has been properly formed, there are certain ongoing requirements with which it must abide in order to comport with corporate formalities and maintain good corporate status. SPCs are governed by the same rules regarding corporate structure as are applicable to other California corporations. See Section 2.3 for more information on corporate governance and regulatory obligations.

In addition, certain other governance and regulatory requirements (summarized below) are also required of SPCs:

ANNUAL REPORTS

In addition to the governance and regulatory obligations applicable to all California corporations, SPCs have certain additional requirements. The management and directors of an SPC must specify objectives for measuring the impact of the SPC's efforts relating to its special purpose or purposes. A discussion and analysis of these efforts must be included in the SPC's annual report, together with the corporation's required financial statements (which is generally required of all California corporations). The annual report, including this special purpose management discussion and analysis, or MD&A (collectively referred to as the annual report), must be made publicly available (for example by posting on the corporation's website)[75]. The MD&A must include certain information regarding the SPC's efforts relating to its special purposes, including the following:

- Identification and discussion of the overall objectives of the SPC relating to its special purpose or purposes and an explanation of any changes made in the special purposes during the fiscal year;

[75] See §§3500-3502 of the California Corporations Code.

- Identification and discussion of the material actions taken by the SPC during the fiscal year to achieve its special purpose objectives, the impact of those actions and the extent to which those actions achieved the special purposes during the fiscal year;
- Identification and discussion of material actions, including the intended impact of those actions, that the SPC expects to take in the short term and long terms with respect to achievement of its special purposes;
- Discussion and analysis of the financial, operating and other measures used by the SPC to evaluate its performance in achieving its special purposes, including any changes made to the evaluation measures during the fiscal year; and
- Discussion of any material expenditures incurred by the SPC during the fiscal year in furtherance of achieving the special purpose or purposes and a good faith estimate of future expenditures over the next three fiscal years.

The annual report must be sent to shareholders at least 15 days prior to the annual meeting of shareholders to be held during the next fiscal year. If an SPC has not sent the annual report for the prior fiscal year to its shareholders within 120 days after the end of the fiscal year, any shareholder may request that the SPC provide the annual report. The SPC must then deliver or mail the annual report to the shareholder making the request within 30 days.

CURRENT REPORTS

In addition to the annual report requirement, SPCs must send current reports to their shareholders if an expenditure or planned expenditure related to a special purpose has had or is likely to have a material adverse impact on the SPC's financial condition[76]. The current report must be sent to shareholders within 45 days of the event.

WAIVER OF REPORTING REQUIREMENT

Under the original legislation, if an SPC had fewer than 100 shareholders, the shareholders could waive the requirement that the SPC provide a special purpose MD&A and current reports. However, the amendment to the legislation removed this exemption.

(f) Tax Treatment

See Section 2.3 for more information on the tax treatment of corporations, including SPCs.

[76] See §3501 of the California Corporations Code.

(g) Financing

As further described in Section 2.3, one major benefit to the corporate form, including the SPCs, is that it offers a wide variety of options for financing and raising funds for the business. As the legislation establishing SPCs only became effective in January 2012, it is not clear what, if any, impact the adoption of the SPC form will have on financing and fundraising. However, it may provide access to investors whose interests are aligned with the SPC's special purposes.

(h) Resources

http://www.sfbar.org/forms/jdc/benefit-corp-memo%20.pdf

http://www.businessforgood.co/2011/03/frequently-asked-questions-proposed.html

http://www.sos.ca.gov/administration/agency-reports/flexible-purpose-and-benefit-corporations-agency-reports

http://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201320140SB1301

3.2 LOW-PROFIT LIMITED LIABILITY COMPANY (L3C)

Key advantages/disadvantages

ADVANTAGES

- Has the advantages generally associated with limited liability companies
- Highlights and brands an organization as having a social or charitable purpose other than the maximization of profits
- May provide access to third parties, consumers, strategic partners, investors and others whose interests are aligned with the organization's social or charitable purposes

DISADVANTAGES

- The same disadvantages associated with LLCs also apply to L3Cs
- May be easy to intentionally or unintentionally enter into and leave L3C status depending on the state of formation
- Relatively new variation of LLC; impact on capital raising is not clear
- Original intent of providing easier access to program-related investments by foundations has not materialized
- No special federal tax treatment advantages over traditional LLCs

Case study

FICTIONAL EXAMPLE

Maine Ocean Resource Conservation, L3C (MORC), is organized as a Maine low-profit limited liability company and is dedicated to the research and conservation of ocean resources and marine biology. MORC specializes in identifying, mapping and continually researching marine life habitats, which they view as being of fundamental concern for human survival. MORC focuses on fulfilling its research and conservation efforts by providing oceanographers, marine biologists and non-profit ocean conservation groups with research and funding to help them accomplish their shared mission.

(a) Overview

A low-profit limited liability company, or L3C, is a form of LLC that has been authorized by amendments to existing LLC statutes in a number of states, including Illinois, Louisiana, Maine, Michigan, Rhode Island, Utah, Vermont and Wyoming.[77] An L3C that is formed in any of these states may operate in any state, although it may be required to become qualified to do business in that state through making one or more filings in that state. In addition, L3C legislation is currently pending in many states. According to interSector Partners, L3C, as of January 2016, 1,326 entities had organized as L3Cs and were showing as active by the various Secretaries of State.[78] Vermont was the first state to enact legislation in 2008.

Under state law governing L3Cs, an LLC may designate itself an L3C if the company is formed for a charitable purpose and it satisfies certain other criteria. An existing LLC may also convert to an L3C. Advocates of the L3C claim that it helps to attract investments from socially-conscious investors and that it may encourage private foundations to make "program-related investments"[79], which the L3C can then leverage to advance its purpose and attract for-profit investments.[80] However, many practitioners believe that the L3C has no real advantage over an LLC. They argue that an LLC can function as an L3C by incorporating similar elements into its operating agreement, and that an L3C does not convey any federal tax benefits over an LLC with respect to program-related investments. Instead, the L3C designation may mislead private foundations into mistakenly believing that their investments in an L3C will automatically qualify as program-related investments under federal tax laws.

The L3C has many of the same features as the LLC. This section will address only areas in which the L3C differs from the LLC. Please see Section 2.4 for additional information regarding LLCs.

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[77] See http://socentlawtracker.org/. The L3C has also been adopted in the following federal jurisdictions: Puerto Rico, the Oglala Sioux Tribe, the Crow Indian Nation of Montana, and the Navajo Nation. North Carolina repealed the state's L3C law effective as of January 1, 2014.

[78] See http://www.intersectorl3c.com/l3c_tally.html.

[79] Under Section 4944(c) of the Internal Revenue Code.

[80] See Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, Vt. L. Rev., Vol. 35, No. 1, pp. 163-209, Fall 2010.

(b) Organizational Structure

As with an LLC, the corporate governance, management, distribution and ownership structure of an L3C is flexible and can be tailored to an organization's desired structure. See Section 2.4 of the Guide for a discussion of these matters.

(c) Establishment Costs and Documentation

DOCUMENTATION

Establishing an L3C requires several state and federal filings and the drafting of certain organizational and governance documents (all of which are also required for establishing an LLC). Like an LLC, an L3C is established by filing articles of organization with the state. An L3C should then establish an operating agreement to govern its operations. See Section 2.4 for establishment costs and documentation required for LLCs. An existing LLC may also be converted to an L3C, either automatically or by making certain filings with the state (depending on the state).

In some states, organizations may become subject to the requirements applicable to L3Cs even if they do not intend to be. For example, in states that define an L3C as an LLC that is established to further the accomplishment of one or more charitable or educational purposes and also satisfies certain other requirements for exempt organizations under federal tax law, an LLC seeking to become an exempt organization under federal tax law may become an L3C in the state of its organization, regardless of whether it elects to become one.[81]

ARTICLES OF ORGANIZATION

In addition to satisfying the general requirements applicable to LLCs, the articles of organization and/or the operating agreement of an L3C must set forth an appropriate purpose. For example, an L3C being formed in Illinois must include an L3C designation in its title and must include an appropriate purpose in its articles of organization. The organization is required to amend the articles of organization to remove the purpose and the L3C designation if the LLC is no longer eligible to identify itself as an L3C.[82]

Typically, under applicable state law the L3C must define its purpose(s) in its articles of organization or operating agreement in accordance with the following:

[81] This is the case under Wyoming law, for example. See Wyo.Stat. 17-29-102(a)(ix).
[82] 805 ILCS 180/1-26(c).

- The L3C must have or significantly further a charitable or educational purpose within the meaning of Section 170 of the Internal Revenue Code, and the L3C would not have been formed but for the charitable or educational purpose.
- The production of income or appreciation of property is not a significant purpose of the organization (although significant income or appreciation of property is not automatically evidence that the organization was formed for an improper purpose).
- The L3C must have no political or legislative purpose.

In some states the company's name must include the designation "L3C," and the designation must be removed if the company ceases to satisfy L3C requirements.[83]

OPERATING AGREEMENT

Just as for an LLC, the principal organization document for an L3C is the L3C's operating agreement. The operating agreement is explored further in Section 2.4. In addition to the items covered by a standard LLC operating agreement, the operating agreement of an L3C should identify the purpose of the organization and identify the rights of each class of membership interests of the LLC.

COST

The cost for establishing an L3C varies. As with LLCs generally, the main cost components include attorney fees for the preparation of documents; state filing fees for organization, qualification and securities filings; statutory representation fees for the LLC's agent for service of process; and any accounting-related fees for taxation-related advice and services. Attorney fees are affected by the complexity of the L3C's management, governance, distribution and ownership structure (as reflected in the L3C's operating agreement) and the number of additional documents required to set the L3C up for business (e.g. employment agreements, securities and regulatory filings). State filing and statutory representation fees are affected by the numbers of states and specific states in which the entity organizes, transacts business or sells securities. State filing fees vary from state to state, with some states imposing the same fees as they do for LLCs.[84]

SELECTING A STATE OF ORGANIZATION

In addition to the general considerations for all LLCs addressed in Section 2.4, there are a number of other factors that should be considered when selecting a state of

[83] See e.g., Wyo.Stat. 17-29-705(e).
[84] See e.g., https://www.sec.state.vt.us/corporationsbusiness-services/fees-filings.aspx.

organization for an L3C. The organization should consider whether additional filing or other obligations apply in certain states but not others, and whether the specific laws related to L3Cs in the state are consistent with the organization's goals and operations.

