

Forms of Organization Overview Step toe & Johnson LLP

Last Updated: June 2013

Table of Contents

1. Nonprofit Corporations
2. For-Profit Corporations
3. Limited Liability Companies
4. Low Profit Limited Liability Companies (L3C)
5. Joint Ventures
6. Partnerships and Limited Partnerships
7. Sole Proprietorships
8. New Forms Social Sector Organizations
9. Resources

The most common legal form of organization utilized by the social sector is the nonprofit corporation; however, for-profit corporations, limited liability companies (LLCs), joint ventures and various kinds of partnerships, including limited partnerships, are increasingly being used--typically to accommodate plans to earn revenues or access capital markets. Each of these forms of organization has advantages and disadvantages and sometimes, with the help of experienced counsel, they are used in combination to maximize strengths and minimize weaknesses of a particular form. The following chart provides a high-level overview of various organizational forms that can be used in the social sector. More detailed descriptions of each form follow in the subsequent text.

	Formation	Management and Control	Liability	Tax Factors	Capital and Loans
Nonprofit 501(c)(3) Corporation	File articles or certificate of incorporation (containing specific info required by IRS) with state and pay filing fee. File application on Form 1023 for tax-exempt status unless below gross receipts threshold. Recruit directors, draft bylaws and hold	Managed by directors who appoint officers to run day-to-day operations as specified in bylaws. Some nonprofit corporations have members (like shareholders) who elect directors.	Members, directors, officers and employees are generally not liable for debts and obligations of the corporation, including for unlawful acts of others involved in the affairs of the corporation. They can be held liable for injuries due to	Generally exempt from federal and state taxes if receive 501(c)(3) exemption. Liable for tax on unrelated business income, and other taxes such as property and sales (unless local and state exemptions apply). Donors can deduct contributions	Can accept charitable donations and grants. Eligible for program related investments (PRIs) by foundations. Can borrow money and issue debt instruments but cannot raise capital by issuing stock.



	Formation	Management and Control	Liability	Tax Factors	Capital and Loans
	organizational meeting. Take steps to comply with license, tax and employment law/regs.		their own misconduct but some states provide limited immunity to such persons and only volunteers.		
For-Profit Corporation	File articles or certificate of incorporation with state and pay filing fee. Decide on board of directors, draft bylaws, hold organizational meeting and issue stock. Take steps to comply with license, tax and employment laws/regs.	Managed by directors that are elected by shareholders. Directors appoint officers to run day-to-day operations as specified in bylaws.	Shareholders are generally not liable for debts and obligations of the corporation, including for unlawful acts of others involved in the business. Unless indemnified by the corporation, directors, officers and employees can be held liable for injuries caused by their own acts or failures to act.	A C Corporation is subject to corporate tax on net income. If net income is paid to shareholders as dividends, the individual shareholders are taxed. If a corporation elects to be an S corporation and meets several criteria, it can receive "pass through" taxation.	Can raise capital by issuing stock (equity) and by borrowing money through loans or other debt instruments. Corporation may be able to accept PRIs from foundations in the form of loans or equity.
B Corp (a for-profit corporation with a social mission that is licensed to use the trade name "B Corporation")	See for-profit corporation	See for-profit corporation. The B Corp license requires the corporation to incorporate specific socially beneficial performance standards into its governing documents and operating principles.	See for-profit corporation.	See for-profit corporation.	See for-profit corporation. A B Corp should be in a better position to attract PRIs from foundations in the form of loans or equity.
LLC	File articles of organization or certificate of formation with state and pay filing fee. Negotiate and execute operating agreement. Take steps to comply with license, tax and employment law/regs.	Flexible structure like a partnership with management responsibilities specified in operating agreement (usually management committee or single manager).	Same as a corporation.	Usually not taxed as an entity because most LLCs choose "pass through" treatment whereby the member/owners report profits and losses on personal tax returns. Tax-exempt member/owners treat their share of income as exempt or subject to unrelated business taxable income, depending on the character of the income.	Can raise capital through contributions by member/owner. Otherwise, same as for-profit corporation.

