BENEFIT CORPORATIONS,
FLEXIBLE PURPOSE CORPORATIONS AND L3CS –
PRACTICAL AND TAX ISSUES
FOR THESE NEW TYPES OF ENTITIES

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1. Topics

1.1. What is "social enterprise"?

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[1] Thanks to Robert A. Wexler and David A. Levitt for their article *Using New Hybrid Legal Forms: Three Case Studies, Four Important Questions and a Bunch of Analysis* (THE EXEMPT ORGANIZATION TAX REVIEW, January, 2012) posted at http://www.adlercolvin.com/pdf/hybrid.pdf; to Celia Roady for her outline *New Social Enterprise Vehicles: Implications for Private Foundations* (October, 2011); to Arthur Rieman, David Adelman and Jessica Shofler for their article *California's New Hybrid Corporation Statute* (LOS ANGELES LAWYER, September, 2012) posted at http://www.lacba.org/Files/LAL/Vol35No6/2954.pdf; to Reynolds Cafferata for his outlines *New Hybrid Corporations: The California Flexible Purpose and Benefit Corporations and the L3C*; to Louis E. Michelson for his outline *Empowering Corporations to be a Strong Force for Good: California's Creation of Benefit and Flexible Purpose Corporations* (February 9, 2012); to W. Derrick Britt, R. Todd Johnson and Susan H. MacCormac, the co-chairs of the working group who created the FlexCorp, for their paper *Everything You Ever Wanted to Know About the Flexible Purpose Corporation (And Then Some)* (February 23, 2011) posted at:
http://www.businessforgood.co/2011/03/frequently-asked-questions-proposed.html
("Everything You Ever Wanted to Know"); and to Will Fitzpatrick, Celia Roady and Robert Wexler for their presentation *Hybrid Entities: Do They Really Have a Place in the Charitable Investment World?* to the Exempt Organization Committee of the Section of Taxation of the American Bar Association in February, 2012 in San Diego, California.

This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

1.2. How are “flexible purpose corporations” different from benefit corporations and regular corporations?

1.3. How are “benefit corporations” different from “flexible purpose corporations” and regular corporations?

1.4. What is the difference between a “benefit corporation” and a “Certified B Corp” or “B Corp”?

1.5. What is the difference between a “low profit limited liability company” or “L3C” and a regular LLC?

1.6. Why did legislatures create these new entities?

1.7. What are the income tax implications of these new entities?

1.8. What are the gift and estate tax implications of these new entities?

1.9. How will interests in these entities be valued?

1.10. When might advisors see them?

1.11. How do these entities affect a professional’s practice?

2. Historical Background

1969 - Private foundation concept added to Internal Revenue Code, along with concept of “program-related investments.”

1977 - Revised California General Corporation Law (a) eliminated long purposes clauses in favor of a short, rigid, all-purpose clause, (b) permitted “close corporations” with 35 or fewer shareholders to change most provisions of the new General Corporation Law.

1980s - To fend off unfriendly takeovers of publicly traded companies, “constituency statutes” in several states allow the directors to consider factors other than maximizing shareholder value – at least when considering a take-over offer.[2]

1986 -Tax Reform Act, *General Utilities* repeal

1988 to 1994 - Rise of the LLC statutes

1996 - Check-the-box regs

2000 - Unilever buys Ben & Jerry's, who later express reluctance at feeling forced to accept the highest offer to maximize shareholder value.

2004 - California permits LLCs to be organized "whether or not for profit."

2008 - Vermont is the first state to adopt a "low-profit limited liability company" act.

2010 - Maryland enacts the first benefit corporation law.

2011 - Occupy Wall St. begins.

2011 - California enacts a benefit corporation law and a flexible purpose corporation law.

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[2] "Mostly, the constituency statutes were adopted in the mid to late-1980's as a response to hostile takeovers. The purpose, in nearly every case, was to provide directors with greater control in accepting or rejecting an offer to purchase a company by permitting consideration of other factors beyond maximization of shareholder value. Due to a lack of judicial decisions interpreting such statutes, the Working Group [who drafted the FlexCorp Act] is not convinced that such provisions will effectively shield board and management from liability if the interests of certain stakeholders are promoted to the detriment of shareholder value." W. Derrick Britt, R. Todd Johnson and Susan H. MacCormac, *Everything You Ever Wanted to Know* (see fn. 1 above).

3. “Social Enterprise” and “Social Enterprise Entities”

3.1. In this outline, “social enterprise” means an enterprise with a mix of profit and other stated purposes, and a “social enterprise entity” means a flexible purpose corporation, a benefit corporation or a low-profit limited liability company.

3.2. The term “social enterprise” has a broader -- and fuzzier -- meaning in common usage.[3]

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[3] From the website of the “Social Enterprise Alliance”:

What’s a Social Enterprise?

Social enterprises are businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas.

Three characteristics distinguish a social enterprise from other types of businesses, nonprofits and government agencies:

- It directly addresses an intractable social need and serves the common good, either through its products and services or through the number of disadvantaged people it employs.

(Footnote continued on next page)

3.3. “Social enterprises” are intended to fill needs that cannot be met by government, nonprofits or businesses – the “missing middle.”[4]

(*Footnote continued from preceding page)*

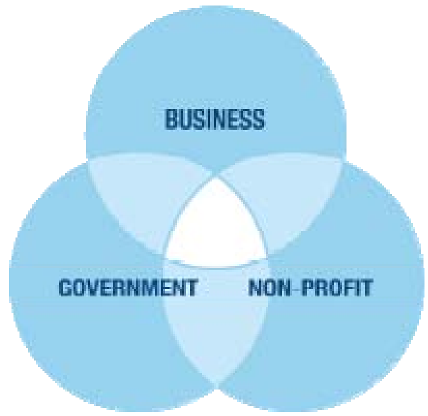
- Its commercial activity is a strong revenue driver, whether a significant earned income stream within a nonprofit’s mixed revenue portfolio, or a for profit enterprise.
- The common good is its primary purpose, literally “baked into” the organization’s DNA, and trumping all others.

https://www.se-alliance.org/why#whatsasocialenterprise (also the source of the two diagrams and the quote in the next footnote).

[4] More from the website of the “Social Enterprise Alliance”:

> It appears that the world’s problems are outstripping our ability to address them, but what may be more accurate is simply that traditional institutions are no longer sufficient.
>
> Social enterprise is emerging as the “missing middle” sector between the traditional worlds of government, nonprofits and business. It addresses social concerns,
>
> - more efficiently than government, which no longer has the mandate or resources to solve every social problem;
> - more sustainably and creatively than the nonprofit sector, which faces declining funding streams and increased demands for innovation, proof of what works and collaboration; and
> - more generously than business, which is mandated to place pre-eminence on shareholder returns, *but is also realizing it can’t succeed in a decaying world*.

Id. (emphasis added).



THE MISSING MIDDLE

3.4. Some would say that businesses and nonprofits could solve many of society's ills if government would just step out of the way. In contrast, the proponents of social enterprise entities view nonprofits and businesses as inadequate to the tasks at hand, if not failures. ("[Business] can't succeed in a decaying world" -- which social enterprises will presumably save.)

4. Flexible Purpose Corporations

4.1. Permitted in California by the Corporate Flexibility Act of 2011.[5]

4.1(a) Let's call them "**FlexCorps**" in this outline.

4.1(b) No other state has FlexCorps.

4.2. Name - A FlexCorp must include in its name the words "flexible purpose corporation," "FPC" or some other abbreviation.[6]

4.3. **Purposes**

4.3(a) The **articles of incorporation** must state that the corporation will conduct its activities "for the benefit of the long-

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[5] Cal. Corp. Code § 2500, added by 2011 Cal. Stats. ch. 740, § 12.

[6] Cal. Corp. Code § 2602(a).

term and the short-term interests of the ... corporation and its shareholders."[7]

4.3(b) In addition, the articles of incorporation must state that a **second (but not secondary) purpose** of the corporation is:

- ♦ One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out; or

- ♦ The purpose of promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the corporation's activities upon any of the following:

  - ⇒ The corporation's employees, suppliers, customers, and creditors,

  - ⇒ The community and society, or

  - ⇒ The environment.[8]

4.3(c) Before 1977 California corporations had long "purpose" clauses listing all of the things they could do. As a reform, the "purpose" clause was limited to say that "the corporation is to engage in any lawful act or activity for which a corporation may be organized."[9]

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7 Cal. Corp. Code § 2602(b)(1).

8 Cal. Corp. Code § 2602(b)(2).

9 Cal. Corp. Code § 202(b).

- To avoid the long "purpose" clauses, nothing can be added to the purpose clause.[10]

  ⇒ So existing law does not permit a regular corporation to have a "second" purpose.

- However, a regular corporation that has 35 or fewer shareholders can elect "**close" corporation** status.[11] A "close" corporation can change the corporate laws that would otherwise apply to it. It makes these changes in its "**shareholders agreement**."[12]

- Everything that a FlexCorp can do could also be accomplished by a close corporation in its shareholders agreement. The FlexCorp has the possible eventual benefit of standardization – investors know that all FlexCorps work the same way. In contrast, each close corporation can modify the corporate laws in a different way.

4.4. Changes to a FlexCorp

4.4(a) A FlexCorp can **convert** to a **regular** California corporation with the consent of the holders of 2/3 of the outstanding shares.[13] Dissenting shareholders have the right to

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10 *Id.* ("The articles shall not set forth any further or additional statement with respect to the purposes or powers of the corporation, except by way of limitation or except as expressly required by any law....").

11 Cal. Corp. Code § 158(a). The election is made by inserting language in the articles of incorporation, to put the world on notice that not all of the regular corporate rules apply to the corporation.

12 Cal. Corp. Code §§ 186, 300(c).

13 Cal. Corp. Code § 3002(a), (c).

have their shares purchased by the corporation at the appraised value for cash (these are "**dissenters' rights**").[14]

4.4(b) A FlexCorp can **convert** to a California **nonprofit** corporation with the consent of the holders of *all* of the outstanding shares.[15]

4.4(c) A **sale of substantially all of the assets** or a **merger** of a FlexCorp requires the consent of 2/3 of the outstanding shares, including the approval of 2/3 of the shares of any class not otherwise entitled to vote.[16] In contrast, the requirement for a regular California corporation is approval by a majority of each class entitled to vote.[17]

4.4(d) It is intentionally difficult to change the purpose of a FlexCorp. The intent is to frustrate investors who lose patience with management and want to turn a profit quickly. The drafters of the law referred to this as "**anchoring the mission**."[18]

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14 Cal. Corp. Code § 3305.

15 Cal. Corp. Code § 3001(a), (c). The same rule applies to convert a regular corporation into a nonprofit corporation. Cal. Corp. Code § 911(c).

16 Cal. Corp. Code §§ 3100(a), 3201. In my view, it is risky to create a situation in which the owners of more than half of the interests in the entity are thwarted. It can easily lead to litigation.

17 Cal. Corp. Code §§ 152, 1001(a), 1201(a).

18 Senate Banking & Financial Institutions Committee, report on SB 201 (DeSaulnier) for first hearing on April 6, 2011:

> The traditional corporate form also presents risks for companies seeking to maintain a special purpose mission during their early stages. In the early years, before profitability has been attained, or when profitability is tenuous at best, there is a strong possibility that early-stage investors may shift the company away from its original special purpose, in order to attain profitability.

