

PERLMAN & PERLMAN, LLP
ATTORNEYS AT LAW
41 MADISON AVENUE
SUITE 4000
NEW YORK, NEW YORK 10010-2202
WWW.PERLMANANDPERLMAN.COM
TELEPHONE (212) 889-0575
FACSIMILE (212) 743-8120

SOCIAL ENTERPRISE: A LAWYER'S PERSPECTIVE
By Allen R. Bromberger

Introduction

There is a lot of talk these days of “social enterprise.” – a term generally used to describe some type of commercial activity in support of a social purpose. Like the terms “community development corporation” and “community reinvestment” which have preceded it, social enterprise is in fact nothing more than a generic term used to describe a particular sphere of activity.

For the purposes of this article, I will use the term “social enterprise” to refer to any commercial activity or venture that is operated to achieve business and social goals simultaneously.” A “social entrepreneur” is any person who is actively engaged in building a social enterprise. In my experience, social enterprises take many different forms, including business corporations, nonprofit corporations, for-profit subsidiaries of nonprofit entities, “captive” charities created by business corporations, joint ventures, and less formal structures created through financing, shareholder and licensing agreements.

Whatever the form, one thing is clear: social enterprise is big and getting bigger. Large consumer markets well-suited to social enterprise are growing, driven by consumers’ desire to align their personal values with their spending habits. These markets – sometimes referred to as “green” or “lifestyle” markets – include the production and distribution of goods and services in areas such as alternative or sustainable energy, eco-tourism, non-toxic cosmetics and personal care, organic foods, nutrition and fitness are experiencing surges of interest among consumers and investors alike.

Companies whose products are produced using natural and sustainable resources, practices that reduce carbon emissions and other destructive environmental effects, socially responsible business practices, fair trade and fair labor practices, dedicating a percentage of profits to charity and other “socially beneficial” practices have a competitive advantage in these markets. A cottage industry of professional advisors and web-based technology companies (including social networking sites and blogs) has sprung into existence to serve the people who are building these companies. At least a dozen organizations now exist expressly to serve entrepreneurs within these fields, and many prominent entrepreneurs and philanthropists are using their wealth to fund these support organizations and the development of these markets. Some have estimated that – depending on how one defines social enterprise – this activity could account for as much as 4 trillion dollars in the global economy. That’s enough to get anyone’s attention.

In a recent poll conducted by the Social Enterprise Alliance, 71% of respondents reported that finding the best legal structure for their ventures was the single greatest challenge they faced. The pool of respondents included not just people who were starting new ventures, but also investors seeking a social return on investment (SROI) in addition to financial returns. Simply put, it is hard to fit these enterprises into traditional legal forms.

Ironically, American law does not provide a legal form that is designed to accommodate the particular needs of social enterprise. Nonprofits, which are formed to accomplish a social purpose, have great difficulty getting access to capital, and their ability to distribute profits to investors is quite limited. Business corporations, which are formed primarily to make a profit for their investors, are vulnerable to challenge if they use the shareholders' money for non-business purposes. Between these two end points lie a variety of structures and relationships that represent "hybrid" arrangements. These include nonprofits that create for-profit subsidiaries; for-profit companies that create corporate giving programs, joint ventures between nonprofits and for-profits, issuance of restricted and preferred stock, restricted and preferred debt, shareholder agreements, financing agreements, licenses and royalty agreements, leases, program-related investments, corporate sponsorships and commercial co-ventures. Each of these plays an important role in the ecosystem of social enterprise, either alone or in combination, in pursuit of the dual objectives of a social enterprise. But from a lawyer's point of view, none of them allow a personal profit motive and a social benefit motive to co-exist peacefully in a single venture.