	Formation	Management and Control	Liability	Tax Factors	Capital and Loans
L3C (low-profit LLC)	Similar to LLC but must be formed for a charitable or educational purpose. Only permitted in certain states (e.g., VT, IL, MI, UT, ME, WY, NC, LA)	See LLC	Same as a corporation	See LLC.	Same as for-profit corporation except L3C enabling legislation is written to comply with PRI regs and is thus intended to attract equity or debt investments by foundations.
Partnership	No filing requirements unless limited partnership (LP) or limited liability partnership (LLP), but partners should sign partnership agreement. Take steps to comply with name, license, tax and employment law/regs.	Partners have equal, full control unless otherwise specified in partnership agreement.	Partners are personally liable for the debts and obligations of the partnership, including for unlawful acts of other partners and employees. Risk can be limited by creating an LP or LLP.	Generally not taxed as an entity. Partners report profits and losses on personal tax returns.	Can raise capital through contributions by partners and by borrowing money through loans or other debt instruments.
Sole Proprietor	No filing requirements. Has no legal existence apart from owner. Take steps to comply with d/b/a name, license, tax and employment law/regs.	Owner has full control.	Owner is liable for all debts and obligations, including for unlawful acts of employees.	Not taxed as an entity. Owner reports business profits and losses on personal tax return.	Owner provides funds for capital investment and owner can borrow money through loans or other debt instruments.
Cooperative	Exists for benefit of member-owners who use its services or buy its goods. Depending on state law, may be for-profit corporation or separate entity. Formation documents and filing requirements specified by state law.	Controlled by member-owners who elect board of directors	In general, member-owners are not liable for debts and obligations of co-op merely on account of their status as member-owners. Risk is limited to amount invested in the co-op.	Depending on purpose, some co-ops can qualify as tax exempt organizations. Both exempt and nonexempt co-ops may reduce or eliminate patronage source earnings at the entity level by distributing income to patrons on the basis of patronage. This is a complex subject; expert tax advice is recommended.	Typically, member-owners invest in shares to provide operating funds but see state authorizing laws for provisions governing capital and loan provisions
Flexible Purpose Corporation	File articles of incorporation which shall set forth a flexible purpose corporation statement as	Managed by directors. Yearly management discussion & analysis of the FPC's special	Liability of the directors of the corporation for monetary damages limited by CA law. FPC is authorized	Taxed as a for profit corporation; subject to corporate tax on net income.	Can raise capital by issuing stock, borrowing money through loans or other debt instruments. FPC

	Formation	Management and Control	Liability	Tax Factors	Capital and Loans
	outlined in Corporate Flexibility Act of 2011, as well as an additional statement regarding one or more charitable or public purposes. Available in CA only.	purpose. Directors may consider and weigh factors such as short and long-term prospects of the FPC, the best interests of the FPC and its shareholders, and the purposes of the FPC	to provide indemnification of agents for breach of duty to the FPC. Protection for directors & management who make decisions based on the agreed special purpose.		may be in a better position to attract impact investment and PRI capital.
Benefit Corporation	File articles of incorporation with state and pay filing fee in accordance with state law. Articles must state org is a benefit corporation. Existing corporations can become a benefit corps by amending articles of incorp. Available in AZ, AK, CA, CO, HI, IL, MD, MA, LA, NV, NJ, NY, OR, PA, SC, VT, VA, DC.	Officer of a benefit corporation shall consider the interests laid out in the articles of incorporation if: the officer has discretion to act with respect to a matter, and it appears that the matter may create general public benefit. An officer does not have a duty to a person that is not a shareholder.	Consideration of interests listed in the articles of incorp shall not constitute a violation of the general standards for directors. officers are not personally liable for monetary damages for performing duties in compliance with the public benefit; officers shall not be personally liable for failing to pursue or create general benefit.	A benefit corporation is a for-profit corporation and is generally not afforded tax breaks, although the municipality of Philadelphia gives up to \$4,000 in tax credits. MD may consider tax incentives for benefit corps.	Benefit corporations are able to attract the same types of capital as regular corporations. Additionally, benefit corporations may be more successful in attracting PRI, socially and environmentally responsible investment or impact investments.

Nonprofit Corporations

Overview

A nonprofit corporation is managed by its board of directors and operated by its officers. Instead of shareholders, a nonprofit corporation may, but is not required to, have members. Nonprofit corporations, of course, are specifically organized to not earn profits. No part of the income or surplus of a nonprofit corporation may be distributed to its members, directors or officers; however, reasonable compensation may be paid for services rendered.

