February 20, 2018

LEGAL STRUCTURES FOR SOCIAL ENTREPRENEURS

BIG IDEAS

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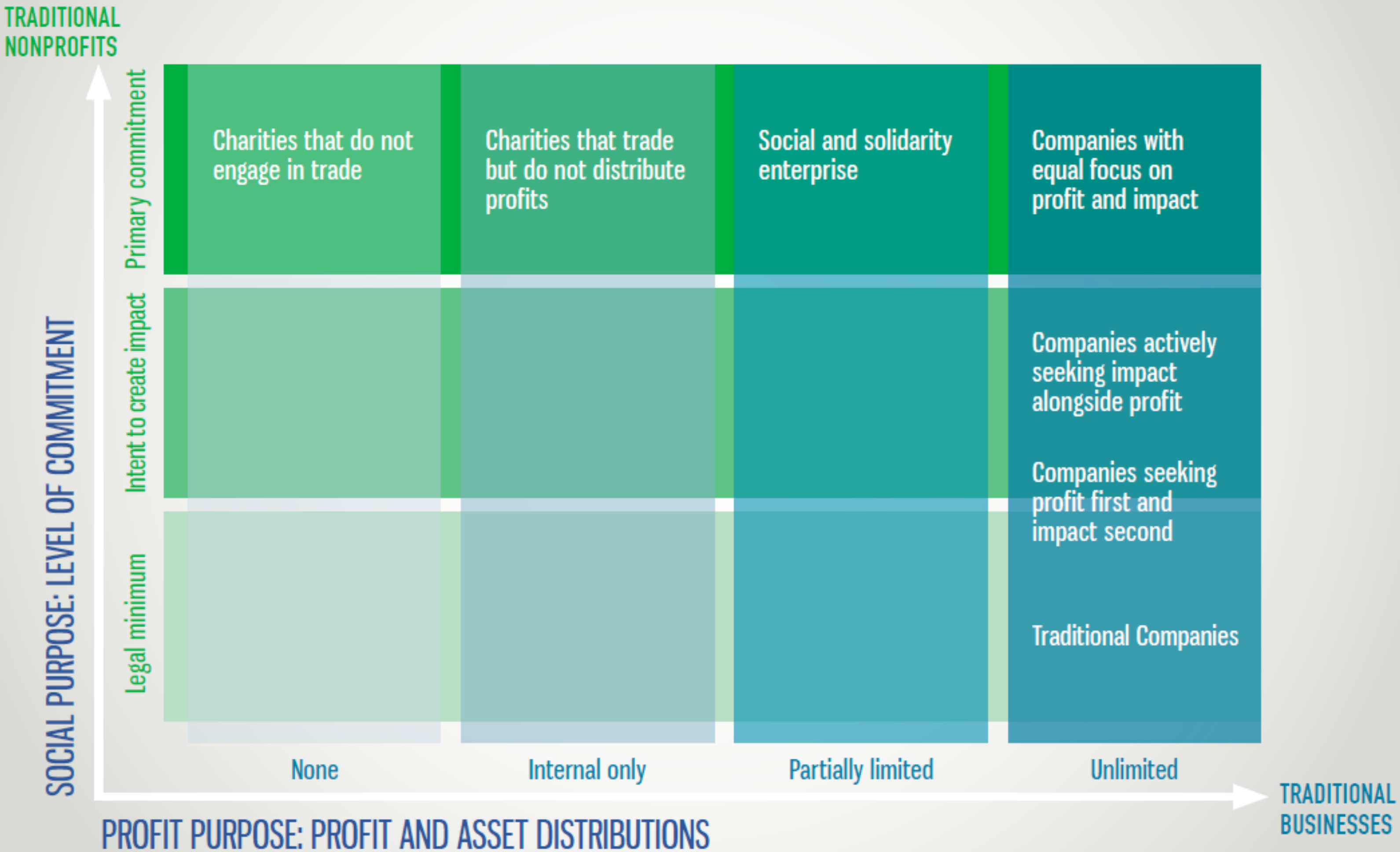
How do non-profits and for-profits differ?

Combining Social Impact + Profitable Business



Special thanks to Jonathan Ng, Global Legal Director of Ashoka: Innovators for the Public.

What is a non-profit?

