2010

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Recommended Citation
85 Chicago-Kent Law Review 619 (2010)

GOVERNING AND FINANCING BLENDED ENTERPRISE

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The image of nonprofit and for-profit as dual and exclusive categories is misleadingly simple. This blurring of the boundary between for-profit and nonprofit has gone on for years and appears only to be gaining steam. Yet, traditionally, the law has put organizations to a choice of either the nonprofit or for-profit form of governance. In the first decade of this century, organizational law is beginning to catch up with the boundary-blurring trend. Legislatures are creating new forms for blended enterprise, including several U.S. states' low-profit limited liability company (the "L3C") and the community interest company (the "CIC") in England and Wales. Along with these more formal efforts, at least one self-regulatory scheme provides a framework to fashion a blended form (the "B Corporation") under traditional state for-profit corporation law. This article will describe and compare these forms and evaluate whether they can enhance the governance and finance of blended enterprise.

Part I will detail these three new hybrid forms of organization. Each hybrid form draws on features found in existing organizational frameworks, adding on organizational innovations. In addition, to understand how hybrid forms seek to house truly blended enterprises, one must appreciate their tax treatment, governance structures, and financing strategies. With the qualities of these three hybrid forms fully explained, Part II offers a comparison and critique. In order to articulate the benefits hybrid forms attempt to secure, this Part will first explore how hybrid forms differ from traditional nonprofit or for-profit forms of organization. This exploration isolates two goals for hybrid forms; they must expand the financing available to blended enterprises and also offer credible commitments to enforce such enterprises' dual missions. Finally, this Part will compare how each of

* Professor of Law, Brooklyn Law School. I greatly appreciate the support of Brooklyn Law School's summer research stipend program, the extraordinary research assistance of Sparkle Alexander, and the comments and suggestions of Miriam Baer, Evelyn Brody, John Colombo, Arthur Pinto, and John Tyler. I also benefitted greatly from exposure to other papers and commentary presented at the Symposium on The Law of Philanthropy in the Twenty-First Century, of which this article is a part, and at the symposium "In Berle's Footsteps" at Seattle University, where it was also presented. I thank Chicago-Kent College of Law, the American College of Trusts and Estates Counsel, and the Berle Center on Corporations, Law and Society for their sponsorship of those events. Any remaining errors are, of course, my own.

the hybrid forms accomplishes these important goals. Part III concludes with the unsettling finding that these vital goals often appear to trade off against each other.

I. NEW HYBRID FORMS OF ORGANIZATION

Hybrid forms vary widely in their provenance and characteristics. Legislation here and abroad has spawned some of them; others are creatures of self-regulation. Although they are certainly novel, none of these hybrid forms have invented their features entirely of whole cloth. Rather, the creators of each form selected an existing form of organization as a core framework and then engrafted special hybrid features onto that basic form. These borrowed frameworks run the gamut. This Part describes the components of three quite different, currently available hybrid forms: the L3C, the CIC, and the B corporation. In doing so, it focuses particularly on how the forms variously address governance, financing, and taxation to create a blended nonprofit/for-profit form.

A. Low-Profit Limited Liability Companies

Vermont was the first U.S. state to permit entities to form as low-profit limited liability companies, adopting legislation creating the form in April 2008.[1] Since then, Michigan, Utah, Wyoming, the Crow and Oglala nations, and Illinois have followed Vermont's lead, enacting L3C legislation of their own.[2] North Dakota and Maine have committed by legislation to studying this new form.[3] Individuals and lawmakers in yet other states are engaged in more informal discussions about the L3C option.[4] As entities can form in any state to do business throughout the United States, the L3C has quickly become a widely available choice of form. As a form of organization only in its infancy, much remains to be learned about how it

1. Americans for Community Development, L3C Legislative Watch, http://www.americansforcommunitydevelopment.org/legislativewatch.html (last visited Jan. 29, 2010) [hereinafter L3C Legislative Watch]; Vermont Secretary of State, Starting an LLC: Low-Profit Limited Liability Company, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Jan. 3, 2010).

2. *See* Ann Meyer, *Firms With Social Bent See Payoff In New Law*, CHI. TRIB., Aug. 10, 2009, at 19 (noting Illinois' enactment of L3C legislation); Nicole Wallace, *Tough Economy Offers New Opportunities for Charity-Run Businesses*, CHRONICLE OF PHILANTHROPY, May 7, 2009, at 33 (describing Michigan, Wyoming, Utah, and the Crow nation's adoption of legislation recognizing the L3C); L3C Legislative Watch, *supra* note 1.

3. *See* North Dakota H.B. 1545, 61st Leg. Assem. (N.D. 2009), *available at* http://www.legis.nd.gov/assembly/61-2009/bill-text/JBQG0100.pdf (last visited Mar. 8, 2010); Maine H. Paper 884, 124th Leg., 1st Reg. Sess. (Me. 2009), *available at* http://www.mainelegislature.org/legis/bills/bills_124th/billtexts/HP088401.asp (last visited Mar. 8, 2010).

4. *Id.*

will function in practice. This subpart uses the existing L3C law and some other materials produced by the form's promoters to (1) outline its basic approach to issues of taxation and (2) to discuss one option for L3C governance and financing.

The L3C takes the limited liability company form as its base, retains much of the LLC's inherently flexible nature, and adds features that hybridize nonprofit and for-profit elements.[5] Each adopting jurisdiction has thus far followed a similar pattern, which engrafts the L3C option onto an existing LLC statute.[6] The L3C enactments add language defining an L3C as organized for business purposes and operated to satisfy four core requirements.[7] An L3C must "significantly further the accomplishment of one or more charitable or educational purposes" under the federal tax code.[8] The enabling legislation typically also issues a kind of negative command, requiring that a company "would not have been formed but for the company's relationship to the accomplishment of" those purposes.[9] Next, the statutes require that neither income production nor property appreciation may be a significant purpose of an L3C, and some require this to be stated in the L3C's formative documents.[10] Yet the enactments generally clarify that producing "significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence" of such a prohibited purpose.[11] Finally, each statute specifically disallows L3Cs from pursuing purposes that would disqualify an entity from exemption under I.R.C. § 501(c)(3)'s limitations on lobbying and political campaign activity.[12]

5. *See, e.g.*, Vermont Secretary of State, Starting an LLC: Low-Profit Limited Liability Company, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Jan. 3, 2010).

6. Illinois, Michigan, Utah, and Wyoming have all amended their Limited Liability Company Acts. *See* 805 ILL. COMP. STAT. 180/1-26 (2009); MICH. COMP. LAWS § 450.4102 (2009); UTAH CODE ANN. § 48-2c-412 (2009); WYO. STAT. ANN. § 17-15-102(a)(ix) (2009).

7. 805 ILL. COMP. STAT. 180/1-26; MICH. COMP. LAWS § 450.4102; UTAH CODE ANN. § 48-2c-412; VT. STAT. ANN. tit. 11, § 3001(27) (2008); WYO. STAT. ANN. § 17-15-102(a)(ix).

8. VT. STAT. ANN. tit. 11, § 3001(27)(A)(i); *see also* 805 ILL. COMP. STAT. 180/1-26(a); MICH. COMP. LAWS § 450.4102(m)(i); UTAH CODE ANN. § 48-2c-412(1)(b)(i); WYO. STAT. ANN. § 17-15-102(a)(ix)(A).

9. VT. STAT. ANN. tit. 11, § 3001(27)(A)(ii); *see also* 805 ILL. COMP. STAT. 180/1-26(a); MICH. COMP. LAWS § 450.4102(m)(i); UTAH CODE ANN. § 48-2c-412(1)(b)(ii); WYO. STAT. ANN. § 17-15-102(a)(ix)(A).

10. VT. STAT. ANN. tit. 11, § 3001(27)(B); *see also* 805 ILL. COMP. STAT. 180/1-26(b)(1); MICH. COMP. LAWS § 450.4102(m)(ii); UTAH CODE ANN. § 48-2c-412(1)(b)(iii); WYO. STAT. ANN. § 17-15-102(a)(ix)(B).

11. VT. STAT. ANN. tit. 11, § 3001(27)(B); *see also* 805 ILL. COMP. STAT. 180/1-26(b)(1); MICH. COMP. LAWS § 450.4102(m)(ii); WYO. STAT. ANN. § 17-15-102(a)(ix)(B); *but see also* UTAH CODE ANN. § 48-2c-412(3).

12. VT. STAT. ANN. tit. 11, § 3001(27)(C); *see also* 805 ILL. COMP. STAT. 180/1-26(b)(2); MICH. COMP. LAWS § 450.4102(m)(iii); UTAH CODE ANN. § 48-2c-412(1)(b)(iv); WYO. STAT. ANN. § 17-15-102(a)(ix)(C).

This homogeneity among the various state enactments is, in large part, due to the genesis of the L3C's contours with its advocates, including the Mannweiler Foundation, its CEO Robert Lang, and attorney Marcus Owens (former head of the Internal Revenue Service Exempt Organizations Division). Along with other contributors, these advocates devised the basic L3C model.[13] The model was intended to fit easily onto various states' LLC bases and provide sufficient limitations so that properly formed L3Cs would qualify to receive "program related investments" (PRIs) under existing Internal Revenue Service (IRS) rules.[14]

PRIs are investments made by non-profit, tax-exempt private foundations that are entitled to two important forms of special treatment. First, like grants and most operating expenditures, PRIs qualify toward the required distribution percentage private foundations must expend for charitable purposes annually.[15] This percentage is determined using a relatively complex formula, but generally it will fall close to 5% of the fair market value of a foundation's assets.[16] Second, a PRI is sheltered from designation as a jeopardizing investment if its primary purpose "is to accomplish one or more of the [organization's exempt] purposes . . . and no significant purpose of [it] is the production of income or the appreciation of property."[17] Jeopardizing investments can subject private foundations to costly and potentially confiscatory excise taxes.[18]

The desire of the L3C's inventors to define the entity to meet the PRI criteria explains much of the form's content. In order for an investment to qualify as a PRI, its primary purpose must be "to accomplish one or more of the purposes described in section 170(c)(2)(B)."[19] Additionally, no significant purpose of a PRI may be "the production of income or the appreciation of property."[20] Other sections of the tax code likewise preclude private foundations from expenditures for the political purposes forbidden to L3Cs.[21] These mandates are reproduced in three of the four core re-

13. Americans for Community Development, The History of the L3C, http://www.americansforcommunitydevelopment.org/history.html (last visited Jan. 3, 2010).

14. *Id.*

15. I.R.C. § 4944(c) (West 2009); *see also* IRS.gov, Program-related investments, http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html (last visited Jan. 3, 2010).

16. WALTER W. POWELL & RICHARD STEINBERG, THE NON-PROFIT SECTOR: A RESEARCH HANDBOOK 283 (2006).

17. I.R.C. § 4944(c) (West 2009).

18. § 4944(a).

19. § 4944(c).