For many, the ideal legal structure for social enterprise would allow management to pursue the dual goals of profit and social benefit within a single venture. It would allow the venture to raise private capital and compensate investors for the use of their capital on competitive terms, but also allow – even require – management to make business decisions that further the social mission of the organization, even at the risk of impairing profit. It would allow donors to support the social purposes of the venture with tax-deductible contributions, provided the money they give is a gift and they do not receive anything in return. Such an enterprise could freely enter into joint ventures and other business relationships with charities or for-profit companies without jeopardizing the tax or corporate status of the participating entities or exposing management to complex regulation or potential liability. Under the right circumstances, the social enterprise itself could become exempt from paying tax on its net revenues.

Unfortunately, there is currently no legal entity that has these characteristics under U.S. law. While there are proposals for "hybrid" legal entity that could do some or all of these things, until such a hybrid model is accepted under U.S. law (a prospect that is not immediate), social entrepreneurs in the U.S. must use existing legal forms – or a combination of them – to achieve the dual goals of profit and positive social impact.

Using Existing Legal Forms

The most common legal forms used for social enterprise today are the nonprofit corporation, the business corporation, the limited liability company (LLC) and various

forms of partnerships, including limited partnerships. Each of these has certain strengths and weaknesses described below. Used in combination, their strengths can be maximized and their weaknesses minimized. Even with the help of the most skillful attorney, however, there is still a “gap” that falls short of the ideal described above.

Nonprofit organizations are specifically designed to pursue social objectives, especially where profit is not an issue. However, they are not well-suited for running a business venture, especially when outside capital is needed. Nonprofit corporations cannot issue stock and therefore have no “owners.” Revenues generated by the nonprofit corporation must remain within it and cannot be paid out to investors or other stakeholders except as reasonable compensation for services rendered. The board of directors of a nonprofit corporation is duty-bound to give its primary attention to pursuit of the social mission rather than the production of net income. Organizations exempt from federal tax under Section 501(c)(3) of the Internal Revenue Code (often referred to generically as *charities*) must abide by even greater restrictions that prohibit payments to insiders and impose taxes on any business activity that is not directly related to the organization’s tax exempt purposes. The notorious *unrelated business income tax* (UBIT) falls into this category.

Just as nonprofits are less than ideal vehicles for carrying out many for-profit enterprises, business corporations are generally not well suited to carry out social purposes. Business corporations do have owners – the shareholders – and the directors of business corporations owe strict duties to look out for the interests of those shareholders. Unless they can tie their charitable or social benefit activities directly to some business purpose, the managers and directors of for-profit companies may be sued for breach of their fiduciary duties and misuse of corporate assets. Only in cases where the owners of the business are in agreement with the idea of operating in a socially responsible manner, or dedicating a percentage of profits to charitable causes, can such activity take place. And such situations are fragile. A change in ownership or control – or a drop in earnings – can bring everything down.

So what are the options under existing law? Well, there are quite a few.

Because the legal world is still largely oriented to thinking in terms of charity versus business, it is important in selecting a legal form to look at the source of capital that will be employed to finance the venture. If the business will be capitalized primarily by *invested capital* (capital provided with the expectation that the investor will receive a financial return), a business corporation or limited liability company is probably a better choice than a nonprofit charity as the mother ship for the enterprise. If the invested capital takes the form of hard work by the founders who may also be taking significant risk, they expect a return on their labor that may goes beyond what the “reasonable compensation” standard will allow, that indicates a business corporation as well. On the other hand, if the venture will be primarily financed by *donated capital* (capital for which no financial return is expected), a nonprofit mother ship will probably be best, especially if the “investors” want or need a tax-deduction for their contributions. But, because of the restraints discussed above, rarely will one entity suffice for a true social enterprise. Usually a combination of entities is required. Fortunately, nonprofit charities

can create and own for-profit subsidiaries. And for-profit businesses can create and control nonprofit charities, although they cannot “own them” in the traditional legal sense. Joint ventures between businesses and charities are yet another option.