(Footnote continued on next page)

4.4(e) A **regular corporation** can convert to a FlexCorp with the consent of 2/3 of its outstanding shares. Shareholders who do not vote for the conversion can exercise dissenters rights (to be bought out at the appraised value of their shares for cash).[19]

4.5. A **director** of a FlexCorp cannot be sued for breach of the director's duty if the director takes into account the special purposes of the FlexCorp.

4.5(a) "In discharging his or her duties, a director *may* consider those factors, and give weight to those factors, as the director deems relevant, including the short-term and long-term prospects of the ... corporation, the best interests of the ... corporation and its shareholders, and the purposes of the ... corporation as set forth in its articles."[20]

(*Footnote continued from preceding page)*

> This difficulty in what the working group calls "**anchoring the mission**" also represents a significant issue for entrepreneurs who try to use a traditional, mature corporation to implement a blended value model. The working group [who drafted the law] notes that traditional corporate attempts to anchor the mission either tend towards being overly broad (e.g., super-voting stock such as used in Google, which places investors at risk of decisions made only by the founders) or overly narrow (where they may either be ignored if they conflict with a director's fiduciary duty, or diluted or deleted by amendment).

[19] Cal. Corp. Code § 1152(c).

[20] Cal. Corp. Code § 2700(c) (emphasis added). In contrast, the directors of a benefit corporation *must* take the social purpose into account for every decision. See text at fn 45 below. *See* Assembly Committee on Banking and Finance, report for the June 20, 2011 hearing on SB201, page 4:

> Example: According to an article titled, "Protecting your Mission: Legal tools to keep your Company on the Righteous Path," Ben Cohen and 20 Greenfield founded Ben and Jerry's Ice Cream in 1978. The mission of Ben and Jerry's was to create top quality ice cream and

(Footnote continued on next page)

- In contrast, the directors of a *regular* California corporation must perform his or her duties "in a manner such director believes to be in the best interests of the corporation and its shareholders…."[21]

- There is no "benefit enforcement proceeding" for FlexCorps.

(*Footnote continued from preceding page)*

> give back to the community. They donated 7.5% of pretax profits to charity and partnered with nonprofits to open shops in inner city neighborhoods to employ low-income residents. The company's feel good image attracted the interest of multinational corporations. In 2000, Unilever made a buyout offer to the company's shareholders. Even though Ben and Jerry did not want to sell out, they had little choice. The board could not risk accepting a lower competing offer without exposing itself to litigation from shareholders asserting their right to the highest possible return at the expense of other considerations -- a right upheld by many courts. Since the takeover, the donations and inner-city shops have gone by the wayside.

Didn't the problem for Ben and Jerry begin in 1984 when the company went public and took the investors' money with the understanding that Ben and Jerry would maximize shareholder value? In 1996 Ben held 35% of the outstanding shares and Jerry held 7%. (According to "Ben & Jerry's Homemade Inc." at: http://www.kellogg.northwestern.edu/faculty/hubbard/htm/research/ec174/benjer2.htm.) Why should the wishes of the holders of 42% of the outstanding shares control? If they had "baked in" an alternate purpose in their corporation before they took the investors' money, they might have been able to reject the Unilever offer. So their problem might not be a problem with the law. It might have been a problem with the intentions that Ben and Jerry expressed when they sold stock to the public. If that's the case, then the anecdote is not much of an argument for adding confusion to the law with new types of entities. See Anthony Page & Robert A. Katz, *The Truth About Ben & Jerry's*, STANFORD SOCIAL INNOVATION REVIEW (Fall 2012), posted at: http://www.ssireview.org/articles/entry/the_truth_about_ben_and_jerrys.

21 Cal. Corp. Code § 309(a).

4.5(b) The special purposes do not give persons outside the corporation the right to sue the directors for not sufficiently taking them into account.[22]

4.5(c) A primary reason for enacting the FlexCorp law was to insulate from liability the directors who take into account factors other than maximizing shareholder profit.[23]

4.6. "**Transparency**"

4.6(a) The board of directors of a FlexCorp must provide an **annual report** to shareholders that includes its financial

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[22] Cal. Corp. Code § 2700(f).

[23] Senate Banking & Financial Institutions Committee, report on SB 201 (DeSaulnier) for first hearing on April 6, 2011:

> Why Do We Need An Alternative To Traditional Corporations or LLCs? Over the past decade, it has become increasingly common for corporations to integrate social and/or environmental goals within their profit-driven business models and focus on pursuing returns for investors. Yet, many organizations that do so are forced to take on potential risk and liability, in order to achieve multiple or blended objectives.
>
> These risks are most often borne by corporate directors trying to weigh the trade-offs between profitability and their organization's special purpose. According to the working group [who drafted the law], courts have traditionally weighed fiduciary duties of care and loyalty by corporate directors using the so-called "business judgment rule," which typically permits some flexibility to consider social and environmental factors when pursuing the long-term best interests of the corporation and its shareholders. However, the business judgment rule may not afford boards of directors and other corporate managers sufficient protection and flexibility to consider blended value in all operating decisions. Further, this rule does not come into play in change-of-control situations, when boards and management generally have a fiduciary duty to act solely in the interest of maximizing shareholder value.

statement and a detailed report by management on how the FlexCorp is meeting its purposes.[24]

- The report is not required to apply a third party standard (which the annual report of a benefit corporation must apply).

- Directors can have liability as a result of misstatements or omission in the annual report. See 4.6(f) below.

4.6(b) The FlexCorp must post on its website the management report, but not the financial statement.[25]

4.6(c) Shareholders can demand and receive quarterly financial statements.[26]

4.6(d) A special report must be distributed to shareholders and posted on the website if an expenditure in planned that will have a material adverse short-term impact, or if the corporation decides to withhold an expenditure that would have a material positive short-term impact, or if the board of directors decides that the special purpose has been satisfied and should no longer be pursued. [27]

4.6(e) For a FlexCorp with less than 100 shareholders, the holders of 2/3 of the outstanding shares can waive the report

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[24] Cal. Corp. Code § 3500(a).

[25] Cal. Corp. Code § 3500(b).

[26] Cal. Corp. Code § 3500(e). In contrast, for a regular corporation, financial statement are required no more often than annually. Cal. Corp. Code § 1501(a).

[27] Cal. Corp. Code § 3502(h).

requirement, but they can revoke the waiver prospectively.[28]

4.6(f) The directors of the FlexCorp can be **liable to any person who relied on the report** if it was "false in a material respect" or the FlexCorp omits "to state any material fact necessary in order to make the statements contained [in the report], in light of the circumstances under which those statements were made, not misleading in a material respect, knowing the omission to be misleading."[29]

4.7. Liquidating distributions - There are no special rules for FlexCorps.

4.7(a) Neither a FlexCorp nor a benefit corporation is required to have a "dissolution clause" like a tax-exempt Section 501(c)(3) organization.

4.8. **History**:

4.8(a) "AB 2944 (Leno), 2007-08 Legislative Session: Until January 1, 2015, would have specified that, in considering the best interests of a corporation and its shareholders, a [regular] corporation's board of directors and other specified individuals with responsibility for running a corporation *could*, in considering the best interests of the corporation and its shareholders, consider the effect of the corporation's actions on the state and national economy, and on the environment, and could incorporate community and

[28] Cal. Corp. Code § 3501.

[29] Cal. Corp. Code § 3503. *See* Senate Banking & Financial Institutions Committee, report on SB 201 (DeSaulnier) for first hearing on April 6, 2011 ("[E]ven if the risk of director liability could be eliminated and an equitable means for anchoring the special purpose mission were possible, traditional corporation statutes do not provide the transparency necessary for shareholders to evaluate how, nor the extent to which, the corporation is achieving its special purposes.")

societal considerations, among other factors, into its evaluation. Vetoed by the Governor."[30]

4.8(b) A working group then drafted the current law.[31]

4.8(c) The drafters thought that institutional investors would prefer to deal with a FlexCorp rather than an LLC.[32]

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30 Senate Banking & Financial Institutions Committee, report on SB 201 (DeSaulnier) for first hearing on April 6, 2011 (emphasis added). "AB 2944 was vetoed by Governor Schwarzenegger who stated that it 'was a package of concepts that could produce unknown ramifications and the need for which have not been fully demonstrated.'" Assembly Committee on Judiciary report on AB361 for its May 3, 2011 hearing, page 7.

31 *Id.*:

> This bill is the product of a working group of corporate law attorneys, which was organized in 2008, to facilitate the creation of a new corporate form, to give companies in California greater flexibility to combine profitability with broader social or environmental purposes. Members of the working group come from a diverse background, including academia, non-profit law firms, organizations that foster social entrepreneurship, and both large and small corporate law firms.

32 Senate Banking & Financial Institutions Committee, report on SB 201 (DeSaulnier) for first hearing on April 6, 2011:

> <u>Why not use an LLC</u>? In short, it is hard to attract equity capital. The pass-through status of LLCs creates tax implications for potential investors. LLCs are also disfavored as an entity choice for widely held companies, because markets favor the standardization of entities formed by statute. According to the working group, the cost and effort of understanding the nuanced differences of operating agreements, and the cost and risk of drafting a prospectus that captures those nuances and fully discloses the risk factors to be considered by potential investors, each represent a difficult and time-consuming effort that companies and investment bankers would be required to undertake on behalf of each individual LLC seeking equity capital. Investors vastly prefer the standardization in statutory approach and the standard set of articles of incorporation common to most corporations.

(Footnote continued on next page)

4.8(d) The Business Law Section of the California State Bar supported the legislation.[33]

5. Benefit Corporations

5.1. Benefit corporations can be organized under California law pursuant to AB261, enacted in 2011.[34]

5.2. What a "benefit corporation" is *not*:

5.2(a) Let's resist the temptation to call them "B corps," because that designation is a trademark that the corporation can use only when it has been certified by B Lab, Inc. [35]

(*Footnote continued from preceding page)*

It remains to be seen whether investors will prefer the "standardization" of FlexCorps over LLCs. The FlexCorp is so different from a "standard" corporation, that most investors probably will not become comfortable with them for many years. Some investors might want to see how the California courts handle claims based on the management reports before investing in a FlexCorp – and how the Attorney General reacts to business home runs that result in large distributions to shareholders.

[33] Senate Judiciary Committee report for hearing on April 12, 2011.

[34] Cal. Stats. 2011, chapter 728.

[35] From the website (www.bcorporation.net) (which reports that six other states have benefit corporation statutes):

> Benefit Corp vs. Certified B Corp. Benefit corporations and Certified B Corporations are often, and understandably, confused. Both are sometimes called B Corps. They share much in common and have a few important differences. Certified B Corporation is a certification conferred by the nonprofit B Lab. Benefit corporation is a legal status administered by the state. Benefit corporations do NOT need to be certified. Certified B Corporations have been certified as having met a high standard of overall social and environmental performance, and as a result have access to a portfolio of services and support from B Lab that benefit corporations do not.

- "Certified B Corp" or "B Corp" is a certification of social responsibility awarded by B Lab.

- It can be awarded to a benefit corporation or to any other type of corporation or business entity.[36]

5.2(b) Also, a "benefit corporation" is not the "for-benefit corporation" to which the group called The Fourth Sector aspires.[37]

5.2(c) Finally, a "benefit corporation" is not a nonprofit "public benefit corporation," one of the three types of nonprofit corporation in California, and the type designed (and most commonly used) for Section 501(c)(3) organizations created under California law.[38]

- This might cause more confusion than anything else in the new California laws.