20. *Id.*

21. § 4945.

quirements for forming as an L3C.[22] The final requirement, that the entity would not have formed but for its charitable or educational purpose,[23] reinforces the L3C's position as an entity created to meet the PRI requirements, helping to signal to private foundations and other investors that it is a predictable, consistent, and useful type—one that its boosters hope will establish a brand.[24]

The L3C legislation includes virtually no additional content beyond the four core requirements,[25] relying instead on existing LLC law to address any matters not covered by these spare enactments. LLC law is quite voluminous, covering myriad topics ranging from filing requirements to investor liability to derivative actions.[26] Certainly, a fulsome exploration of the subject is beyond the scope of this article. The pivotal issues for the current inquiry, though, relate to LLC taxation, governance, and financing.

Much has already been said about the L3C's position on issues of taxation. Its genesis was in large part to create a form for entities that would receive PRIs, a tax category; language from tax statutes defining that category provide much of the content of L3C enactments.[27] In addition, however, the L3C relies heavily on the tax treatment of LLCs to produce its desired effects. Since 1997, LLCs have been treated as partnerships under federal income tax law.[28] That is, LLCs (and L3Cs by extension, it is as-

22. VT. STAT. ANN. tit. 11, § 3001(27) (2008); *see also* 805 ILL. COMP. STAT. 180/1-26 (2009); MICH. COMP. LAWS § 450.4102(m) (2009); UTAH CODE ANN. § 48-2c-412 (2009); WYO. STAT. ANN. § 17-15-102(a)(ix) (2009).

23. VT. STAT. ANN. tit. 11, § 3001(27)(A)(ii); *see also* 805 ILL. COMP. STAT. 180/1-26(a); MICH. COMP. LAWS § 450.4102(m)(i); UTAH CODE ANN. § 48-2c-412(1)(b)(ii); WYO. STAT. ANN. § 17-15-102(a)(ix)(A).

24. *See* Robert M. Lang Jr., *Americans for Community Development Overview*, http://www.americansforcommunitydevelopment.org/supportingdownloads/ACDOverview.pdf (last visited Jan. 29, 2010); *see also* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 371-76 (2009) (arguing that the L3C form takes major strides in creating a brand for social enterprise).

25. The enactments do contain some additional definitional language, as well as requirements that L3Cs label themselves appropriately to alert consumers, associates, employees, and others to their special status. *See, e.g.*, 805 ILL. COMP. STAT. 180/1-26(b)–(d); UTAH CODE ANN. § 48-2c-412(1)(a); WYO. STAT. ANN. § 17-15-102(a)(ix).

26. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT §§ 201–211, 301–303, 1101–1104 (1996); UNIF. LTD. LIAB. CO. ACT § 201–209, 301–304, 1101–1106 (2006). Please note that the citations throughout this article are to the Original Uniform Limited Liability Company Act of 1996. There was a revision in 2006, but this will only be cited if there were significant changes to the sections cited.

27. Americans for Community Development, About L3C, http://www.americansforcommunitydevelopment.org/about.html (last visited Jan. 8, 2010) ("The legislation was specifically written to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations.").

28. The "check-the-box" regulations issued December 17, 1996 and effective January 1, 1997 permits unincorporated business entities to elect tax treatment as corporations or partnerships. *See* Treas. Reg. § 301.7701-2(a) (2009).

sumed) are treated as pass-through entities.[29] The entity itself is not subject to taxation on its income; rather, profits and losses are allocated to the members, each of whom must pay tax accordingly to their own tax status.[30] According to current IRS guidance, an LLC qualifies for entity-level exemption under § 501(c)(3) only if it is a single-member LLC with an exempt organization as its sole member or a multiple-member LLC in which all members are themselves exempt entities.[31] An L3C would often not, therefore, itself be eligible for tax-exemption. But, for federal income tax purposes, pass-through treatment makes the entity-level exemption of precious little consequence. Because each member is credited profits and losses and then pays tax or not, depending on its own taxable or tax-exempt status,[32] the profits a tax-exempt L3C member receives from its membership may avoid federal income tax liability. Whether and to what extent these profits will avoid federal income tax will depend on the type of exemption the tax-exempt member possesses (e.g., as a public charity or private foundation) and whether the profits are taxable as unrelated business income.

For state property tax exemption, the question of an L3C's entitlement to entity level exemption has greater salience. An LLC (and an L3C by extension) can hold property in its own name.[33] Unless the L3C entity could achieve entity-level exemption, it would be liable for state property taxes on property so held. In a fully for-profit LLC this might not matter, as the entity would pay the taxes and then take them as losses. These losses would then be passed on to the members and would reduce their income from the LLC accordingly, thereby yielding lower overall income tax burdens for those members. In an L3C hybrid with some exempt and some taxable members, however, property tax will be payable at the entity level but will not reduce the exempt entities' income tax burdens when translated into losses—because these entities are not liable for income tax in the first place.

29. *See* 26 U.S.C. § 701 (2009).

30. *Id.* In fact, it was the desire to achieve pass-through tax treatment that motivated the creation of the first LLC statute, Wyoming's, in 1977. Kathleen King Parker, *The Limited Liability Company: An Introduction*, 39 B. B. J. 8, 8 (1995). Kentucky and Tennessee allow LLCs to form for nonprofit purposes, but the relevant statutes treat these as just another type of wholly nonprofit entity and do not contemplate hybridization. *See, e.g.*, KY. REV. STAT. §§ 275.015, 275.520–275.540 (West 2006); TENN. CODE ANN. § 48-101-704 (West 2002).

31. *See* I.R.C. § 501(c)(3) (West 2009); Richard A. McCray and Ward L. Thomas, *Limited Liability Companies As Exempt Organizations Update* 30 (2001), http://www.irs.gov/pub/irs-tege/eotopicb01.pdf (last visited Feb. 22, 2010).

32. *See supra* notes 29–30 and accompanying text.

33. UNIF. LTD. LIAB. CO. ACT § 112(b)(2) (1996).

It remains to be seen how state governments will respond to the issue of property tax exemption for hybrids, including L3Cs. However, existing law and current trends suggest that it will be a struggle for L3Cs to obtain property tax exemption. As a type of LLC, states likely will view L3Cs as for-profit, taxable entities, at least at first glance. L3Cs individually or as a category may advocate for property tax reductions or exemptions, but their path will be difficult, as states already are challenging exemptions for traditional nonprofits engaged in commercial activity, producing large profits, and competing with for-profits.[34] Additionally, several states employ tests for exemption eligibility that specifically bar distribution of profits.[35]

In sum, the L3C offers some tax benefits over a standard for-profit form. Regardless of its tax-exempt status, the L3C can avoid entity-level federal income tax liability entirely due to its pass-through treatment. Further, tax-exempt members will receive profits distributed to them by the L3C tax-free. Still, these tax benefits are not on par with those available to entities formed as nonprofit corporations and charitable trusts. At least some of an L3C's profits will be taxable—those it distributes to its taxable members. Additionally, state property taxes, and other types of taxes where pass-through treatment is not available, will likely apply to L3Cs.

On the topic of governance, the hallmark of LLC law is flexibility. The LLC form typically provides two alternative sets of default rules for governance: a member-managed or a manager-managed structure.[36] Under the default rules for a member-managed LLC, the member owners that form the LLC through contributions manage it directly, much as in a general partnership.[37] Operating agreements set up internal governance processes, including setting thresholds for members' consent to decisions, and may even set up a managing committee of members or some other executive structure.[38] Most LLC decisions will be made using these structures, and their terms will govern members' interactions with each other and members' ability to bind the LLC and fellow members to transactions with third parties. Still, LLC statutes do stake out certain decisions for which unanimous consent will be required.[39] These commonly include dissolution, merger, sale of all assets and other major organic changes to the LLC,

34. *See* Evelyn Brody, *Introduction*, *in* PROPERTY-TAX EXEMPTION FOR CHARITIES IX (Evelyn Brody ed., 2002); *see also* Janne Gallagher, *The Legal Structure of Property-Tax Exemption*, *in* PROPERTY-TAX EXEMPTION FOR CHARITIES 3 (Evelyn Brody ed., 2002).

35. *See, e.g.*, CAL. REV. & TAX. CODE § 214(a)(4) (West 2009).

36. *See* UNIF. LTD. LIAB. CO. ACT § 101(11)–(12).

37. *See* § 404(a)(1).

38. *See* § 103.

39. *See* § 404(c).

admission of new members, and amendment of the operating agreement.[40] Members in a member-managed LLC also owe fiduciary obligations of care and loyalty to the LLC and its members, at least to the extent they are not expressly relieved of management obligations.[41] LLC law will permit, at least to some degree, fiduciary duties themselves to be altered or removed, though some limit on misconduct will remain as the existence of the operating agreement imposes on LLC members at least a minimal obligation of good faith and fair dealing.[42]

Rather than retaining control with members, the default rules for manager-managed LLCs delegate it.[43] The manager role somewhat resembles that of a general partner in a limited partnership, but the LLC manager need not be a member of the LLC. Statutes vest broad authority to conduct the LLC's activities in the manager, though again details may be varied substantially by operating agreement.[44] The statutes and operating agreements also deal with how manager-managed LLCs with multiple managers will share control.[45] However, members retain some important powers even in a manager-managed LLC. Members select the manager or managers and retain authority to remove them, typically through a consent-based process.[46] Additionally, fiduciary duties bind managers of manager-managed LLCs, imposing upon them obligations of care and loyalty to the LLC and its members.[47] Non-manager members typically owe no such duties to the LLC, as long as they are not in a position to control the manager.[48] Again, these fiduciary duties may be altered or dissipated by individual operating agreements.[49]

Various finance provisions of LLC law state default rules for buying into the entity, and receiving distributions from it, while the business is ongoing and at liquidation.[50] Individuals and entities can become member owners of an LLC in one of two ways. They may make contributions directly to the entity and thereby receive rights as members through the LLC's operating agreement (original or amended).[51] These contributions

40. *See id.*
41. *See* § 409(a)–(c).
42. *See* § 103(b)(2)–(4).
43. *See* § 301(b)(1).
44. *See* § 301(b)–(c).
45. *See* § 404(b).
46. *See* § 404(b)(3)(i).
47. *See* § 409(h)(2).
48. *See* § 409(h)(1), (3).
49. *See* § 409(h)(4).
50. *See* §§ 401, 403, 405–407.
51. *See* § 401.

are often monetary, but they need not be.[52] Alternatively, an individual or entity may purchase the membership of an existing LLC member.[53] The purchase is made from the existing member, and only that member need receive the relevant consideration.[54] Purchasing this financial interest alone, however, will not transfer the seller's governance rights to the buyer.[55] In order for the buyer to have rights in governance, the LLC must admit the buyer to member status, typically through a vote of the membership.[56]

Under most LLC statutes, default rules do not entitle members to any distributions during the term of the LLC's operations, though such distributions may be made in cash.[57] At dissolution, any remaining assets of the LLC will be paid out to the members, following, of course, superior creditors.[58] Unreturned contributions made to the LLC are repaid first.[59] These are followed by a distribution of all remaining assets in proportions set by the operating agreement, which need not be equal.[60] As a matter of default, members may leave the LLC at will, though the operating agreement may restrain this right, and selling one's share may entail significant financial costs if the remaining members are reticent to grant admission to new members.[61]

As noted above, these governance and financing rules operate as defaults, and individual adopters may vary these structures to a significant degree.[62] Most importantly, member owners' rights need not be identical to each other, and governance rights need not track financial ones.[63] An LLC may bestow governance rights on its members of one kind and not on another, or may weight their participation in various ways and for various

52. *See id.*

53. *See* §§ 501(b), 502.