Using Nonprofits as Vehicles for Social Enterprise

Nonprofit corporations are not prohibited from engaging in commercial activities, and so long as they stay within the limits of the law, they can do so quite vigorously. In fact, although nonprofits are often thought of as charitable entities, the two are not synonymous. Nonprofit corporations are a creature of state law, whereas tax exemption (including tax exemption as a charity) is a function of federal tax law. There is theoretically no limit to the amount of commercial activity a “taxpaying nonprofit” can conduct in support of its corporate purposes. This has advantages for social entrepreneurs under the right circumstances, especially for cooperatives and other ventures where groups of individuals or companies come together for a common purpose – even a common business purpose – but where the structure of the venture does not require much capital and the generation and distribution of profit is not a significant issue. Although they are not “owned” by anyone in the classic sense, these nonprofits typically have members who exercise the same kind of control as the owners of a business, and those members can engage in a wide variety of transactions with the nonprofit entity. The organization itself is formed for a non-pecuniary purpose, so the managers are legally bound to carry out the nonprofit’s social mission rather than focusing solely on maximizing profit for the owners. And for “break-even” organizations, taxes are not likely to be a significant issue anyway, so there is little downside to the absence of tax exemption.

Even if a nonprofit has charitable status with the IRS, however, there is still a great deal it can do in the commercial business realm. A charity is permitted, for example, to carry on a business that supports its charitable purposes, so long as no individual or entity is receiving financial benefits except as reasonable compensation for services rendered. A charity formed to reduce unemployment, for example, can operate a furniture manufacturing business that employs a disadvantaged population and sells its furniture on the open market at a profit. If it wants to use recycled lumber, or organic cotton, or pay its employees a living wage, it may do so, even though such measures may impair or eliminate the venture’s profitability. Of course, if those practices increase profits rather than reducing them, that is OK, too. Social ventures conducted within charities must answer to a board of directors that governs the organization, exercises oversight over its management, and makes sure the nonprofit stays on mission – just as with a business corporation – but there are no shareholders to complain that their profits are being diluted, which gives management a free hand to run the business in a way that serves the social purpose. If the business is low profit or no-profit, there are a variety of ways in which the organization can receive tax-deductible contributions to subsidize it, which is generally not an option for for-profit businesses or taxpaying nonprofits.

It is also permissible under existing law to move revenue from a charity to another party in ways other than as reasonable compensation for services rendered. A nonprofit cannot issue shares nor pay a dividend on those shares, but it can issue debt and pay interest on

that debt. So long as the rate of interest is commercially reasonable, and the purpose of the debt is to further the charity's interests rather than that of the lender, it does not matter that the lender is motivated purely by a profit motive. A charity can even create different classes of debt, each with different economic rights based on different financial arrangements. So, for example those who lent money to the venture when it was new and most risky can earn a higher rate of return than later lenders. But beware: profit-sharing arrangements are generally taboo, even when they are dressed up as debt. It is the substance of the arrangement, rather than its form, that determines whether or not it is allowed. And charities have another reason to be careful with debt: under the UBIT rules discussed below, income from debt-financed property is subject to special rules and is more likely to be taxed than other kinds of earned income.

Charities can also license intellectual property and pay the owner royalties for its use. They can lease equipment or real estate and pay rent to the owner. But they have to be careful to avoid conflict of interests, and insiders (those involved in the oversight or management of the business) are generally restricted from doing business with the charity in a manner that results in non-trivial financial benefits to them, members of their families, or entities which they control.

Finally, nonprofits can also enter into joint ventures with other non-profits or for-profit businesses. A joint venture is another generic term that simply refers to a contractual arrangement whereby more than one person or entity will operate a venture. If two nonprofits want to co-operate a revenue generating activity, they can do so. Each may contribute capital to the venture and they may divide profits and losses however they wish. The only real limitation is that the activity must further the legitimate interests of each charity, and the "reasonable compensation" rule applies to the venture because it applies to each of the charities. Limited liability companies (LLC's) are often used as vehicles for such joint ventures, because they offer a flexible structure, pass-through tax treatment, and limited liability, which protects the members of the LLC from being held liable for debts of the joint venture.

