

Attachment A

To do justice to this topic, we turned to Allen Bromberger, the leading attorney in the emerging and highly specialized field of social enterprise financing. In recognition of his passion and brilliance in this field, he was recently awarded the 2008 Leadership Award by the Social Enterprise Alliance. He has a great way of turning arcane legal constructs into vivid, simple concepts you can work with. He graciously provided a primer on this topic for our readers.

STRATEGIC IMPLICATIONS OF SOCIAL ENTERPRISE FORMS

By Allen R. Bromberger

Because social enterprises often seek to pursue business and non-business objectives within a single entity, it is hard to fit them into traditional legal forms.

If the business will be capitalized primarily by *invested capital* (capital provided with the expectation that the investor will receive a financial return), a business corporation or limited liability company is probably a better choice than a non-profit charity as the mother ship for the enterprise. On the other hand, if the venture will be primarily financed by *donated capital* (capital for which no financial return is expected), a nonprofit mother ship will probably be best, especially if the “investors” want or need a tax deduction for their contributions. But rarely will one entity suffice for a true social enterprise. Usually a combination of entities is required.

Using Non-profits for Social Enterprise

Non-profit corporations cannot issue shares and cannot distribute profits to “owners” the way that business corporations or LLC’s can. However, non-profits can issue debt and pay interest to lenders. So long as the rate of interest is commercially reasonable, and the purpose of the debt is to further the charity’s interests rather than that of the lender, it does not matter that the lender is motivated purely by a profit motive. A charity can even create different classes of debt, each with different economic rights based on different financial arrangements.

Another significant challenge for charities that operate businesses is Unrelated Business Income Tax, otherwise known as UBIT. UBIT is a tax on income to the charity that comes from an “unrelated” business activity. A charity’s income is subject to UBIT – which means it is taxed at normal corporate tax rates – if it comes from a trade or business that is regularly carried on *and which does not contribute to the charity’s mission in any important way other than through the production of income*. Certain activities, such as publishing or advertising, are treated as unrelated income by IRS regardless of whether they are related to the charity’s purposes, and revenues from those activities are therefore automatically subject to UBIT.

Using For-Profits for Social Enterprise

Using a for-profit entity as the vehicle for social enterprise offers a number of business advantages. It avoids all of the restrictions of using a charity, and it allows the organizers much greater flexibility in raising capital. In addition to debt, business corporations can issue shares and pay dividends, they can enter into profit-sharing arrangements with other businesses, and they are not subject to the "reasonable compensation" rule or UBIT. A primary disadvantage of a business corporation is the fact that contributions to the business are not tax deductible, and contributions by the business are only deductible up to 10% of net income.

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

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

LLC laws in virtually every state allow great flexibility in structuring governance and management, much more so than the laws that govern business corporations or non-profit corporations. LLC members have wide leeway to allocate profit and loss and management powers among themselves however they see fit, and as with business corporations, different classes of membership are permitted, each with its own economic rights.

LLC's are well-suited for enterprises with a limited number of investors and relatively low investor turnover. However, if shares are to be offered to the public, or frequent investor turnover is expected, a business corporation will probably serve better than an LLC.

Using a Joint Venture for Social Enterprise

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

The participants in a joint venture do not, of course, have to create a separate entity as the vehicle for a joint venture. Many so-called joint ventures are created by agreement only, using such vehicles as grant agreements, financing agreements, management agreements, joint operating agreements, leases, licenses, corporate sponsorship agreements or contracts for services.

*Bromberger has been an innovator in developing new and unique forms for social enterprises because there are conflicting advantages and disadvantages to the existing non-profit and for-profit choices. His knack is for creating structures that offer the social enterprise the best of both worlds because, neither form is perfect.*Select this line and start typing