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[36] http://www.bcorporation.net/about; http://www.bcorporation.net/legal-framework.

[37] "The For-Benefit corporation equitably distributes ownership rights among its stakeholders in accordance with their contributions.... The For-Benefit corporation shares information and control among stakeholder constituencies as they develop.... In the event of dissolution, the assets remain dedicated to social purposes and may not be used for the private gain of any individual beyond reasonable limits on compensation." http://www.fourthsector.net/learn/for-benefit-corporations. The last point might be a bad omen if attorneys general impose it on social enterprise entities.

[38] Cal. Corp. Code § 5060.

5.3. **Election to be a benefit corporation**

5.3(a) A corporation **elects** to be a benefit corporation by including a statement in its articles of incorporation.[39]

5.3(b) A corporation can **amend its articles of incorporation** to become a benefit corporation. A corporation can also **merge** into a benefit corporation. Doing so in either case requires the consent of 2/3 of the shares of each class, without regard to the voting rights of the class.[40]

5.3(c) A shareholder who votes against the amendment or merger has dissenters' rights (to have his shares bought for cash at their appraised value).[41]

5.4. **Purposes**

5.4(a) A benefit corporation must "have the purpose of creating general public benefit." This means "means a material positive impact on society and the environment, taken as a whole, *as assessed against a third-party standard*, from the business and operations of a benefit corporation."[42]

- ♦ The "third party standard" is the key to the benefit corporation.

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39 Cal. Corp. Code § 14610(b).

40 Cal. Corp. Code §§ 14601(d), 14603.

41 Cal. Corp. Code § 14603.

42 Cal. Corp. Code §§ 14601(c), 14610 (emphasis added).

5.4(b) A benefit corporation may also have a more specific purpose, but the specific purpose cannot limit the general purpose.[43]

5.4(c) Permissible specific purposes include:

- Providing low-income or underserved individuals or communities with beneficial products or services.
- Promoting economic opportunity for individuals or communities beyond the creation of jobs in the ordinary course of business.
- Preserving the environment.
- Improving human health.
- Promoting the arts, sciences, or advancement of knowledge.
- Increasing the flow of capital to entities with a public benefit purpose.
- The accomplishment of any other particular benefit for society or the environment.[44]

5.5. **Directors**

5.5(a) **Constituencies**. "In discharging their respective duties, and in considering the best interests of the benefit corporation, the board of directors, committees of the board, and individual directors of a [benefit corporation] *shall* con-

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43 Cal. Corp. Code § 14610(b).

44 Cal. Corp. Code § 14601(e).

sider the impacts of any action or proposed action upon all of the following:

- "The shareholders of the [benefit corporation].
- "The employees and workforce of the [benefit corporation] and its subsidiaries and suppliers.
- "The interests of customers of the [benefit corporation] as beneficiaries of the general or specific public benefit purposes of the benefit corporation.
- "Community and societal considerations, including those of any community in which offices or facilities of the [benefit corporation] or its subsidiaries or suppliers are located.
- "The local and global environment.
- "The short-term and long-term interests of the [benefit corporation], including benefits that may accrue to the [benefit corporation] from its long-term plans and the possibility that these interests may be best served by retaining control of the [benefit corporation] rather than selling or transferring control to another entity.
- "The ability of the [benefit corporation] to accomplish its general, and any specific, public benefit purpose."[45]

5.5(b) In discharging their duties, **the** directors may consider:

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[45] Cal. Corp. Code § 14620(b) (emphasis added); *see* § 14622 (same for officers). In contrast, the director of a FlexCorp may consider the social purpose of the entity, but are not required to do so. See fn. 20 above.

- "The resources, intent, and conduct, including past, stated, and potential conduct, of any person seeking to acquire control of the corporation.

- "Any other pertinent factors or the interests of any other person or group."[46]

5.5(c) The directors of a benefit corporation are not required to give priority to shareholders or any other person or group "unless the [benefit corporation] has stated its intention to give priority to a specific public benefit purpose identified in the articles."[47]

5.5(d) A director of a benefit corporation is not liable for the failure of the benefit corporation to create a general or specific benefit.[48] The director does not have a fiduciary duty to any person as a member of a group that the benefit corporation is organized to benefit.[49]

5.5(e) A director of a benefit corporation organized in another state gets these protections in California.[50]

5.6. **Transparency**

5.6(a) A benefit corporation must deliver to each shareholder a detailed "annual benefit report."[51]

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46 Cal. Corp. Code § 14620(c).

47 Cal. Corp. Code § 14620(d).

48 Cal. Corp. Code § 14620(f), (g); *see* Cal. Corp. Code § 14622 (same for officers).

49 Cal. Corp. Code § 14620(i).

50 Cal. Corp. Code § 14620(j).

51 Cal. Corp. Code § 14630(a), (b).

5.6(b) The report must include the name of each person who owns 5% or more of the benefit corporation.[52] This is included in the part of the report that is disclosed to the public.[53]

5.6(c) The report must include an "An assessment of the overall social and environmental performance of the benefit corporation, prepared in accordance with a third-party standard applied consistently with any application of that standard in prior benefit reports or accompanied by an explanation of the reasons for any inconsistent application. The assessment does not need to be audited or certified by a third party."[54]

5.6(d) The directors must include a statement in the report whether the benefit corporation failed to pursue its mission in all material respects.[55]

5.6(e) The report must be posted on the benefit corporation's website, but without compensation info for directors.[56]

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52 Cal. Corp. Code § 14630(a)(3). The report of a FlexCorp does not require this. A shareholder of a regular corporation (as well as a benefit corporation or a FlexCorp) has the right to the names and addresses of the other shareholders. Cal. Corp. Code § 1600.

53 See Section 5.6(e) below.

54 Cal. Corp. Code § 14630(a)(2). The criteria for the "third party standard" is set forth in minute detail. Cal. Corp. Code § 14601(g). See Section 5.9(c) (History) below.

55 Cal. Corp. Code § 14621.

56 Cal. Corp. Code § 14630(c). An early amendment deleted "a requirement for benefit corporations to provide a copy of their annual benefit reports to the Secretary of State—and an associated filing fee of up to $70—and instead [required] any benefit corporation lacking a website, on which benefit reports must be posted, to provide the benefit report to any person, upon request, at no charge." Assembly Committee on Appropriations report for hearing on May 18, 2011, at page 3.

5.7. Accountability and Liability

5.7(a) The only claim that can be brought against the directors or officers of a benefit corporation is a "benefit enforcement proceeding."[57]

5.7(b) A "benefit enforcement proceeding" is a claim or action relating to any of the following:

- ♦ Failure to pursue the general public benefit purpose of the benefit corporation or any specific public benefit purpose set forth in its articles.
- ♦ Violation of a duty or standard of conduct imposed on a director under the benefit corporation law.
- ♦ Failure of the benefit corporation to deliver or post an "annual benefit report."[58]

5.7(c) A "benefit enforcement proceeding" may be commenced or maintained only as follows:

- ♦ Directly by the benefit corporation;
- ♦ Derivatively by any of the following:
  - ⇒ A shareholder;
  - ⇒ A director;
  - ⇒ A person or group of persons who own 5% or more of the benefit corporation's parent; or

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57 Cal. Corp. Code § 14623(a).

58 Cal. Corp. Code § 14601(b).

⇒ Other persons whom the benefit corporation's articles or bylaws specifically allow to bring a "benefit enforcement proceeding".[59]

5.7(d) The benefit corporation cannot be held liable for failing to achieve its specified purposes.[60]

5.7(e) If the court finds that the failure to comply with the benefit corporation law was "without justification," the court can award attorneys fees to the plaintiff.[61] The statute does not say who pays the attorneys fees. If the benefit corporation paid them there would be less funds available to serve the social purpose. So it seems likely that the court would require the offending director(s) to pay the attorneys fees.

5.8. Liquidating distributions - There are no special restrictions on the liquidating distributions of benefit corporations.

5.9. **History**

5.9(a) This law was advanced by B Lab, Inc.

5.9(b) AB361 was introduced with a halo during the heyday of the Occupy events.[62]

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59 Cal. Corp. Code § 14623(b).

60 Cal. Corp. Code § 14623(c).

61 Cal. Corp. Code § 14623(d).

62 As framed by the Assembly Committee on Judiciary report for its May 3, 2011 meeting:

> Key Issue: Should businesses that wish to pursue a socially or environmentally beneficial mission, broader than simply maximizing profit, have the ability to voluntarily incorporate in California as "benefit corporations" - a new form of corporate entity attractive to socially responsible

(Footnote continued on next page)

5.9(c) There was controversy about the role of B Lab as the arbiter of the "third party standard."[63]

(*Footnote continued from preceding page)*

investors that, among other things, provides greater accountability to shareholders to enforce the beneficial corporate mission?

[63] Assembly Committee on Judiciary report for its May 3, 2011 meeting:

Concern about selection of the third-party standard used to assess social and environmental performance. Under this bill, the directors select a third-party standard by which the benefit corporation's social and environmental performance shall be assessed and reported in the annual benefit report distributed to all shareholders. The third-party standard is essentially a specialized assessment tool, a form of intellectual property developed by a third-party standards organization (of which B Lab, the sponsor of this bill, is one example). Section 14601(g) specifies a number of characteristics that must be true of the third party standard for its approved use by a benefit corporation, perhaps the most important of which is that the standard is developed by an entity that has no material financial relationship with the benefit corporation or any of its subsidiaries.

[The Corporations Committee of the Business Law Section of the California State Bar ("CCBLS")] expresses concern that directors will be free to shop for standards that suit them best, outside the control of the shareholders. This could mean defensive directors would shop for the most protective standard to forestall shareholder claims, or zealous directors would shop for increasingly demanding standards that may elevate the public purpose well above the pursuit of maximizing shareholder value. In addition, CCBLS expresses concern that the bill requires the third party standard to meet such specialized criteria that B Lab is "uniquely positioned" to take advantage of the bill it is sponsoring and will become the principal certification agency of benefit corporations qualified to form under the statute.

B Lab responds that there are many third party standards organizations that meet the statutory criteria for a third party standard. Some examples are: the Global Reporting Initiative (GRI), GreenSeal, Underwriters Laboratories (UL), ISO2600, and Green America, several of which have also submitted letters of support to the Committee. B Lab

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6. Program-Related Investments ("PRIs")

6.1. An L3C is designed as an entity in which private foundations can comfortably make "program related investments." This requires a bit of a running start – in the form of an explanation of PRIs, MRIs, investment standards for nonprofits, charitable trusts and commercial coventurers.

6.2. All Section 501(c)(3) organizations are "private foundations" unless they IRS rules otherwise when organization obtains its tax exemption.[64] Generally, private foundations are organizations that are privately supported. The charitable work of a private foundation is usually making grants to "hands on" Section 501(c)(3) organizations. The grants are usually made from the income on the foundation's endowment.

6.3. Private foundations are subject to penalty taxes on several types of "prohibited transactions."

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reports that it and GRI both offer companies the use of their reporting (GRI) and assessment (B Lab) tools for free, and that more than 1,000 businesses currently use B Lab's assessment tool for free.

Notwithstanding the sponsor's representations about the suitability of other third party standards organizations, it is indisputable that this bill does not require a benefit corporation to use any particular third party standard to prepare its benefit report, nor must the report be certified or audited by any third party. The bill contemplates that, ultimately, the directors and shareholders of the benefit corporation are free to decide for themselves which third-party standards they feel meet the statutory requirements and their needs. It does not appear to the Committee that the sponsor stands to realize any direct financial profit from this bill from the information currently available to the Committee.