Another significant challenge for charities that operate businesses is UBIT. As noted earlier, UBIT is a tax on income to the charity that comes from an "unrelated" business activity. A charity's income is subject to UBIT – which means it is taxed at normal corporate tax rates – if it comes from a trade or business that is regularly carried on and which does not contribute to the charity's mission in any important way other than through the production of income. Certain activities, such as publishing or advertising, are treated as unrelated income by IRS regardless of whether they are related to the charity's purposes, and revenues from those activities are therefore automatically subject to tax. Corporate sponsorships are another area of UBIT concern. When a corporate sponsor provides funding for a charitable program and receives more than an incidental benefit in return, the sponsorship may be treated as advertising revenue, and automatically subject to UBIT. Carefully drafted agreements can generally avoid these problems.

Using For-Profits for Social Enterprise

Using a for-profit entity as the vehicle for social enterprise, either alone or in combination with charities, avoids all of the restrictions of using a charity, but it can be hard to embed the social purpose or values that drive the business into the “DNA” of the company. Organizational documents may contain provisions that require adherence to a social mission or at least a social impact; shareholder agreements can enshrine social purposes or values into the management of the business, but corporate documents and shareholder agreements can be amended or abrogated, and thus are imperfect. It is possible to create procedures that make changes to those documents difficult, but because every business changes over time, investors will rarely finance a business whose basic principles must remain inviolate forever. Wriggle room is thus both a blessing and a curse; it allows the flexibility every business needs, but it also makes it impossible to guarantee fidelity to any particular mission over time.

The basic vehicle for for-profit activity in the U.S. today is the business corporation, sometimes referred to as a “C” corporation because of the section of the Internal Revenue Code under which it is taxed. Such a corporation is generally formed for the purpose of making money and distributing its profits to owners and managers in the form of executive compensation and dividends to shareholders, but there is no reason a business corporation could not include a social mission or values in its corporate charter. That, however, would merely *authorize* the corporation to pursue social benefit; it would not *require* it to do so. Only the owners of the corporation can require the corporation to pursue a social mission or adhere to certain values. Perhaps the best way to do this is through a shareholder’s agreement. A shareholder’s agreement is an agreement between the shareholders of a company relating to the ownership and management of the company. It can be used to supplement and enhance (or restrict) the behavior of companies and the rights of its owners in ways that are not contained in the company’s organizational documents or the statutes and regulations that define “normal” corporate behavior. Under certain circumstances, it can even be used to circumvent the normal rules entirely.

The owners of business corporations are issued shares of stock to represent their ownership interests, and the managers of the company have a fiduciary obligation to run the company in the best interests of the shareholders. Because the interests of shareholders is typically interpreted to mean the shareholder’s *economic* interests, most experts agree that the pursuit of financial gain for the benefit of the owners is the primary function of a business corporation. A case can be made, however, that the shareholder’s interests in a social enterprise include the accomplishment of social outcomes, especially when the shareholders themselves have included a provision to that effect in a well-drafted shareholder’s agreement. In such a case, the managers’ duty would extend to producing social outcomes as well as profits.

Another business form that lends itself to social enterprise is the LLC. LLC’s are technically not corporations at all, but they are privately owned legal entities that can be formed for the purpose of realizing profits, pursuing a social mission, or both. In fact, Tennessee offers a unique structure known as a “nonprofit LLC.” This entity has the ownership and governance features of a “regular” LLC, but in all other respects it is

governed by the state's nonprofit corporation law. Even without a special statute, however, the members of an LLC can be formed for the purpose of pursuing a social mission.

LLC's differ from corporations in that they are formed and owned by "members" rather than "shareholders" and they offer pass-through tax treatment. That means that the income and expenses of the business are reported as though the members had incurred them directly, and any profit or loss is taxed at the ownership level, rather than the entity level. Thus, if one member of the LLC is a business corporation, and another is a charity, the business corporation would pay tax on its profits, but the charity would not (assuming the business is related to the charity's purpose.)