(d) Liabilities

Members of an L3C have limited personal liability for the business debts, judgments and actions of the L3C, consistent with such limitations applicable to LLCs generally. See Section 2.4. As a relatively new form of LLC, it is not clear whether members or managers of an L3C would have additional fiduciary duties related to the L3Cs charitable purpose.[85]

(e) Governance and Regulatory Obligations

GOVERNANCE OBLIGATIONS

Just as with an LLC, many of an L3C's ongoing governance obligations are determined internally by the L3C through the L3C's operating agreement. See Section 2.4. State law may also compose additional governance obligations.

REGULATORY OBLIGATIONS

L3Cs, like other entities, will be subject to federal, state and local regulatory requirements applicable to the type of business it operates. See Section 2.4 for a discussion of filings and other regulatory obligations applicable to LLCs generally.

(f) Tax Treatment

An L3C, as a type of LLC, generally has several options related to its tax treatment. See Section 2.4 for a more detailed discussion of tax treatment of LLCs.

(g) Financing

As a type of LLC, L3Cs have few formal restrictions on financing and raising funds. See Section 2.4 of the Guide for a discussion of financing and fundraising matters applicable to all LLCs. In general, financing and fundraising issues applicable to all LLCs are also applicable to L3Cs. Although an L3C must have or further a charitable purpose, the L3C is structured as a for-profit entity. As a result contributions to an L3C are not tax-deductible.

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[85] See e.g., John Tyler, *Negating the Legal Problem of Having "Two Masters": A framework for L3C Fiduciary Duties and Accountability,* Vt. L. Rev., Vol. 35, No.1, pp. 117-161, Fall 2010.

PROGRAM-RELATED INVESTMENTS

As noted above in the introduction to Section 3, proponents of the L3C suggest that in addition to traditional forms of financing, the L3C structure makes it more susceptible to equity investments by private foundations. However, as discussed above, there is significant disagreement on this point among practitioners in this area.

TRANCHED INVESTMENTS

One point raised by proponents of the L3C is that an L3C's operating agreement could provide for different classes of membership interests structured in tranches to accommodate differing investor goals. For example, an L3C could have three tranches, or layers, of investors: (i) a class of membership interests that would have the highest risk and the lowest rates of return applicable to all investors, primarily held by private foundations making program-related investments; (ii) a second class of membership interests held by investors motivated by social benefit, which would carry less risk and more potential reward than that held by the first class; and (iii) a senior class of membership interests, which would be held by investors more interested in obtaining a high investment return. However, critics of the L3C note that tranched investing is already possible in a typical LLC (see Section 2.4 above), as the operating agreement need only be drafted to reflect different classes of membership interests. In addition, critics of the L3C have raised concerns that if the principal attribute of a tranched investment structure is to provide market or above market rate returns to for-profit investors, there is a serious risk that the program-related investment by a private foundation would be viewed by the IRS as resulting in a private benefit to the for-profit investor, which may jeopardize the status of the investment for the foundation, risking excise tax penalties as well as possible loss of the foundation's tax exempt status. This concern is applicable to both L3Cs and other LLCs.

(h) Resources

http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm

http://americansforcommunitydevelopment.org

http://citmedialaw.org/legal-guide/low-profit-limited-liability-company

3.3 BENEFIT CORPORATION

Key advantages/disadvantages

ADVANTAGES

- The same general advantages applicable to corporations also apply to benefit corporations
- Highlights and brands an organization as having a social or charitable purpose other than the maximization of profits
- May provide access to third parties, consumers, strategic partners, investors and others whose interests are aligned with the organization's social or charitable purposes
- Third party certifications may provide some certainty to potential investors and strategic partners that the corporation is pursuing a social purpose

DISADVANTAGES

- The same general disadvantages application to corporations also apply to benefit corporations
- Relatively new variation of corporation; impact on capital raising is not clear
- Extensive variation among state law with differences outweighing similarities resulting in lack of standard model across states
- Lack of integration in many states between benefit corporation statutes and general corporation statutes results in ambiguity or potential conflicts
- Unrelated third parties may be able to bring claims in some states to enforce benefit corporation's mission
- Ambiguity in state statutes regarding duties of "benefit" director and discretion of board of directors and management to weight different goals
- Potential confusion with certain third party certification standards – such as the "B Corporation" from B Lab
- Third parties cannot easily identify benefit corporations as no requirement to explicitly designate "benefit corporation" in corporate name

- Third party certification requirements provide significant power and authority to third party providers of such certifications
- Extensive certification process and reporting requirements may be expensive and time consuming
- May be difficult for a corporation with numerous shareholders to transition to/from status as benefit corporation

Case study

PATAGONIA, INC.

Patagonia, Inc., a California benefit corporation, is a leading designer of core outdoor apparel for climbing, snow sports, surfing and fly fishing. The company is noted for its commitment to authentic product quality, environmental responsibility, and support for grassroots conservation. In addition, Patagonia is a founding member of 1% for the Planet and, through its Common Threads Partnership, takes back any Patagonia product ever made for recycling or down cycling. The company's commitment to transparency is exemplified by its interactive website, The Footprint Chronicles, which outlines the environmental and social footprint of Patagonia products. For more information, please visit http://www.patagonia.com.

(a) Overview

A benefit corporation is a new type of for-profit corporation currently recognized in 29 states and the District of Columbia.[86] Additional legislation is also proposed or pending in at least 7 other states. Benefit corporations are required to recognize a public benefit as one of their corporate purposes. In general, each state statute is based off of model benefit corporation legislation promulgated by B Labs, a third-party certification organization. While the model legislation provides uniformity in certain common approaches and concepts, there is significant variation among states in the requirements for and features of the benefit corporation. Key provisions which differ from state to state include:

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[86] This figure does not include the state of Delaware as the Delaware public benefit corporation statute differs from the model legislation in significant ways.

- Whether there is a requirement to have a benefit director to serve on the board and the fiduciary duties of such director;

- The nature of benefit enforcement proceedings pursuant to which shareholders or third parties can sue to enforce the mission;

- Whether appraisal rights are available for dissenting shareholders; and

- Varying shareholder approval thresholds to alter a benefit corporation's mission or to convert into or out of benefit corporation status.

This summary does not identify the specific requirements and features in each state; for additional information, please consult the applicable state statute for the proposed state of incorporation.

While a typical for-profit corporation is generally required to operate for the purpose of generating shareholder value, a benefit corporation must also operate for a general public benefit that has a material positive impact on both society and the environment. According to most benefit corporation statutes, such impact must be measured by a statutorily defined third party standard. In addition to a general public benefit, a benefit corporation is permitted (but not required) to recognize one or more specific public benefits. Generally, the benefit corporation may adopt one or more of the following seven purposes: (i) providing beneficial products or services to low income or underserved individuals or communities, (ii) promoting economic opportunity beyond job creation, (iii) preserving the environment, (iv) improving human health, (v) promoting the arts, sciences or knowledge, (vi) increasing capital flow to public benefit entities, and (vii) accomplishing other particular benefits for society or the environment.[87] A benefit corporation's decision to establish one or more specific public benefits should be informed by the goals of the applicable benefit corporation and the activities and operations proposed to attain such goals.

All current benefit corporation statutes require a benefit corporation to prepare an annual benefit report, which, except for a Minnesota benefit corporation, must be delivered or made available to each shareholder of the benefit corporation within 120 days following the end of each fiscal year (or at the same time as the benefit corporation provides other annual reports to shareholders). The assessment

[87] See e.g., Cal. Corp. Code § 14601(e); H.R.S. §420D —5; Md. Corp. Code Ann. § 5-6C-01(d); N.J. Stat. Ann. § 14A:18-1; Vt. Stat. Ann. 11A § 21.03(a)(6); Va. Code Ann. § 13.1-782;; N.Y. SB 79-A § 1702(e); Pa. SB 433 § 3302(a). The State of Hawaii also recognizes as a specific public benefit the use of the right to exclude conferred by a patent to create or retain jobs in Hawaii or the United States, uphold fair labor standards or protect the environment.

component of the annual benefit report provides shareholders with an evaluation of the benefit corporation's social and environmental performance during the year covered by the report. The assessment must be prepared in accordance with the third party standard selected by the benefit corporation (however the criteria in the legislation matches exactly with the B corporation standards leading some critics to claim the legislative model is designed to drive revenue to B Lab).

(b) Organizational Structure

The benefit corporation is a type of for-profit corporation. As such, the corporate form is the only available form of entity for this type of organization. See Section 2.3 of this Guide for more information about the structure of a corporation.

BOARD AND OFFICER COMPOSITION REQUIREMENTS

Some benefit corporation statutes require that benefit corporations elect a benefit director to the board of directors. All states that require a benefit director indicate that such director must be independent, as independence is defined in such state's benefit corporation statute, and provide that each benefit corporation may, at its discretion, set forth in its charter documents additional qualifications for the benefit director.

The benefit director generally has, in addition to the powers and duties of the other directors on the benefit corporation's board, certain powers and duties relating to the preparation of the benefit corporation's annual benefit reports. In all states that require a benefit director, such director must prepare and include in each annual benefit report a statement or opinion regarding whether the benefit corporation acted in accordance with its general and, if applicable, specific public benefit purposes during the year covered by the report, and whether the directors and officers of the benefit corporation complied with their respective duties in connection with creating such public benefits during such year. Additionally, if the benefit director believes that the corporation and/or its directors or officers failed to act in accordance with the public benefit purposes of the corporation, then the statement or opinion must include a description of the ways in which the corporation and/or its directors or officers so failed.[88] It is important to note that most states that require the election of a benefit director also protect such benefit director from personal liability for acts done in his or her capacity as the benefit director (with exceptions for acts that constitute self-dealing, knowing violations of law and the like). The responsibilities of and protections afforded to a benefit director by statute in the states that require this role

[88] See e.g., Cal. Corp. Code § 14621. Benefit corporation law in California does not require a benefit director, but requires that such a statement or opinion be made by all of the directors of the benefit corporation and included in each annual benefit report.

should be considered in determining whether and in what state to form a benefit corporation, since the role of benefit director may be difficult to fill if burdensome obligations or insufficient protections are provided by applicable statutes. In addition, such directors should consider how the additional fiduciary duties required for a benefit director may conflict with traditional fiduciary duties applied to directors of corporations generally.

In addition to a benefit director, some states permit benefit corporations to appoint a benefit officer, who would generally have duties relating to the creation of the corporation's general and, if applicable, specific public benefit. Most states that permit the appointment of a benefit officer require such officer to assist the benefit director in preparing the annual benefit report.[89]

(c) Establishment Costs and Documentation

The formation procedures and costs associated with establishing a for-profit corporation are generally applicable to the formation of a benefit corporation. See Section 2.3 for more information about forming a for-profit corporation.