[64] I.R.C. § 508.

6.4. One prohibited transaction is making stupid investments that jeopardize the foundation's endowment.[65]

6.4(a) But "program-related investments" ("PRIs") are not treated as stupid.[66]

6.4(b) A PRI can be a loan, a loan guarantee or letter of credit, or it can be an equity investment of any type.[67]

6.4(c) The entity in which the foundation makes the PRI can "customize" the investment vehicle (such as a promissory note, a credit agreement or a class of preferred stock) to accommodate the foundation's demand that the investment satisfy the requirements of a PRI.

6.5. An investment is a PRI if:

6.5(a) The primary purpose of the investment is to accomplish one or more charitable purpose;[68]

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65 I.R.C. § 4944(a); Treas. Reg. § 53.4944-1(a)(2) ("stupid" = "at the time the investment is made, foundation managers fail to exercise ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation"). These are usually called "jeopardy investments." The foundation managers can take into account the entire portfolio and the long-term benefits of diversification.

66 I.R.C. § 4944(c).

67 A PRI can also be a no-interest loan or a below-market rate loan.

It will rarely make sense for a foundation to become a general partner in a general or limited partnership, because each general partner has unlimited liability for the obligations of the partnership. The foundation can invest indirectly, usually by using a C corporation to hold the general partner interest and to operate or participate in the partnership's business.

68 I.R.C. § 4944(c). As defined in I.R.C. § 170(c)(2)(B) ("organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of

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6.5(b) No significant purpose of the investment is the production of income or the appreciation of property;[69]

6.5(c) No purpose of the investment is to influence legislation or to participate or intervene in a political campaign;

6.5(d) The investment significantly furthers the accomplishment of the private foundation's tax-exempt mission;

6.5(e) The investment would not have been made but for the relationship between the investment and the accomplishment of the foundation's tax-exempt mission; and

6.5(f) The private foundation obtains a written commitment from the recipient of the PRI that the funds received will be used only for the private foundation's purposes.[70]

6.6. Another prohibited transaction is to fail to distribute to "hands on" charities at least 5% of the value of the private foundation's endowment.[71] For this purpose, a PRI is not counted as part of

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its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals").

[69] I.R.C. § 4944(c). However, hitting a business "home run" will not threaten the PRI status. Treas. Reg. § 53.4944-3(a)(2)(iii).

[70] Treas. Reg. §§ 53.4944-3(a)(1), (2)(i), 53.4945-5(b)(4), 53.4945-6(c)(1)(i).

[71] This is the "minimum distribution requirement" of I.R.C. § 4942.

the endowment.[72] Also, an investment in a PRI is treated as distribution to a "hands on" charity for this purpose.[73]

6.7. Holding a large percentage interest (generally over 20%) in a for-profit business for too many years (usually more than five) is also a prohibited transaction. But holding any percentage interest in a PRI or an MRI is exempt from this "excess business holdings" penalty tax.[74]

6.8. Improper grants by private foundations are also subject to a penalty tax. To avoid this penalty tax on "taxable expenditures," the foundation managers must require, obtain, and report to the IRS annually on whether the PRI is meeting the foundation manager's expectations.[75] This is exercising "**expenditure responsibility**."

6.9. A private foundation is subject to an annual excise tax (generally 2%) on its net investment income.[76] There does not appear to be any exemption from this tax for investment income from a PRI.[77]

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72 Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d). Investments in MRIs are also excluded. See Section 7 below.

73 Treas. Reg. § 53.4942(a)-3(a)(2)(i).

74 Treas. Reg. § 53.4943-10(b). An MRI is defined for this purpose as a "functionally related business" by reference to I.R.C. § 4942(j)(4), which is used, in turn, in the definition of a "private operating foundation" (which is outside the scope of this outline.). See Section 7 (Mission-Related Investments) below.

75 Treas. Reg. § 53.4945-5(b)(4).

76 I.R.C. § 4940.

77 The IRS seems to have concluded as much. *See* PLR 2003-36-050, June 13, 2000 ("Interest, dividends, and other items of gross investment income under section 4940(c)(1) of the Code arising from program-related investments are taxable under section 4940.")

6.10. A PRI will cease to qualify 30 days after the foundation's managers become aware that the PRI if it serves "an illegal purpose or the private purpose of the foundation or its managers."[78]

6.11. What all this means is that if the foundation managers are wrong about a particular investment being a PRI, they and the foundation could be subject to whopping penalty taxes.[79]

6.11(a) The California Attorney General would probably require the foundation's directors or trustees who approved the investment to pay the penalty taxes, or to reimburse the foundation if it had already paid them.[80]

6.11(b) The foundation managers generally should rely on an opinion from their lawyers or a private letter ruling from the IRS as to whether an investment qualifies as a PRI, but neither alternative is inexpensive.[81]

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[78] Treas. Reg. § 53.4944-3-(a)(3)(i).

[79] See Section 12.5 (The Failed PRI) at page 42.

[80] See the California Attorney General's Form RRFi, line 4, Part B and the accompanying instructions.

[81] See TAM 2002-18-038, April 23, 2001. A private foundation requested a private letter ruling that an investment was a PRI. "Materials submitted with the ruling request included a letter from legal counsel for [the hands-on charity] which concluded that the investment by [the foundation] should be considered a PRI and hence it could not be a jeopardizing investment. A separate legal opinion with the same conclusion was also obtained by [the limited partnership in which the foundation made the investment] from an independent attorney with vast experience in exempt organizations." The foundation made the investment, then requested a private letter ruling. The attorneys in the IRS Assistant Chief Counsel's office told the foundation's people that the IRS attorney were "leaning adversely on the PRI issue." The foundation immediately withdrew its ruling request and exercised the right (that it had negotiated) to redeem its investment. The IRS examining agent thought that the investment was not a PRI, so the foundation had engaged in a "jeopardy investment." "However, he also recommended that any tax assessed should be abated because legal advice in this matter was provided to [the foundation] coincident with the investment." In the Tech Advice, the IRS concluded that the

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6.11(c) The process of obtaining a private letter ruling on PRI status is imperfect.[82] When a ruling or legal opinion is obtained, generally only the parties who requested it can rely on it. In 2011 the Council on Foundations, a trade association for private foundation managers, proposed the "Philanthropic Facilitation Act of 2011" to require the IRS to rule promptly on requests for rulings on PRI status.[83]

6.12. The IRS added nine new examples to the PRI regulations in 2012. This was half the number the American Bar Association had requested many years ago. [84]

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investment was not a PRI, but the investment was not a jeopardy investment subject to a penalty tax, in part because the foundation managers "had reviewed two separate opinions of counsel which both concluded that investing in [the limited partnership] was not a jeopardizing investment."

[82] "[I]n practice, the ruling request process is plagued by excessive or indefinite delays, and is often unworkable." Council on Foundations, *Issue Paper* on the Philanthropic Facilitation Act of 2011 (January, 2012). See fn. 83 below.

[83] The Act would also allow more than one foundation to rely on a ruling on an IRS ruling. It would require the entity in which the PRI is made to file annual information returns with the IRS and to disclose those returns to the public. http://www.cof.org/files/Bamboo/programsandservices/publicpolicy/documents/philanthropic_faciliation_act_092011.pdf. The bill was introduced in the House of Representatives as H.R. 3420 in November, 2011, but has been stuck in the House Ways and Means Committee since then. A similar "Philanthropic Facilitation Act of 2010" was proposed by Americans for Community Development, a trade association for L3Cs. The latter Act would have created a rebuttable presumption that an investment in an L3C qualified as a PRI. *See:* http://www.americansforcommunitydevelopment.org/downloads/PhilanthropicFacilitationAct2010.pdf

[84] The Treasury Department and the IRS are aware that the private foundation community would find it helpful if the regulations could include additional PRI examples that reflect current investment practices and illustrate certain principles, including that: (1)

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6.13. As noted above, the L3C was designed to be the perfect entity in which to make program-related investments.[85]

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> an activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the United States; (2) the charitable purposes served by a PRI are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas; (3) the recipients of PRIs need not be within a charitable class if they are the instruments for furthering a charitable purpose; (4) a potentially high rate of return does not automatically prevent an investment from qualifying as program-related; (5) PRIs can be achieved through a variety of investments, including loans to individuals, tax-exempt organizations and for-profit organizations, and equity investments in for-profit organizations; (6) a credit enhancement arrangement may qualify as a PRI; and (7) a private foundation's acceptance of an equity position in conjunction with making a loan does not necessarily prevent the investment from qualifying as a PRI.

77 Fed. Reg. 23429, April 19, 2012 (Background). It appears that the IRS is unwilling to devote more resources to PRIs at this time.

[85] "The "low-profit limited liability company" (L3C) is a new, hybrid business form which can leverage foundations' program-related investments to access trillions of dollars of market-driven capital for ventures with modest financial prospects, but the possibility of major social impact." From the L3C page of the website of Marc J. Lane, the attorney who promoted the legislation as head of the Chicago chapter of the Social Enterprise Alliance. See:

http://www.marcjlane.com/index.php?submenu=L3C&submenu=Social_Enterprises&src=gendocs&ref=L3C&category=Capabilities

Robert Lang, who "first created the concept of the L3C," has a fuzzier view. "The vision was straightforward: As a variant form of the widely accepted LLC, the for-profit L3C would operate at the intersection of for-profit and nonprofit enterprises. Under its state business charter, the L3C would be required to have a primary goal of performing a socially beneficial purpose, not maximizing income."

See http://www.americansforcommunitydevelopment.org/letterfrombob.html.

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7. Mission-Related Investments ("MRIs")

7.1. Foundation advisers distinguish PRIs from MRIs.[86] An MRI is an investment that is made by a foundation to further the exempt purpose of the foundation, but that avoids being a prohibited transaction without requiring classification as a PRI. That is, an MRI is a reasonably prudent investment on its own.

7.2. The penalty tax on excess business holdings does not apply to an investments in a "functionally-related business."[87]

7.3. An MRI has the huge advantage of not requiring "expenditure responsibility," making it a low-maintenance investment.

7.4. An MRI could be made in a social enterprise entity or an "old school" entity.

8. Investments Standards for Nonprofit Organizations

8.1. Nonprofit tax-exempt organizations are subject to several sets of laws.[88] They are not all consistent.

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"Americans for Community Development [the tag line for which is "the organization for the L3c"] began as the professional organization to promote the L3C Movement and assist the entrepreneurs finding this new business form as an opportunity to turn their passion to impact social change into a sustainable business."

See http://www.americansforcommunitydevelopment.org/.