LLC's are more akin to partnerships than to corporations, with the advantage of limited liability for the members that is equivalent to the limited liability enjoyed by shareholders of a business corporation. LLC laws in virtually every state allow great flexibility in structuring governance and management, much more so than the laws that govern business corporations or nonprofit corporations. Like partners, the members have wide leeway to allocate profit and loss and management powers among themselves however they see fit, and as with business corporations, different classes of membership are permitted, each with its own economic rights.

From an economic point of view, LLC's are much better than business corporations as vehicles for social enterprise, especially for joint ventures between a charity and a for-profit business. Because they do not incur "double taxation" (the effect of taxing income at the corporate level and then again when it is taken as income by an owner. An LLC operating agreement – which is almost like a corporate charter, bylaws, and a shareholder agreement in a single document -- may contain provisions requiring adherence to a social purpose or a set of values chosen by the members, and such purposes or values can be interwoven throughout the an operating agreement as needed. LLC's are well-suited for enterprises with a limited number of investors and relatively low investor turnover. However, if shares are to be offered to the public, or frequent investor turnover is expected, a business corporation will probably serve better than an LLC.

The problem of permanence of purpose and fidelity to a social mission is not trivial when a for-profit entity is used for social enterprise. The managers of such entities have a general duty to serve the interests of the investors, which is typically presumed to refer to the investors' profit motive. This presumption can be overcome, as mentioned above, by embedding the investors' interest in a social purpose in organizational documents and internal agreements between the owners of the business. Business corporations and LLC's can even go a step further if they wish. It is possible, for example, to create a special class of shareholders or members, who do not have economic rights, and whose consent is required in order to change those aspects of the corporate documents that contain the commitment to social purpose. That special class of shareholders or members can be made up of charities, foundations, or any other person or entity whose primary goal is to be the "keeper" of the mission. If properly structured, (provision should be made, for example, to change or remove those shareholders or members if circumstances

warrant), it ensures that decisions about mission will not be made solely based on financial considerations. While not generally desirable with a “normal” business, this feature can be very useful in certain types of social enterprises.

Using a Joint Venture for Social Enterprise

As noted above, a joint venture is a contractual arrangement whereby more than one person or entity will operate a venture. Joint ventures can take many legal forms and the form of cooperation between the joint venturers can vary widely as well. Nonprofit corporations, business corporations and LLC’s can all be used as vehicles for joint ventures, although the LLC is by far the most popular choice when liability protection is needed and the number of participants is small.

Nonprofit corporations, business corporations and LLC’s can all participate in joint ventures. So, for example, a charity and a for-profit company can form a joint venture using an LLC as the vehicle for the enterprise and use the operating agreement to specify the rights and obligations of each member. Each member is bound by the rules that govern its own existence, so the charity may not use the joint venture to confer an undue economic benefit on the for-profit coventurer, nor may the business corporation use the joint venture to do something that it could not do directly, but in most situations, this is not a problem.

The participants in a joint venture do not, of course, have to create a separate entity as the vehicle for a joint venture. Many joint ventures are created by agreement only, using such vehicles as grant agreements, financing agreements, management agreements, joint operating agreements, leases, licenses, corporate sponsorship agreements or contracts for services. What all these agreements have in common is a description of the activity that will be taken in concert, identification of the parties, and a delineation of the parties’ rights and obligations with respect to each other and to third parties. It is common for these agreements to contain representations and warranties and provisions that cover termination, amendment, indemnification, and provisions covering the legal and financial relationship between the parties.