The charter of a benefit corporation must include the same elements as are required in the charter documents of a for-profit corporation in the applicable state. In addition, a benefit corporation's charter must expressly state that the corporation is a benefit corporation. A benefit corporation that adopts a permitted specific public benefit must also state the specific public benefit in its charter. In order to amend, add or delete a specific public benefit from a benefit corporation's charter, a statutorily-defined minimum status vote must approve such change. In most states, the minimum vote required is the affirmative vote of at least two-thirds of the shareholders of each class or series of stock of the applicable benefit corporation entitled to vote on the matter.[90]

If an existing for-profit corporation desires to become a benefit corporation, its charter must be amended to state that it is a benefit corporation. According to most benefit

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[89] See Vt. Stat. Ann. 11A § 21.12. Of the states that expressly permit the appointment of a benefit officer, only Vermont does not require such officer to assist in the preparation of the annual benefit report.

[90] See e.g., Cal. Corp. Code §§ 14601(d), 14610(d); H.R.S. §§420D—2, —5; N.J. Stat. Ann. §§ 14A:18-1, 14A:18-5. Maryland, Virginia and Vermont do not separately define a minimum status vote in their benefit corporation statutes. The corporate law in Maryland generally requires the affirmative vote of ⅔ of all votes entitled to be cast in order to amend the charter of a corporation that has issued stock. Md. Corp. Code Ann. § 2-604(e). Similarly, the corporate law in Virginia generally requires the approval of ⅔ of each group of shareholders entitled to vote in order to amend a corporation's charter. Va. Code Ann. § 13:1-707(D). In Vermont, although the benefit corporation law does not separately define a "minimum status vote", approval of ⅔ of the shares entitled to be cast by shareholders or shareholder groups is required to amend a benefit corporation's charter to adopt a specific public benefit or to change its status as a benefit corporation. Vt. Stat. Ann. 11A § 21.08.

corporation statutes, such a charter amendment must be approved by the statutorily-defined minimum status vote in the applicable state of incorporation.[91]

(d) Liabilities

Because a benefit corporation is a type of corporation, its directors and officers are generally subject to and protected from the same kinds of personal liability as are directors and officers of corporations. Most states provide directors and officers with explicit protection from liability for pursuing the public benefit purpose established in the benefit corporation's charter. As a result, generally benefit corporation directors and officers should have no liability for pursuing a stated public benefit purpose at the expense of maximizing shareholder value. However, the extent of this protection varies from state to state, and there has been no litigation testing the limits of such protections.

Nearly all states expressly provide for a right of action against directors and officers of benefit corporations for a violation of their duties under the applicable state's benefit corporation statutes. This right of action, termed a "benefit enforcement proceeding", generally grants to certain identified parties the right to bring direct or derivative claims against directors and/or officers of a benefit corporation to enforce the general or specific public benefit purposes of the benefit corporation and the statutorily defined standards of conduct for the directors and officers (such standards of conduct are discussed below in part (e) of this Section). In many states, this benefit enforcement proceeding is the only type of action, proceeding or claim that may be brought or asserted against a benefit corporation or its directors or officers to enforce the benefit corporation law of the applicable state.

The parties permitted to bring a benefit enforcement proceeding against directors and officers of a benefit corporation generally include: (i) the benefit corporation itself, (ii) the shareholders of the benefit corporation, (iii) the directors of the benefit corporation, (iv) the holders of at least 5% (or 10% in New Jersey and Vermont) of the stock or other equity ownership of an entity of which the benefit corporation is a subsidiary, or (v) other classes of individuals specifically identified in the benefit corporation's charter documents.[92] In addition, unrelated third parties may be able to bring claims in some states to enforce a benefit corporation's mission.

The founders of a benefit corporation should carefully consider the different degrees of liability protection set forth in the laws of each state in which the benefit corporation

[91] See e.g., Cal. Corp. Code §§ 14601(d), 14603(a); H.R.S. §§420D—2, —3; Md. Corp. Code Ann. §§ 2-604(e), 5-6C-03(b)

[92] There are exceptions to each of these groups in certain states.

form is available in determining where to incorporate, since insufficient protections might dissuade directors and officers from serving on the board or management team of the benefit corporation. See also the discussion in "Director and Officers Standards of Conduct" below for a discussion of certain additional obligations of directors and officers of benefit corporations.

(e) Governance and Regulatory Obligations

ANNUAL BENEFIT REPORTS

All current benefit corporation statutes require a benefit corporation to prepare an annual benefit report, which except for a Minnesota benefit corporation, must be delivered or made available to each shareholder of the benefit corporation within 120 days following the end of each fiscal year (or at the same time as the benefit corporation provides other annual reports to shareholders). Additionally, benefit corporation law in some states requires that the annual benefit report be filed with the state in which the benefit corporation is incorporated. While the required content of an annual benefit report varies in each of the states that recognize the benefit corporation form, the law in all such states requires that the benefit report include a narrative and an assessment.[93]

The narrative of an annual benefit report generally requires a discussion of the manner in which the benefit corporation pursued a general and, if applicable, specific public benefit during the applicable year and the extent to which the benefit corporation created such public benefits. Further, the narrative must address any circumstances that hindered the benefit corporation's creation or promotion of a general or specific public benefit in the applicable year.

The assessment component of the annual benefit report provides shareholders with an evaluation of the benefit corporation's social and environmental performance during the year covered by the report. The assessment must be prepared in accordance with the third party standard selected by the benefit corporation, applied consistently with such corporation's benefit reports in prior years. If the third party standard is not consistently applied, then the benefit report must include an explanation of the reasons for the inconsistent application.

In addition to the narrative and the assessment, some states require additional types of information in an annual benefit report. For instance, in several states, a benefit report must include the names of all individuals and entities owning 5% or more of the

[93] http://benefitcorp.net/sites/default/files/Benefit%20Corporations%20Chart.pdf

benefit corporation's outstanding shares. Similarly, most states require disclosure of directors' compensation in each benefit report. Additionally, a few states require that each benefit report include a statement of any connection between the benefit corporation and the organization that created its third party standard. A careful review of the applicable laws in the state of incorporation is necessary to ensure that each annual benefit report includes all required information.

THIRD PARTY STANDARD

The statutory requirements relating to the third party standard used to measure a benefit corporation's social and environmental performance vary from state to state. The third party standard must be developed by a person or organization that is independent from the applicable benefit corporation. Generally, an independent party is one with no material relationship with the benefit corporation or its subsidiaries (either directly or as the owner or manager of an entity with a material relationship), where a material relationship exists when an individual has an employment relationship with the benefit corporation, has a family relationship with an officer of the benefit corporation, or owns a minimum of 5% of the outstanding stock or equity of the benefit corporation.[94] Additionally, the third party standard must meet certain transparency requirements, such as making publicly available the factors considered when measuring performance, the relative weighing of such factors and the identity of persons and processes involved in developing and controlling the third party standard.[95] Some benefit corporation laws also require that the third party standard provide for a comprehensive assessment of the benefit corporation's impact on certain required or permitted considerations, and/or be developed by an organization that is experienced in social and environmental performance and allows public comment in developing the standard.

DIRECTOR AND OFFICER STANDARDS OF CONDUCT

All effective and pending benefit corporation legislation includes standards of conduct that must be followed by directors, and sometimes officers, of benefit corporations. In

[94] See e.g., H.R.S. §420D—2; Md. Corp. Code Ann. § 5-6C-01(c); N.J. Stat. Ann. § 14A:18-1. Notably, California requires that the third party standard be determined by an organization with no material financial relationship with the applicable benefit corporation, which is deemed to be the case when not more than ⅓ of the members of the governing body of the organization are representatives of an association or business whose performance is measured by such third party standard, and California law also requires that the organization is not materially financed by such an association or business. Cal. Corp. Code § 14601(g).

[95] Some benefit corporation laws, such as in California, Hawaii, New Jersey, Vermont, and Pennsylvania, also require that the financial interests, if any, of the persons involved in developing and controlling the third party standard be identified in publicly available documentation. Cal. Corp. Code § 14601(g); H.R.S. §420D—2; N.J. Stat. Ann. § 14A:18-1; Vt. Stat. Ann. 11A § 21.03(a)(8); Pa. SB 433 § 3302(a).

light of the additional public benefit purposes of such corporations, these standards of conduct generally take the form of certain considerations that directors and officers must take into account when taking corporate actions, and certain other considerations that directors and officers are permitted (but not required) to take into account when taking corporate actions.

In most states that recognize the benefit corporation form, the following factors must be considered by benefit corporation directors when taking corporate action: (i) the shareholders of the benefit corporation; (ii) the employees and workforce of the benefit corporation; (iii) the interests of customers as beneficiaries of the benefit corporation's public benefit purposes; (iv) community and societal considerations; (v) local and global environmental effects; (vi) the short-term and long-term interests of the benefit corporation itself; and (vii) the benefit corporation's ability to accomplish its public benefit purposes.

Common permissible considerations - those that benefit corporation directors may (but are not required to) take into account when taking corporate action - include (i) the resources, intent and conduct of a person or entity seeking to acquire control of the benefit corporation, and (ii) a "catch all" category of other pertinent factors or interests of any other person or group that the directors deem appropriate to consider.

In their considerations of these required and permitted factors, most benefit corporation statutes provide that directors are not required to give priority to any such consideration or the interests of a particular group affected by any consideration unless the intention to allocate priority is expressly identified in the benefit corporations' charter documents.[96]

In addition to the statutorily defined standards of conduct for benefit corporation officers, some states' benefit corporation laws stipulate standards of conduct that must be followed by officers of a benefit corporation.[97] In such states, benefit corporation officers are generally required to take into account the required or permitted considerations of benefit corporation directors, as set forth by the law of the applicable state, when such officer has discretion to act on a matter and when it reasonably appears that the matter will have a material effect on the general or specific public benefits of the benefit corporation.[98] Those considering incorporating

[96] Exceptions include benefit corporation statutes in Hawaii and Maryland, which do not address whether or not priority may be allocated among the required and permitted considerations.

[97] For example, California, Hawaii, New Jersey, Vermont and Pennsylvania stipulate standards of conduct for officers of benefit corporations.

[98] H.R.S. §420D—8; N.J. Stat. Ann. § 14A:18-8; Vt. Stat. Ann. 11A § 21.11; Pa. SB 433 § 3323. A notable exception to this phrasing is the benefit corporation law in California, which requires officers to take into

as a benefit corporation should conduct a thorough review of the standards of conduct for directors and officers in the state in which they incorporate to ensure a complete understanding of the items to be taken into account by the board and the management team in making operational and other corporate decisions.

