Legal Considerations for Social Enterprises

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TOPICS TO BE COVERED

- What is a Social Enterprise?
- What is Impact Investing?
- Should My Startup be a For-Profit, Social Benefit, or Non-Profit?
- What are the Types of For-Profit, Benefit, and Non-Profits Social Enterprises?
- What is B Corp Certification?
- Additional Questions?
WHAT IS A SOCIAL ENTERPRISE?

A “social enterprise” is “a business that directly addresses a social need through its products and services.”

- Jerr Boschee, Adjunct Social Enterprise Alliance
REASONS FOR FOUNDING A SOCIAL ENTERPRISE

- Do something positive for
  - Society; and/or
  - Environment.

- Economic Benefit:
  - Customers.
  - Investors.

- Possible Funding Sources
  - Foundations.
  - Impact Investors.
SOCIAL AND ENVIRONMENTAL IMPACT INVESTMENTS

An investment intended to generate positive social and/or environmental impact and generate financial returns involving a diverse group of investors

- Public and Private Partners
- Institutions and Individual Investors
IMPACT INVESTING IN PITTSBURGH

PITTSBURGH FOUNDATIONS; “Programmatic Regional Investments” (PRIs)
Richard King Mellon Foundation Social Impact Investment Challenge

CIVIC-MINDED INVESTORS make socially and environmentally motivated investments to benefit the Pittsburgh Region
BNY Mellon Bank’s UpPrize

Racial and Gender Lens Investing
Black Tech Nation
https://blacktechnation.com/
Common Types of Social Enterprise Entities

For Profits (including C-corps and LLCs)

Social Benefit Entities (including Benefit Corporation & Benefit Company)

Non-Profits (including 501(c)(3) organizations)

Hybrid (Combination) Entities
WHAT ENTITY IS BEST FOR SOCIALLY RESPONSIBLE VENTURES?

- It Depends…
  - What Is My Purpose?
  - Source of Funding?
  - Management Control?
  - Tax Consequences?
  - Flexibility?
  - Administrative Burdens?
Advantages of For-Profit Entities

1. Require less explanation
   - Easy to raise money as equity or debt.
   - Can tap U.S. SBA grants, loans, and technical assistance.
   - Easy to sell or shut down (as long as you pay their creditors).
   - Extensive precedents on best practices.
   - Can convert to a nonprofit more easily than a nonprofit can convert to a for-profit.
   - Flexibility of Tax Treatment
Disadvantages of For-profit Legal Entities

- Branding/Public Perception (although For-Profit can achieve socially responsible branding through other means)
- Subject to tax.
- Strong fiduciary duty to act in the shareholders’ best interests by making money for them.
- It may be challenging to obtain foundation grants and non-taxable contributions.
- Any social bottom line is not built into the structure but is instead dependent on the leadership.
- Limited Flexibility for the Board in Case of Sale of the Company.
FOR-PROFIT ENTITY CHOICES

- Three “REAL” choices
  - C Corporation
  - S Corporation
  - Limited liability company

- Others
  - Sole Proprietorship
  - Partnerships
  - Limited Partnerships
### Form of For-Profit Entity Considerations

<table>
<thead>
<tr>
<th>Corporation*</th>
<th>Limited Liability Company</th>
<th>S Corporation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>No Double Tax</strong></td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td>Flow Through</td>
<td>✗</td>
<td>✓</td>
</tr>
<tr>
<td>VC Acceptable</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Limitation on Shareholders</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Medicare Tax Efficient</td>
<td>✓</td>
<td>✗</td>
</tr>
</tbody>
</table>

*Benefit Corporations are taxed as corporations, and Benefit LLCs are taxed as LLCs.*
Corporate Structure v. LLC Structure

- Shareholders
  - Corporation
    - Managed by Directors/Officers

- Members
  - Limited Liability Company
    - Managed by Managers or Members
CHANGING COURSE