A nonprofit corporation has an existence of its own, independent of the terms of office or employment of members, directors or officers. It can sue or be sued in its own name and can own real estate in its own name.

Advantages of Incorporation: pros and cons of nonprofit vs. for-profit

The principal advantage of incorporation is that it protects the shareholders or members from personal liability for the obligations and liabilities of the corporation, including unlawful actions of officers, directors and staff acting on its behalf. In addition, incorporation establishes continuity; corporations (both nonprofit and for-profit) are subject to a body of statutes that provide very specific guidance as to their formation and operation; and incorporation brings stature to the organization and implies stability.

Where profit is not a goal and the enterprise can be funded without the need for access to capital markets, the nonprofit corporation is the preferred vehicle for pursuing social objectives. Although nonprofit corporations are not prohibited from engaging in commercial activities, the directors of a nonprofit are duty-bound to devote primary attention to the promotion of the social mission of the corporation rather than the production of net income. A notable benefit for incorporating as a nonprofit is that the organization is eligible to apply for tax-exempt status (often referred to as “501(c)(3)” status from the Internal Revenue Service. Tax-exempt status allows an organization to be exempt from federal corporate taxes and to be eligible for tax-deductible donations.

On the other hand, if access to capital markets is needed, a for-profit corporation (or limited liability company, discussed below) is likely to be the preferred option because nonprofit corporations cannot issue capital stock. The directors of a for-profit corporation, however, owe strict duties to the shareholders to maximize profits and value. Therefore, unless the directors and managers can tie the social mission of their for-profit corporation directly to its business purpose, they can be sued for breach of their duties to shareholders and for misuse of corporate assets if they focus too much on the social mission and forego profits. This problem can be avoided if all shareholders agree to pursue a social mission or devote a percentage of revenues to charitable causes but such agreements may be temporary because a change in control—or a drop in earnings—can lead to amendment or abrogation of shareholder agreements.

Formation

A nonprofit corporation attains its separate legal status through the filing and approval of its articles of incorporation. This document is in essence a contract between the state and the nonprofit corporation in which the state grants individual legal status to the corporation in exchange for the corporation’s commitment to follow its rules.

If the nonprofit corporation intends to obtain exemption from federal income tax, the articles of incorporation must conform with applicable federal statutes and regulations.

Management and Control

Once the nonprofit corporation has been established, the initial board of directors should meet to ratify the acts in connection with the initial formation of the corporation and adopt bylaws. Bylaws set forth the rules and procedures governing the decision-making process of the board of directors and the general operation and management of the corporation consistent with the applicable state statutes and the articles of incorporation.

Typically, the bylaws of a nonprofit corporation contain provisions governing member, director and officer qualifications, powers, and duties; voting; filling of vacancies; meetings; indemnification of directors and officers; committees; books and records; fiscal years; conflicts of interest; and amendment procedures. Each state has unique statutes governing the management and control of nonprofit corporations.

Liability of Members, Directors and Officers

The directors, officers, employees and members of the corporation shall not be personally liable for the corporation’s obligations.

In some jurisdictions, directors of the corporation can be personally liable to the corporation or its members for monetary damages or breach of fiduciary duty as a director.

No member of a board of directors of a nonprofit corporation is personally liable for any damages resulting from any negligent act or omission of an employee or another director of that nonprofit corporation.

Mergers, Acquisitions and Dissolution

Each state has unique statutes governing mergers, acquisitions and dissolution.

Recordkeeping, State Reports and State Taxes

Each state has unique requirements for recordkeeping, state reports, and taxes.

Insurance

Nearly every type of activity by a nonprofit corporation can become the target of some kind of a claim by a firm or an individual that alleges damage or injury by the corporation or individuals responsible for it (i.e., directors, officers or employees). Even if the claim is without merit, the costs of defending against the claim can be very substantial.

To encourage qualified individuals to accept positions as directors and officers, many nonprofit corporations purchase insurance to cover director and officer (D&O) liability. In addition, most responsible nonprofit corporations purchase a basic comprehensive general liability policy that covers liability for accidents in the corporation's offices, at sponsored meetings and the like.

Liability insurance for nonprofit corporations is often a very complicated matter. Consultation with an experienced and knowledgeable agent or consultant is essential in order to obtain the right coverage at the lowest premium.