(f) Tax Treatment

Benefit corporations are subject to the same tax treatment as other for-profit corporations.[99] See Section 2.3 of this Guide for more information about the tax treatment of for-profit corporations.

(g) Financing

All effective and proposed benefit corporation statutes include provisions that serve to notify potential investors or other supporters of the entity's status as a benefit corporation. For instance, as discussed above, all benefit corporation laws require that the charter documents of the corporation expressly state that the entity is a benefit corporation. Additionally, some states require that all share certificates representing equity ownership of a benefit corporation include a legend indicating that the certificate represents ownership of the shares of a benefit corporation.

A benefit corporation will likely experience both advantages and disadvantages in its financing and fundraising efforts as compared to other for-profit corporations. Potential advantages include exposure to new groups of investors that have a particular interest in the public benefits pursued by the benefit corporation, and differentiation of the benefit corporation from other entities seeking funding. On the other hand, investors that receive or expect to receive an ownership interest in the company in exchange for their investment may be disincentivized from investing in benefit corporations because of the requirement that factors other than shareholder value be considered when making corporate decisions. The types of investors and supporters that are likely to contribute to the enterprise and the motivations of such investors and supporters are important to consider when deciding on the most appropriate entity form.

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account such considerations when the officer has discretion to act on a matter OR when it reasonably appears that the matter will have a material effect on the general or specific public benefits of the benefit corporation. Cal. Corp. Code § 14622.

[99] *See* B Lab, "Benefit Corporation - FAQ", available at http://benefitcorp.net/faq.

(h) Resources

http://www.bcorporation.net/what-are-b-corps

http://benefitcorp.net/

http://www.sos.ca.gov/administration/agency-reports/flexible-purpose-and-benefit-corporations-agency-reports

3.4 COOPERATIVES

Key advantages/disadvantages

ADVANTAGES

- Worker control and management
- Alignment of worker and investor interests
- Expanded access to business ownership for communities
- Accountability to community
- Favorable tax treatment of member distributions

DISADVANTAGES

- Difficulties in raising patient capital and scaling
- Additional governance requirements
- Level of financial investment does not determine control

Case studies

OCEAN SPRAY

Ocean Spray is an agricultural cooperative of over 700 cranberry and grapefruit growers headquartered in Middleborough, Massachusetts. Members grow the fruits and the cooperative transforms the fruit into marketable products such as cranberry sauce, fruit juices, fruit snacks, and dried cranberries. The cooperative employs about 2,000 people in states ranging from New Jersey to Oregon and had sales of $2.2 in billion 2013. For more information, please visit http://www.oceanspray.com/Who-We-Are.aspx.

MONDRAGON COOPERATIVE

Mondragon Cooperative is a conglomeration of various cooperative businesses ranging from credit unions, to industrial manufacturing, to infrastructure construction. Since its inception in Spain in 1956 it has grown to employ over 74,000 people in its

257 subsidiary companies and cooperatives. In 2014 it held nearly €24.8 billion in assets. For more information, please visit http://www.mondragon-corporation.com/eng/about-us/

ALVARADO ST. BAKERY

Semper Virens Bakery Food Cooperative, doing business as Alvarado St. Bakery is a local business in Petaluma, California. They have over one hundred members that bake and deliver 40,000 loaves of organic whole grain bread daily to retailers within their nearby community, as well as throughout the country and in Canada and Japan. Their mission is as much about healthy eating as it is about worker ownership. For more information, please visit http://www.alvaradostreetbakery.com/about_us.php.

(a) Overview

Cooperatives are businesses that are owned and controlled by their members. These businesses can serve any number of functions ranging from selling goods and services ("worker-owned cooperative"), to enabling a network of producers to bring their goods to market ("producer cooperatives" or "agricultural cooperatives"), to providing banking services ("credit unions"), to consolidating buying power to increase access to goods and services ("consumer cooperatives").

Cooperatives are defined by seven basic principles: (i) membership is open and voluntary; (ii) control is democratic on a one-member-one-vote basis; (iii) members participate in the financial gains of the entity; (iv) they provide education and training to members; (v) they are autonomous; (vi) they cooperate with other cooperatives; and (vii) concern for community is central.[100]

The cooperative sector in the United States is flourishing according to a 2009 study by the University of Wisconsin Center on Cooperatives, the most comprehensive such study to date.[101] Researchers found there are roughly 30,000 cooperative businesses in the United States; together they hold greater than $3 trillion in assets, generate about $650 billion in revenue, provide over two million jobs, and pay nearly $75 billion

[100] See: http://ica.coop/en/whats-co-op/co-operative-identity-values-principles
[101] See: http://reic.uwcc.wisc.edu/summary/

in wages. Dairy cooperatives supply 80% of all milk in the USA; farm supply cooperatives supply 30% of all farm supplies; and 75% of land in the USA is served by rural electric cooperatives.[102]

A cooperative structure offers a number of benefits for socially or environmentally minded entrepreneurs. A primary way that cooperatives create benefits for their members (and the communities that surround them) is by democratizing business ownership and wealth. Employees—or "worker-owners"—of cooperatives often enjoy good working conditions because the business is in existence primarily for their benefit. Cooperative workers tend to benefit from above-market pay, increased job stability, more skill building, a voice in governance, and an influence over their workplace conditions. Additionally, participatory decision-making helps to keep the focus of the business on the fulfillment of its members' social or environmental missions and goals. Finally, by making ownership accessible to people without large amounts of investment capital, cooperatives can channel the benefits of successful businesses into communities. Not only do members get to share in the profits of a successful business, but they are also more likely to reinvest or spend that money in their own local communities.

(b) Organizational Structure

Fewer than a dozen states have statutes that enable incorporation of various types of cooperatives; however a cooperative can be formed as any type of legal entity. The defining feature of a cooperative is not its legal form, but rather the way its ownership and governance is distributed. Other than specific cooperative forms provided by statute, LLCs are the most common choice of legal entity as the form's flexibility enables cooperative principles to be written into the business's governing documents.

(c) Governance and Management

The central principle of cooperative governance is that each member has a single vote regardless of their capital contribution or participation. However, members are not required to vote on every governance decision, and the bylaws will stipulate which decisions warrant member votes. For instance, ordinary business decisions are generally made by staff or management, and the members elect a board of directors with governing responsibility over more significant decisions. To ease governance, cooperatives often limit members to voting on larger issues such as the election of the board of directors, expansion into new areas of business, acquisition, dissolution, and issues pertaining directly to work environment.

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[102] See: http://community-wealth.org/sites/clone.community-wealth.org/files/downloads/WorkerCoops-PathwaysToScale.pdf

Given the role of members in the governance of the business, it is important for boards of directors and management to proactively educate members on changes to the business environment and related strategies. This process enables members to develop business acumen that serves both the cooperative and the members as individuals. For members and advocates of the cooperative form, this education—and the civic engagement it empowers—is itself seen as an important benefit of the cooperative form.

Many cooperatives accept capital contributions in return for membership or issue preferred stock and have the option of providing special voting rights to investor-members. In some circumstances, governing documents disallow investor-members from voting all together, while in others, investor-members may be allowed to exert additional influence over key financial decisions like mergers, acquisitions, and dissolution. While members tend to balance their own personal wages and security with the success of the business entity differently than non-member investors, the interests of the two constituencies remain largely in alignment because members' interests are dependent on the continuing profitability of the business.

Despite the differences from other mainstream business forms, like any other entity, a key to success of cooperatives is to have effective business managers. These managers will be members themselves and should be aligned with the philosophy of the cooperative so that they work in tandem with the rest of the members. An ideal cooperative business manager will relish the opportunity to train less experienced members since increasing business expertise in the cooperative improves its chances for success.

(d) Financing

With worker ownership, cooperatives retain the drive to maximize shareholder value because financial success translates into economic benefit for members of the cooperative as well as outside investors. That the majority of beneficiaries are worker-members who also receive wages affects the way decisions are made, but does not remove the drive for profitability.

For most cooperatives, some amount of financing comes directly from the active members in the form of capital contributions. In return for their contributions, each member is designated a patronage account. At the end of each year, members receive deposits in their patronage accounts based on how much they participated in the cooperative over the previous year, often calculated based on hours worked. The bylaws detail how distributions are allocated, which may vary based on factors such as the type of contributions a member makes. The bylaws also stipulate how and when members can access and withdraw funds from their patronage accounts. Some patronage accounts are set up to receive automatic distributions at regular intervals, while others require a certain threshold amount to be maintained or limit how much can be drawn per year. Importantly, cooperatives should ensure that funds are not taken out too quickly because the entity may need the money in the accounts for business purposes up until the moment the members get personal access to it.

Cooperatives can also accept outside investment through passive investor-members or by issuing preferred stock. Investor-members tend to be members of the immediate community that make a contribution equal to what worker members make and can vote but do not participate in the cooperative. Investor-members frequently receive smaller patronage distributions, whereas purchasers of preferred stock tend to make larger contributions and tend to be given special voting rights in return for their investment. These rights are limited so as not to interfere with the principle that members should primarily be in control of the business.

Patient capital (also known as long-term capital) is a key to success for cooperatives, and studies suggest that member-financed cooperatives are the most likely to succeed, in part because their capital is the most patient. Cooperatives established by grants are the second most likely to succeed, and cooperatives established by loans are less likely. Patient capital enables the benefits of the cooperative to accrue to the members, the community, and investors without exerting the kind of pressure that could cause the cooperative to abandon its principles for the sake of its financials.