54. *See* § 501(b).

55. *See* § 502.

56. *See* § 503(a).

57. *See* §§ 405–406.

58. *See* § 806.

59. *See id.*

60. *See id.*

61. *See* § 602(a)–(b). Expulsion is also permitted, with statutes defaulting to a unanimous consent requirement, but allowing operating agreements to vary this significantly. *See* § 601(4)–(6).

62. *See supra* notes 36–61 and accompanying text. To some degree, due to the check-the-box regulations, the tax classification of an LLC as a pass-through is also only a default rule, and an L3C could opt for tax treatment as a corporation. However, the benefits of attracting both taxable and tax-exempt investors would be frustrated by such a decision, and is unlikely to occur.

63. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 404 cmt.; *see also* MARK A. SARGENT & WALTER D. SCHWIDETZKY, LIMITED LIABILITY COMPANY HANDBOOK § 1.3, at 5 (2009).

reasons.[64] Likewise, financial contributions need not be equal, nor need they correspond to governance rights.[65]

Advocates of the L3C tout this flexibility as key to the value of this new hybrid form and have highlighted the L3C's ability to create a tranched membership structure.[66] An equity tranche of members could be tax-exempt private foundations making program-related investments. Because the PRI regulations specifically bar foundations from contemplating a financial return as a motive for investment,[67] this tranche of members would be given scant or very remote rights to distributions. A mezzanine tranche of individuals or entities could purchase L3C memberships as a type of socially-responsible investment. This tranche of investors would agree to operating agreement terms that provided them with some access to distributions, but at a rate lower than market return, presumably doing so in return for the social or psychic value produced by the entity. The L3C's operating agreement could then provide for a market-like return to a senior tranche of individuals and entities seeking such returns, presumably doing so in competition with other market-rate investment opportunities. The structure of these provisions might be more debt-like or equity-like (though if the latter, more like preferred than common stock), providing either a guaranteed return or a return keyed to the L3C's profits.

Despite their limited or attenuated financial rights, LLC law would permit an L3C using tranched membership to endow the equity tranche of tax-exempt entities with significant governance advantages.[68] They could be granted overwhelming voting power, enhanced rights to vote on matters of management or policy, powers to select or monitor managers, or other rights that would vest significant control over the L3C's operations in this tranche.[69] Likewise, LLC law permits a corresponding reduction or exclusion of governance rights in the other tranches.[70] This technique assumes that governing rights in this tranche of investors without a profit motive or

64. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 404 cmt.; *see also* SARGENT & SCHWIDETZKY, *supra* note 63, §1.1, at 1–3.

65. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT §§ 401 cmt., 404 cmt.; *see also* SARGENT & SCHWIDETZKY, *supra* note 63, §§ 1.1 at 1–3, 1.3 at 5.

66. *See* Lang Jr., *supra* note 24, at 4; Posting of Jim Witkin to Triple Pundit, *The L3C: A More Creative Capitalism*, http://www.triplepundit.com/2009/01/the-l3c-a-more-creative-capitalism (Jan. 15, 2009); Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 582 (2009).

67. *See* I.R.C. § 4944(c) (West 2009).

68. This can be specified in the operating agreement. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 103; *see also* Lang Jr., *supra* note 24, at 4.

69. *See* Lang Jr., *supra* note 24, at 4.

70. *See, e.g.*, UNIF. LTD. LIAB. CO. ACT § 103.

with only a limited one would safeguard the mission of the L3C to pursue charitable or educational purposes.

Of course, the question of transferability will crucially impact both governance and financing of L3Cs with tranched memberships. As noted above, LLC statutes default to placing significant limits on transfer of membership rights, generally permitting each member to voluntarily and unilaterally transfer her financial rights to another, but requiring the other LLC members to approve of the transferee's admission before the transferee will receive any rights in governance.[71] L3C enactments thus far do not vary this pattern; however, since these are only default positions, operating agreements may vary them to some extent. If transfer limitations are left in the LLC default mode, the member interests of those tranches of investors with governing rights will not have a high degree of transferability, which may be the desired effect. These tranches will be locked into the L3C and will be unable to effectively sell to buyers intent on changing its mix of social and market goals. In contrast, those tranches of investors purchasing member interests that do not offer governance rights will see no additional loss in transferability, as they will not have governance rights to offer to buyers in the first place.

The extreme flexibility of the L3C form of course allows for variations beyond tranched membership structures. For example, an L3C might be used to structure an angel investment fund with a limited membership admitted only on consent of a gatekeeper foundation.[72] Investors seeking a social and financial return could, therefore, be screened for a commitment to blended enterprise. The foundation could be empowered to mandate redemption of memberships in certain circumstances, making it the sole arbiter of entry and exit for the L3C's investors. Likewise, the foundation could be granted dominant governance rights, such as a veto to prevent the L3C from taking actions that could jeopardize its L3C status or the foundation's program-related investment in it. This type of structure is another way to deploy the flexible L3C framework to appeal to both foundations and some broader class of investors.

Ultimately, L3C status appears to be neither a permanent nor a publicly-guarded designation. Such entities might over time veer away from their charitable or educational purposes for various reasons. If this occurs, and the L3C no longer pursues primarily social purposes, the statutes pro-

71. *See supra* notes 53–56 and accompanying text.

72. I thank John Tyler for this example, which is similar to the structure described and blessed by the IRS in a 2006 private letter ruling. *See* I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 15, 2006).

vide that it would simply be converted to a standard LLC.[73] The statutes do not say how this conversion would take place or who would monitor whether such a transformation has occurred in the first place. The L3C form thus boils down to a tremendously flexible financing and governance regime.

B. Community Interest Companies

Across the Atlantic, the United Kingdom recently initiated a hybrid form of organization that is now available in England, Wales, Scotland and Northern Ireland.[74] The form is called a community interest company, or CIC.[75] The CIC idea was first proposed in a report by the Prime Minister's Cabinent Office Strategy Unit in 2002, as part of a broader reform agenda for UK charity law.[76] The report proposed the CIC to "improve access to finance, create a strong new brand, be legally protected from demutualization, and preserve assets and profits solely for social purposes."[77] The CIC was officially created in a 2004 set of amendments to the UK company law—the analogue to corporate law in the U.S.[78] Although CICs are still quite new, recent tallies show thousands of organizations have used the form.[79]

The actual content of the CIC enactment is relatively thin, relying on company law as the basic framework for the new form, though supplying more details than do the L3C statutes. This enactment delegates continuing

73. *See* VT. STAT. ANN. tit. 11, § 3001(27)(D) (2008); *see also* 805 ILL. COMP. STAT. 180/1-26(c) (2009); MICH. COMP. LAWS § 450.4102(m) (2009); UTAH CODE ANN. § 48-2c-412(2) (2009); WYO. STAT. ANN. § 17-15-102(a)(ix) (2009).

74. On July 1, 2005, legislation came into effect providing rules for the creation and operation of CICs. On July 25, 2005, the Regulator's office was opened to accept applications from organizations in England, Wales, and Scotland. On April, 6 2007, additional legislation made it possible to form or convert a CIC in Northern Ireland. THE REGULATOR OF COMMUNITY INTEREST COMPANIES, COMMUNITY INTEREST COMPANIES INFORMATION PACK 4 (2009), *available at* http://www.cicregulator.gov.uk/CICleaflets/CIC%20INFORMATION%20PACK%20V00.02D.pdf.

75. For a general discussion of the CIC, see generally Debra Morris, *Structures at the Seam: The Architecture of Charities' Commercial Activities Comparative Panel: A View of Other Landscapes* (2008), http://www1.law.nyu.edu/ncpl/resources/documents/Conf2008DebraMorris.pdf (last visited Feb. 22, 2010).

76. CABINET OFFICE STRATEGY UNIT, PRIVATE ACTION, PUBLIC BENEFIT: A REVIEW OF CHARITIES AND THE WIDER NOT-FOR-PROFIT SECTOR 9 (2002), *available at* http://www.cabinetoffice.gov.uk/media/cabinetoffice/strategy/assets/strat%20data.pdf (last visited Feb. 22, 2010).

77. *Id.*

78. QUEEN'S PRINTER OF ACTS OF PARLIAMENT, EXPLANATORY NOTES TO COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004 ¶ 4 (2004), *available at* http://www.opsi.gov.uk/acts/acts2004/en/ukpgaen_20040027_en_1 (last visited Feb. 22, 2010).

79. There are currently 3335 companies registered as CICs. The Regulator of Community Interest Companies, List of Community Interest Companies, http://www.cicregulator.gov.uk/coSearch/companyList.shtml (last visited Jan. 17, 2010).

rulemaking and supervision for CICs to a light touch, dedicated CIC Regulator.[80] The Regulator has been fairly active, issuing copious guidance materials for CICs as well as calls for comment on revising them toward improvement.[81] Like other UK companies, CICs are required to register their existence and then must apply to the Regulator for their special community interest status.[82] Once authorized, the CIC moniker must be incorporated into the entity's name,[83] and special features of CIC status will apply to differentiate the entity from other companies. In reviewing the CIC's contours, this subpart will again focus on the paramount issues of taxation, governance, and financing.

In the area of taxation, CIC status does not confer any benefits beyond those available to other UK companies.[84] CICs are treated as companies for tax purposes and thus are subject to entity-level tax.[85] A CIC may be formed as a company limited by shares (similar to U.S. for-profit corporations) or one limited by guarantee (similar to U.S. nonprofit corporations).[86] However, even if formed as a company limited by guarantee, a CIC is expressly prohibited from being deemed a charity under UK tax law.[87] Indeed, if a UK charity were to convert to a CIC, it would automatically lose its charity tax status.[88]

Charity tax status entitles UK charities to various tax benefits. Charities are "exempt from tax on most forms of income and capital gains if they are applied to charitable purposes."[89] They are eligible for "gift aid," whereby the UK tax system treats donations to charities as if the donor had already paid the tax on the relevant amount and allows the charity to reclaim the amount representing that tax from the government, thereby in-

80. *See* Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 27 (U.K.); The Regulator of Community Interest Companies, About Us, http://www.cicregulator.gov.uk/aboutUs.shtml (last visited Jan. 17, 2010).

81. *See* The Regulator of Community Interest Companies, Information and Guidance Notes, http://www.cicregulator.gov.uk/guidance.shtml (last visited Jan. 17, 2010).

82. *See* Companies (Audit, Investigations and Community Enterprise) Act § 36.

83. § 33.

84. The Regulator of Community Interest Companies, Information and Guidance Notes § 7.6 (2008), http://www.cicregulator.gov.uk/guidance/Chapter%207%20-%20October%202009%20%20(version%204%20final).pdf.

85. *Id.*

86. Companies (Audit, Investigations and Community Enterprise) Act § 26(2).

87. § 26(3)(a).

88. The Regulator of Community Interest Companies, Information and Guidance Notes § 2.4.1 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%202%20-%20October%202009%20(version%203%20Final).pdf.