86 The term "mission-related investment" will not be found in the Internal Revenue Code or the Treasury Regulations.

87 See fn. 74.

88 These include corporate or trust law, federal tax laws affecting their exemption from federal income tax, state tax laws affecting their exemption from state income tax, federal laws affecting their exemption, if any from private foundation status, federal and state tax laws regarding charitable contributions, state laws regarding chari-

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8.2. For the directors of a California nonprofit public benefit corporation, the basic standard for investing is this: "[I]n investing, reinvesting, purchasing, acquiring, exchanging, selling and managing the corporation's investments, the board shall ...[a]void speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety of the corporation's capital."[89]

8.2(a) However, "[a]ssets which are directly related to the corporation's public or charitable programs are not subject to this [basic investment standard]." [90]

8.3. For endowments to which it applies, the Uniform Prudent Management of Institutional Funds Act ("UPMIFA") requires the directors to use modern portfolio theory, including diversification, when making decisions about investment assets.[91]

8.3(a) UPMIFA does not apply to "program-related assets."[92]

8.3(b) In determining whether an investment is prudent, UPMIFA allows the foundation's managers to take into

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table trusts, laws of the state attorney general (often the Uniform Supervision of Charitable Trusts Act), state laws about endowments (often the Uniform Prudent Management of Institutional Funds Act), and local laws regarding the solicitation of charitable contributions.

89 Cal. Corp. Code § 5240(b). The directors are required to follow any investment instructions in the gift instrument, and are absolved from liability for doing so. Cal. Corp. Code § 5240(b)(2), (c).

90 Cal. Corp. Code § 5240(a).

91 Cal. Probate Code § 18503(e). Each of these laws provides that they both apply. Cal. Corp. Code § 5240(e); Cal. Probate Code § 18503(f). However, they impose two different standards

92 Cal. Probate Code § 18502(e)(1), (g).

account an "asset's special relationship or special value, if any, to the charitable purposes of the institution." [93] This suggests that a investment in an MRI would be held to a more generous standard than other investments.

9. Charitable Trusts

9.1. Under California law a "charitable trust" is created when someone receives something from someone else with the understanding that the recipient will give the "something" to a charity or use it for charitable purposes.[94] No trust instrument is required. *It is easy to create an* ***inadvertent charitable trust***.

9.2. California's Supervision of Trustees and Fundraisers for Charitable Purposes Act gives the California Attorney General broad powers over the trustees of charitable trusts, including annual reporting requirements that are available for public inspection.[95]

9.3. The California Attorney General probably has the authority to enforce charitable trusts, possibly under common law principles.

9.4. The FlexCorp Act seems to both negate a charitable trust resulting from the creation of the FlexCorp and to give the Attorney General the power to enforce the non-existent charitable trust.[96]

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[93] Cal. Probate Code § 18503(e)(1) (H).

[94] Cal. Bus. & Prof. Code § 17501.8; *see* Cal. Bus. & Prof. Code §§ 17501.1 and .2 (definitions).

[95] Cal. Gov. Code §§ 12580 to 12599.7.

[96] Notwithstanding any of the purposes set forth in its articles, a flexible purpose corporation shall not be deemed to hold any of its assets for the benefit of any party other than its shareholders. However, nothing in [The FlexCorp Act] shall be construed as negating existing charitable trust principles or the Attorney General's authority to enforce any charitable trust created.

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9.5. The California Attorney General's office would view a social enterprise entity that held assets for charitable purposes as a charitable trust subject to the jurisdiction of that office.[97] However, no written guidance is available to determine how a social enterprise entity active in California can avoid this.

10. Commercial Coventurers

10.1. The California Attorney General regulates "commercial coventurers."

10.2. A "commercial coventurer" is "any person who, for profit, is regularly and primarily engaged in trade or commerce other than in connection with the raising of funds, assets, or property for charitable organizations or charitable purposes, and who represents to the public that the purchase or use of any goods, services, entertainment, or any other thing of value will benefit a charitable organization or will be used for a charitable purpose."[98]

10.3. A commercial coventurer is a trustee of a charitable trust [99] and must transfer funds to the charity and account for the funds col-

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> Nothing in this section [regarding the duties of the director of a FlexCorp], express or implied, is intended to create or grant or shall create or grant any right in or for any person or any cause of action by or for any person, and a director shall not be responsible to any party other than the flexible purpose corporation and its shareholders.

Cal. Corp. Code § 2700(e), (f).

97 Arthur Rieman, David Adelman and Jessica Shofler for their article *California's New Hybrid Corporation Statute* (LOS ANGELES LAWYER, September, 2012) text at fn. 47.

98 Gov. Code § 12599.2(a).

99 Gov. Code § 12599.2(b).

lected every 90 days.[100] If the commercial coventurer does not do so, it must register with the Attorney General and pay an annual fee.[101]

10.4. It is possible that a social enterprise entity active in California would be a coventurer subject to these requirements.

11. Low Profit Limited Liability Companies ("L3Cs")

11.1. California does not have a L3C statute. However, a California LLC can be organized for a nonprofit purpose.[102]

11.2. Since the first L3C statute was enacted in Vermont in 2008, L3C statutes have been enacted in nine states. In this outline the L3C provisions of the Vermont and Illinois limited liability company statutes will be used as examples. The L3C laws of the states that have adopted them are not identical.

11.3. An L3C must be organized for "a business purpose" but must not have as a significant purpose the production of income or the appreciation of property.[103]

11.4. An L3C must have "L3C" in its name and must state in its articles of organization that it is a low-profit limited liability compa-

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[100] *Id*.

[101] Gov. Code § 12599.2(c).

[102] "[A California] limited liability company may engage in any lawful business activity, whether or not for profit...." Cal. Corp. Code § 170029(a). The California LLC Act was amended at the request of the California State Bar to permit "activity ... not for profit" to allow an LLC subsidiary of a tax-exempt charity to qualify for the "welfare" exemption from California property tax, if other requirements are satisfied.

[103] Ill. Limited Liability Company Act § 1-5, 805 ILCS 180/1-5; 11 V.S.A. § 3001(23) (Vermont).

ny.[104] If the L3C ceases to qualify as an L3C, it must delete "L3C" from its name.[105] (This is similar to a clause in a license agreement for the use of a trademark. It protects the brand.

11.5. For an Illinois L3C, the articles of organization must also state that:

11.5(a) No significant purpose of the L3C is the production of income or the appreciation of property;[106] and

11.5(b) No purpose of the company is to accomplish one or more political or legislative purpose prohibited to a PRI.[107]

11.6. The articles of organization or the operating agreement should state that:

11.6(a) The L3C must at all times significantly further the accomplishment of one or more charitable or educational purposes for which a PRI can be made; and

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[104] Ill. Limited Liability Company Act §§ 1-10(a)(1), 1-26(b), 805 ILCS 180/1-10, 1-26; 11 V.S.A. § 3005(a)(1) (Vermont). All Vermont LLCs must state in their articles of organization "whether the company is an L3C." 11 V.S.A. § 3023(a)(6).

[105] Ill. Limited Liability Company Act § 1-26(c), 805 ILCS 180/1-26; 11 V.S.A. § 3001(23)(D) (Vermont).

[106] This awkward language is straight out of the PRI requirements in the Internal Revenue Code. See fn. 69 above. "[H]owever, the fact that [the L3C] produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property." Ill. Limited Liability Company Act § 1-26(b)(1); 11 V.S.A. § 3001(23)(B) (Vermont).

[107] Ill. Limited Liability Company Act § 1-26(b)(2). A Vermont L3C must "at all times be operated to satisfy [these] requirements," but they are not required to be in its articles of organization. 11 V.S.A. § 3001(23).

11.6(b) The L3C would not have been formed but for the relationship to the accomplishment of such charitable or educational purposes.

11.6(c) If these statements are not in the article or the operating agreement, the L3C must comply with them anyway. [108]

11.7. An Illinois L3C's operating agreement may not "eliminate or reduce" these obligations while the L3C holds itself out as an L3C.[109] This also protects the brand.

11.8. An Illinois L3C is a trustee of a charitable trust. [110] This provision is strikingly different from the L3C statutes of other states and from benefit corporation laws and the California FlexCorp law.

11.8(a) This also applies to an entity that is not formed under an L3C law but is "holding itself out as a low-profit limited liability company" in Illinois.

11.8(b) A chief operating officer, director, or manager of any a real or pseudo L3C is a trustee of a charitable trust.

11.8(c) Although other states do not have this in their statute, it is a concern for all social enterprise entities in all states with active state supervision of charitable trusts.[111]

11.9. The existence of the Illinois L3C statute does not prevent a Illinois LLC that is not an L3C "from electing a charitable or educational purpose in whole or in part."[112] In other words, an Illinois LLC

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108 Ill. Limited Liability Company Act § 26(a).

109 Ill. Limited Liability Company Act § 1-5-5(b)(6.5), 805 ILCS 180/5-5.

110 Ill. Limited Liability Company Act § 1-26(d), 805 ILCS 180/1-26.

111 See Section 9 (Charitable Trusts) above.

112 Ill. Limited Liability Company Act § 1-26(e) , 805 ILCS 180/1-26.

can have a charitable or educational purpose without becoming an L3C (for example, when it was not seeking investments from private foundations as PRIs or did not believe that L3C status would help it attract those funds).

11.10. Unlike the benefit corporation statutes or the California FlexCorp Act, the L3C statutes (which generally predated them) do not provide:

11.10(a) Protection for management;

11.10(b) Transparency reporting to members; or

11.10(c) Public disclosure requirements to non-members.[113]

11.11. Liquidating distributions – If the assets of an L3C were sold for a high price, there is nothing about the L3c statutes that prevents an investor who is not a foundation from receiving a large liquidating distribution.

11.11(a) However, if the attorney general viewed the assets of the L3C to be held in a charitable trust,[114] the attorney general might require the L3C manager(s) to contribute the proceeds of the sale of assets to a charity with a purpose similar to the L3C's social purpose, rather than distribute the assets to the members who were not tax-exempt entities.

11.11(b) If the L3C manager(s) had any concern about this, they would seek the attorney general's advice immediately

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113 "[T]he model forms prepared for L3Cs lack mission anchoring mechanisms, decision-making protection for managing members balancing mission and profitability, and transparency reporting obligations around the charitable or special purpose." W. Derrick Britt, R. Todd Johnson and Susan H. MacCormac, *Everything You Ever Wanted to Know* (see fn. 1 above).

114 See Sections 9 and 10 above.

before distributing the sale proceeds to the members. This timing would give the manager(s) the most comfort from the attorney general's advice, if the attorney general allowed the distribution to the members.

- Because the manager(s) would wait until after the sale to request the attorney general's advice, an investor who was not tax-exempt would have no certainty at the time of making his investment that there was any hope of ever receiving a large liquidating distribution, even if the L3C's business proved to be very valuable.

- A regular LLC that did not create a "charitable trust" would not have this concern, even if tax-exempt foundations were members.

11.12. Venture capital investors generally avoid LLCs and invest in corporations, because (a) corporations go public and LLCs don't, and (b) starting out as an LLC and later converting to a corporation is possible, but has its hazards. Consequently, the L3C is unlikely to attract venture capital.

11.13. However, many real estate deals use LLCs because (a) they will never go public, (b) and the investors who are individuals want to avoid a double tax (at the corporate and shareholder level), and (c) the tax rules favor LLCs over S corporations.[115]

[115] See my outline *Structuring Businesses for the Recovery* on the "Events" page of www.staleylaw.com.

12. Income Tax Issues

12.1. **Classification**

12.1(a) Because benefit corporations and FlexCorps are organized under a state statute that describes them as corporations, they are corporations for tax purposes.[116]

- A benefit corporation or flex corp (or an L3C that elected to be taxed as a corporation) that satisfied the other eligibility requirements could become an S corporation.[117]

- Otherwise, the entity would be a C corporation.[118]

12.1(b) An L3C with at least two members (including a registered limited liability partnership or "LLP") would be classified as a partnership by default.[119]

- The partners would take into account their distributive shares of the partnership's tax items. [120]

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116 Treas. Reg. § 301.7701-2(b)(1); Cal. Rev. & Tax Code § 23038(a).