Taxation

Nonprofit entities are not automatically exempt from property and sales tax. They must apply for such exemption in their respective state. This process varies across the United States.

Resources

- Oleck and Stewart, *Nonprofit Corporations, Organizations & Associations* (Prentice-Hall, 1994, Cum. Supp. 2002)
- Jacobs, Jerald A., *Association Law Handbook* (ASAE & The Center for Association Leadership 4th ed., 2007)
- *Nonprofit Governance and Management* (American Bar Association and American Society of Corporate Secretaries, 2002)
- *Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley* (American Bar Association Section of Business Law, 2005)
- *Guidebook for Directors of Nonprofit Corporations* (American Bar Association Section of Business Law 2d ed., 2002)
- Takagi, Gene. "Nonprofit Bylaws - Common Issues" Nonprofit Law Blog <http://www.nonprofitlawblog.com/home/2009/09/nonprofit-bylaws-common-issues.html>

For-Profit Corporations

Using For-Profit Corporations to Pursue Social Objectives

The for-profit form of organization can and frequently is used as a vehicle for conducting a business that also has a social mission or objective. Although for-profit corporations are usually formed for the purpose of making money and distributing it to managers and shareholders, there is no reason why a for-profit corporation cannot include a social mission in the purposes clause of its articles [certificate] of incorporation.

While such a provision would authorize the corporation to pursue social objectives, it would not require the corporation to do so—only the shareholders/owners have this power. And unless all shareholders agree to pursue social aims, dissenters could sue the corporation's directors and managers for failing to operate the corporation in the best economic interests of the shareholders.

A shareholders' agreement is probably the best way to address this problem. Such an agreement, entered into by all shareholders and the corporation, would require the corporation to be managed and operated so as to pursue specified social objectives thereby overriding fiduciary duties and similar legal principles that govern "normal" behavior of for-profit corporations.

But even the most skillfully drafted shareholders' agreement is not a perfect solution because agreements can always be abrogated and amended and the owners of the shares can change via sale, gift or inheritance. Moreover, a tightly drafted shareholders' agreement which makes it difficult to respond to business changes over time would tend to render the for-profit corporation much less attractive to investors (potential new shareholders).

Formation

Like a nonprofit corporation, the incorporators must file articles of incorporation (sometimes called a certificate of incorporation). However, the formation process varies by state.

Management and Control

A for-profit corporation has a hierarchical control structure. It is managed by or under the direction of a board of directors and its officers, although its shareholders vote on important corporate issues, such as election of directors, mergers, sale of all assets and dissolution.

Similar to a nonprofit corporation, once the for-profit corporation has been established, the initial board of directors meets (in person or by consent), ratifies the acts in connection with initial formation of the corporation and adopts bylaws which set forth the rules and procedures governing the operation and management of the corporation consistent with the applicable state statutes and the articles of incorporation.

In general, the bylaws of a for-profit corporation contain provisions governing director and officer qualifications, powers and duties; voting; meetings of shareholders, directors and officers; filling of vacancies; committees; indemnification of directors and officers; bank accounts; fiscal years; and amendment procedures.

Liability of Shareholders, Directors and Officers

Shareholders, directors, and officers generally are not liable for a debt or liability of a corporation. However, if the shareholder, director, or officer is the "alter ego" of the corporation commingles assets and/or does not follow normal corporate procedures, it may be possible for the corporate veil to be pierced, and for that individual to be liable on behalf of the corporation.

Raising Capital

For-profit corporations (and LLCs) offer the most flexibility in raising capital, ranging from various kinds of equity (common stock, preferred stock, options, warrants) to numerous types of debt instruments (convertible notes, subordinated notes, bonds, commercial paper)

Recordkeeping and State Reports

The corporation must keep correct and complete books and records. Generally, states require annual or bi-annual reports to be filed by domestic and foreign corporations operating in such state.

Taxation

An S corporation's income is not taxed on the federal level. Rather, the corporation's income and losses are "passed through" to the shareholders in relation to their ownership interests. The shareholders report that income or loss on their individual tax returns.

State-level taxation varies across the United States.