89. HM Revenue & Customs, Detailed Guidance Notes, Annex I—Charitable Tax Exemption, http://www.hmrc.gov.uk/charities/guidance-notes/annex1/annex_i.htm (last visited Jan. 17, 2010).

creasing the value of donations.[90] Further, charities receive an automatic 80% rate reduction on "business rates," which impose property taxes on UK businesses to be collected and used by local authorities.[91] CICs are ineligible for exemption from corporation taxes on income or capital gains and value added tax, and they do not qualify for gift aid.[92] Although an individual CIC may apply to its local authority for business rate relief, any grant of such relief is entirely discretionary.[93] In sum, tax treatment of a CIC appears to be quite straightforward, offering no special benefits over traditional for-profit forms.

As under company law generally, CIC governance is primarily enshrined in the board of directors. CICs organized as private companies may have only one director; other companies must have two or more.[94] All directors are fiduciaries who must exercise their management and supervisory duties with "reasonable care, skill and diligence"[95] and avoid conflicts of interest or other situations of potential disloyalty.[96] The goals and responsibilities of a company versus a CIC director, however, diverge considerably. In a typical company limited by shares, directors should pursue the interests of the shareholder members in good faith and need only *consider* other interests such as employees or the environment in their decision-making.[97] In a CIC or other company with purposes other than solely to benefit shareholders (such as charities set up as companies limited by guarantee), these alternative stated purposes are to be the directors' *primary* goals.[98]

90. HM Revenue & Customs, Gift Aid—an overview, http://www.hmrc.gov.uk/charities/gift-aid.htm (last visited Jan. 17, 2010).

91. HM Revenue & Customs, Charities and tax: the basics, http://www.hmrc.gov.uk/charities/tax/basics.htm#3 (last visited Jan. 17, 2010). Note that charities appear to get an automatic 80% reduction and other non-profit-making entities may apply for rate reduction or elimination, so it is possible that a CIC could apply for this. *Id.* Yet, with the general position against tax benefits for CICs articulated by the Regulator, receiving such dispensation from local authorities seems unlikely.

92. The Regulator of Community Interest Companies, Information and Guidance Notes §§ 7.6, 7.6.1, 7.6.3 (2008), http://www.cicregulator.gov.uk/guidance/Chapter%207%20-%20October%202009%20%20(version%204%20final).pdf.

93. § 7.6.2.

94. THE REGULATOR OF COMMUNITY INTEREST COMPANIES, FREQUENTLY ASKED QUESTION 13 (2009), *available at* http://www.cicregulator.gov.uk/CICleaflets/FAQ%20-%20October%202009%20V5.00%20Final.pdf [hereinafter CIC FREQUENTLY ASKED QUESTION].

95. Companies Act, 2006, c. 46, § 174(1) (U.K.).

96. §§ 175–77.

97. § 172.

98. The Regulator of Community Interest Companies, Information and Guidance Notes (2009), § 2.3, http://www.cicregulator.gov.uk/guidance/Chapter%202%20-%20October%202009%20(version%203%20Final).pdf.

CIC directors are also made responsible for preserving the CIC's ability to meet the community interest test.[99] This test, which must be met in order to form as a CIC in the first place, requires that "a reasonable person might consider [the CIC's] activities are being carried on for the benefit of the community."[100] The CIC must report its community interest achievements to the Regulator annually,[101] and in this report, it must "confirm that access to the benefits it provides will not be confined to an unduly restricted group."[102]

UK company law, and by extension CIC law, also provides a role for members in governance.[103] In a CIC limited by shares, these members will generally be shareholders; in a CIC limited by guarantee, they will be donors or others admitted to membership by the terms of the CIC's organic documents.[104] While members will not typically manage the company or oversee its operations on a regular basis, like US shareholders, they retain a few important rights in company governance, including election and removal of directors, amending the company's organic documents, and approving major transactions.[105] Moreover, the Regulator asserts that members have especially important responsibilities in a CIC.[106] As its Guidance explains:

> In all companies, but more so with CICs, members should not regard delegation to directors as being the same as abdication of responsibility. It is important that the members should monitor the performance of the CIC and the directors, for example, to satisfy themselves that the company continues to meet the community interest test and fully involves the community in its activities and development.[107]

99. The Regulator of Community Interest Companies, Information and Guidance Notes § 9.1.2 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%209%20-%20October%202009%20(version%204%20Final).pdf.

100. Companies (Audit, Investigations and Community Enterprise) Act, 2004, 27, § 35(2) (U.K.); CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 8.

101. CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 11.

102. *Id.* at 8. The criteria are intentionally broader than the public benefit standard that charities must meet. *See* Charities Act, 2006, c. 50, §§ 1–5 (U.K.); *see also* Polly Curtis & Owen Bowcott, *Offer Free Places or Lose Charity Status, Private Schools Told*, THE GUARDIAN, July 14, 2009, http://www.guardian.co.uk/education/2009/jul/14/charity-status-private-schools (reporting on a Charity Commission audit finding several schools and eldercare facilities that had previously been deemed charities did not offer sufficient services without fee in order to meet the public benefit test).

103. The Regulator of Community Interest Companies, Information and Guidance Notes §§ 9.1.2, 9.1.3 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%209%20-%20October%202009%20(version%204%20Final).pdf.

104. *Id.*

105. *Id.*

106. *Id.*

107. *Id.*

Furthermore, the Regulator notes that it counts on members to be an important source of information revealing concerns about a CIC's activities that might merit regulatory action.[108]

Beyond members, the Regulator has also directed CICs to include other stakeholders in its governance scheme.[109] The specific form of stakeholder involvement is not mandated, with the idea that CICs of various types and sizes will flourish using diverse techniques to involve stakeholders in governance.[110] Yet, the CIC Regulator has offered suggestions on how stakeholder governance roles might be articulated.[111] Its Guidance explains:

> The provision of adequate information is clearly the starting point for the consultation process together with the provision of easily used methods of feedback.
>
> This can be achieved by simple methods such as circulating news letters and holding stakeholder meetings or more sophisticated methods such as setting up a web site with dialogue facilities or issuing formal consultation documents before taking a major policy decision. Alternatively, stakeholder groups can be given official standing under a company's constitution (for example, by requiring that they are consulted before the directors or members make certain types of decisions).
>
> Other stakeholders could be included with the members in the circulation of the company annual report and accounts and invited to attend an open forum linked to the company's annual general meeting.
>
> In many organisations the setting up of user and advisory groups or a club committee separate from the board of directors can be an effective way of bringing stakeholders into the running of the organisation.[112]

Each CIC can craft individualized stakeholder processes accordingly, but all CICs must describe their efforts to include stakeholders in governance in the annual community interest report they submit to the Regulator, and the Regulator will review it.[113]

The CIC form also entails several important financing aspects. A CIC's assets are subject to an "asset lock."[114] This asset lock prohibits a CIC from disposing of assets for consideration of less than their fair market

108. *Id.*

109. The Regulator of Community Interest Companies, Information and Guidance Notes § 9.2 (2008), http://www.cicregulator.gov.uk/guidance/Chapter%209%20-%20October%202009%20(version%204%20Final).pdf.

110. *Id.*

111. *Id.*

112. *Id.*

113. *See* CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 12, 17.

114. The Regulator of Community Interest Companies, Information and Guidance Notes § 6.1 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%206%20-%20Feb%202010.pdf; Companies (Audit, Investigations and Community Enterprise) Act, 2004, c.27, § 30 (U.K.).

value, except in pursuit of the community benefits the CIC is designed to pursue or in a transfer to a charity or another CIC.[115] On dissolution, assets may not be paid out to directors, members, or equity holders; all assets must go to another entity whose assets are perpetually devoted to community benefit.[116] The Regulator views the asset lock feature of a CIC's financial structure as its "fundamental feature."[117]

In addition to locking assets into community benefit purposes, CICs are subject to important financial limits relating to dividends. The CIC statute permits dividends to be paid to members of a CIC limited by shares only if the Regulator authorizes such dividends by regulations; the statute also permits the Regulator to place limits on any such dividends.[118] The CIC Regulator has issued regulations granting such permission, and subjects these dividends to three types of restrictions.[119] The first limitation caps dividends per share. For shares issued prior to April 6, 2010, dividends per share may not exceed five percent over the Bank of England base lending rate,[120] currently set at half a percent.[121] For later issued shares, "[t]he share dividend cap shall be 20 percent of the paid up valud of a share in a relevant company."[122] In addition to the per share caps, the total dividend declared for all shares may not exceed thirty-five percent of distributable profits.[123] Finally, unused dividend capacity may be carried over for no more than four years.[124]

The Regulator set all three caps as part of the initial creation of the CIC form, but recently issued the change to the per share cap, to be effective prospectively from April 6, 2010. The change was made in response to

115. § 6.1.1.

116. The Regulator of Community Interest Companies, Information and Guidance Notes § 10.5.2 (2007), http://www.cicregulator.gov.uk/guidance/Chapter10%20October%202009%20version%204%20Final.pdf.

117. The Regulator of Community Interest Companies, Information and Guidance Notes § 6.1 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%206%20-%20October%202009%20(version%204%20final).pdf.

118. Companies (Audit, Investigations and Community Enterprise) Act § 30.

119. CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 10–11.

120. *Id.* at 11.

121. Bank of England Home Page, http://www.bankofengland.co.uk (last visited Jan. 17, 2010).

122. THE REGULATOR OF COMMUNITY INTEREST COMPANIES, NOTICES UNDER THE COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004 1 (2009), *available at* http://www.cicregulator.gov.uk/Notices-%20Dividend%20&%20Interest%20Cap%20v01.pdf.

123. CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 11.

124. *Id.* The CIC form also places limits on "performance related interest" in order to ensure such payments are not structured to avoid the caps applied to dividend payments. The Regulator of Community Interest Companies, Information and Guidance Notes § 6.4 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%206%20-%20October%202009%20(version%204%20final).pdf.

the Regulator's consultation asking for feedback on how well the various limits on CIC financing balanced encouragement of investment in CICs and devotion of these entities to community interests.[125] The Regulator's summary of responses to that consultation reported significant dissatisfaction with how the dividend caps limited access to capital.[126] In response, the Regulator issued the revised per share cap, but declined to change the aggregate cap or carryover provisions.[127]

When the dividend restrictions are viewed in conjunction with the asset lock, the CIC can be seen as offering investors a significantly altered form of equity investment. Investors may purchase shares and can participate in the profits of a CIC limited by shares. Yet, shares entitle investors only to capped dividends—not the full measure of the CIC's profits it might be prudent to disburse—and on dissolution, shares do not entitle their owners to residual earnings.

As compared with the L3C's virtually complete flexibility, CIC governance and financing interact in a relatively prescribed fashion. When equity-type shares are owned, shareholders are members and accordingly have governance rights to appoint and remove directors, amend the entity's organic documents, and approve major transactions.[128] These control rights accompany their financial entitlements, which include the ability to receive (capped) dividends.[129] However, shareholders are not be the only voice in CIC governance. The Regulator demands that stakeholders have input as well, though this involvement may be structured in various ways.[130] Thus, the CIC statute and accompanying regulations impose a fairly rigid structural sense of how to finance and govern these blended enterprises, and empower both shareholders and a dedicated external regulator to enforce.

125. THE REGULATOR OF COMMUNITY INTEREST COMPANIES, CONSULTATION ON THE DIVIDEND AND INTEREST CAPS 3 (2009), *available at* http://www.cicregulator.gov.uk/%27Caps%27%20Consultation%20V00.01SO.pdf [hereinafter CONSULTATION ON THE DIVIDEND AND INTEREST CAPS].