117 I.R.C. § 1361(a)(1). If it was certified by B Lab, it could be a … "BS Corp"!

118 I.R.C. § 1361(a)(2).

119 Treas. Reg. § 301.7701-2(c)(1) (the L3C could elect to be classified as a corporation); California has adopted the federal check-the-box regs. Cal. Rev. & Tax Code § 23038(b)(2)(B)(i). The classification of a non-corporate entity for California tax purposes must be the same as the federal classification. Cal. Rev. & Tax Code § 23038(b)(2)(B)(ii) (for example, an LLC that elects to be classified as a corporation for federal tax purposes cannot be taxed as a partnership or disregarded for California tax purposes.).

120 I.R.C. § 702(a)

♦ The tax items that flowed through the partnership would retain their character.[121]

12.1(c) An L3C with a single member would be "disregarded as an entity separate from its owner" (except for employment and excise tax purposes, for which it is treated as a corporation, and the California minimum tax) by default.[122]

12.1(d) None of these entities would be exempt from income tax unless their organization documents contained specific provisions and they applied for and obtained determination letters from the IRS and the FTB confirming their tax-exempt status.[123]

12.2. **Converting to or from a social enterprise**

12.2(a) Converting a regular corporation to a FlexCorp or to a benefit corp, or vice versa, should be a Type F reorganization – a mere change of form.[124] This is also true for a conversion from a benefit corporation to a FlexCorp, or vice versa.

12.2(b) Converting any type of corporation to an L3C that will be classified as a partnership for tax purposes will be a liquidation of the corporation for tax purposes, trigger-

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121 I.R.C. § 702(b)

122 Treas. Reg. § 301.7701-2(c)(2) (the L3C could elect to be classified as a corporation). A disregarded LLC is subject to the annual minimum tax (currently $800) and the gross receipts tax, and it must file an FTB Form 568, unless it obtains its own tax exemption. Cal. Rev. & Tax Code § 23038(b)(2)(B)(iii).

123 I.R.C. § 508(a); Cal. Rev. & Tax Code § 23701d(c).

124 I.R.C. § 368(a)(1)(F).

ing tax at the corporate level and the shareholder level.[125]

12.2(c) Converting an L3c that is classified as a partnership for tax purposes to any type of corporation will probably be a tax-free exchange, but the requirements of Section 351 should be checked.[126]

12.2(d) Converting a for-profit corporation of any types to a tax-exempt corporation generally will be treated for tax purposes as a taxable sale of all of the corporations assets at their fair market value.[127]

12.3. **Business expenses**

12.3(a) Is it possible for a social enterprise to "dial down" its profit purpose so far that its expenses will no longer be "ordinary and necessary expenses incurred in the opera-

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[125] I.R.C. §§ 331, 336; See PLR 2006-06-009, October 17, 2005. See my outline *Dissolving Business Entities* at http://www.staleylaw.com/eventsandoutlines.html.

[126] I.R.C. § 351.

[127] Treas. Reg. § 1.337(d)-4(a)(1), (2). The tax consequence for the shareholders might depend on whether the type of tax exemption affords the shareholder any hope of receiving a liquidating distribution. See Rev. Rul. 2003-125, 2003-2 CB 1243 (effect on sole shareholder of conversion of a corporation to a disregarded entity depends on whether the corporation is solvent at the time of conversion). For example, an exemption under Section 501(c)(2), (6) or (7) might afford a hope of a liquidating distribution, so the shareholders would retain the basis of their shares. But an exemption under Section 501(c)(3) would dedicate the assets to exempt purposes, and the shareholders would have no hope of a liquidating distribution. In the latter case, they might be able to write off the stock as worthless in the year of the conversion. However, when the event that caused the stock to become worthless (the conversion to a Section 501(c)(3) organization) is entirely within the control of the shareholders, the shareholders seems to be less entitled to a worthless stock deduction and more likely entitled to a charitable contribution deduction. But where is the transfer? We have wandered beyond the scope of this outline.

tion of a trade or business" and therefor not deductible?[128]

12.3(b) "[T]o be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that *the taxpayer's primary purpose for engaging in the activity must be for income or profit*. A sporadic activity, a hobby, or an amusement diversion does not qualify."[129]

12.3(c) The specter that haunts the non-exempt nonprofit might cast its shadow over the social enterprise that eschews profit, or makes profit a low priority. Is all of its income gross income, and are none of its expenses deductible? In that case gross income = taxable income.

- ♦ If on audit the IRS or FTB determined that "gross income = taxable income" for a C corporation, the corporation would be liable for the additional tax. The shareholders would be insulated from the catastrophic tax liability.

- ♦ If on audit the IRS or FTB determined that "gross income = taxable income" for an S corporation or an L3C classified as a partnership or disregarded, the shareholders or member(s) would be liable for all of the additional tax. They would bear the catastrophic tax liability.

- ♦ The professional organizing a social enterprise or preparing a tax return for one should make the client aware of this risk.

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128 I.R.C. § 162(a).

129 Comm'r vs. Groetzinger, 480 U.S. 23 (1987) (deciding that a full-time gambler for his own account was engaged in a trade or business) (emphasis added).

- ♦ Is a tax preparer who treats the expenses of a social enterprise as deductible trade or business expenses on the return effectively opining that the primary purpose of the entity is "for income or profit"?

12.4. **Taxation of a PRI's income**

12.4(a) A PRI can be stock of an S corporation.[130] In that case, all of the income that flows through the S corporation to the private foundation will be subject to unrelated business income tax, without regard to the actual character of the income or its relation to the purposes of the foundation.[131] The gain on the disposition of the shares is also UBI.[132]

12.4(b) If the PRI is a partnership or a membership interest in an LLC classified as a partnership for tax purposes, the character of the income will flow through.[133] A Section 501(c)(3) organization will lose its tax exemption if it engages in more than an insubstantial amount of activity that does not further its exempt purpose.[134] For this

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130 I.R.C. § 1361(c)(6)(B).

131 I.R.C. § 512(e)(1). Query whether this UBTI rule prevents the character of the income from flowing through for other purposes, such as determining whether the charity is engaged in a substantial amount of exempt activity. *See* I.R.C. § 1366.

132 *Id.*

133 I.R.C. § 702(b).

134 To be exempt from income tax, the foundation must be organized "exclusively" for a tax-exempt purpose. I.R.C. § 501(c)(3). It must also be "operated exclusively for [exempt] purposes." Treas. Reg. § 1.501(c)(3)-1(d)(1)(i). It is not organized exclusively for a tax-exempt purpose if a substantial part of its activities advance a non-exempt commercial purpose. There is no bright-line standard – in fact, there is no certainty as to whether the test applies to relative hours or dollars spent, or on gross receipts, or some combination.

(Footnote continued on next page)

purpose, the foundation's share of the partnership's non-exempt activities will be balanced against the foundation's exempt activities.[135] An investment that qualifies as a PRI should not threaten the tax-exemption of the investing foundation. *A PRI in a partnership or LLC that goes bad and ceases to be a PRI could threaten the tax-exempt status of the investing foundation.* This same concern would apply to an investment in a L3C that was classified as a partnership and was intended to be a PRI, but failed.[136]

12.4(c) A single-member LLC or L3C that did not elect to be taxed as a corporation would be disregarded for tax purposes. The IRS has recently publicly accepted that this rule applies to tax-exempt organizations.[137] Consequently, the activities of a disregarded LLC or L3C are treated for tax purposes as if the investing foundation en-

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(*Footnote continued from preceding page)*

> In determining the existence or nonexistence of [the] primary purpose [of carrying on an unrelated trade or business], all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. An organization which is organized and operated for the primary purpose of carrying on an unrelated trade or business is not exempt under section 501(c)(3)....

Treas. Reg. § 1.501(c)(3)-1(e)(1).

135 Redlands Surgical Services v. Comm'r, 113 T.C. 47, 77 (1999), aff'd & petition for rehearing denied, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 2004-51, 2004-1 C.B. 974.

136 See Section 12.4 (The Failed PRI) below.

137 IRS Notice 2012-52 in I.R.B. 2012-35 (August 6, 2012) ("A U.S. charity that wholly owns a disregarded entity must treat the operations and finances of the disregarded entity as its own for tax and information reporting purposes. ... [T]he Internal Revenue Service will treat a contribution to a disregarded LLC ... as a contribution to a branch or division of the U.S. charity.").

gaged directly in these activities. The L3C's activities probably be a business regularly carried on. So the income from the L3C's activity would be taxable unless it was related to the mission of the investing foundation.

12.4(d) If the activity was not sufficiently related, the activity would threaten the foundation's tax exemption if the L3C's unrelated activities represented a substantial portion of the investing foundation's total activities (including the activities of the L3C).

- ♦ If the tax exemption was lost, the California Attorney General might hold the managers personally responsible for any additional taxes on the foundation or additional professional fees incurred by the foundation.

12.4(e) If the activity did not threaten the investing foundation's tax exemption, the profit from the L3C's unrelated activity could be taxable as unrelated business income.[138]

- ♦ If the IRS or FTB (1) determined on audit that the L3C's activities were unrelated to the exempt purpose of the foundation and (2) imposed penalties for failure to properly report the UBTI and to file and disclose the appropriate return, the California Attorney General might want the foundation managers to bear the penalties.

12.4(f) A PRI in an entity that is *not* a single-member LLC can be disregarded for purposes of testing the foundation's tax-exempt status if the foundation effectively manages the entity's business.[139] The entity and the foundation

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[138] I.R.C. § 514.

[139] "The IRS carefully audits an organization's activities to ensure compliance with the operational test. Many organizations lose their exempt status for conducting activities more than an insubstantial part of which do not further any exempt purpose."
(Footnote continued on next page)

should not use the same officers, facilities and employees. For example, the person who spends the most time on the foundation's activities should not spend as much or more time on the affairs of the business entity. A small degree of overlap is permissible (for example, some of the foundation's board members sitting as some -- but not all -- of the members of the PRI entity's board of directors.)

12.5. **The Failed PRI**

12.5(a) For this discussion, a "failed PRI" is one that ceases to qualify as a PRI (rather than one that does not return the expected return on investment).

12.5(b) Any failed PRI exposes the private foundation investor to penalty taxes for several possible prohibited transac-

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(*Footnote continued from preceding page)*

S.D. Simpson, TAX-EXEMPT ORGANIZATIONS: ORGANIZATIONAL AND OPERATIONAL REQUIREMENTS, Tax Mgmt. Port. No. 869 (BNA) at IX.B. fn. 929 (2012).

> A parent's exempt status may be jeopardized if the commercial activities of its subsidiary can be considered to be, in fact, activities of the parent. If the parent corporation so controls the affairs of the subsidiary that it is merely an instrumentality of the parent, the corporate subsidiary may be disregarded (See IRC 482). This is because the subsidiary is in reality an arm, agent or integral part of the parent.
>
> Currently, the definition of "control" in the case of exempt organizations having taxable subsidiaries, is ownership directly, indirectly, or by attribution of at least 50 percent of stock, by vote or value.… Other indications of control are common corporate offices, common management, and not arms length transactions.