Limited Liability Companies (LLCs)

Using LLCs to Pursue Social Change

Combining certain characteristics of both partnerships and corporations, LLCs are privately owned legal entities that can be formed for the purpose of earning profits, pursuing a social mission, or both, although some states require an LLC to be formed only for a "business purpose." LLCs differ from for-profit corporations because they are formed and owned by members rather than shareholders; however, like S corporations and partnerships, LLCs are eligible for pass-through income tax treatment. This means that

income and expenses are reported as though the members incurred them directly, and profits or losses are taxed at the ownership (member) level, rather than the entity (company) level.

Members of LLCs can be individual investors as well as for-profit corporations and tax-exempt nonprofit corporations. For this reason and also because of pass-through taxation which eliminates “double taxation” (the effect of taxing income at the corporate level and again when it is included in the owner’s income), LLCs are preferred over for-profit corporations as vehicles for social enterprise, especially for joint ventures between a tax-exempt nonprofit with a social change mission and a for-profit business. LLCs are akin to partnerships because the members have broad discretion to allocate profit and loss and management powers among themselves (via an “operating agreement”). On the other hand, as with the shareholders of corporations, the members of an LLC can be divided into classes, each with its own economic rights, and members have limited personal liability (discussed below).

Two states, Tennessee and Kentucky, specifically authorize the formation of nonprofit limited liability companies (nonprofit LLCs). The statutes of numerous states, including California, have language that permits nonprofit LLCs to exist. Assuming state laws permit formation of nonprofit LLCs, the IRS will recognize such an LLC as tax-exempt under Internal Revenue Code Section 501(c)(3) if it elects to be treated as a separate legal entity for tax purposes and its operating agreement includes the language mandated by the organizational test (purposes, distribution of assets upon dissolution, etc.) and it meets numerous requirements largely designed to guard against inurement and private benefit. These conditions will be discussed in the Nonprofit Taxation section.

Formation

Formation of an LLC generally requires that articles of organization or certificate of formation be filed with the Secretary of State, commission, or appropriate state agency. States may also have unique additional requirements.

Management and Control

Typically, an LLC “operating agreement” (sometimes called a limited liability company agreement) among the members governs the management of an LLC. The operating agreement—which is like the articles of incorporation, bylaws and a shareholder agreement all in a single document— may contain provisions requiring adherence to a social purpose and such purpose and the values it embodies may be interwoven throughout the operating agreement.

An LLC is owned by its members and although all members typically share in the economic benefit of the LLC, an LLC may have non-economic members (for example, a lender can be a non-economic member for management or voting purposes). Although a membership interest in an LLC is not generally evidenced by a certificate, an operating agreement may provide that the LLC can issue certificates evidencing each member’s interest in the LLC. Unless otherwise provided in the articles of organization or the operating agreement, generally a member may not transfer its management or voting rights in the LLC without the consent of all of the other members. However, generally a member may transfer its right to receive profits or distributions to a transferee, provided that such transferee shall have no vote, interest or claim in the LLC and shall not become a member of the LLC, unless otherwise provided in the articles of organization or the operating agreement.

Limited Liability of Members and Managers

Unless otherwise provided in the articles of organization, or in an operating agreement signed by the member or manager charged with the debt, no member or manager of an LLC is individually liable for the LLC’s debts or liabilities. Generally, subject to any standards and restrictions in the operating agreement, an LLC has the power to indemnify any person who was, or is, a party to an action, suit or proceedings because the person is, or was, a member, manager, employee or agent of the LLC.

Merger, Dissolution and Term of Existence

Each state has unique statutes governing mergers, acquisitions and dissolution.

Raising Capital

An LLC offers the same flexibility in raising capital as a for-profit corporation.

Recordkeeping and State Reports

An LLC must keep correct and complete books and records; annual reports are generally required by states in which the LLC is doing business.

Taxation

An LLC is not required to be a separate tax entity like a corporation; instead it can be a “pass-through entity” so that the LLC owners report business losses or profits on their personal tax returns, like a partnership.

Federal Income Tax: Unless you elect to tax the LLC as a corporation, the IRS treats single-member LLCs as sole proprietorships for tax purposes. This means the LLC itself does not pay taxes and does not have to file a tax return. Unless you elect to tax the limited liability company as a corporation, the IRS treats multi-owned LLCs as partnerships for tax purposes. This means that LLC owners each pay taxes on their lawful share of the profits on their personal income tax returns, not the LLC itself.