The IRS has addressed the issue of charities engaging in joint ventures with for-profit entities, and the rules that govern the kinds of benefits that charities can confer on for-profit entities in the context of joint ventures. The basic rule is that the charity, in order to maintain its tax exempt status, must remain faithful to its charitable mission and must receive fair value for the use of its assets or resources in the joint venture. As to the first issue, faithfulness to mission, the IRS requires that the board of the charity review the transaction for fairness, and that the charity hold a majority interest in the joint venture so that it can veto any action that might be contrary to its mission. In 2004, the IRS ruled that a charity may participate in a joint venture even if it does not hold a majority interest, so long as the charity maintains “effective control over those aspects of the business that relate to its tax-exempt purposes” and “the joint venture does not represent a substantial part of the charity’s overall activity.” This ruling, while clearly a liberalization of the former rule, severely limits the ability of smaller charities to engage in joint ventures with for-profit businesses when the charity does not have majority ownership. As a practical

matter, the most obvious way to get around the rule is for the charity to create a for-profit subsidiary that participates in the joint venture, but the charity must still answer for the use of its assets. This is not only complicates legal compliance, but the IRS has never blessed it, so it may not be a viable approach and should only be used by those with a spirit of adventure and an appetite for risk.

Other Options Under Existing Law

Partnerships and limited partnerships can of course be used in the context of social enterprise. In fact, until the advent of the LLC in 1986, partnerships were the classic alternative to a corporation. They allow virtually unlimited flexibility in governance and management; profits and losses are allocated according to the capital contributions of each partner, but unlike LLC's, the total assets of each partner are at risk in the venture, not just the assets that have been put into the business. Limited partnerships changed this, by allowing for the creation of a special class of partners, known as "limited" partners, who provide capital but do not participate in the management of the business. In limited partnerships, the limited partners enjoy protection from liability, but the general partner (the one who manages the business) does not. Limited partnerships are still used as financing vehicles, and are most useful where investors are to have no role in management and a simple or flexible governance structure is needed.

Another option for social enterprise is the use of a charitable trust. A charitable trust is created by entrusting assets to one or more Trustees, who are bound to use the assets solely for charitable purposes. Technically, the trust is formed when the Trustee(s) accept custody of the assets, although in practice every charitable trust is created by a written instrument of trust which defines the charitable purposes of the trust and specifies the rights and powers of the Trustee(s). Charitable trusts are governed by the law of trusts rather than corporate law, and their defining characteristic is that the Trustee(s) are duty-bound to fulfill the wishes of the creator of the trust. This is the primary advantage of a trust: it allows the person who establishes it to set the basic terms and structure of the trust, and once set, the terms cannot be changed except by leave of court under very limited circumstances. In cases where a corporation wants to embed certain social purposes into its basic operating documents, it may wish to create a charitable trust to hold a special class of shares, to ensure that the purposes of the company cannot be changed without the acquiescence of the Trustee(s).

Another financing vehicle to be considered is the "program related investment" or "PRI". A PRI is used when a private foundation (which is a form of charity) wants to provide financial support to a venture to support its charitable purposes, but wants to provide that support in the form of a loan or investment rather than a grant. A private foundation may make a PRI to a nonprofit corporation, a business corporation, a LLC, a trust or even to an individual. A PRI can take the form of an equity investment, a loan (or a convertible loan), a guarantee, or virtually any other form of financial arrangement. The key is that the foundation must be making the investment as a way to further its charitable mission rather than for the purpose of making money. One of the great features of a PRI is that it counts towards the foundation's 5% minimum payout requirement, just as it would if it were a grant. But if the investment is successful, the foundation can recapture the full

amount of the investment, plus a reasonable rate of return, which it must then pay out again in the form of grants of more PRI's.

Conclusion

To a large extent, the field of social enterprise is still in its infancy, and while it appears to be growing rapidly, the economic success of this new sector on a significant scale is dependent on the continued existence of markets and customers who seek to align their own values with their purchasing behavior, and who see social enterprises as a way to accomplish this. The legal structure of any social enterprise should therefore be driven by the capital structure and business model it intends to pursue, rather than some abstract notion of how a social enterprise "should" be structured. There is in fact no single, correct way to structure a social enterprise from a legal point of view. Form must follow function.

[Note: This draft is subject to refinement and revision. Comments and suggestions are welcome. The author can be reached at allen@perlmanandperlman.com.]