Alternative Structures for "Social Businesses"

Jennifer Kassan

Increasing numbers of entrepreneurs are interested in starting "triple-bottom line" businesses. In other words, while they want to make a reasonable return on their investment, they are also interested in ensuring that their businesses return benefits to their communities and the environment. Nobel Peace Prize winner Mohammed Yunus has termed these kinds of enterprises "social businesses" in his recent book *Creating a World without Poverty - Social Business and the Future of Capitalism*.

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While many social businesses are structured as LLCs, C Corporations, and S Corporations, there are alternatives to these basic structures that were explicitly designed for social businesses and may allow entrepreneurs to better protect the social missions of their businesses.

The purpose of this article is not to discuss the risks and benefits of such alternative structures in depth, but to provide a starting and discussion point for those businesses that are interested in alternative structuring. To that end, I identify and generally discuss three types of entities to consider when structuring a social business: the L3C, the B Corporation, and Cooperatives.

The L3C

The L3C is short for "Low Profit Limited Liability Company." The first L3C statute was enacted in Vermont in 2008 and was developed in response to a very specific concern related to the Internal Revenue Code's provisions governing foundations—i.e., the making of Program Related Investments (PRIs). Their history is as follows:

Foundations are required to distribute 5% of the value of their net assets for charitable purposes each year. To meet this requirement, foundations primarily make grants to charitable organizations (organizations exempt from taxation under Section 501(c)(3) of the Internal Revenue Code). However, foundations are also permitted under the IRC to invest the required 5% of net assets in for-profit entities that meet a three-pronged test:

1. The entity must be formed primarily for charitable or educational purposes;
2. No significant purpose of the entity is the production of income or the appreciation of property; and
3. No purpose of the entity is to conduct legislative or political activities.

Internal Revenue Code (I.R.C.) § 4944(c) and Treas. Reg. § 53.4944–3. The 5% investment (called a Program-Related Investment or PRI) may produce significant income or capital appreciation so long as the production of income or the appreciation of property was not a significant purpose.

The option of making a PRI is very attractive for foundations in that, unlike grants, PRIs can produce significant returns. Nonetheless, PRIs remain relatively uncommon because foundations are unwilling to risk the uncertainty of having the IRS determine that a PRI it makes does not in fact meet the statutory requirements. Foundations that decide to make PRIs often feel compelled to seek costly Private Letter Rulings to prevent this risk. According to the Foundation Center, of the many thousands of grant-making foundations in the United States, only a few hundred make PRIs.

In response to this unfortunate reality, a group of advocates for socially responsible business called Americans for Community Development wrote model legislation to create a new entity designed to meet the requirements for a PRI. As noted above, Vermont was the first state to adopt this legislation; however, such legislation has now been adopted in several more states.

The Vermont legislation created a new entity called an L3C that is identical to a Vermont LLC except that it is "organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:

(A) The company:

(i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of

Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and

(ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person 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.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D)."

Vt. Stat. Ann. tit. 11, § 3001(23).

It is hoped that foundations will make PRIs in L3Cs because they are specifically designed to meet the requirements for a PRI under the Internal Revenue Code. Legislation pending in Congress would explicitly allow foundations to make PRIs in L3Cs.

B Corporations

Another option available to socially responsible startups is the "B Corporation" model. B Corporations are not statutory entities, but rather model businesses that operators can choose to apply when drafting their startup documents. The model was created by a nonprofit organization called B Lab. To become a B Corporation, an entity incorporates the following language into its articles of incorporation:

> In discharging his or her duties, and in determining what is in the best interests of the Company and its shareholders, a Director shall consider such factors as the Director deems relevant, including, but not limited to, the long-term prospects and interests of the Company and its shareholders, and the social, economic, legal, or other effects of any action on the current and retired employees, the suppliers and customers of the Company or its subsidiaries, and the communities and society in which the Company or its subsidiaries operate, (collectively, with the shareholders, the ***"Stakeholders"***), together with the short-term, as well as long-term, interests of its shareholders and the effect of the Company's operations (and its subsidiaries' operations) on the environment and the economy of the state, the region and the nation.
>
> Nothing in this Article express or implied, is intended to create or shall create or grant any right in or for any person or any cause of action by or for any person.
>
> Notwithstanding the foregoing, any Director is entitled to rely upon the definition of "best interests" as set forth above in enforcing his or her rights hereunder and under state law, and such reliance shall not, absent another breach, be construed as a breach of a Director's fiduciary duty of care, even in the context of a Change in Control Transaction where, as a result of weighing other Stakeholders' interests, a Director determines to accept an offer, between two competing offers, with a lower price per share.

The B Corporation website provides information on the advisability of forming a B Corporation in each state. B Corporations formed in California are not recommended because, according to the website, California "is among 20 states that do NOT currently have corporate statutes that explicitly allow directors to consider the interests of stakeholders." California Assembly Bill 2944, which would have explicitly authorized directors to consider stakeholder interests, passed both the California Senate and Assembly but was vetoed by Governor Schwarzenegger on September 28, 2008. For these reasons, it is also not recommended to operate a B Corporation in California even if formed in another state.[1] However, entrepreneurs that want to form B Corporations can do so safely in 30 states according to the B Corporation website.

Companies that want to identify themselves as B Corporations and use the B Corporation logo must, in addition to adding the language above to their formation documents, meet social responsibility and environmental sustainability criteria, and pay an annual licensing fee.