Non-Profit: Charitable Organizations

- Typically incorporated in the state where they are located
- In CA, three types:
  - **Public benefit corporation**
  - Mutual benefit corporation
  - Religious corporation
- Charitable or public purpose
- Incorporation process:
  - File Articles of Incorporation with Secretary of State
  - Charitable or public purpose
  - Appoint Board of Directors (independence requirements – 51% non-interested)
  - Board adopts Bylaws and appoints Officers
- Tax exemption: federal and state filings

Non-Profit: 501(c)(3)

- Federal tax exemption: 501(c)(3)
- Why? Donations to 501(c)(3)s are generally tax deductible.
- **Exempt purpose**: religious, charitable, scientific, testing for public safety, literary, education, fostering national and international sports competition, or the prevention of cruelty to children or animals
- Apply to IRS – file form 1023 or 1023-EZ and wait for determination letter
  - 1023-EZ: ~3-12 weeks
  - 1023: ~3-12 months
- Exemption is retroactive to date of incorporation (if filed within 18 months)
- Two types: Public charity v. Private foundation
  - Public charity must meet public support test

Non-Profit: Charity

- Public Charity
  - Most common for operating organizations (e.g., American Cancer Society, World Wildlife Federation)
  - **No private inurement**
    - Must ensure that earnings do not inure to the benefit of any private shareholder or individual (loss of exemption; excise taxes)
    - No stock/stock options (public assets)
  - **No private benefit**
    - Not operate for the benefit of private interests such as those of its founder, the founder's family or other controlling parties
  - **Operated for exempt purpose**
    - Not operate for the primary purpose of conducting a trade or business that is not related to its exempt purpose
  - **No lobbying**
    - Refrain from participating in political campaigns and restrict lobbying activities to an insubstantial part of total activities

Non-Profit Forms: Two basic types

- Private Foundation
- Often associated with a family or corporation (Gates Foundation, Google.org)
- Generally grant-making organizations
- All requirements of public charity
  - No private inurement
  - No private benefit
  - Exempt purpose
- No self-dealing between private foundations and their substantial contributors or other disqualified persons (people who give the money or are involved in senior management)
- Requirements that the foundation annually distribute income for charitable purposes

What are the common for-profit structures?

For-Profit Forms: LLC

- Limited Liability Company (LLC) is a very flexible entity
- Governed by contract law (rather than statutory/corporate law)
- Governing document: Operating Agreement
  - Specifies how the LLC will be governed, the financial obligations of the members and how profits, losses and distributions are shared
  - Either Member-managed or Manager/Board-managed
    - No requirement for a Board of Directors (unlike corporations)
  - Custom-tailored to suit the needs of the members
- Formation: Certificate of Formation (DE) or Articles of Organization (CA)
- **Pass-through taxation**: profits/losses taxed at member level; no separate entity tax
  - **LLC is not suitable for VC investments because of tax restrictions on the funds' partners**
- Some states permit adjusting fiduciary duties, which would allow pursuit of mission over pursuit of profit
- Relatively easy to convert from LLC to corporation

For-Profit Forms: L3C

- Low-Profit Limited Liability Company (L3C) is a statutory variant of the LLC, currently adopted in 9 states
  - Designed to assist for-profit companies that have a primarily charitable purpose
    - Members agree that the purpose of the organization is social or charitable, not maximizing income
  - Created with hope that this structure would spur L3Cs to obtain program-related investments (**PRIs**) from foundations
    - PRIs must have primary purpose to accomplish the foundation's exempt purpose and production of income cannot be a significant purpose of the investment
    - Generally very fact-intensive inquiries; foundations have typically been reluctant to use PRIs, though this is changing slowly
  - Still have all of the issues of the LLC from an investment perspective
  - You can arguably create this same structure with a traditional LLC

For-Profit Forms: Corporation

- **Corporations** - less flexible than LLCs; governed by statutory law
  - Corporations are governed by a Board of Directors
  - Governing documents: Certificate of Incorporation (DE); Articles of Incorporation (CA) + Bylaws
  - Tax: Corporations are separate taxable entities; franchise taxes (state) and corporate income taxes (state and federal)
- Fiduciary Duties: Board must act in the **best interests of the stockholders**
  - Corporations have significant leeway to pursue social/environmental goals as long as rationale is the long-term benefit of stockholders
  - In a sale, the short-term pay-out to stockholders controls, so board must take the highest offer on the table

For-Profit Forms: Benefit Corporation

- **Benefit Corporations** – New form of corporation; adopted in 30+ states (though with *significant variations* among state laws)
- Arose to accommodate social enterprises that pursue a dual purpose: public benefit + profit
- **Corporate purpose:** to create a general public benefit
  - Optional specific public benefit purpose (e.g. providing low-income or underserved with beneficial products or services, promoting economic opportunity, improving human health, protecting or restoring the environment)
- **Fiduciary Duties**: Requires directors to consider a broad range of non-stockholder interests (employees, customers, local and global environment, community and societal factors, etc)
- **Transparency and Accountability**:
  - Many states require a "benefit director" accountable solely to the public benefit
  - Required annual benefit report using an independent third-party assessment
  - Benefit enforcement proceeding: Special lawsuit to enforce public benefit purpose
- Benefit corporations ≠ "B Corps"

Benefit Corp. v. Traditional Corp.