Federal Tax Identification Number: Your LLC may need to obtain a federal tax identification number which is similar to an individual's social security number. Generally, you will not need a separate EIN number for your LLC as long as you are the sole owner and the LLC has no employees.

Resources

- Humphreys, Thomas, Limited Liability Companies and Limited Liability Partnerships (Incisive Media, 2009)

Low-Profit Limited Liability Companies (L3Cs)

Overview

The L3C, or Low-Profit Limited Liability Company, is a new type of corporate entity that is a cross between a nonprofit and a for-profit corporation. L3Cs are not eligible for tax-exempt treatment by the IRS. Rather, they are intended to be profit-generating entities with charitable and educational (including positive social change) missions as their primary objectives. Building upon the LLC structure, the L3C has thus far been enacted in Vermont (May 2008), Michigan (January 2009), Utah (March 2009), Wyoming (July 2009), Illinois (January 2010), Maine (April 2010), Louisiana (June 2010), North Carolina (2010), Rhode Island (2011), L3C legislation is also being considered in several other states, including North Dakota, Georgia, and Missouri. For more information about the status of L3C legislation please visit: <http://www.americansforcommunitydevelopment.org/laws.html>.

Many states have not passed any legislation authorizing L3Cs as of June 2013. However, all states must recognize LLCs formed in other states and the L3C is a variant form of an LLC.

L3Cs are similar to LLCs in that they have the liability protection of a corporation, the flexibility of a partnership and membership shares can be sold to raise capital just like common stock. However, unlike the LLC, the L3C must be formed for a charitable or educational purpose, it cannot have a significant goal of producing income or capital appreciation and it may not accomplish political or legislative objectives. L3Cs are intended to be vehicles which can both attract capital investment from for-profit enterprises and investment by foundations. Nontraditional for-profit investors who are willing to sacrifice market-level returns in exchange for social impact are prime candidates to provide capital investments or loans to L3Cs. Similarly, private foundations that wish to provide support in the form of a loan or equity rather than a grant may find an L3C to be attractive because the enabling legislation is written in such a way as to comply with the IRS “program related investment” or “PRI” regulations, thus eliminating the need for private letter rulings or legal opinions for such investments. PRIs can be attractive to foundations because they count toward its 5% minimum payout requirement, just as if they were grants. But if the investment is successful, the foundation could recapture the full amount of the investment, plus a reasonable rate of return, which it then must pay out again in the form of grants or more PRIs.

Existing nonprofit corporations can utilize the L3C structure in at least two ways. First, if the nonprofit generates enough earned income to qualify as “low profit,” it could reincorporate as a stand-alone L3C. Second, it could establish a subsidiary as an L3C to conduct low-profit earned income activities.

It is too early to tell whether L3Cs will proliferate and whether they will attract significant investments from non-traditional investors and foundations. Some experts have predicted that since PRIs comprise a relatively small amount of foundation grants and capital, the L3C will not succeed in attracting significant funds from foundations and thus this form of organization will not become the preferred vehicle.

Resources

- Lang, Robert. “Overview.” Americans for Community Development. <http://www.americansforcommunitydevelopment.org>
- Peeler, Heather, “The L3C: A New Tool for Social Enterprise,” *Community Wealth Vanguard*, Aug. 2007, <http://www.communitywealth.com/Newsletter/August%202007/L3C.html>
- Tozzi, John, “Turning Nonprofits into For-Profits,” *Business Week: Small Business Financing* (June 15, 2009), http://www.businessweek.com/smallbiz/content/jun2009/sb20090615_940089.htm
- “How-to: An Insider’s Look at the L3C and What it Could Mean for you and your Social Enterprise.” Social Earth. <http://www.socialearth.org/how-to-an-insider’s-look-at-the-l3c-and-what-it-could-mean-for-you-and-your-social-enterprise>
- Chang, Emily, L3C-Developments & Resource, Nonprofit Law Blog,, available at <http://www.nonprofitlawblog.com/home/2009/03/l3c-developments-resources.html#more>

Joint Ventures

A joint venture is not a statutory entity or form of doing business. Rather, it is a contractual arrangement whereby more than one person or entity join forces to operate a venture. Many joint ventures operate by agreement only; the participants do not have to create a separate entity as the vehicle for a joint venture. However, nonprofit corporations, for-profit corporations and LLCs can each function as the entity vehicle for joint ventures. When liability protection and maximum flexibility are required and the number of participants/investors is small, the LLC is the preferred entity/vehicle for the joint venture.