(e) Taxation

Cooperatives benefit from a significant federal tax exemption: Earnings that are passed through to members are only taxed once. Under Subchapter T of the Internal Revenue Code, cooperatives are exempt from taxes on the distributions they make to members so long as at least 20% of the distributions is in the form of cash. The members themselves still pay income tax on the cash distributions; however, the exemption creates an opportunity for cooperatives to strategically reduce tax liability by shifting compensation of workers from wages to distributions.[103] There are also additional tax exemptions under the Internal Revenue Code for sector-specific cooperatives such as credit unions and some farmer cooperatives.[104]

[103] See: http://www.co-oplaw.org/topics-2/patronage/
[104] See: http://reic.uwcc.wisc.edu/issues/

(f) Resources

- Worker Cooperatives: Pathways to Scale: http://community-wealth.org/sites/clone.community-wealth.org/files/downloads/WorkerCoops-PathwaysToScale.pdf
- Legal Sourcebook for California Cooperatives: http://cccd.coop/files/LegalSourcebookForCaliforniaCooperatives.pdf
- Cooperative Statutes By State: https://docs.google.com/spreadsheets/d/1-RwKQTaspCyMbE7tLsKRhd8_GAhvmCzxA4zsm9gQg40/edit#gid=5
- How to Create a Worker Owned Business: https://drive.google.com/a/berkeley.edu/file/d/0B_rgt0QdXUbycnprd3hhYzdWNnc/view
- Organizations that support cooperatives: http://ica-group.org/ and https://www.ncba.coop/

3.5 HYBRIDS

Key advantages/disadvantages

ADVANTAGES

- Provides versatility in adapting business form to the desired goals of the entrepreneur
- Facilitates scaling of mission-driven entities by allowing revenue generation, thereby freeing such entities from reliance on charitable donations alone
- Allows access to widest pool of capital, including equity investments and charitable donations
- May increase ability to attract and incentivize talent through equity incentives for employees

DISADVANTAGES

- May be difficult and costly to establish and maintain
- Organizational structure may be complex
- Requires continual documentation regarding the flow of funds, services and personnel between the entities, to avoid negative tax consequences from private inurement and unrelated business income

Case studies

GREYSTON FOUNDATION AND GREYSTON BAKERY

Greyston Foundation and Bakery present a prime example of a thriving hybrid model. In 1982, a Buddhist monk and former NASA engineer opened the Greyston Bakery in an effort to address poverty in his community. Greyston was built upon an open hiring model, offering employment to individuals on a first-come, first-served basis, without an interview or background check, and regardless of their education, job experience, or criminal or drug records.

As the bakery grew, the corporate structure evolved as well. Greyston Bakery is a for-profit entity with over $11 million in annual revenues, supplying brownies to Ben & Jerry's and Whole Foods, among others. The bakery's success sustains the charitable work of Greyston Foundation, which includes multiple poverty eradication initiatives. While the non-profit is directly supported by the revenue from the for-profit, the for-profit benefits as well from its non-profit parent. Greyston's non-profit social impact commitment has enhanced the bakery's reputation, creating loyalty with other mission-oriented corporations and consumers.

MEDICINES360 AND ALLIANCE PARTNERS360

Medicines360 is a California nonprofit and Section 501(c)(3) tax-exempt charitable organization. Its mission is to improve access to women's health products both domestically and globally. Medicines360 researches the health needs of women to identify gaps and barriers in healthcare access, and then develops health products and forms partnerships to bring the products to market. Medicines360 reinvests all proceeds from its partnerships into advocacy, education, and additional product and partnership development. Medicines360 created a for-profit subsidiary, Alliance Partners360, that works with a major pharmaceutical company to market and sell its women's reproductive devices commercially, enabling the nonprofit to fulfill its mission. Whereas the non-profit focuses on providing reliable and safe birth control devices to low-income women with a concentration on the developing world, the for-profit subsidiary commercializes the same products in the developed world. Through this hybrid partnership, Medicines360 is able to achieve greater scale and impact than would otherwise be possible. For more information, please visit http://medicines360.org.

EMBRACE INNOVATIONS

Embrace Innovations is an offshoot of Embrace, a federally tax exempt nonprofit organization. The organization develops disruptive healthcare technologies aimed at reducing infant and maternal deaths in emerging markets. Specifically, the company created the Embrace Warmer as an alternative to expensive infant incubators for premature babies. Founded in 2008, Embrace announced a new hybrid organizational structure in January 2012. Embrace Innovations was spun out as a separate for-profit social enterprise focused on product design, manufacturing, and sales/distributions to governments and private clinics in emerging markets. Embrace Innovations also adopted research and development responsibilities. For each warmer sold, the for-profit arm pays a royalty to the nonprofit, which owns the intellectual property. The nonprofit then sets up partnerships with nongovernmental organizations and government entities in under-resourced communities and distributes warmers for free to clinics and hospitals that have limited access to modern technology. For more information, please visit http://embraceglobal.org.

DIGITAL DIVIDE DATA

Digital Divide Data, or DDD, is a federally tax exempt non-profit corporation formed under the laws of California. Its mission is to create better futures for disadvantaged youth in developing countries through employment in a financially sustainable business. Founded in 2001, DDD identifies and recruits bright, motivated youth who would not otherwise have access to good jobs or higher education. It then trains and employs them at a fair wage, while offering them scholarships to attend university. The employment is in a social business that delivers high-quality, cost-effective, enterprise digital solutions to clients, while creating opportunity for some of most disadvantaged people on the planet. In 2010, DDD formed its wholly-owned subsidiary Digital Divide Data Ventures LLC, or DDD Ventures, a for-profit Delaware limited liability company, for purposes of operating for-profit businesses which are consistent with its exempt purpose as a charitable organization. Such operations are intended to facilitate the creation of sustainable jobs and educational opportunities for individuals throughout the world. DDD Ventures owns for-profit enterprises located in Kenya, Laos and Cambodia. For more information, please visit http://www.digitaldividedata.org.

PACIFIC COMMUNITY VENTURES, INC.

Pacific Community Ventures, Inc. is a California non-profit and Section 501(c)(3) tax exempt charitable organization. Its purpose is to create jobs and economic opportunity in low-income communities through the direct support of small businesses as well as by advocating for systemic change to increase investment in these communities. In support of this purpose, Pacific Community Ventures, Inc. provides business advising services and debt capital to small and high growth businesses that create jobs and opportunities in lower income communities, offers impact evaluation services to investment and philanthropic institutions and undertakes policy research in the areas of impact investing and small business needs to drive capital and resources to underserved communities. Pacific Community Ventures, Inc. also manages for-profit investment funds that invest in California businesses that bring significant economic gains to low-to-moderate income employees through its wholly-owned subsidiary, Pacific Community Management, Inc., a for-profit Delaware corporation, and its affiliate, Pacific Community Ventures, LLC, a for-profit Delaware limited liability company (see the case study in Section 2.4 above). For more information, please visit http://www.pacificcommunityventures.org.

RSF SOCIAL FINANCE

Rudolf Steiner Foundation, Inc. (dba as RSF Social Finance), a New York non-profit corporation, is a financial services organization dedicated to transforming the way the world works with money. In partnership with a community of investors and donors, RSF Social Finance and its affiliates (RSF) provide capital to non-profit and for-profit social enterprises addressing key issues in the areas of food & agriculture, education & the arts, and ecological stewardship. Since 1984, RSF has made over $275 million in loans and over $100 million in grants to non-profit and for-profit social enterprises. RSF offers investing, lending, and giving services that generate positive social and environmental impact while fostering community and collaboration among participants. RSF provides such services directly and through its for-profit and non-profit affiliates including RSF Capital Management, Inc., a for-profit Delaware corporation and certified B Corporation, which provides senior working capital and subordinated term debt to businesses meeting a rigorous social enterprise profile, and RSF Social Investment Fund, Inc., a non-profit California public benefit corporation, which provides loans to non-profit organizations and makes investments related to RSF's mission. For more information, please visit http://rsfsocialfinance.org/.

KEPLER'S 2020, FPC

Kepler's 2020, FPC, or Kepler's, is a community-supported bookstore organized as a California flexible purpose corporation. Kepler's was formed in 2012 and evolved from the former Kepler Corporation, which previously operated a book store in the San Francisco bay area since the 1950s. Kepler's mission is to serve as an accessible intellectual and cultural hub for public education, community dialog, and browsing and discovery of new ideas and books in order to open minds, deepen literacy, and promote critical thinking. Kepler's also strives to promote positive short-term and long-term effects of, and minimize adverse short-term and long-term effects of, such activities on Kepler's employees, authors, speakers, publishers, suppliers, customers, creditors, partners, the community and society. To pursue its mission, Kepler's partners with Peninsula Arts & Lectures, a California nonprofit public benefit corporation. Peninsula Arts & Lectures offers arts and lectures events, panel discussions, on-stage interviews and educational workshops covering the arts, culture, technology and current affairs to foster intellectual discourse and civic engagement. Although separate legal entities, Kepler's and Peninsula Arts & Lectures collaborate closely by sharing certain resources pursuant to a resource sharing agreement with the goal of bringing people together around ideas and books to foster intellectual discourse and civic engagement in the community. The two organizations share core values of community engagement, stewardship, and sustainability. For more information, please visit http://www.keplers2020.com/.

(a) Overview

Increasingly, entrepreneurs with both an impact-oriented mission and a revenue generating model are choosing an integrated structure, which marries non-profit and for-profit corporate forms. Whereas historically, social enterprises faced a binary choice between a for-profit corporation and a non-profit corporation, the hybrid model balances social impact and commercial pursuits. Hybrids can take on various combinations of for-profit and non-profit forms, including: (i) a charitable organization as parent with a for-profit subsidiary, (ii) a for-profit parent with a non-profit subsidiary (e.g., a foundation), or (iii) separately owned for-profit and non-profit entities, working in tandem with their relationship governed by contract.

HYBRID SYNERGIES

At their best, hybrids enable social enterprises to reap the benefits of both for-profit and non-profit legal forms. Through the for-profit entity, the organization can generate revenue, raise capital through traditional capital markets, distribute returns to investors, and offer equity incentives to attract and retain talent. The non-profit entity, on the other hand, enjoys a range of benefits associated with being a charitable organization, including often tax exempt status, social legitimacy, and access to donations of money and resources (e.g. pro bono legal services).

When working well together, the combination of for-profit and non-profit entities creates synergies that reinforce the mission of each entity—ideally, leading to a whole that is greater than the sum of its parts. For example, the charitable organization benefits from a steady source of capital contributed by the for-profit, freeing it from reliance on fundraising alone. It also benefits from access to talent that might otherwise be drawn to the purely for-profit sphere. While donations to the non-profit cannot be used for the benefit of the for-profit or any private purposes, the work of the non-profit reinforces the mission of the for-profit and a close relationship lends legitimacy and goodwill to the mission-orientation of the for-profit. For example, consider the Greyston case study below. The for-profit entity has clear marketing and reputational advantages due to its relationship with and commitment to the charitable mission. A socially-conscious consumer would be more inclined to buy a brownie from Greyston Bakery, as compared with a competitor, if she knows she is supporting the mission of Greyston's non-profit.

UNIQUE CHALLENGES OF HYBRIDS

Hybrids also present unique challenges from an operational perspective. Entities considering a hybrid structure should engage legal, accounting and tax advisors familiar with the complexities of hybrid structures. There are number of issues to consider, both at the outset when first structuring the hybrid, and on an ongoing basis as the organization matures. Parties must carefully consider control and board composition, avoiding private benefit (particularly for insiders) and conflicts of interest, unrelated business income tax issues, and issues relating to respecting corporate separation. In particular, a hybrid structure requires ongoing monitoring and documentation regarding the flow of funds, services and personnel between the entities to avoid negative tax consequences from private inurement and unrelated business income.