126. THE REGULATOR OF COMMUNITY INTEREST COMPANIES, SUMMARY OF THE RESPONSES TO THE CONSULTATION ON THE DIVIDEND AND INTEREST CAPS 5–6 (2009), *available at* http://www.cicregulator.gov.uk/Summary%20of%20Responses%20V00.01SO.pdf [hereinafter SUMMARY OF RESPONSES].

127. *See* NOTICES UNDER THE COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004, *supra* note 122, at 1-2.

128. The Regulator of Community Interest Companies, Information and Guidance Notes § 9.1.3 (2009), http://www.cicregulator.gov.uk/guidance/Chapter%209%20-%20October%202009%20(version%204%20Final).pdf.

129. CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 10–11.

130. The Regulator of Community Interest Companies, Information and Guidance Notes § 9.2 (2008), http://www.cicregulator.gov.uk/guidance/Chapter%209%20-%20October%202009%20(version%204%20Final).pdf.

C. *B Corporations*

The final hybrid form to be canvassed here, the B corporation, is self-imposed and privately regulated, as opposed to the legislatively approved L3C and CIC forms. A B corporation, also sometimes called a "for-benefit" corporation, uses the traditional, state-law-governed corporate form as its base.[131] This base is then varied through statements amending an individual corporation's organic documents to commit it to "use[] the power of business to solve social and environmental problems."[132] So amended, the creators of the "B" idea envisioned the entity's documents as self-enforcing.[133] A private, nonprofit organization, B Lab, vets the changes and the company's structure and operations as part of its certification system.[134] Once B Lab certifies a company as meeting its requirements, the company may license the "certified B Corporation" trademark from B Lab.[135]

As a private certification system, the B corporation designation offers no special tax treatment for corporations that obtain it. Ordinary federal and

131. B Lab also offers tools for entities formed as sole proprietorships, limited liability companies, and general, limited or limited liability partnerships to become certified "for benefit" businesses. However, as the B corporation brand and most of B Lab's materials appear to default to the corporation form and to avoid unnecessary complexity and redundancy, this article will concentrate on B *corporations*.

132. B LAB, INTRODUCING THE B CORPORATION 3 (2009), http://www.bcorporation.net/resources/bcorp/documents/2009%20B%20Corp_Intro_Package.pdf.

133. B Lab, About B Corp, http://www.bcorporation.net/about (last visited Jan. 17, 2010) [hereinafter About B Corp].

134. B certification applicants must submit to B Lab scoring its performance under the B Ratings System, and must consent to possible audits. *See* B Lab, How are companies Certified and Audited as B Corporations?, http://www.bcorporation.net/index.cfm?fuseaction=modalContent.content&id=f7224b49-ed7f-4037-894c-31c6e3c32178 (last visited Dec. 29, 2009) [hereinafter How are companies Certified and Audited as B Corporations?]. This process seeks to ensure that future B corporations will "[m]eet comprehensive and transparent social and environmental performance standards." About B Corp, *supra* note 133. It includes a comprehensive self-survey addressing a wide and diverse range of issues. For example, the survey inquires about the inclusion of social and environmental goals in an applicant's corporate mission, tax avoidance behavior, board accountability, communication and training for employees, occupational health and safety, involvement in local communities, water and energy usage, among many other topics. *See, e.g.*, B LAB, THE B RATINGS SYSTEM: VERSION 1.0 (2008), *available at* http://www.bcorporation.net/resources/bcorp/documents/B%20Ratings%20System%20-%2030+%20Emp%20Mfg.pdf [hereinafter B RATINGS SYSTEM]. Applicants must score eighty out of 200 points or better on their surveys to be eligible to license the "B" mark. *See* How are companies Certified and Audited as B Corporations?, *supra*. In addition, ten percent of certified companies will be audited each year, based on a random selection process. *Id.* If any audited company's survey scores below the required level, it will have ninety days to cure the defects to avoid revocation of certification. *Id.* In reviewing this system, however, it must be noted that the entire process is quite new. To date only the first year's audits have been completed and, in them, all certified entities passed. B Lab, Audits, http://www.bcorporation.net/index.cfm/fuseaction/content.page/nodeID/62c0a177-6625-4373-9142-01e788e468cd (last visited Dec. 29, 2009).

135. B Lab, Become a B Corp—Make It Official, http://www.bcorporation.net/index.cfm/nodeID/3C192853-ADFD-4C10-B5F3-3D9654551A98/fuseaction/content.page (last visited Dec. 29, 2009).

state income and property taxes will apply regardless of B certification, though it is possible that this situation may change over time.[136] Commentators are currently debating whether and how tax benefits should be extended to for-profit companies pursuing social ends. Anup Malani and Eric Posner argue for uncoupling tax exemption from nonprofit form and its non-distribution constraint.[137] They further assert that when for-profit entities engage in activities that benefit the community, they should receive the same tax benefits and other government subsidization as nonprofit charities.[138] These claims are roundly criticized by James Hines, Jill Horwitz, and Austin Nichols, who argue that it is unnecessary and unwise to extend tax benefits for the community benefit activities undertaken by for-profits.[139] First off, they explain that any profit losses taxable entities experience as a result of their community benefit activities already proportionally decrease their tax liability.[140] In addition, they worry that Malani and Posner's proposal will encourage tax arbitrage[141] and competition with traditional nonprofits that will negatively influence them away from their charitable missions.[142]

My own view charts a middle course. I believe charity tax status and its attendant panoply of tax benefits should not be extended to wholesale hybrid organizations.[143] These forms differ too significantly from traditional charities to match well with the incentives these benefits create. Yet, hybrid forms do offer promise of societal benefit. As we learn more about how they benefit communities, I believe that distinct, targeted tax incentives to encourage some or all of these forms will be warranted. These issues will no doubt be debated for years to come. Currently, though, "B" status will not confer any special tax treatment on those who adopt it.

136. *See* Posting of Thomas A. Kelley III to Nonprofit Law Prof Blog, *Update on B Corporations*, http://lawprofessors.typepad.com/nonprofit/2009/09/update-on-b-corporations.html (Sept. 1, 2009); B LAB, PUBLIC INFRASTRUCTURE TO CREATE PRIVATE SECTOR SOCIAL INNOVATION: PRESENTATION TO THE OBAMA-BIDEN PRESIDENTIAL TRANSITION PROJECT 1–2 (2009), *available at* http://www.bcorporation.net/resources/bcorp/documents/Obama-Biden--TransitionTeam_Private-Sector-Social-Innovation-Briefing.pdf.

137. *See* Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2064–65 (2007).

138. *Id.*

139. *See* James R. Hines, Jill R. Horwitz, & Austin Nichols, *The Assault on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV (forthcoming May 2010).

140. *See id.*

141. *See id.* Victor Fleischer also notes that there would be serious regulatory challenges to be overcome in order to execute Malani and Posner's proposal. *See* Victor Fleischer, *"For Profit Charity": Not Quite Ready for Prime Time*, 93 VA. L. REV. IN BRIEF 231, 231–33 (2008).

142. *See id.*, at 22–24.

143. *See* Dana Brakman Reiser, *Charity Law's Essentials* 34 (Brooklyn Law Sch. Legal Studies Research Papers Working Papers Series No. 167, 2009), *available at* http://ssrn.com/abstract=1479572.

In contrast, B corporations depart significantly from their strictly for-profit counterparts in terms of governance. Shareholders and directors both play important roles in B corporation governance, operating in much the same fashion as in any other for-profit corporation organized under state law. Shareholders must approve amendments to the corporate charter[144] as well as other major transactions, including merger, sale of all or substantially all assets, and dissolution.[145] They also compose the body that elects the board of directors and maintain certain rights to remove or recall directors from the board.[146] Directors are empowered to manage the corporation or direct its management by officers and staff.[147] In doing so, the directors are bound by fiduciary obligations, to act with due care, loyalty, and in good faith.[148]

The B corporation concept, however, imposes an important gloss on directors' fiduciary obligations. As noted, to be eligible to license the "B" mark, corporations must amend their organic documents to include language instructing directors to consider interests beyond those of shareholders in carrying out their duties.[149] More specifically, a New York B corporation[150] would need to insert 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

144. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242(b)(1)–(b)(2) (2009).

145. *See, e.g.*, §§ 251, 253, 271, 275.

146. *See, e.g.*, § 141(k).

147. *See, e.g.*, § 141(a).

148. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE §§ 4, 5 Introductory Notes (1994).

149. About B Corp, *supra* note 133 (corporations amend their "corporate governing documents to incorporate the interests of employees, community and the environment").

150. B Lab specifically requires applicants to incorporate in a state with another constituency statute, and recommends New York, Nevada and Pennsylvania as particularly hospitable. Each has a relatively broad statute, but Nevada's seems potentially the most sweeping, permitting directors to consider *inter alia* the interests of society at large. *Compare* NEV. REV. STAT. § 78.138(4) (West 2009), *with* N.Y. BUS. CORP. LAW § 717(b) (McKinney 2010), *and* 15 PA. CONS. STAT. ANN. § 1715 (West 2009).

> (and its subsidiaries' operations) on the environment and the economy of the state, the region and the nation.[151]

To give these instructions the best chance of legal enforcement, B Lab requires applicants to incorporate in a state with an "other constituency" statute or to reincorporate in such a jurisdiction.[152] "Other constituency" statutes expressly permit directors to consider constituencies other than shareholders in directorial decision-making, often particularly contemplating takeover situations.[153] The quoted language above resonates with New York's relatively broad constituency statute, which allows directors to consider the interests of employees, retirees, creditors, customers, and the broader community when they make decisions in the context of changes of control or otherwise.[154] Yet, under the required charter amendments, a New York B Corporation director would be obliged to go further, as she would be commanded to consider these outside interests.[155] Moreover, the range of outside interests she must consider is even broader than that described by the statute, including abstract social and environmental concerns.[156]

These changes impose unique and seemingly forceful obligations on B corporation directors. Yet, the charter language and statutes both explicitly

151. B Lab, Legal Roadmap, (emphasis added) (to access the quoted information select "C Corporation" under "Corporate Structure" and "NY" under "State of Incorporation"), http://survey.bcorporation.net/become/legal2.php (last visited Jan. 3, 2010) [hereinafter Legal Roadmap]

152. B LAB, B CORPORATION LEGAL FRAMEWORK: FOR NON-CONSTITUENCY STATES, http://survey.bcorporation.net/become/Non-Constituency%20State%20Legal%20Framework.pdf (last visited Jan. 3, 2010); *see, e.g.*, Katovich Law Group, Blog Archive: Yes, you can be a B!, http://katovichlaw.com/2009/07/10/yes-you-can-be-a-b/ (last visited Jan. 3, 2010).

153. *See, e.g.*, NEV. REV. STAT. § 78.138(4), N.Y. BUS. CORP. LAW § 717(b), 15 PA. CONS. STAT. ANN. § 1715(a).

154. N.Y. BUS. CORP. LAW § 717(b). The text of the statute is somewhat more specific and possibly narrower than the suggested language for article amendment. It states:

> In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) both the long-term and the short-term interests of the corporation and its shareholders and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any of the following:
>
> (i) the prospects for potential growth, development, productivity and profitability of the corporation;
>
> (ii) the corporation's current employees;
>
> (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits from or pursuant to any plan sponsored, or agreement entered into, by the corporation;
>
> (iv) the corporation's customers and creditors; and
>
> (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Id.