LLC → C CORP

Wrong Way

Correct Way
STATE-CREATED
SOCIAL ENTERPRISE ENTITIES

- Purpose: “General Public Benefit” or a Specific One
- Adopted in 37 States (including Pennsylvania and Delaware).
  - Benefit Corporations (38 States, including PA and Delaware; 6 Pending)
  - Benefit LLCs (3 States, including PA)
  - Low Profit Limited Liability Companies (LC3) (8 States, 4 Pending)
  - Social Purpose Corporations (4 States)
- Taxation: May be Taxed as a C Corporation, S Corporation, LLC or Partnership
- Map of Different State Social Enterprise Entities
  - http://socentlawtracker.org/#!/map
BENEFIT CORPORATIONS

- For-profit entity that is “intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner”.
- Affirmative duties on directors to consider different stakeholders.
- Adopted in 38 States
- Taxation: May be Taxed as a C Corporation, Partnership or as an S Corporation.
BENEFIT LLCs

- Adopted in 6 States, so far: Pennsylvania, Delaware, Maryland, Utah, Kansas and Oregon (pending in Connecticut)
BENEFIT CORPORATION & BENEFIT LLC ADVANTAGES

- Great Marketing Tool
- Strong Commitment to Social Purpose
- Legal Protection for Directors
- Flexibility for the Board in Case of Sale of the Company
- Possible access to Impact Investors & Foundation Funding
BENEFIT CORPORATION & BENEFIT LLC DISADVANTAGES

- Traditional Investor Hesitancy / Raising Funds.
- Legal Uncertainty/Fewer Legal Precedents.
- Additional Reporting and Disclosure Requirements.
- No Tax Incentives.
- Control can be more diffuse
- Exit options may be more constrained than with for profit
EXAMPLE OF LOCAL FOR-PROFIT TURNED SOCIAL BENEFIT ENTITY: THREAD INTERNATIONAL

• Began as Pennsylvania For-Profit
• Switched to Delaware Benefit Corporation
• Why?
B CORP CERTIFICATION

- Third Party Certification, like LEED or Fair Trade certification
- Not a Legal Entity, although you must be a Benefit Corporation or Benefit LLC to get certified.

Requirements
- Purpose
- Amendment of Certificate of Incorporation
- Annual Reporting Requirements
- Other Burdens
B CORP CERTIFICATION

- Advantages
  - Commitment to Social Purpose
  - Access to Community of Other B Corps
  - Marketing Tool for Consumers
  - Does Not Intimidate Investors

- Disadvantages
  - No Tax Incentives
  - Costly and time-consuming certification process
  - Stringent Annual Reporting Requirements

- You can now complete a Benefit Report for Free, but you need to pay for certification (Approximately 5,000 have completed report v. 2,500 who have paid for B Corps Certification)
What Is a Non-Profit Organization?

- An organization formed under a state’s nonprofit corporation statute
- To qualify for tax-exempt status, must have a charitable, educational, or scientific purpose (IRS application required)
NONPROFIT CORPORATION ADVANTAGES

- Liability protection
- No conflict between the venture and the social objectives
- Tax-exempt status
  - Exemption from federal income tax
    - May be prerequisite for state tax benefits
    - 501(c)(3) status – tax-deductible contributions
  - Can accept grants directly from foundations
  - Individuals receive a tax deduction for Contributions to non-profit
NONPROFIT CORPORATION
DISADVANTAGES

- A Non-profit is “owned” by the public, so there are no investors, and the only exit is to transfer the assets to another non-profit
- Sharing control and governance - Control is with board of directors, not the founder – “founder’s syndrome” is when founder thinks he is in control of non-profit
- Usually dependent on traditional charitable fundraising
  - Grants are difficult to get and involve complicated applications and agreements
  - Charitable events are labor intensive and often lose money
- Limitations on compensation and distributions
- Public scrutiny and Attorney General oversight
- Less confidentiality
- Restrictions associated with tax-exempt status (including taxation and limitations on unrelated business income)
- Complex legal rules, both state and federal
FOR-PROFIT/NON-PROFIT HYBRID ENTITIES

- Governance structures and/or contracts that bind a for-profit and nonprofit together in a hybrid structure.
- Advantage is that the nonprofit and the for-profit entities each retain the advantages that are unique to those legal structures.
- Disadvantage: They are complicated! Make sure you have a lawyer who understands all the restrictions!
QUESTIONS?

Thank you!