Cooperatives

Entrepreneurs who want to provide voting rights to stakeholders—such as employers and/or customers—may want to consider forming a cooperative. Cooperative statues vary widely state by state, allowing startups to choose the statute that best meets their needs. Cooperatives, if they meet certain requirements

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a former employee from engaging in his or her profession, trade, or business unless the agreement falls within one of the exceptions to the rule." *Edwards*, 44 Cal. 4th at 946-947. In doing so, the Court provided a bright-line rule, expressly rejecting the federal "narrow restraint exception" used by some courts to construe Cal. Bus. & Prof. Code § 16600 as permitting non-competition agreements where one is barred from pursuing only a small or limited part of a business, trade, or profession.

Notably, in the Court's decision, there is negative treatment of the Ninth Circuit's decision in *General Commercial Packaging, Inc. v. TPS Package Engineering, Inc.*, 126 F.3d 1131 (9th Cir. 1997), which was cited by the *Comedy Club* court in its analysis. The Court noted that *General Commercial Packaging, Inc.* is one of the cases that follows the Ninth Circuit narrow restraint exception and goes on to state that "no reported California state court decision has endorsed the Ninth Circuit's reasoning, and we are of the view that California courts have been clear in their expression that section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat." *Edwards*, 44 Cal. 4th at 949-950.

D. Lessons From the Case

Notwithstanding the lack of precise clarity in California law concerning non-competition covenants in the franchise setting, franchisors should review their franchise agreements, employment agreements, and operating manuals to ensure that they at least comport with the minimum requirements of California law. Apart from copyright, patent, trademark, and potential contract remedies, another avenue to help franchisors protect their intellectual property assets from unlawful in-term and post-term competition by franchisees is California's Uniform Trade Secrets Act, Civ. Code § 3426, *et seq.* ("CUTSA"). Franchisors should ensure that they have adequate trade secret protections in place so that they can attempt to avail themselves of CUTSA remedies. The following lessons may be gleaned from *Comedy Club* by counsel for franchisors:

1. In-term covenants not to compete may be enforceable in the franchise context in California "to protect trademarks, trade names, and goodwill of a licensor" if they are narrowly tailored and do not foreclose a party from engaging in its business or trade in a substantial section of the market—the geographic scope should be the territory where the company or companies are doing business during the agreement. Franchisors' counsel should review their client's agreements to ensure that they comport with the court's decision and bear in mind that a California court may find that the covenant still violates Cal. Bus. & Prof. Code § 16600 in light of the *Edwards* decision.

2. Businesses should use caution before utilizing any covenants not to compete in California and should assess whether the restriction on competition can be tied to one of the statutory exceptions to Cal. Bus. & Prof. Code § 16600. Businesses cannot assume that Cal. Bus. & Prof. Code § 16600 does not have potential applicability to in-term covenants not to compete. Further, existing California authority holds that post-term covenants not to compete in franchise agreements are void and unenforceable. *See Scott v. Snelling*, 732 F.Supp. 1034, 1040-41 (N.D. Cal. 1990).

3. Franchisors should not include overly broad definitions of "affiliates" in their franchise agreements in California. Courts will not enforce overly broad covenants that restrict non-party relatives from engaging in a lawful business because such covenants violate Cal. Bus. & Prof. Code § 16600.

4. The court's decision may be seen by some franchisees/licensees/employees as allowing greater mobility, even where proprietary information is taken. Franchisors should consider auditing their intellectual property protections, including trade secret protections, to protect against this risk and ensure that their intellectual capital is adequately protected. Such an audit will assist franchisors to protect their trade secrets from unlawful competition under the CUTSA. ■

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regarding the payment of patronage dividends to their members, have a tax advantage over C Corporations under Subchapter T of the Internal Revenue Code. Dividends paid to the patrons of the cooperative (such as employees or customers) in proportion to the amount of their patronage are not subject to the double tax.

Wisconsin's relatively new cooperative statute is particularly interesting. The statute is a "hybrid" cooperative statute that includes many features from the limited liability company model. This new model was created in response to the fact that under the traditional cooperative statute (including the California cooperative statute), it is virtually impossible to attract outside investment from non-patrons due to severe limits on voting rights for such investors.

Wisconsin's Chapter 193 authorizes the creation of membership interests for investors who are not patrons of the cooperative. Such investor-members' voting rights may not exceed a total of 49%, but the bylaws may provide such members with the power to veto certain unusual decisions such as merger or dissolution. And, the investors' may not receive more than 70% of the profit allocations and distributions of the cooperative.

A cooperative formed under Chapter 193 may elect to be taxed as a partnership under Subchapter K of the Internal Revenue Code or as a cooperative under Subchapter T.

Proposed Legislation

In addition to the three models described above, there is proposed and pending legislation in several states to provide even more alternatives for social businesses. For example, a group of California attorneys and advocates for socially responsible business is drafting legislation to create a new corporate form that would include provisions in the articles of incorporation that explicitly identify one or more social or environmental purposes of the corporation. A group called Citizens for Corporate Redesign in Minnesota has introduced a bill to create a new corporate form called Socially Responsible (SR) Corporation (see the proposed legislation at https://www.revisor.leg.state.mn.us/bin/bldbill.php?bill=S0510.0.html&session=ls86).

Conclusion

Recent events have caused many to question whether business entities should be required to behave more responsibly. For entrepreneurs who want to clearly demonstrate their commitment to socially responsible behavior and practices, there are several structuring options from which to choose. ■

Endnote

1 However, California LLCs may incorporate B Corporation language into their operating agreements.