Thus, for example, a tax-exempt nonprofit corporation pursuing a social mission and a for-profit corporation operating a business can join together and form a joint venture using an LLC as the vehicle for the enterprise. The operating agreement would spell out the rights and obligations of each member. However, each member would be bound by the laws and rules governing its own existence, so that the nonprofit may not confer an undue economic benefit on the for-profit co-venturer, nor may the business corporation use the joint venture to do something that it could not do directly.

The IRS has addressed the circumstances in which tax-exempt social and charitable enterprises may engage in joint ventures with for-profit entities, and has adopted rules that govern the kinds of benefits that tax-exempt enterprises can confer on for-profit entities in the context of joint ventures. The IRS rules are extremely complicated. A tax-exempt social enterprise should not enter into a joint venture with a for-profit entity without first seeking advice from expert counsel.

- Sanders, Michael I., *Joint Ventures Involving Tax-Exempt Organizations* (John Wiley & Sons, 3d revised ed 2007)

Partnerships and Limited Partnerships

Partnerships, limited partnerships and limited liability partnerships are forms of organization that can be used to pursue social objectives and are recognized as statutory entities. Until the advent of LLCs in 1986, partnerships were the most oft-used alternative to a nonprofit corporation.

Partnerships provide almost unlimited flexibility in governance and management. Profits and losses are allocated according to the capital contributions of each partner but unlike LLCs and nonprofit

corporations, the total assets of each partner in a general partnership are at risk, not just the capital that has been put into the enterprise. Limited partnerships changed this by permitting the creation of a special class of partners, known as “limited” partners, who provide capital but do not participate in management. In limited partnerships, the limited partners are shielded from liability beyond their capital contributions, but the general partner—who manages the affairs of the limited partnership—does not have this liability protection. Limited partnerships are often used as financing vehicles and are most useful when investors are to have no role in management and a simple or flexible governance structure is needed. Limited liability partnerships (LLPs) function like general partnerships but provide extra protections for the general partners. Such protections include personal immunity for liability arising from the negligence and wrongful acts of other partners, unless the other partners were under their direct supervision. Thus, a partner’s loss with respect to the LLP is usually limited to his/her investment in the partnership.

Sole Proprietorships

Persons conducting a social enterprise alone without the protections afforded by incorporation are called sole proprietors. A sole proprietorship has no legal existence apart from its owner and may be formed without any expense or formality. Profits and losses are borne directly by the proprietor. The proprietor may operate under a trade name that is registered. Such registration provides limited protection for exclusive use of the name, absent trademark or service mark registrations.

The main disadvantage of forming a sole proprietorship is that the owner is wholly liable for all debts and obligations of the enterprise. All of the owner’s personal assets and assets devoted to the social enterprise can be seized. A sole proprietorship itself cannot be sold since there is complete unity between the enterprise and its owner, but the assets used in the enterprise can be sold. A sole proprietorship terminates upon the death of its owner.

New Forms of Social Sector Organizations

Leading thinkers in business, philanthropy and academia are studying the rapid growth of social enterprise which is taking root in the space between the for-profit corporate world, which is constrained by the duty to generate profits for shareholders, and the nonprofit world, which lacks the market efficiencies of commercial enterprise and does not have ready access to invested capital. A major legal question that has emerged from these studies is whether new laws and tax regulations are needed in order to nurture and support the growth of this new generation of social sector organizations.

Starting with a meeting in 2007 titled “Exploring New Legal Forms and Tax Structures for Social Enterprise Organizations,” the Aspen Institute’s Nonprofit Sector and Philanthropy Program has been bringing legal scholars and practitioners together to grapple with this question and related issues. Under the auspices of the Fourth Sector Network, many of the same individuals are also working on this question.