155. *See supra* note 150 and accompanying text.

156. *Id.*

decline to create new rights of action in individuals to assert that directors did not sufficiently consider these non-shareholder interests or constituencies.[157] Nor do they suggest that these interests should or must predominate serving the interests of shareholders. Perhaps this is merely pragmatism on the part of the B corporation's creators. It seems likely that courts would enforce a mandate that directors consider social impact in their decisions,[158] but even strong "other constituency" statutes frequently block enforcement rights expressly.[159]

Perhaps shareholders who invest in a B corporation will do so because of its commitment to social impact, and these shareholders can serve as a proxy for the non-shareholder constituencies. B corporation shareholders do elect directors and have a statutory veto on at least some transactions.[160] They could elect only director candidates who promise to heed this mission and cast aside those who do not; they could reject mergers or other actions that would imperil it. B corporation shareholders have significant rights to litigate, though of course they face substantial obstacles in challenging the directorial action—including the formidable business judgment rule, demand requirements, and other procedural hurdles involved in derivative litigation. They could attempt to use litigation to enforce the charter requirements explained above, possibly succeeding in requiring due consideration of social and environmental impact in the company's operations. On the other hand, shareholders might simply purchase for return, come to the position that return can be maximized by less consideration for society and the environment, or sell to those who would take such a position. Which type of shareholders a B corporation attracts, particularly if it is not closely-held and shareholder identity changes over time, will be far from certain.

The B Ratings survey does address the question of stakeholder involvement in governance, but does not demand it. In the section on governance, questions regarding accountability are split into "Board" and "Other"

157. Legal Roadmap, *supra* note 151 ("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."); N.Y. BUS. CORP. LAW § 717(b) ("Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions.").

158. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE § 2.01 reporter's note 6 ("Because the obligations in § 2.01 run to the shareholders, rather than to third parties or the state, there is little doubt that such limitations [restrictions on the general profit-making objective] would normally be permissible if agreed to by all the shareholders. Such an agreement might be embodied in the certificate of incorporation, or not.").

159. *See e.g.*, NEV. REV. STAT. § 78.138(5) (West 2009), N.Y. BUS. CORP. LAW § 717(b) (McKinney 2010), 15 PA. CONS. STAT. ANN. § 1715(d) (West 2009).

160. *See supra* notes 143–46 and accompanying text.

categories, which notably receive equivalent weightings.[161] Within the "Other" category, however, are four questions, two of which ask whether the company has a policy on whistleblowing and maintains financial controls to enable it to prevent fraud and generate accurate reporting.[162] The other two ask whether "the company has a forum to directly engage external stakeholders on a regular basis" and to "describe how [the] company engages stakeholders," to which applicants may respond that they offer annual meetings for stakeholders, fora for them on company websites, surveys of them, other means they may fill in, or that the question does not apply.[163] The entire section is allocated between 1.6 and 3.3 out of 200 points in the B scale, depending upon whether the company operates in the manufacturing/wholesale, transportation/distribution or service sectors.[164] Companies must achieve a score of 80 or higher in order to be eligible to license the "B" mark.[165] Rather than relying upon stakeholders in governance, the B Ratings rely on their certification and auditing systems to ensure B corporations are pursuing and achieving their blended aims.[166] The B Ratings heavily weight questions about how the applicant integrates its business and social goals, including relationships with employees, suppliers, local communities, and the environment.[167]

Thus, the B corporation form realistically offers only moral, rather than legal, assurances to non-shareholder constituencies and social interests. Stakeholders have no structural rights in governance, and no additional parties are granted standing to litigate. B corporation directors are empowered to act in the interests of other constituencies; whether they do so will depend on their own desires or feelings of moral obligation.

Finance, too, tracks the standard for-profit menu. B corporations issue debt and may utilize equity investors by selling various classes of common or preferred stock.[168] Dividends are uncapped and shareholders have rights to acquire any residual assets on dissolution, following the usual order of priority.[169] B corporation shares may be kept closely-held or may be offered for sale to the wider public.[170] Closely-held shares may be subject to

161. *See* B RATINGS SYSTEM, *supra* note 134, at 3, 26.

162. *Id.* at 3–4

163. *Id.* at 4.

164. *Id.* at 26.

165. *See* Certified B Corporation, Become a B Corporation, http://www.bcorporation.net/become (last visited Oct. 3, 2009).

166. *See* How are companies Certified and Audited as B Corporations?, *supra* note 134.

167. *See* B RATINGS SYSTEM, *supra* note 134, at 27–28.

168. *See, e.g.*, DEL. CODE ANN. tit. 8, § 151 (2009).

169. *See, e.g.*, §§ 170, 281.

170. *See, e.g.*, §§ 151, 342.

de jure transferability limits under shareholder agreements or de facto ones due to their closely held nature.[171] Publicly-held shares are freely transferable but offer much greater risk of changing the complexion of a B corporation's shareholding constituency.[172] B corporation founders and leaders may well desire to keep the corporation closely-held in order to scrutinize potential shareholders and constrain them by agreement. Even if the financing capacity of public share ownership becomes attractive, those leaders committed to the "B" ideals may well adopt additional structures to limit shareholder power or avert takeovers by a less committed individual or group.[173]

The B Corporation thus makes few changes from the traditional corporation, save branding. This branding may, of course, be an important contribution.[174] It could draw in directors committed to a blended mission and investors willing to enforce it. It could become something consumers, employees, and business partners value. The brand also entails a private regulatory system to help enforce a blended enterprise's dual mission, but it remains to be seen whether this system will have strong teeth.

II. COMPARISON AND CRITIQUE

To be an effective governance structure, a hybrid form must provide a mechanism for accomplishing and enforcing the idea of a blended mission: doing well by (or at least while) doing good. Existing charitable and business forms are not ideal structures for entities pursuing blended profit and social missions. It is this inhospitability, in part, that generates the interest in crafting new hybrid forms to accommodate such endeavors. For the innovations offered by L3Cs, CICs and B corporations to be worth the effort made to enable and adopt them, they must provide some advantages in achieving a blended mission over the traditional charitable or business forms available.

Standard charitable forms are constrained in performing this role in two important ways. First, nonprofit corporations or charitable trusts are

171. Jimmy G. McLaughlin, *The Limited Liability Company: A Prime Choice for Professionals*, 45 ALA. L. REV. 231, 242 (1993) ("It is quite common, especially in closely held corporations, for substantial restrictions to be placed on shareholders' rights to transfer their stock interests."); Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 BERKELEY BUS. L.J. 263, 275 (2008) ("[C]lose corporation shareholders will seek restrictions on transfer of stock so they can control who they have to work with.").

172. *See, e.g.*, DEL. CODE ANN. tit. 8, § 159.

173. Brakman Reiser, *supra* note 143, at 37.

174. *See* Kelley, 84 TUL. L. REV. at 361-62, 368-70, 376-77 (noting the importance of branding for social enterprise, though expressing doubts about the B corporation's viability to create one).

subject to a legal bar on distributing their profits.[175] This non-distribution constraint is imposed by many sources, including nonprofit corporate, charitable trust, and federal income tax law.[176] The impact of these restrictions is clear: a charity's founders and managers may not pursue a profit-taking strategy beyond provision of reasonable compensation for services rendered. Second, and relatedly, the unavailability of profit-distribution likewise places equity financing, and its attendant potential stream of investment, off-limits to fund traditional nonprofits. They must finance their operations through some combination of debt, donations, and retained earned income. Earned income financing strategies are further constrained by the limitations that federal tax exemption regulation imposes on charities' commercial activity. These limitations are by no means complete, and traditionally structured charities may and do engage in substantial commercial activity. The commerciality doctrine and the federal income tax on charities' unrelated business income will, however, complicate and overhang their commercial endeavors.[177]

Standard business forms likewise align imperfectly with the goals of hybrid activity, mainly due to legal and practical problems incident to their owners' control. The issues arise most starkly in a publicly-held corporation. Despite occasional exceptions permitting incidental consideration of other constituencies' interests, for-profit corporate law expects directors to manage their corporations in order to maximize shareholder wealth.[178] Even where this law is unclear or permits directors some flexibility to consider social objectives, it does not suggest that broader social concerns should be treated on a par with shareholder interests. Moreover, with or without a legal imperative, market realities incline directors and managers of public corporations to pursue profits for shareholders. If directors leave potential profits unexploited, they run several serious practical risks. They may be turned out in a future election or, more likely, they may face a sel-

175. *See* REVISED MODEL NONPROFIT CORP. ACT § 13.01 (1988); *see also* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) ("A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.").

176. Brakman Reiser, *supra* note 143, at 7–8.

177. *See generally* Evelyn Brody, *Business Activities of Nonprofit Organizations*, *in* NONPROFITS & BUSINESS 83–127 (Joseph J. Cordes & C. Eugen Steuerle eds., 2009); MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 247–48, 289–95 (2004); John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667, 669–79 (2007).

178. *See* Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 736 (2005) ("Unless modified by statute, traditional fiduciary duties require corporate managers to further the interests of shareholders, and thus require them to maximize corporate profits subject to the obligation to comply with independent legal constraints.").

loff by irate existing shareholders or a hostile tender offer by outsiders confident they can make the corporation more profitable if they train their sights exclusively on profit-generation.

Smaller, closely-held corporations and unincorporated forms offer somewhat greater room for blended objectives. These forms often indicate a greater overlap between management and ownership, which can remove the opportunity for conflict. Even when these categories are not identical, in a close corporation, shareholder agreements enable founders to exert significant control over who buys into the corporation, as well as the transfer of ownership shares thereafter.[179] In the partnership and LLC form, controls over admission and transfer operate as statutory defaults.[180] If owners come together to pursue a blended mission and can contract to prevent each other from selling out to more single-mindedly profit-oriented investors, they can protect their vision. Still, the appetites and desires of owners can shift, and even closely-held and unincorporated business forms are *business* forms. If a set of owners come, over time, to favor profits over social goals, it will be hard to constrain them from voting their preferences. If enough owners come to this position, their votes can dominate their fellows and change the course of the entity. Thus, neither traditional charitable nor traditional business forms precisely track the needs of blended enterprise.

The hybrid forms described here have been created to bridge this gap. Each is essentially defined by an intention to pursue a blended mission. An L3C is an entity organized for business purposes but operated to further charitable or educational purposes, without which it would not have been formed.[181] A CIC is a company "designed in particular for social enterprises that want[s] to use [its] profits and assets for the public good."[182] A B corporation "uses the power of business to solve social and environmental problems."[183] The forms vary, however, in the means by and extent to which they offer a structure for financing and enforcing a blended profit and social mission. This variation may over time create a natural data set allowing comparison of which form provides the greatest encouragement for blended enterprises. Such a review would now be considerably premature. At this early stage, instead, the remainder of this part points to some

179. Wells, *supra* note 171, at 275.
180. *See* UNIF. P'SHIP ACT §§ 501–502 (1997); UNIF. LTD. LIAB. CO. ACT §§ 501–503 (1996).
181. *See, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27)(A) (2008).
182. *See* CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 4.
183. *See* About B Corp, *supra* note 133.

of the pressure points that seem likely to arise from the varying ways these forms resolve the questions of financing and enforcing a blended mission.