While several types of exempt organizations may be involved in hybrid structures, most social enterprise hybrids involve charitable organizations, which are exempt under section 501(c)(3) of the Internal Revenue Code,[105] or public welfare organizations, which are exempt under section 501(c)(4) of the Internal Revenue Code. Both types of exempt organizations must be organized and operated exclusively for exempt purposes set forth in Section 501(c)(3) or Section 501(c)(4), and none of the earnings may inure to any private shareholder or individual—i.e., the for-profit affiliate or founder. Charitable organizations are also restricted in various ways and leadership must be careful to not run afoul of such restrictions. For example, a charitable organization may not attempt to influence legislation as a substantial part of its activities and may not participate in any campaign activity for or against political candidates.[106]

(b) Examples of Hybrid Structures

While hybrid structures can take various forms, the most common models include: (i) a charitable organization as parent with a for-profit subsidiary, and (ii) a for-profit parent with a non-profit subsidiary (e.g., a foundation). In addition, some hybrid enterprises include separately owned for-profit and non-profit entities, working in tandem with their relationship governed by contract. The two most common structuring models are described below.

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[105] Charitable organizations include both private foundations and public charities in hybrid structures due to strict IRS rules.

[106] Forming a non-profit corporation and obtaining federal tax-exempt status is a complex process. Organizations may also qualify for tax-exempt status through sections of the Internal Revenue Code other than Section 501(c)(3). For more information on these topics, please see the Charitable Organization Guide.

CHARITABLE ORGANIZATION AS PARENT AND FOR-PROFIT ENTITY AS SUBSIDIARY

Social enterprises may choose to form as a charitable organization and create a for-profit subsidiary in order to create more flexibility. For example, a charitable organization may find that it would like to explore a variety of financing alternatives for certain activities it would like to engage in or may want to provide equity compensation to attract employees. However, the charitable organization may not be permitted to pursue those financing activities and maintain its tax-exempt status. The charitable organization could establish a subsidiary corporation in order to finance further growth in those areas. Depending on the nature of the subsidiary's activity, an LLC might also be used. The charitable organization would own shares of stock or hold membership interests in the subsidiary, which could also raise funds from other investors. The charitable organization would retain sufficient ownership in the for-profit entity to control the activities of the new entity.

Please see the Charitable Organization Guide for information regarding the formation of non-profit corporations and qualifying as a tax-exempt organization. Any subsidiary of charitable organization would be formed as described elsewhere in this Guide.

NON-PROFIT FOUNDATION OF FOR-PROFIT ENTITY

Another option available to social enterprises is to form a for-profit entity (as described elsewhere in this Guide) and establish a non-profit private foundation to pursue a charitable purpose. These are commonly referred to as corporate foundations, although they can be created by any type of for-profit entity. A private foundation is a charitable organization with federal tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. A private foundation may receive tax deductible donations, but unlike a public charity, it is not required to have a diversified donor base; typically it is funded primarily by the related for-profit entity, its owners, and its employees. Unlike a public charity, a private foundation may be controlled by the sponsoring for-profit entity, although it is subject to restrictive rules, particularly with respect to transactions with the affiliated for-profit business. This structure frequently is used to provide a for-profit company with an avenue for pursuing charitable purposes.

Please see the Charitable Organization Guide for information regarding the formation of non-profit corporations and qualifying as a tax-exempt organization.

3.6 DELAWARE BENEFIT CORPORATION

Key advantages/disadvantages

ADVANTAGES

- Enjoys advantages applicable to Delaware corporations generally
- Protects boards of directors and management of corporations pursuing one or more enumerated publicly beneficial purposes
- Provides boards of directors and management ability to adjust weighting of social and profit maximization focus to account for changing circumstances
- Mandatory reporting requirements will provide some measure of accountability and certainty for mission to investors and strategic partners
- Highlights and brands an organization as having a publicly beneficial purpose in addition to the maximization of profits
- Provides shareholders with say in determining mission of entity
- May provide access to information to third parties, consumers, strategic partners, investors and others whose interests are aligned with the corporation's charitable or public purposes
- Substantially similar to the Social Purpose Corporation in California

DISADVANTAGES

- The same disadvantages applicable to corporations generally also apply to PBCs
- Must comply with potentially time-consuming and costly additional annual reporting requirements related to public benefit or benefits
- New form of corporation; potential impact on capital raising is unclear
- May be difficult for a corporation with numerous shareholders to transition to/from status as PBC because of approval requirements and dissenters' rights
- PBCs acting as an acquirer of a non-PBC in a merger or acquisition must obtain two-thirds approval of the outstanding stock of the corporation entitled to vote thereon

- PBCs acting as a target company in a merger or acquisition with a non-PBC acquirer must obtain the approval of two-thirds of the outstanding stock of the corporation entitled to vote thereon
- Effect of PBC status is unclear on valuation in public markets and reporting requirements of a PBC are not entirely reconciled with those required by the U.S. Securities and Exchange Commission for a public reporting company
- PBC is confused with the “Benefit Corporations” in other states despite significant differences
- A “public benefit corporation” in other states (like California) is a type of non-profit corporate entity leading to further confusion

Case studies

YEAR UP PROFESSIONAL RESOURCES, PBC

Year Up Professional Resources, PBC, or YUPRO, is a social enterprise that is organized as a Delaware public benefit corporation. YUPRO was formed in 2014 as a for-profit subsidiary of Year Up, an award-winning non-profit organization that empowers disadvantaged young adults to obtain professional skills and employment in one year. YUPRO acts as a career placement services and career support agency for Year Up alumni and corporate partners. By providing companies with motivated trained professionals, YUPRO is able to generate profit that directly contributes to the continued mission of the Year Up program. For more information, please visit http://www.yupro.com/

NEW LEAF PAPER, INC

New Leaf Paper, Public Benefit Corporation is a Delaware public benefit corporation whose mission is to be the leading national source for environmentally responsible, economically sound paper. The company has developed a unique approach to business, embedding its social and environmental values into every product line and every business relationship. New Leaf Paper develops and distributes environmentally superior printing and office papers that compete aesthetically and economically with leading virgin-fiber products. New Leaf Paper's goal is to inspire a fundamental shift toward environmental responsibility in the paper industry. New Leaf Paper is a founding public benefit corporation, converting from a traditional corporation in 2013. For more information, please visit http://www.newleafpaper.com/.

(a) Overview

In August 2013, Delaware adopted a new form of for-profit corporation, the public benefit corporation, or PBC.[107] The new legislation explicitly permits corporations to be formed in Delaware as a PBC or to convert from a corporation or other entity into a PBC in order to pursue one or more specifically enumerated social or charitable goals, a "public benefit", alongside other purposes of the corporation. Directors of a PBC are required to manage the business of the corporation in a manner that balances the specific public benefit(s) named in the corporation's charter on the one hand, and the pecuniary interests of the corporation's stockholders and those affected by the corporation's conduct on the other. Unlike the benefit corporation legislation passed in many other states, a Delaware PBC retains significant autonomy in deciding what public benefit(s) the corporation aims to further and how pursuit of such benefit(s) will be prioritized relative to other corporate purposes. As a result, the legislation provides a flexible framework and liability protection against claims of breach of fiduciary duty for directors of a PBC when making such weighting decisions.

(b) Organizational Structure

PBCs are governed by substantially the same rules regarding corporations as are applicable to other Delaware corporations.[108] See Section 2.3 for more information.

(c) Establishment Costs and Documentation

See Section 2.3 above for more information on the requirements for establishing a corporation in Delaware. In addition to the requirements applicable to establishing all Delaware corporations, to be a PBC, a corporation must also comply with requirements specific to PBCs:

[107] See 8 Del. C. §§ 361-368. The legislation became effective August 1, 2013.
[108] See 8 Del. C. § 368.

CERTIFICATE OF INCORPORATION

The Certificate of Incorporation of a PBC must identify one or more specific public benefits to be promoted by the corporation and state within its heading that it is a public benefit corporation.[109]

A public benefit is defined as "a positive effect (or reduction of negative effects) on 1 or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature."[110]

CHANGES TO THE PUBLIC BENEFIT

As noted above, a PBC's public benefit(s) must be clearly identified in its Certificate of Incorporation. The public benefit(s) established in the Certificate of Incorporation may only be amended or eliminated by a vote of at least two-thirds of the outstanding stock entitled to vote thereon.

CHANGE OF CORPORATE FORM TO OR FROM A PUBLIC BENEFIT CORPORATION

New entities may incorporate using the PBC form and existing for-profit corporations may also convert into PBCs. However, any decision by a pre-existing business entity to become a PBC, by either amending its Certificate of Incorporation or through a merger or other business consolidation, requires the approval of at least two-thirds of the outstanding stock of the corporation entitled to vote thereon.

The conversion of a PBC into another corporate entity requires the approval of at least two-thirds of the outstanding stock of the PBC entitled to vote thereon. PBCs may merge with other PBCs or with other entities governed by laws that permit such mergers, and the PBC may either survive or terminate in such mergers. However, any merger or reorganization materially altering or eliminating an existing PBC's public benefit(s) requires the approval of the holders of at least two-thirds of the outstanding stock entitled to vote thereon.

In addition, dissenting stockholders of a corporation converting into a PBC may retain appraisal rights in the event that the required vote is obtained approving an amendment to the Certificate of Incorporation or certain business combinations

[109] See 8 Del. C. § 362.
[110] See 8 Del. C. § 362(b).

resulting in PBC status and the stockholder did not vote in favor of the amendment or transaction. However, with respect to stockholders of a non-PBC converting into a PBC, rights will not be available for holders of shares listed on a national securities exchange or held of record by more than 2,000 holders (with certain limited exceptions).

(d) Liabilities

In addition to the existing rights of a corporation's directors and officers to exercise their business judgment as provided under Delaware law, PBC directors and officers retain the discretion to make decisions that specifically offset maximization of profit with the public benefit(s) set forth in the corporation's Certificate of Incorporation when, in their business judgment, such a decision is necessary and appropriate. The Delaware PBC statute provides great flexibility in making such weighting decisions due to its silence on how balancing pecuniary interests to the stockholders, the interests of those materially affected by the corporation's conduct and the specific public benefit(s) should be achieved. As a result, the directors and officers of a PBC are free to exercise their discretion within reasonable bounds and subject to oversight by the corporation's stockholders.