As of this writing, these groups have not achieved a consensus as to whether new or revised organizational and tax laws are needed to encourage and incentivize the growth of social enterprise. Indeed, some participants have suggested that existing legal and tax regimes already allow nonprofit social enterprises to operate broadly at the intersection of philanthropy and business and they express skepticism that any legal reform is needed. On the other hand, many participants advocate broad change, including revisions in federal tax and state corporate laws to accommodate new forms of social enterprise. Since 2010, some states have created new legal structures options for organizations seeking to generate a profit while pursuing a social or environmental mission. The most popular new structure is the benefit corporation which is distinct from BCorp certification granted by an organization called BLab. The sections below describe benefit corporations and flexible purpose corporations.

Benefit Corporations

Benefit corporations are for-profit corporations with social missions currently allowed in eighteen states and the District of Columbia. This legal structure, first adopted in Maryland in 2010, arose as a legal structure option after organizations began to seek BCorp certification from BLab. The BCorp certification process allowed companies to complete a self-audit approved by BLab that would result in the

organization receiving the “BCorp” label upon successful completion. In response to an interest in allowing organizations to legally form as benefit corporations, instead of only receiving certification from BLab, state statutes were drafted and adopted to allow for the creation of a new for-profit corporate entity that also had a social purpose written into its corporate documents. Often, the growth of benefit corporations is attributed to the decline in public perception of large for-profit corporations that pursued profit at the cost of other benefits. Benefit corporations are very similar to for-profit corporations with a few key differences: purpose, accountability, and transparency. In its articles of incorporation, a benefit corporation may identify one or more specific public benefit purposes. Notably, significant variations exist among the state benefit corporation statutes. Some states may require that benefit corporations create a “general public benefit,” which is defined typically as a material positive impact on society and the environment. Some states require that this impact be assessed against a third-party standard. Examples of some specific public benefits that may be included are to preserve the environment, promote economic opportunity for individuals, and improve human health.

Since 2010, multiple states have adopted the benefit corporation structure. As of June 2013, Delaware is considering the creation of a public benefit corporation. Companies that have opted to use the new structures in their state have reported the following incentives for using the structure: provides clarity to directors regarding the corporation’s purpose, offers legal protection to directors and officers, preserves the corporation’s social mission over time, and creates branding and marketing opportunities for for-profit corporations.

Since there is variation among the states about the reporting, purpose, and accountability requirements for benefit corporations, it is prudent to consult with experienced counsel when deciding to use this new corporate structure.

Flexible Purpose Corporations

Flexible purpose corporations are currently only available in California and went into effect at the same time as the California benefit corporation (January 1, 2012). Similar to benefit corporations, flexible purpose corporations require the inclusion of social and/or environmental missions in their certificates of incorporation. This legal structure creates a “safe harbor” for social enterprises and their officers and directors in addition to the business judgment rule. This added benefit derives from the legal requirement that the directors and officers consider the corporation’s state mission in addition to shareholder value in the course of operating the corporation. A qualifying special purpose, which is required in a certificate of incorporation, may be a charitable purpose that a nonprofit corporation is permitted to conduct or the promotion of short-term or long-term positive effects or the minimizing of these effects upon the corporation’s employees, etc. or the community, social, or environment.

The Lex Mundi Pro Bono Foundation will continue to monitor the adoption of the flexible purpose corporation form since several states are currently considering adopting the form. In Washington, a statute was passed that allowed for the creation of a social purpose corporation. Though the Washington structure is often described as part of the benefit corporation movement, it has strong similarities to the California flexible purpose corporation.

Resources

- Austin, James E., et. al., “Capitalizing on Convergence,” Stanford Social Innovation Review, Winter 2007. http://www.Ssireview.org/images/articles/2007WI_feature_autstinetal.pdf
- Billiteri, Thomas J., “Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach?” The Aspen Institute, January 2007. http://www.nonprofitresearch.org/usr_doc/New_Legal_Forms_Report_FINAL.pdf
- Searing, Jane M., “Capital With a Conscience,” Journal of Accountancy Online, July 2008. http://www.aicpa.org/PUBS/jofa/jul2008/capital_conscience.htm
- Wolk, Andrew, “Social Entrepreneurship & Government: A New Breed of Entrepreneurs Developing Solutions to Social Problems,” Root Cause, 2007. http://www.rootcause.org/assets/files/SE_and_Gov_Wolk.pdf

- “Structures at the Seam: The Architecture of Charities’ Commercial Activities,” New York University School of Law and National Center on Philanthropy and the Law, conference materials, October 2008.