IRS Release 2008-42-050, July 18, 2008 (Letter retroactively revoking a corporation's tax exemption "because it is determined that you are not operated exclusively for an exempt purpose"). The corporation was required to file Form 1120 for all years going back to the effective date of the revocation of its tax exemption.

tions: jeopardy ("stupid") investments, excess business holdings, and insufficient annual distributions.

- ♦ For a private foundation active in California, the Attorney General will probably require the managers involved to bear the penalty taxes, including those that are imposed on the foundation under the Internal Revenue Code.

12.5(c) For a failed PRI in a C corporation that is not controlled by the foundation, that is the extent of the risk.

12.5(d) For a failed PRI that is classified as a partnership for tax purposes, that is disregarded for tax purposes, that is an S corporation, or the business of which is controlled by the foundation, the failed PRI can also threaten the tax-exempt status of the foundation.

- ♦ A foundation that terminates its private foundation status by losing its exempt status could be subject to a "termination tax" equal to the lesser of (1) all of its assets or (2) the entire tax benefits afforded since 1913 to its substantial donors by their charitable contributions and to the foundation by its tax exemption, plus interest.[140] The IRS can institute court action to collect the tax at any time without assessment.[141] The IRS at its discretion can abate the tax (1) if the foundation's assets are transferred to Section 501(c)(3) organizations that have been exempt for at least five years or (2) the Attorney General steps in and as-

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[140] I.R.C. § 507(c).

[141] I.R.C. § 6501(c)(6).

sures the IRS that the foundation will be operated properly.[142]

- ♦ "Small" PRI investments that cease to be PRIs will not threaten the tax exemption of the foundation, but will require the foundation to file UBTI returns (Form 990-T), which must be made public.[143]

12.5(e) The bottom line is that a foundation should rarely make a large PRI investments in any type of entity other than a C corporation.

13. Gift and Estate Tax Issues

13.1. Because a social enterprise is not a tax-exempt entity, a "gift" or bequest to a social enterprise will not be deductible for gift or estate tax purposes.[144]

13.2. Enthusiastic promoters of social enterprises will probably encourage well-meaning, but ill-advised, people to make "gifts" and bequests to social enterprises.

13.2(a) If the "gifts" are gifts for tax purposes, they will reduce the lifetime exemptions and require gift tax returns and, if the amounts are sufficient, the payment of gift tax.[145]

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142 I.R.C. § 507(f).

143 I.R.C. § 6104(b). "Small" in this context means that a small amount of activity passes through to the charity. Note that a small amount invested in a low-margin business such as a natural gas distributor could pass through a surprisingly large amount of gross receipts.

144 I.R.C. §§ 2522(a) (gift tax deduction), 2055(a) (estate tax deduction).

145 Rev. Rul. 82-216, 1982-2 C.B. 220 ("The Service continues to maintain that gratuitous transfers to persons other than [political] organizations described in section 527(e) of the Code *are subject to the gift tax* absent any specific statute to the contrary,

(Footnote continued on next page)

13.2(b) If the transfer is not a gift, the gift tax will not apply.[146] Of course, a transfer in exchange for stock of a benefit corporation or a FlexCorp or for a membership interest in an L3C will not be a gift if there is an expectation of profit. If the "investor" instead becomes a "supporter" and has no rights to dividends or distribution, including liquidating distributions, the transaction ceases to look like a contribution to capital.

- "In Stern v. US, the Court of Appeals for the Fifth Circuit held that a political contribution was made 'for an adequate and full consideration' within the spirit of the regulations exempting such transfers [from gift tax] because the taxpayer's motive was to support a slate of candidates 'that would protect and advance her personal and property interests.' While this rationale left some room for distinguishing between contributions serving the donor's personal and business objectives and those impelled by less self-centered concerns, the Court of Appeals for the Tenth Circuit subsequently ruled without qualification that campaign contributions cannot be considered taxable gifts in the light of the legislative history and purpose of the gift tax."[147]

(*Footnote continued from preceding page)*

even though the transfers may be motivated by a desire to advance the donor's own social, political *or charitable goals.*") (emphasis added.)

146 Treas. Reg. § 25.2512-8. ("[A] sale, exchange, or other transfer of property made in the ordinary course of business (a transaction that is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth [and therefore not a gift].").

147 Stern v. US, 436 F2d 1327, 1330 (5th Cir. 1971); Carson v. CIR, 641 F2d 864 (10th Cir. 1981). This quote and the next bullet are from B. Bittker & L. Lokken: FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS (RIA)¶ 121.9

- ♦ The authors conclude that "it remains to be seen whether the *Stern* rationale will be applied by the courts to contributions to nonprofit organizations that are neither political organizations within the meaning of § 2503(a)(5) nor charitable organizations as defined by Section 2522(a)."[148]

13.3. If the enthusiastic promoter is a natural object of the "investors" bounty, and the promoter has some upside in the deal but the "investor" has little or none, the transaction might be a gift to the promoter.[149]

13.4. If a bequest is made to a social enterprise, the bequest will be subject to estate tax, possibly paid from the residual interest.

14. Valuation Issues

14.1. If "investments" in social enterprises can be subject to gift and estate tax, what are they worth?

14.2. If there is every indication that the product or service private foundation the social enterprise is being offered at its "highest and best use" (that is, if the FlexCorp's "dial" is set all the way to "profit") then the enterprise probably would be valued using the same techniques as any other business.

14.3. If instead the value of the business assets (including intangibles such as technology and brands) are not being used as a prudent, profit-seeking business person would use them, the appraiser probably has a different task. The first step would be to determine whether the asset being valued could realize its full market value.

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148 *Id.*

149 *See generally*, Bittker & Lokken, *supra*, at ¶ 121.4.

14.3(a) For example, if a 5% stock interest in a benefit corporation was valued, the holder of that stock would not have sufficient leverage to force the corporation's assets to be sold or used to maximize their full promise, so the actual earning history of the corporation might be the best basis on which to value that 5% interest.

- ♦ Discounts for lack of control and lack of a ready market for the shares would also apply.

- ♦ The appraiser might consider that there might be a constricted market for stock in a company that was dedicated to realizing less than the full earning power of its assets. On the other hand, the "social" aspect of the enterprise might make its stock more valuable in the eyes of some. How an appraiser would account for these things remains to be seen.

- ♦ We might be reading in appraisal reports some day about studies of the effects on value of various types of provisions in the organizing documents of social enterprises.

14.3(b) In contrast, if a 70% interest (or any interest more than 2/3) in a benefit corporation was valued, and that interest was sufficient to approve a sale of the asset or to convert the corporation into a regular corporation, the appraiser might be required to determine the earnings that could be derived from maximizing the earnings power of the assets, and then (based on those assumptions -- and taking into account the fact that they are only assumptions) value the enterprise and the 70% interest as if it was a regular corporation.

14.4. What seems most certain is that appraisals of interests in social enterprises will take more time and cost more that appraisals of "comparable" enterprises in regular corporations and LLCs. At least for the next few years.

15. When Might Advisors See Social Enterprise Entities?

15.1. The most likely scenario for an FlexCorp or a benefit corporation is as a for-profit subsidiary of a tax-exempt organization or as a vehicle for a PRI.

15.1(a) If (i) the new entity will perform a function that the tax-exempt organization could have performed, (ii) the tax-exempt organization is not a private foundation, and (iii) the new entity should be tax-exempt, then a **supporting organization** might be a better choice. Because a supporting organization has its own tax exemption, it does not need to worry about whether its expenses will be deductible.[150]

15.1(b) If the only shareholders of the entity will be one or more tax-exempt organizations, there is probably a very low risk that a shareholder will complain if the directors take into account the social purposes of the exempt parent(s) in making decisions – so the management protections of a FlexCorp or a benefit corporation will not be required.

- The shareholders can require whatever reports they want from management, and can publicize the reports as they see fit.

- Groups of nonprofits and their advisors can create standards for this, so that each deal does not need to be created from the ground up. But there is no need for legislation to facilitate this.

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150 See Section 12.2 (Business expenses) above.

- Note that the entity is likely to be a C corporation to protect the tax-exempt status of the parent organization(s).[151]

15.2. If the business objective is to build up the entity's business and eventually to sell it and to distribute the sale proceeds to investors, no tax-exempt entity will work. A social enterprise entity will rarely be a good choice for this business model.

15.2(a) Also, an entity that holds its assets in charitable trust will not work because the proceeds of the eventual sale might be required to be distributed to charities. This concern probably rules out the L3C.[152]

15.2(b) The directors of a benefit corporation *must* take into account the social purposes of the corporation. In contrast, the directors of a FlexCorp are permitted -- but not required -- to do so. Consequently, a FlexCorp that protects in its organization documents the rights of the for-profit investors to liquidating distributions and does not create a charitable trust would be the best social enterprise vehicle (but not necessarily the best entity) for an investor who hoped to hold his investment for a business home run.

- Note: If the articles of incorporation and the bylaws protect the right of the investors to liquidating distributions, the question arises as to why the

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151 See Sections 12.4(a) to 12.4(f) above. A single-member LLC or L3C would be disregarded and the parent would be treated as engaging in the business activity of the LLC or L3C. The character of the business activity might flow through a partnership (or multi-member LLC or L3C) or S corporation. I.R.C. §§ 702, 1366. For these reasons, a for-profit subsidiary of a tax-exempt organization is typically a C corporation. The C corporation's income is subject to a corporate-level tax, but distributions are not taxed to the tax-exempt parent.

152 See Section 9 above.

entity should be a social enterprise entity at all, and not a regular LLC or corporation.

15.2(c) Individual shareholders of C corporations often hope that a sale of the business can be structured as a **sale of shares**, to avoid the second level of tax on an asset sale. However, it will be the rare buyer who is willing to buy the stock or membership interests in a social enterprise entity. Even that rare buyer will probably proceed much more slowly and with much more caution than if the entity were not a social enterprise entity. This concern will arise for every investor with strong financial objectives, even if they are not the dominant objectives.

15.3. Any social enterprise entity might be used by a promoter who hopes to raise money from both private foundation and socially conscious investors. The entity chosen will probably reflect what the promoter believes will be most attractive to investors.

15.3(a) Could a promoter who used an L3C could take a low initial interest in capital and a low initial profits interest, with his profits interest "flipping" to a more substantial interest when the other investors had received as distributions a priority return and the value of their capital contributions? This would be a typical structure for a real estate deal.

- Would the "flip" indicate that the entity was intend to be operated for appreciation and prevent the entity from being an L3C?

15.3(b) If the business is not expected to go public and individual investors will be sought, an LLC (or L3C) might be the best vehicle, to avoid double tax for the individual investors.

- The tax-exempt investors in this business will often use a C corporation (or "blocker corporation") to prevent the character of the LLC's (or

:3C's) business activity from flowing through and to avoid UBTI. This results in one level of tax on the income to the tax-exempt organization, but could result in tax on the disposition of the LLC interest that would have been avoided if the entity was held directly.[153]

15.3(c) It is possible that the "L3C" suffix in the name of an entity will enhance its products in the marketplace. This could also be true (but probably to a lesser degree) for benefit corporations or FlexCorps.

15.3(d) If there is market cache to be gained, it can probably best be obtained by a third-party certification and use of a mark, such as the B Corp mark.

15.3(e) Fans of social enterprises have expressed concern about their use for "greenwashing" a business that is really all about profits.[154]

15.3(f) Managers of Section 501(c)(3) organizations who need to use for-profit entities might be most comfortable using social enterprise entities because they are not entirely comfortable with a full-on profit-making purpose.