	Traditional Corporation	Benefit Corporation
Purpose	The purpose of the corporation is to create value for its stockholders.	In addition to stockholder value, benefit corporations must commit to producing a general public benefit and to operate in a responsible and sustainable manner.
Governance	Directors have a fiduciary duty to manage the corporation in the best interests of the stockholders.	Directors must consider the interests of chosen constituencies other than shareholders that are affected by the company's conduct (e.g. employees, local community, the environment).
Transparency	Shareholders have limited rights to inspect the corporation's books and records.	The corporation must report on its overall social and environmental performance to shareholders, and in some jurisdictions, to the public.
Accountability	Stockholders can sue for breach of fiduciary duties, generally for failure to maximize economic return for shareholders.	In addition to standard shareholder rights, shareholders can sue to enforce the company's public benefit mission. In some states, stakeholders affected by the corporation's conduct can also sue to enforce the corporation's public benefit mission.

For-Profit Forms: PBC/SPC

- **Public Benefit Corp. (DE) & Social Purpose Corp. (CA)**
  - PBC is a for-profit corporation intended to produce a public benefit and operate in a responsible and sustainable manner
  - **Corporate Purpose**:
    - Requires a specific public benefit/social or charitable purpose (clearly stated in charter) in addition to the other purposes of the corporation
  - **Fiduciary Duties**:
    - Requires boards and management to consider environmental and social factors in addition to shareholder value and protects them from related shareholder liability
      - PBC: Board must balance the public benefit purpose, the interests of the stockholders and the interests of those materially affected by the corporation's conduct.
    - No "benefit" director
  - **Transparency/Accountability**:
    - Benefit report has no third-party standard requirement
      - PBC: biannual report to shareholders
      - SPC: annual report made public
    - No "benefit enforcement proceeding"

For-Profit Social Enterprise Forms

LLC & L3C → Benefit Corp. → PBC & SPC → C Corp.

- **Challenges & Opportunities**
  - These forms are still new!
    - First benefit corporation legislation adopted 2010; DE PBC in 2013
    - Many CEOs report having to explain these to investors
  - Lack of guidance
    - No case law on benefit corporations, PBCs or SPCs
    - Little guidance from authorities on how conflicting fiduciary duties should be handled
  - Confusion over nomenclature
    - “B Corps” is often used as a catch-all, but each of these have distinct legal differences
  - State law variations
    - Some state benefit corp. legislation does not fit within broader corporate codes
    - CA has a benefit corporation and the SPC
  - Lack of compliance?
    - Many companies may not be strictly adhering to the benefit reporting requirements in the statutes

What is a hybrid/tandem structure?

Hybrid/Tandem Corporate Structures

- A close relationship – via equity ownership, funding, or contract – between a non-profit and for-profit entity
- Five general types
  - For-profit with contractual relationship with non-profit
  - Non-profit as minority investor in for-profit
  - For-profit as wholly owned subsidiary of non-profit
  - Non-profit with for-profit as sole member
  - Non-profit investment in for-profit impact fund

Why choose a hybrid/tandem structure?

Hybrid/Tandem Corporate Structures

- Substantial flexibility in the types of activities that can be engaged in out of the various entities.
- Ability to raise both investment and philanthropic capital.
- Credibility in impact circles by including nonprofit arm to engage in charitable activities.
- Cost-shifting strategies related to nonprofit research that benefits the for-profit's activities. [*Note that the nonprofit's research products should be made public to avoid a private inurement issue*.]

But it's not all positive…

Hybrid/Tandem Corporate Structures

- Management of the two entities is complicated, costly and time-consuming (largely because of the private inurement issue), and includes:
  - Tracking/documenting the flow of funds, assets (including IP), services and resources between the non-profit and the for-profit
  - Monitoring Unrelated Business Income Tax ("UBIT")
  - Ensuring that the for-profit always pays at least market rates to the non-profit
  - Appointing disinterested directors on the governing bodies of both the nonprofit and for-profit.
- The non-profit and for-profit must have clearly separate functions and must avoid offering competing goods and/or services.

Legal Issues Surrounding Hybrid/Tandem Structures

Hybrid/Tandem Corporate Structures

- In each of these models, the non-profit, for-profit and investors must consider the following:
  - Both entities must **track and document** the flow of funds, the flow of services and resources and the flow of IP between the non-profit and the for-profit.
    - One entity can make loans to the other; the interest on loans may be unrelated business taxable income ("UBTI") to the non-profit.
    - Alternatives include dividends on the equity held by the non-profit in a profit subsidiary and royalties on license agreements.
  - Documentation takes the form of **intercompany agreements** including an IP license agreement, services agreement and/or resource sharing agreement.
  - Both entities must have **separate functions** and avoid offering competing goods/services.