A. *Financing Blended Enterprises*

The forms described here all provide blended enterprises with a means to attract more investment, but each varies the traditional investor role somewhat differently.[184]

Following LLC default rules, the L3C offers members the right to share in midstream and residual profits, but transferability (and therefore liquidity) may be quite limited. The default LLC rule permits a member to transfer her economic interest at will, but governance rights will not follow this transfer unless the other members (often unanimously) agree to admit the transferee to membership. This distinction makes the default LLC membership interest differ importantly from standard common stock. Of course, these rules are defaults only, and L3C operating agreements can certainly be tailored to provide more fully transferable membership rights that are more closely akin to common shares.[185]

As an extremely flexible default structure, it is difficult to generalize about how L3Cs will be financed in practice. The tranched membership model, however, provides one fully articulated vision of L3C finance that can be considered, drawing on three different pools of investors. First, the tranched membership L3C offers the potential for these entities to access philanthropic funds. As noted, the equity tranche of the L3C is targeted to secure program-related investments from private foundations. Although, of course, other donors could also provide funds to L3Cs, the entire L3C project has been tailor-made to appeal to the PRI market. Whether this will unleash dramatic new waves of financing for blended enterprises is again subject to some important assumptions. First, there are those who argue that foundations would like to make more PRIs but are frustrated in doing so by the cost of obtaining advance rulings that particular investments will

184. Investors in all of these hybrid forms would have limited liability; their liability for the entities' debts is capped at their investment.

185. The simple model operating agreement developed by Americans for Community Development appears to permit unilateral transfers of the economic interest in an L3C membership subject to a right of first refusal by current members. If other members do not exercise this right, a transferee may take on full membership rights by consenting to the operating agreement and admission by the manager. *See* L3C OPERATING AGREEMENT 6, 8 (2007), *available at* http://www.americansforcommunitydevelopment.org/supportingdownloads/L3COperatingAgreement.pdf; *see also* LOW-PROFIT LIMITED LIABILITY COMPANY OPERATING AGREEMENT, 35, 37 (2008), *available at* http://www.americansforcommunitydevelopment.org/supportingdownloads/L3C_Prototype_Operating_Agreement.pdf (similarly creating right of first refusal and admission on vote of governing board).

so qualify.[186] If the IRS were to issue a blanket ruling that a state-sanctioned L3C would pre-qualify as a proper PRI, or even provide a safe list of vetted organizations or a safe harbor for foundations investing in L3Cs with various qualities, these fears would be significantly eased. If the IRS does not do so, these potential funds will not be accessed much more easily by the equity investors in a tranched L3C than they are by current social enterprises structured as for-profits. The IRS has not yet issued any such blanket ruling, and some recent comments suggest their possible unease with doing so.[187] Even if the IRS takes the blanket ruling course, there are also critics who argue that the current law is very open to PRIs and suggest that the need for a new PRI vehicle is overstated.[188] If these critics are correct, then even regulator-blessed L3Cs may not find a large and willing market for their equity tranche memberships.

Additionally, the success of a tranched membership L3C's mezzanine tranche depends on how large a slice of the investing public will be interested in a below-market financial return combined with the psychic value of investing in an entity pursuing a blended mission. In order for L3C mezzanine tranche financing to be successful, this untapped market must be large, and the L3C model must be known to its consumers and provide them sufficient confidence that a blended mission will be pursued.

Finally, the senior tranche provides a means for attracting market investors akin to preferred shareholders or debtholders. These types of investors by definition agree to limited or no access to governance rights, instead obtaining a safer or greater share of an entity's profits than common shareholders. Senior tranche L3C memberships are structured on just this model.[189] A for-profit investor invests, agreeing to abdicate governance rights to the equity tranche foundations, in exchange for seniority and ac-

186. Michael N. Fine, Kerrin B. Slattery & Keith Staats, *Illinois Recognizes New Business Entity That Mixes For-Profit And Nonprofit Elements*, MCDERMOTT WILL & EMERY, Aug. 28, 2009, *available at* http://www.mwe.com/index.cfm/fuseaction/publications.nldetail/object_id/7e32373a-065a-4d91-a8c2-556532d769a9.cfm ("The only way to be certain of PRI treatment, currently, is for a private foundation to seek a private ruling from the IRS. However, the private letter ruling process consumes both time and money.").

187. *See* Mark Hrywna, *The L3C Status: Groups Explore Structure that Limits Liability for Program-Related Investing*, NONPROFIT TIMES, Sept. 1, 2009, *available at* http://www.nptimes.com/09Sep/npt-090901-3.html (reporting comments made by Ron Schultz, senior technical advisor with the IRS's Tax Exempt and Government Entities Division, that "warned against jumping on the LC3 bandwagon too early because of unresolved tax questions").

188. *See, e.g.*, MARK KRAMER & ANNE STETSON, A BRIEF GUIDE TO THE LAW OF MISSION INVESTING FOR U.S. FOUNDATIONS, 9–10 (2008), *available at* http://www.fsg-impact.org/app/content/ideas/pdf/TheLawandMissionRelatedInvestingBrief.pdf (last visited Feb. 23, 2010).

189. Ensuring the transferability of these memberships will again be important, in order to access a traditional bondholder or preferred market.

cess to market-rate returns. Yet, in a traditional corporate financing structure, the company's objective is singularly or predominantly to maximize profits. Although preferred shareholders and debtholders do not have governance rights per se, they may count on the governance rights of shareholders—and directors' fiduciary obligations to them—to provide protection for their investment. In a tranched L3C with a blended profit and social mission, investors in preferred- or debt-like products may be made wary by foundations' dominance of the governance process.

To know whether the L3C form will draw in significant new investment to blended enterprises, one must answer the empirical question regarding the size of investors' appetites for investments in them. There are empirical questions as to the size of the frustrated PRI market, if any, and whether the IRS will regulate to prop up the L3C form. In addition, for the mezzanine tranche to be successful, the L3C must provide social investors with a recognizable and trusted brand. Finally, a tranched membership L3C must find a way to assure its targeted market-rate investors that their promised returns will be achieved when the entity is not being managed toward an ultimate profit goal. Thus, L3Cs' ability to enhance funding for blended enterprises is subject to many risks.

With its multiple funding stream approach, though, the L3C does perhaps diversify some of these risks. It is also possible that the three funding tranches could be pursued in turn, one at a time, rather than all at once at the L3C's founding. Both social and market rate investors will likely be more confident in investing in an established L3C than in an unknown start-up. However, the L3C will not be able to offer the traditional carrot social mission-based entities offer to suppliers of investment capital—tax-exempt interest payments.

The CIC form seems likely to confront the greatest challenges in developing financing for blended enterprises. The CIC specifically targets equity investors, but it offers them only a fairly radically altered version of shares. Members of CICs limited by shares hold shares of the entity, but these shares entitle their owners to receive midstream profits only—and these profits remain capped. Shareowners are not entitled to residual profits on the dissolution of a CIC. Indeed, the enabling statute specifically prohibits such residual distributions through the asset lock. A CIC may also utilize debt-like financing instruments, but these are subject to additional regulation to ensure that they do not undermine the dividend cap and asset

lock provisions.[190] In addition, CIC investors cannot be certain that their interests will predominate the concerns of management. Instead, investors must share governance rights, or at least access to the governance process, with all manner of stakeholders that a CIC is required to include in its governance structure.

This rigid financing structure seems to compound the various funding concerns identified with respect to the L3C. Again, the CIC assumes a pool of investors with an appetite for wedding financial and social return and sufficient brand awareness and confidence to appeal to them. The CIC, however, requires these investors to be especially devoted to the blended enterprise concept by substantially limiting the upside of their investments. Imagine a CIC that becomes spectacularly successful and could pay out substantial profits to investors while still achieving a significant social impact. The limits on distributing midstream profits and the prohibition on distributing residual ones will prevent this CIC's investors from seeing any greater return than would investors in a CIC making only sufficient profits to declare the statutory maximum dividend. As the oldest of these young forms of organization, some of these challenges to CIC's financing strategies have already been the subject of criticism, documentation, and revision.[191] The revised CIC dividend caps may better strike the necessary balance; only time will tell.

The B corporation preserves the traditional attributes of equity ownership virtually unscathed. Shareholders remain the ultimate owners, entitled to the residual profits and assets of the corporation. These profits may be provided to them during the B corporation's operations, via dividends, or at dissolution through a liquidation or sale process. Like in any other corporation, the practical realities of the size of the entity and the dispersal of its

190. The Regulator of Community Interest Companies, Information and Guidance Notes § 7.3 (2008), http://www.cicregulator.gov.uk/guidance/Chapter%202%20-%20October%202009%20(version%203%20Final).pdf (last visited Feb. 23, 2010).

191. As noted above, the recent CIC Regulator consultation sought input on whether current cap levels may have frustrated CIC's ability to attract capital. *See* CONSULTATION ON THE DIVIDEND AND INTEREST CAPS, *supra* note 125; *see also* David Ainsworth, *Government urged to lift dividend and interest caps on CICs*, THIRD SECTOR, http://www.thirdsector.co.uk/Channels/SocialEnterprise/Article/914804/Government-urged-lift-dividend-interest-caps-CICs/ (June 23, 2009) (reporting on the Charity Law Association's response to the consultation urging CICs to be permitted to "distribute to 49 percent of their profits and have no maximum dividend . . . per share"). The responses demonstrated significant frustration with the dividend caps, with financiers reporting they disincentivize investment, and non-CIC social enterprises suggesting the caps were a reason they chose not to utilize the CIC form. *See* SUMMARY OF RESPONSES, *supra* note 126, at 5–6. The Regulator's responded by changing the dividend cap to "20 percent of the paid up value of a share." NOTICES UNDER THE COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) ACT 2004, *supra* note 122, at 1.

shareownership will determine the extent to which B corporation shareholders may sell or otherwise transfer their shares. Legally, however, B corporation investors' shares are freely transferable and liquid. B corporations also may use other standard corporate financing methods, including debt and preferred shares, without restriction, but they seem unlikely to be able to gain broad access to donations.

All of a B corporation's investors, however, must be willing—if not eager—to invest their funds in an entity that will not pursue the funds' growth as its predominant objective. Thus, whether the B corporation form will increase the financing available for blended entities depends largely on the success of its branding efforts and the size of the market for investments such as these. If there is a large amount of capital waiting for an opportunity to invest in a blended enterprise, and they are aware of and assured by the "B" brand, this model should draw increased investment. If any of these key ingredients are missing, the promise of the B corporation's funding stream is limited.

B. Enforcing Blended Missions

The question of enforcement relates importantly to those of financing blended enterprise. As noted in the previous section, none of these forms can achieve their financing goals without establishing a recognizable brand that investors will view and trust as meaningfully distinct from business as usual. They must offer some real and enforceable commitment to social good. The L3C, CIC and B corporation forms each offer such commitment methods to investors, the strength of which will ultimately determine the success of their branding efforts.