Third parties do not have enforcement rights to bring a cause of action against a Delaware PBC for failing to adhere to the pursuit of its public benefit(s). However, a PBC remains policed by its stockholders – stockholders may elect and remove directors and sue under a claim for breach of fiduciary duties under Delaware law. Moreover, stockholders owning at least 2% of a PBC's shares may bring a derivative suit on behalf of the corporation.[111] Derivative suits in Delaware present a higher degree of certainty than comparable mission-preserving enforcement mechanisms in other states – unlike the new, statutorily created "benefit proceedings" which exist in many benefit corporation jurisdictions, derivative suits in Delaware fall within the framework of the state's well-developed body of corporate case law.

(e) Governance and Regulatory Obligations

After a corporation has been properly formed, there are certain ongoing requirements with which it must abide in order to comport with corporate formalities and maintain good corporate status. PBCs are governed by the same rules regarding corporate structure as are applicable to other Delaware corporations. See Section 2.3 for more information on corporate governance and regulatory obligations.

[111] See 8 Del. C. § 367.

In addition, certain other governance and regulatory requirements (summarized below) are also required of PBCs:

REPORTING

In addition to the governance and regulatory obligations applicable to all Delaware corporations, PBCs have certain additional requirements. No less than every two years, a PBC must provide its stockholders with a report on the corporation's pursuit of its public benefit(s). The report must include (i) the objectives set forth by the corporation's board of directors to promote the public benefit(s); (ii) the standards adopted by the board of directors to measure progress in promotion of the public benefit(s); (iii) objective, factual information based on those standards regarding the success of the corporation in meeting its public benefit objectives; and (iv) an assessment of the corporation's success in meeting its objectives and promoting its enumerated public benefit(s).[112]

There is no requirement that a PBC must publicly publish its report. However, a PBC may elect to include a provision in its Certificate of Incorporation or Bylaws that such reports must be made publicly available.[113]

In addition, a PBC may also elect to include provisions in its Certificate of Incorporation or Bylaws to (i) provide its report more often than every two years or (ii) rely on a third-party standard or certification in its report and assessment of its pursuit of its public benefit(s). However, absent such a provision, a PBC is not required to issue its reports more than once every two years or utilize any third-party standards.

(f) Tax Treatment

See Section 2.3 for more information on the tax treatment of corporations, including PBCs.

(g) Financing

As further described in Section 2.3, one major benefit to the corporate form, including the PBC, is that it offers a wide variety of options for financing and raising funds for the business. As the legislation establishing PBCs only became effective on August 1, 2013, it is not clear what, if any, impact the adoption of the PBC form will have on financing and fundraising. However, it may provide access to investors whose interests are aligned with a PBC's public benefit(s).

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[112] See 8 Del. C. § 366(b)(1)-(4).
[113] See 8 Del. C. § 366(c)(2).

(h) Resources

http://delcode.delaware.gov/title8/c001/sc15/

http://www.srr.com/article/examination-delaware-public-benefit-corporation-legislation

http://www.theconglomerate.org/2013/10/delaware-public-benefit-corporations-specific-public-benefit-purposes.html

4. CERTIFICATIONS, RATINGS AND REPORTING SYSTEMS

4.1 OVERVIEW

In recognition that the traditional available structures of for-profit and not-for-profit organizations may not be adequately meeting the needs of many social entrepreneurs[114], some states have recently created new forms of entities that are specifically designed for social enterprises. These entities are intended to allow companies to access a wider variety of financing options while pursuing goals that include both profits and other objectives.

Ratings agencies and ratings systems have been developed to provide stakeholders, investors, consumers and other interested parties with a mechanism by which they can assess the social impact of a particular social enterprise. By standardizing the ratings or providing a certification program, interested parties may be able to better assess whether a social enterprise makes the social impact that it claims.

There are a number of different rating agencies and certification programs available for social enterprises. Some assess an organization's total social impact, while others focus on a particular social goal, such as sustainability. There is no universal standard rating system, and some ratings may be applied to a social enterprise irrespective of its organizational structure. Also, none provide means for verification of information or audits or assurances other than Sustainable Accounting Standards Board (SASB) for public companies, which can often lead to green-washing.

Well-known certification programs include the "B Corporation" certification provided by non-profit corporation B Lab[115] and UL's product, safety and environmental certifications.[116] The non-profit organization Global Reporting Initiative (GRI) is one of the oldest, most robust and established such programs and has established its

[114] Failure of existing forms is not for the most part because of issues that are intrinsic to the corporate form itself but because of other factors.
[115] See http://www.bcorporation.net/what-are-b-corps/about-b-lab.
[116] See http://www.ul.com.

Sustainability Reporting Guidelines to guide companies providing sustainability reports, although GRI does not itself certify the reports or assure compliance with its Sustainability Reporting Guidelines. Another important resource is the Foundation Center's TRASI database, which contains a comprehensive database that includes different tools, methods, and best practices for conducting and implementing social impact assessment, and which provides information regarding a wide variety of certifications and rating systems.[117]

Below are brief descriptions of a number of the certification programs, ratings systems and social impact reporting programs available to social enterprises. There are many, many such programs available, and this list is not intended to be exhaustive. Further, as the number of such rating agencies has grown, separate programs have been created to rate such rating agencies' effectiveness. For example, the Global Institute for Sustainability Ratings (GISR)[118] does not provide its own rating system for companies, but instead accredits other sustainability ratings, rankings or indices with respect to their standards in measuring sustainability performance.

(a) Global Reporting Initiative's Sustainability Reporting Framework

GRI's Sustainability Reporting Framework provides guidance for companies disclosing sustainability performance.[119] This framework is applicable to organizations of any size or type, from any sector or geographic region, and has been used by thousands of organizations worldwide as the basis for producing their sustainability reports. Sustainability Reporting Guidelines contain recommended performance indicators and management disclosures that organizations may adopt voluntarily. GRI is not a rating agency; it does not monitor whether a particular company has correctly applied its guidelines and it does not provide any certifications. Instead, it is a standard setter for corporate sustainability disclosures. However, rating and certification organizations may use the data provided by companies complying with GRI's Sustainability Disclosure Guidelines.

(b) "B Corporation" Certification

B Lab is an independent, non-profit company that has established a certification process pursuant to which companies may become "B Corporations." To become a "B Corporation" a company must: (i) take and pass the B Impact Assessment; (ii) adopt the B Corporation legal framework, which requires companies to incorporate certain provisions in their charter and governance documents, (iii) sign a term sheet

[117] See http://trasi.foundationcenter.org.
[118] See http://ratesustainability.org/.
[119] See www.globalreporting.org.

agreement with B Lab; and (iv) pay certain fees. The ratings system is designed to measure the impact of a company on all of its stakeholders. The standards change depending on the size of the company and the sector in which the company operates. All forms of social enterprises are eligible to become certified "B Corporations", not just corporations.[120] It is easy to confuse benefit corporations (see Section 3.3 above) with B corporations. As described earlier, a benefit corporation is an enterprise formed as a benefit corporation in a state permitting the organization of such an entity, whereas a B Corporation is an enterprise that has been certified by B Lab. However, B Corporation certification often is the third party rating system relied upon by benefit corporations when preparing annual reports.

(c) Product, Safety and Environmental Certifications

There are a wide variety of product, safety and environmental certifications available to social enterprises depending on the industry and purposes of the organization. The availability of product, safety and environmental certifications generally does not depend on the corporate form a social enterprise takes. For example, UL Environment offers a number of well-respected environmental and sustainability certifications applicable to enterprises and products. UL 880: Sustainability for Manufacturing Organizations defines core sustainability metrics for manufacturing businesses within the following five areas: (i) sustainability governance; (ii) environmental matters; (iii) work force matters; (iv) customer and supplier matters; and (v) community engagement and human rights.[121]

UL also offers a Sustainable Product Certification, which tests and certifies products, processes and materials to current environmental standards.[122] Once testing is complete and a product is certified, information about it is included on UL's Database of Validated and Certified Products, an online tool that allows industry professionals, as well as consumers, to identify sustainable products by product category, company name, product name or standard.[123]

(d) Impact Reporting and Investment Standards

Impact Reporting and Investment Standards, or IRIS, provides an independent set of metrics for organizations to use when reporting their social impact.[124] IRIS was developed by the Global Impact Investing Network, or GIIN, a not-for-profit

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[120] See http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp.
[121] See http://ulstandards.ul.com/standard/?id=880.
[122] See http://industries.ul.com/environment/certificationvalidation-marks.
[123] See http://productguide.ulenvironment.com/QuickSearch.aspx.
[124] See http://iris.thegiin.org.

organization dedicated to increasing the scale and effectiveness of impact investing.[125] IRIS developed out of a perceived need in the impact investing community for a common framework for reporting the performance of impact investments. IRIS provides a standard set of performance measures for describing social and environmental performance. These performance measures include a variety of performance objectives, as well as specialized metrics for a range of industry sectors. Organizations that adopt the IRIS definitions for their impact reporting can contribute data to the GIIN, which will then produce industry-wide benchmarks based on such data. As with GRI, IRIS is not a rating agency and does not provide certifications.

(e) Sustainable Accounting Standards Board

The Sustainability Accounting Standards Board (SASB) is a registered 501(c)(3) non-profit organization engaged in the development and dissemination of industry-specific sustainability accounting standards for use by publicly-listed corporations in disclosing material sustainability issues for the benefit of investors and the public. SASB is establishing an understanding of material sustainability issues facing industries and creating sustainability accounting standards suitable for disclosure in standard filings for public companies such as the Form 10-K and 20-F. Such standards seek to define the materiality of key environmental, social and governance issues within each industry and produce a set of concise, comparable industry-based sustainability accounting standards. SASB provides integrated reporting of sustainability fundamentals alongside financial fundamentals in order to enable investors and the public to compare performance on critical dimensions of sustainability, better understand risks and opportunities, and adjust behavior accordingly. SASB is not affiliated with any other accounting standards board.

4.2 COSTS AND DOCUMENTATION

A company seeking to obtain a certification, verification or rating must consider both the fees charged by the rating agencies as well as the additional costs of implementing or complying with the guidelines or other applicable requirements. For example, while the B Impact Assessment itself is a free tool, B Lab charges an annual fee to certified B Corporations.[126] The fee is based on annual revenues and ranges from $500 for a company with less than $50,000 in annual sales revenues to more than $50,000 for a company with more than $1 billion in annual sales revenues. In addition, B Corporations must comply with ongoing reporting and compliance

[125] See http://www.thegiin.org.
[126] See http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/make-it-official.

requirements, which could result in increased costs to the company but for which there are no means to verify or mechanisms for audit. Many other certification programs and ratings agencies require a company to submit a quote after providing certain information. Such fees can vary.