Hybrid/Tandem Corporate Structures

- The documentation must ensure that the for-profit always pays at least **fair value or market rates** (for funding, services/resources and IP).

- There also must be **good governance**, specifically disinterested or independent directors on the boards of both the non-profit and for-profit.

- Management is required to **report** on the flow of funds, services and IP to the special committee on a quarterly basis; amendments to the intercompany agreements are usually required as the hybrid evolves over time.

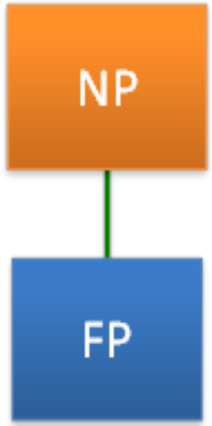
Contract-Based Relationship

- A frequently used hybrid corporate structure involves a specific contractual relationship between a nonprofit entity and a for-profit entity.
- Among other items, the two entities may contract for the provision of specific services or products, the sharing of resources, or use of IP, at fair value or market rates .
- Key aspects defining the relationship:
  - **No ownership of equity** in for-profit by the nonprofit.
  - Often **no overlapping board** members.

Non-Profit Forms Wholly Owned For-Profit Subsidiary

This form of hybrid/tandem structure occurs where a for-profit entity is held as a wholly owned subsidiary by a nonprofit entity (usually a 501(c)(3) charity).

- Several key advantages including the relative ease of structuring and clear corporate governance – mission alignment through oversight by the nonprofit.
- Key structural, strategic and corporate governance best practices include:



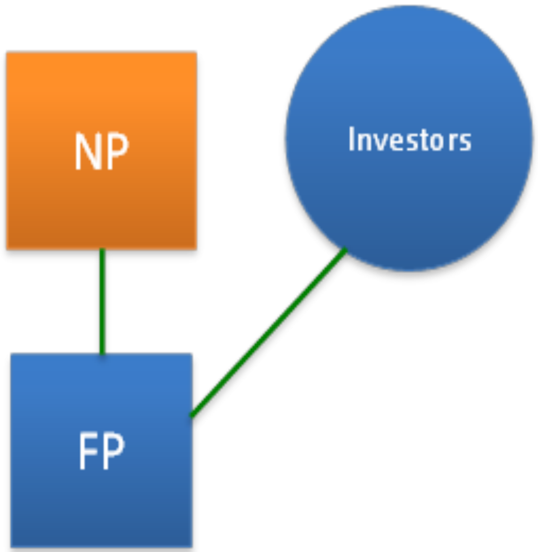
  - The entities **should not be in competition** with one another.
  - Must carefully consider potential **employment**, **UBTI** and **compensation** issues.
  - All flow of funds, services/resources and IP is **documented**.
  - **Independent/disinterested directors** to evaluate potential self-dealing and conflicts of interest.

Non-Profit as Minority Investor in For-Profit

Involves a non-profit with a minority ownership stake (for private foundations, typically 20% or less) in a for-profit. May be structured as a PRI.

Non-profit minority ownership implicates several challenges:

- **Greater difficulty to ensure alignment** with the non-profit's mission.
- **Potential conflicts** between the non-profit and for-profit investors, and careful management of **UBTI issues**.
- **Redemption rights** for a non-profit investor with a PRI can dampen enthusiasm of mainstream investors.
- **Impact on exit opportunities** for the for-profit investors.
- Increased **importance of independence**.



For-Profit Establishment of a Non-Profit

A for-profit entity may establish a non-profit entity (structured often as a 501(c)(3) private foundation). Although the for-profit cannot formally own the non-profit, it can maintain control through funding and governance of the entity.

- Typically **favored by large corporations** rather than mission-driven social enterprises.
- Key corporate governance best practices:
  - Maintenance of **corporate governance independence** – board member overlap should be kept to a minimum.
  - Issues raised by **resource and employee sharing**.
  - Awareness of potential **private benefit issues**.

Additional Legal and Practical Issues

- Maintaining tax-exempt status of non-profit
- Unrelated business income tax
- Exposure to/insulation from liability
- Governance and control
- Protection against mission drift
- Funding and sustainability
- Double taxation vs. pass-through entity
- Branding/credibility of the charity

Additional Resources

- MoFo Impact Twitter: **@MoFoImpact**
- MoFo Impact Blog: **http://impact.mofo.com**
- MoFo Impact Resource Center: **http://www.mofo.com/impact**
- Cooley: **www.cooleygo.com**

~ The End ~