Under the default rules, the blended mission of the L3C is essentially unprotected. The L3C is directed to pursue a charitable or educational purpose along with its profit objective. If the L3C at any time ceases to pursue its social mission, though, the consequence is merely conversion into a for-profit LLC. The invested and earned assets may remain within the former L3C. Its membership need not change. Neither internal constituencies nor an external regulator appear empowered to seek remedies against the former L3C or its management. So, at least as a default, an L3C's commitment to blended enterprise seems enforceable only by internal consensus. While the members invested in an L3C remain committed to its blended mission, the L3C will follow that mission. When sufficient numbers become disenchanted, the experiment with blended enterprise will quietly end. This end might come through the existing membership expressing the desire for a change toward profit objectives to the L3C's management, or

by voting in new management. Alternatively, if the default LLC transfer restrictions have been sufficiently altered, L3C members might sell their interests to buyers seeking to transform its mission.

The tranched membership structure is one way L3C founders might create their own enforcement architecture to safeguard their commitment to blended enterprise.[192] If the foundation funders in the equity tranche of an L3C's funding structure have control over the board, they can be entrusted not to put profit ahead of social good. As the last tranche entitled to payout, and even that at the lowest rates, these foundation investors will have less incentive to seize on profit goals. In addition, the limitations of the PRI context (in which we assume foundations' L3C investments will be made) prohibit foundation funders from allowing income generation or capital appreciation to become a significant purpose. The IRS may operate as a kind of shadow regulator here; as it monitors that PRIs are used properly, its enforcement may overhang the entire L3C environment. Thus, if adopted, the equity tranche control strategy seems fairly well-tailored to enforce an L3C's social commitments.

Still, the equity tranche control strategy for enforcing L3C's social commitments will not sufficiently enforce an L3C's business commitments and the truly *blended* mission idea. If the equity tranche has effectively no interest in profits, its control might well leave the L3C subject to the same lack of rigor and efficiency that is sometimes said to characterize charity management. Returning to the interplay between finance and enforcement, to attract sufficient capital for the mezzanine and senior tranches, potential investors will need to be convinced that the L3C structure provides an enforceable commitment to both profit and social good.

In contrast, the CIC form offers a high degree of structural enforcement for blended objectives, along with enforcement rights conferred on both internal constituencies and a dedicated external regulator. The major features of the CIC—its community benefit requirement, asset lock, and capped dividends—create a structural framework for balancing concerns of profit and social good. The entity must commit in advance to its desired social impact and its assets must be irretrievably dedicated to pursuing it. Even if the entity is sold or dissolved, its assets must remain in the community benefit or charitable stream. Yet, in the CIC limited by shares, the form specifically contemplates an equity class that will hold governance and profit-sharing rights. These rights, though, in turn are undercut by the

192. Lang Jr., *supra* note 24, at 4. The L3C's commitment to social goals could also be enhanced by retaining or strengthening the default LLC restrictions on transfer of membership interests. Doing so, however, would likely undermine the L3C's to access the capital markets to an unacceptable degree.

required involvement of other stakeholders in governance and the cap on dividends. These structural components will impede investors or outside forces seeking to vary the social mission of a CIC. In addition, shareowners in a CIC limited by shares might have standing to sue. It is possible this power might be used by shareowners so inclined to compel company directors to hew to the CIC's blended mission. Perhaps the group of shareowners invested in a CIC would be particularly likely to undertake such suits, as they will be motivated by the combination of a desire for community benefit and (albeit capped) investment gains. A CIC could perhaps further empower other stakeholders with rights to sue, but they are not granted such rights by the CIC statute, nor does the Regulator suggest such a role would be fitting.[193]

The CIC form, however, does not rely solely on internal enforcement. Instead, it empowers a dedicated CIC Regulator to monitor CICs' compliance with their mandates. In general, the Regulator oversees initial CIC registration and receives annual reporting documents updating the Regulator's office on a CIC's pursuit of community benefit and involvement of stakeholders. The Regulator does, however, have additional powers to "investigate complaints" and "act if it is found that a CIC is not working in the interest of the community or that the profit/asset lock is not being observed."[194] Specifically, the Regulator may change the makeup of the board or terminate the CIC.[195] Rather than leaving CICs to internal and private enforcement methods, this format envisions and funds a public backup system, at least for enforcing social commitments. Like the L3C, this additional enforcement apparatus does not give any support to enforcement of profit objectives. Perhaps its creators believe it unnecessary or are convinced that the shareowners and the realities of the marketplace will create sufficient incentives toward profit generation.

The B Corporation also employs weak structural enforcement mechanisms, and it empowers both internal constituencies and an external regulator. The structural components include the demands of the B Lab ratings system and the required language for B corporation charters. The B Ratings do not demand any specific commitments but rather give weight to a series of commitments an applicant makes to combining its social and profit goals. The initial certification offers a snapshot of how an enterprise is fulfilling its blended mission at the time it receives a passing score from B

193. None of the guidance provided by the Regulator suggests empowering other stakeholders with the right to sue.

194. CIC FREQUENTLY ASKED QUESTION, *supra* note 94, at 12.

195. *Id.*

Lab. The survey questions do not, however, generally require the applicant to show an enforceable commitment to retaining those programs or practices that add up to a score entitling it to license the B mark. The charter amendments suggest a somewhat stronger commitment. They require B corporation directors to consider the impact of all of their business decisions on the environment and society. Enshrining this obligation in the corporation's charter goes some distance toward structuring the corporation with blended objectives.

Neither of these components, however, is necessarily self-enforcing. The B corporation form imposes no limits on transfer of ownership by individual investors, offers potentially limitless profit-sharing possibilities, and does not lock any of the corporation's assets into the social enterprise or charitable stream. A B corporation may revise its purposes away from social and environmental goals and redeploy its assets for this use. To ensure that the profit objective does not overwhelm social ones, the B corporation form empowers individual investors to enforce the blended mission through ordinary shareholder mechanisms. They may use their voting rights or rights to sue to encourage directors to follow the charter's instructions, but will do so only if they have sufficient incentives.

Additionally, here, unlike in the CIC, if directors stray too far from social mission in pursuit of profits, these profits may be shared with investors with few limits. Thus, there is the potential for shareholders to be co-opted into a decision to consolidate mission around profit objectives. Without limitations on transfer of shares, these investors might also be bought out by those willing to be so co-opted. The B form does not leave open the possibility that other corporate constituencies will enforce such obligations. The required charter amendments specifically and explicitly decline to empower other stakeholders with standing to sue.

This is, perhaps, why the B corporation also establishes a means for external enforcement by a private regulator: B Lab. Through the audit process and licensing agreements, B Lab is able to revoke its brand from companies that, over time, stray from the blended commitments that initially qualified them. It remains to be seen how seriously B Lab takes this enforcement obligation. On the one hand, if it wants to build the value of its brand, it must not allow "B" to become a marker for greenwashing or its social good equivalent. It must enforce at some level in order to build credibility with investors and other groups it desires its mark to impress. On the other hand, in order for the "B" mark to do any of this, network effects are also important. It must have enough licensed users of the brand to make consumers aware of it, and if its demands are too stringent or too

strictly enforced, it will offer the mark to too small a group to succeed.[196] Providing the optimal level of self-regulation in light of these two sometimes conflicting objectives is challenging. B Lab at the moment seems quite dedicated to this task, but its ability to succeed remains to be seen.

III. CONCLUSION

To achieve their goals of broadening the scope and reach of blended enterprise, hybrid forms of organization must both expand the financing available to these entities and offer some means for enforcing their commitments to blended missions. The L3C, CIC and B corporation each tackle these questions, offering a menu of options to hybrid founders. All offer something like equity financing. They also enable more and more flexible forms of debt financing, similar to those utilized by for-profits. Each form also offers some means to constrain hybrid organizations and their management from straying off the blended mission path—or at least from focusing too fully on profit-making. Each provides a method for constraining these actions internally, usually through governance, though sometimes through limitations on transfer of investments or assets. The CIC and B corporation complement internal enforcement with external regulation and monitoring, through a public or private regulator, respectively.

At this early moment in their development, it is too soon to diagnose with certainty which, if any, of the extant hybrid forms will emerge as successful and which will fall by the wayside. One pattern that does emerge, however, is striking. The two invaluable contributions a hybrid form must make—expanding financing options and providing enforceable commitments to a blended mission—appear to trade off against each other. The CIC form faces the most serious obstacles to enhancing financing, by virtue of the dividend cap and asset lock limiting the gains investors may take from the entity. Yet, the very same dividend cap and asset lock mechanisms endow the CIC with the staunchest commitments to social good of all the forms.[197] These strong structural enforcement mechanisms are then further backstopped by the possibility of private enforcement by shareholders and public enforcement by the CIC Regulator.

196. *See* Mary Kay Gugerty & Aseem Prakash , *Voluntary Regulation Of Ngos And Nonprofits: An Introduction To The Club Framework* at 56-57, *in* VOLUNTARY REGULATION OF NGOS AND NONPROFITS: AN ACCOUNTABILITY CLUB FRAMEWORK (Gugerty & Prakash, eds. forthcoming Cambridge University Press 2010).

197. The CIC Regulator has noted this dilemma already. *See* CONSULTATION ON THE DIVIDEND AND INTEREST CAPS, *supra* note 125 (noting the Regulator's receipt of complaints about the restrictiveness of the dividend caps interfering with CIC's ability to obtain initial and growth funding, yet also receiving compliments that the same appropriately protect community purpose).

The B corporation, by its ability to provide an unrestricted upside to investors, seems poised to access a greater share of the investment market. However, a B corporation's commitment to blended enterprise may be ephemeral. If its shareholders change their minds about pursuing social benefit, or sell to those who would do so, the corporation's assets may be redeployed for this new purpose without restriction. Of course, B Lab may eventually unearth a B corporation's decision to stray from its blended purposes and revoke the B mark, but this would appear to be the only potential risk of such a strategy.

Even the tranched membership variant of the L3C form appears subject to this quandary. By tranching the funders, it attempts to appeal to three different streams of funding: foundations seeking to place PRIs, socially-responsible investors, and market-rate investors. Assuming there are indeed foundation and socially-responsible investor markets sufficient to capitalize L3Cs' equity and mezzanine tranches, this seems indeed poised to unlock substantial new capital for social enterprise. However, for foundations to make their PRIs, they need to be granted significant power to control the L3C's fidelity to a social mission and the LLC's flexible governance framework will enable it. The IRS' role monitoring foundations will buttress this arrangement. But, this puts governance in the hands of an entity perhaps over-committed to social goals, rather than blended ones. Socially-responsible investors may or may not be willing to rely on foundations' judgment to run blended enterprises. Market rate investors will likely be even charier of relying on foundation-controlled boards to generate returns sufficient to meet L3Cs' obligations to them. No external regulatory mechanism has, as yet, been created to mediate these conflicting goals.

It is possible that the impasse cannot be breached, and instead the creators of any hybrid model will simply have to choose a point at which they are willing to trade access to capital for enforcement of blended mission. Perhaps the current vigorous experimentation in this field will one day generate invaluable data on the optimal point to select, via a kind of natural experiment. Or, perhaps, over time, private or public regulators like B Lab and the CIC Regulator will be able to offer insights on how best to set this balance. Until then, the L3C, CIC and B corporation models offer founders of blended enterprises a range of possibilities to try to improve the financing and enforcement of their dual goals.