- For them, the term "L3C" in the name of the entity or the third-party certification might be a way

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[153] For issues involving I.R.C. §§ 168(h)(6) and 514, see the slides *UBTI or Not UBTI – Tax-Exempt Investor Issues*, presented to the Real Estate Committee of the ABA Tax Section on September 14, 2012 by Ofer Lion, James M. Lowy and H. Neal Sanford.

[154] "Greenwashing" is defined in Wikipedia as "a form of spin in which green PR or green marketing is deceptively used to promote the perception that an organization's aims and policies are environmentally friendly. Whether it is to increase profits or gain political support, greenwashing may be used to manipulate popular opinion to support otherwise questionable aims."

to signal that they had not entirely gone over to the dark side.

- ♦ The issue is whether concerns about using a social enterprise entity would give them more discomfort.

15.4. A business owner or family who wants to assure that successor owners and managers retain the founders' social consciousness vision for the company could convert it to a social enterprise, possibly a benefit corporation that requires annual measurement to a third-party standard.

15.4(a) If enough of the successor owners want to abandon the social enterprise, they may do so -- as long as the assets of the company have not been dedicated to a charitable trust.

15.4(b) If adherents of the social enterprise are unsuccessful in voting to retain the social enterprise entity, they might argue that the assets had been dedicated to a charitable trust, unless the organizing documents are clear that this was not intended, and management had been careful at all times to avoid this.

15.5. A promoter who seeks grant money from private foundations and donations from private individuals should use a nonprofit corporation (probably a public benefit corporation in California) and obtain federal and California tax exemptions.

15.5(a) For grants to Section 501(c)(3) organizations, a private foundation does not need to exercise expenditure responsibility. So these organizations are often the first or only choice of grant-making foundations.

15.5(b) The promoter who uses a Section 501(c)(3) organization must understand that he or she will never get rich from the activity in that organization.

15.6. A promoter who will need to raise money from private investors or seek SBA loans will need to use a regular LLC or corporation, or a FlexCorp with the primary profit purpose.

15.6(a) Using a social enterprise entity might help to attract funds from the investors who value social goals over economic return, at the cost of alienating investors who primary objective is an economic return.

15.6(b) Promoters who choose social enterprises:

- ♦ Should avoid the L3C because it might be a charitable trust.[155]

- ♦ Should avoid the benefit corporation because it social purposes are so "baked in" that its expenses might not be deductible.[156]

- ♦ Should dial up the profit purpose of a FlexCorp to a degree that assures that the entity avoids charitable trust status and is certainly engaged in a trade or business for purposes of Section 162 of the Internal Revenue Code.[157]

- ♦ "Ultimately, the Working Group [who drafted the FlexCorp Act] believes that Benefit Corporations are primarily designed for use by private companies focused on sustainability that avail themselves of socially responsible capital, as opposed to companies seeking access to traditional capital

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155 See Section 9 (Charitable Trusts) above.

156 See Section 12.2 (Business expenses) above.

157 *Id.*

markets [who should use regular corporations or FlexCorps]."[158]

15.7. Managers of a private foundation who want to make an MRI should carefully consider whether the reduced financial return on a social enterprise entity makes it an inappropriate investment. That is, if the investment is not a PRI, the foundation managers should consider whether the "profit" objective has been dialed down too far in the entity, and whether the entity holds its assets in an inadvertent charitable trust.

15.8. If the purpose of a PRI is to demonstrate that there is a market for product or technology that would help an underserved population, a social enterprise entity might be the wrong tool for the task.

16. What Social Enterprises Mean to Professional Advisors

16.1. Professional advisers will need to exercise more care with organizations that they encounter after the formation stage.

16.1(a) They should determine whether an organization that appears to be a nonprofit is actually formed as a social enterprise.

- The website of the California Secretary of State, while very helpful, does *not* even distinguish among for-profit and nonprofit corporations.[159]

- They should be alert that a "benefit corporation" is *not* the same as a "nonprofit public benefit cor-

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158 W. Derrick Britt, R. Todd Johnson and Susan H. MacCormac, *Everything You Ever Wanted to Know* (see fn. 1 above).

159 http://kepler.sos.ca.gov/.

poration" – and should expect that their clients will constantly confuse the two.[160]

16.1(b) They will need to determine whether what appears at first to be a nonprofit organization is really tax exempt.

16.1(c) They will also need to determine whether a check that appears to represent a deductible contribution to a charitable organization is in fact an investment in a for-profit social enterprise – or a taxable gift.[161]

- ♦ One tool for this is Select Check on the IRS website, a digital version of IRS Publication 78 that lists Section 501(c)(3) organizations.[162]

- ♦ If the organization is exempt, the Form 990s for the last three years are available on line soon after they are filed (but not instantly).[163]

- ♦ If the organization has filed with the California Attorney General, information about it will be available online.[164] Sometimes this includes everything filed with the Form CT-1, including the articles of incorporation.

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160 See Section 5.2(c) above.

161 See Section 13.2 above regarding taxable gifts.

162 http://www.irs.gov/Charities-&-Non-Profits/Exempt-Organizations-Select-Check.

163 www.guidestar.org.

164 http://rct.doj.ca.gov/MyLicenseVerification/Search.aspx?facility=Y. It is sometimes best to get the corporate number from the Secretary of State website and use that to search the Attorney General's website, which is finicky about name searches.

- ♦ Ultimately, the professional's due diligence file should include the articles of incorporation or other organizational document of the entity, and a copy of the federal and state determination letters, if the organization is supposed to be tax-exempt.

16.2. Professional advisers who work with foundations that make PRIs or with the promoters of PRIs need to obtain an opinion of counsel or a private letter ruling on the qualification of the PRI -- even if the investment is in an L3C, a FlexCorp, or a benefit corporation.

- ♦ Certification by B Labs or another third-party is *not* a substitute for an opinion of counsel or a private letter ruling.

16.3. Professionals advising persons starting new business entities should consider whether a traditional business entity (including the LLC) would achieve the client's goals before using a new entity that might have unforeseen legal or tax problems.

16.4. Professionals advising managers and directors of social enterprise entities – especially L3Cs and benefit corporations – who wish to make distributions to members or shareholders must consider whether the entity holds the assets in a charitable trust and the consequences to the managers, directors, officers and advisors if they permit a charitable trust to distribute its assets to the wrong "beneficiaries."[165]

16.4(a) Similar concerns arise if a social enterprise entity decides to convert to a regular entity.

16.4(b) It is not at all certain the amount of information that promoters of social enterprise entities – or mangers of

[165] One probable consequence is that the attorney general will require those who received the distribution to return it to the entity and that the management group personally pay any shortfall. The members and shareholders who were required to return the distribution might have recourse against the management and their advisers.

regular entities that seek member or shareholder votes to covert to social enterprise entities – must provide to fulfill their duties under federal and state **securities laws**.

- ♦ Is the disclosure standard lower because the objective is "more pure"?

- ♦ Or is the disclosure standard higher because these entities are newer and so even sophisticated investors cannot be expected to anticipate them if the promoter does not do so explicitly?

16.5. For professionals who advise management and directors of social enterprise entities about **directors and officers liability coverage**:

16.5(a) Does the policy covers the defense of a "benefit enforcement proceeding"?

16.5(b) It would be a good idea to make the insurer specifically aware that the entity is a social enterprise entity, so that the insurer cannot deny coverage later on the basis that the insured withheld material information during the application process.

16.5(c) Professionals who advise promoters to use social enterprise entities or to convert to them should advise the promoters to determine first whether D&O coverage will be available to the entity and at what cost.

17. Does the World Need Special Entities for Social Enterprise?

17.1. Corporations

17.1(a) From a corporate lawyer's perspective, the only decent argument for these entities is that they absolutely prevent a shareholder (or, to a lesser extent, a member of an LLC) from successfully bringing a claim against management for making decision to further "social" as opposed to "profit" motives.

17.1(b) But existing corporate and LLC laws provide sufficient flexibility to insert special purposes into a shareholders agreement or operating agreement and thus to put the shareholders or members on notice that the directors will use factors other than maximizing profit to guide their decisions.

- If social enterprises are expected to have more than 35 investors in a single entity, the existing limit on the number of shareholders in a "close" corporation could be increased. This would be a much more simple change than creating new types of entities.

- It would be possible for a group to publish on a website a form of shareholders agreement for a close corporation that has social enterprise aspirations. The shareholders in that entity would agree to the transparency and disclosure arrangement and would, by contract, agree not to sue the directors for taking into account social as well as profit concerns. They could agree to require management to report based on a third-party standard, or to obtain certification from a third party. This type of agreement could be widely adopted. None of this requires new laws.

17.2. **Maximizing profit**

17.2(a) The perceived need for new forms of entity rests on the assumption that existing corporate and LLC laws require the managers to focus exclusively on profit maximization. And that a "movement" is needed to free businesses from the tyranny of profit maximization. But that is a false assumption.[166] Managers routinely take into account their employees, the community, the environment and their suppliers.

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[166] See fn. 20 above regarding the myth of Ben & Jerry's.

17.2(b) Managers cannot change the laws of supply and demand, so not all these objectives can be maximized at any given time.

- But a "movement" can't change those laws either.

- To keep an enterprise going, it must either make a profit or receive constant infusions of capital.

17.3. **A fad?**

17.3(a) There is a sense in these statutes and the literature promoting them that regular entities are passé, that "capitalism was tried and has failed," kind of an "occupy" concept. So the enlightened will not use the old, failed capitalist model, but the new, enlightened models. And the truly enlightened will have a third-party agency certify that their entity is good. It sounds a bit like a fad -- like having "dot com" in the name of the company so it could go public in 1999.

- The cost of this fad is confusion in the marketplace.

17.3(b) Compare how LLCs were created. After the Tax Reform Act of 1986, a C corporation could not avoid a double tax, even when it dissolved. LLCs were created in 1988 to provide limited liability for all owners, but with only one level of tax. The IRS and Treasury conceded the issue in the 1997 check-the-box regulations. So the LLC is a product of the 1986 repeal of the *General Utilities* doctrine. It filled a real need – albeit a need created by government action. If the corporate tax was repealed. the need for LLCs would evaporate.

- It is not at all clear that a need exists for social enterprise entities.

- The laws creating social enterprise entities make corporate and LLC laws more confusing, without permitting anything that was not already possible. If they do not fill an urgent need, their existence is sand in the gears of commerce.

17.4. **L3Cs**

17.4(a) The tax definitions of a PRI apply to an *investment*, while the L3C laws apply to the entire *entity*.

- It is reasonable for the PRI regulations to require that a foundation not have a profit purpose for an *investment*. This still allows the *entity* and the other investors in it to have a profit purpose.

- The regulations do not require, and it will seldom be reasonable to require, that the *entity* itself not have a profit purpose. This prevents the entity from access to any investors with goals that differ from the foundation's very specialized needs. It's somewhat like an entrepreneur reading that venture capital investors prefer convertible preferred stock, and deciding to issue only convertible preferred stock to make his company more attractive to VC investors.

17.4(b) Just as the VC investor will want the founders to hold the common stock and to have "skin in the game," the foundation often will want the entity to be managed by people who are motivated by profit and have a substantial upside if the business succeeds.

17.4(c) Investors in an entity can have different goals, and corporations and LLCs are flexible enough to permit *investment vehicles* to match those goals. Designing the *entity* (the L3C) to match the goals of a only one type investor is getting it backwards.

[End of outline.]