4.3 IMPACT ON GOVERNANCE AND REGULATORY OBLIGATIONS

The level of impact of participation in a rating, certification or reporting program on a company's governance or regulatory obligations depends on the program. For example, UL Environment's sustainable production certification process does not require any governance obligations, but does require the company to submit its products, processes and materials for testing and certification. However, a company that desires to certify through B Lab may be required to amend its formation documents.

4.4 IMPACT ON FINANCING

Companies frequently make claims about the level of their social impact. However, without a standard certification process or rating system, investors are unable to measure how different companies compare against one another. Rating, certification and reporting agencies and systems claim that by obtaining a certification or a favorable rating, or by complying with certain uniform reporting requirements, a company can provide potential investors and stakeholders with reliable information to accurately assess the social impact such companies make. By providing more transparency, investors may be able to make better investment decisions among companies claiming to make a social impact. As a result, a company that has been certified by a well-respected certification program or that complies with established rating guidelines may find it easier to raise funds by providing investors increased transparency and, in some cases, third party independent review of its claims.

5. BIBLIOGRAPHY

5.1 SELECT STATUTES

- General Corporation Law of the State of Delaware § 101 et seq.
- Delaware Revised Uniform Partnership Act § 15-101 et seq.
- Delaware Limited Partnership Act § 17-101 et seq.
- Delaware Revised Uniform Partnership Act § 15-1001 et seq.
- Delaware Limited Partnership Act § 17-214, Delaware Limited Partnership Act § 17-101 et seq.
- Delaware Revised Uniform Partnership Act § 15-1001 et seq.
- California Corporations Code § 1 et seq.
- California Uniform Partnership Act of 1994 §16100 et seq.
- California Uniform Limited Partnership Act of 2008 §15100 et seq.
- California Uniform Partnership Act of 1994 §16951 et seq.
- Delaware Limited Liability Company Act § 18-101 et seq.
- California Limited Liability Act § 17000 et seq.
- New York Business Corporation Law § 1 *et seq.*
- Nevada Revised Statutes Chapter 75 *et seq.*
- Revised Uniform Limited Liability Company Act.

5.2 IRS TAX GUIDES AND WEBSITES

- Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)
- Internal Revenue Service, Publication 3402: Taxation of Limited Liability Companies (Rev. March 2010)
- https://www.irs.gov/Filing/Charities-&-Non-Profits
- https://www.irs.gov/Filing/Corporations

- https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed
- https://www.irs.gov/publications/p541/index.html

5.3 OTHER WEBSITES

- www.corp.delaware.gov
- http://revenue.delaware.gov/services/Business_Tax/business_structures_table.pdf
- http://revenue.delaware.gov/services/Business_Tax/Step2_old.shtml
- www.sos.ca.gov/business
- http://www.sos.ca.gov/business/be/starting-a-business-types.htm
- www.dos.ny.gov/corps
- www.nvsos.gov
- www.irs.gov
- www.ftb.ca.gov
- www.tax.ny.gov
- http://trasi.foundationcenter.org
- www.benefitcorp.net
- www.giirs.org
- www.globalreporting.org
- www.thegiin.org
- http://iris.thegiin.org
- www.sustainability.com
- www.bcorporation.net
- www.ul.com

5.4 SELECT FORMS

Below are links to forms related to forming business entities in Delaware and California, two of the most common states of formation in the United States. Similar information for other states is frequently found on the website of the Secretary of State, Department of Corporations or similar entity in the applicable state. Please note that this list of forms is not meant to be comprehensive.

(a) General Partnership

For forms and filing information regarding forming a general partnership in Delaware, see:

- STATEMENT OF PARTNERSHIP EXISTENCE: http://corp.delaware.gov/webpartnership09.pdf
- NAME RESERVATION: http://corp.delaware.gov/gp-namres.pdf
- STATE TAXATION: http://revenue.delaware.gov/services/BusServices.shtml and http://corp.delaware.gov/paytaxes.shtml
- FEDERAL TAXATION: https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Partnerships and Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)

For forms and filing information regarding forming a general partnership in California, see:

- STATEMENT OF PARTNERSHIP AUTHORITY: http://bpd.cdn.sos.ca.gov/gp/forms/gp-1.pdf
- NAME RESERVATION: http://www.sos.ca.gov/business/be/name-availability.htm
- FOREIGN QUALIFICATION: http://www.sos.ca.gov/business-programs/business-entities/faqs#form-question8
- STATE TAXATION: http://www.ftb.ca.gov/businesses/bus_structures/partner.shtml and http://www.edd.ca.gov/payroll_taxes/
- FEDERAL TAXATION: https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Partnerships and Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)

(b) Limited Partnership

For forms and filing information regarding forming a limited partnership in Delaware, see:

- CERTIFICATE OF LIMITED PARTNERSHIP: http://corp.delaware.gov/lpform09.pdf
- NAME RESERVATION: http://corp.delaware.gov/lp-nameres.pdf
- FOREIGN QUALIFICATION: http://corp.delaware.gov/lp-For-Registration09.pdf

- STATE TAXATION: http://revenue.delaware.gov/services/BusServices.shtml and http://corp.delaware.gov/paytaxes.shtml
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98214,00.html and Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)

For forms and filing information regarding forming a limited partnership in California, see:

- CERTIFICATE OF LIMITED PARTNERSHIP: http://www.sos.ca.gov/business/lp/forms/lp-1.pdf
- NAME RESERVATION: http://www.sos.ca.gov/business/be/name-availability.htm
- FOREIGN QUALIFICATION: http://www.sos.ca.gov/business/lp/forms/lp-5.pdf
- STATE TAXATION: http://www.ftb.ca.gov/businesses/bus_structures/partner.shtml and http://www.edd.ca.gov/payroll_taxes/
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98214,00.html and Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)

(c) Limited Liability Partnership

For forms and filing information regarding forming a limited liability partnership in Delaware, see:

- STATEMENT OF QUALIFICATION: http://corp.delaware.gov/llpstate09.pdf
- NAME RESERVATION: http://corp.delaware.gov/llp-nameres.pdf
- FOREIGN QUALIFICATION: http://corp.delaware.gov/ForLLPQual09.pdf
- STATE TAXATION: http://revenue.delaware.gov/services/BusServices.shtml and http://corp.delaware.gov/paytaxes.shtml
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98214,00.html and Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)

For forms and filing information regarding forming a limited liability partnership in California, see:

- APPLICATION TO REGISTER AN LLP: http://www.sos.ca.gov/business/llp/forms/llp-1.pdf

- NAME RESERVATION: http://www.sos.ca.gov/business/be/name-availability.htm
- FOREIGN QUALIFICATION: http://corp.delaware.gov/ForLLPQual09.pdf
- STATE TAXATION: http://www.ftb.ca.gov/businesses/bus_structures/partner.shtml and http://www.edd.ca.gov/payroll_taxes/
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98214,00.html and Internal Revenue Service, Publication 541: Partnerships (Rev. December 2010)

(d) Corporation

For forms and filing information regarding forming a corporation in Delaware, see:

- CERTIFICATE OF INCORPORATION: http://www.corp.delaware.gov/corpformscorp09.shtml
- NAME RESERVATION: http://corp.delaware.gov/llc-nameres.pdf
- FOREIGN QUALIFICATION: http://www.corp.delaware.gov/forqual09.pdf
- STATE TAXATION: http://revenue.delaware.gov/services/BusServices.shtml and http://corp.delaware.gov/paytaxes.shtml
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98277,00.html and Internal Revenue Service, Publication 542: Corporations (Rev. March 2012)

For forms and filing information regarding forming a corporation in California, see:

- ARTICLES OF INCORPORATION: http://www.sos.ca.gov/business/be/forms.htm#corp
- NAME RESERVATION: http://www.sos.ca.gov/business/be/name-availability.htm
- FOREIGN QUALIFICATION: http://www.sos.ca.gov/business/corp/pdf/foreign/corp-s&dcgen.pdf
- STATEMENT OF INFORMATION: https://businessfilings.sos.ca.gov/
- STATE TAXATION: http://www.taxes.ca.gov/corpC.shtml; https://www.ftb.ca.gov/businesses/bus_structures/cCorp.shtml and http://www.edd.ca.gov/payroll_taxes/
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98277,00.html and Internal Revenue Service, Publication 542: Corporations (Rev. March 2012).

(e) Limited Liability Company

For forms and filing information regarding forming a limited liability company in Delaware, see:

- CERTIFICATE OF FORMATION: http://corp.delaware.gov/llcform09.pdf
- NAME RESERVATION: http://corp.delaware.gov/llc-nameres.pdf
- FOREIGN QUALIFICATION: http://corp.delaware.gov/llc-for%20reg09.pdf
- STATE TAXATION: http://revenue.delaware.gov/services/BusServices.shtml and http://corp.delaware.gov/paytaxes.shtml
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98277,00.html and Internal Revenue Service, Publication 3402: Taxation of Limited Liability Companies (Rev. March 2010)

For forms and filing information regarding forming a limited liability company in California, see:

- ARTICLES OF ORGANIZATION: http://www.sos.ca.gov/business/llc/forms/llc-1.pdf
- NAME RESERVATION: http://www.sos.ca.gov/business/be/name-availability.htm
- FOREIGN QUALIFICATION: http://www.sos.ca.gov/business/llc/forms/llc-5.pdf
- STATEMENT OF INFORMATION: http://www.sos.ca.gov/business/llc/forms/llc-12.pdf
- STATE TAXATION: http://www.ftb.ca.gov/businesses/bus_structures/LLcompany.shtml and http://www.edd.ca.gov/payroll_taxes/
- FEDERAL TAXATION: http://www.irs.gov/businesses/small/article/0,,id=98277,00.html and Internal Revenue Service, Publication 3402: Taxation of Limited Liability Companies (Rev. March 2010)

(f) Social Purpose Corporation

For forms and filing information regarding forming a social purpose corporation in California, see the forms and filing information for forming a corporation in California.

(g) Low-Profit Limited Liability Company

The L3C is not available in either Delaware or California. The most common state of formation for L3Cs appears to be Vermont. For forms and filing information regarding forming an L3C in Vermont, see http://www.sec.state.vt.us/corps/forms/llcarts.htm. Generally, the forms applicable to an LLC are also required for an L3C.

(h) Benefit Corporation

For forms and filing information regarding forming a benefit corporation in California, see the forms and filing information for forming a corporation in California.

(i) Delaware Public Benefit Corporation

For forms and filing information regarding forming a public benefit corporation in Delaware, see the forms and filing information for forming a corporation in Delaware.

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