

SYMPOSIUM INTRODUCTION

CORPORATE CREATIVITY: THE VERMONT L3C & OTHER DEVELOPMENTS IN SOCIAL ENTREPRENEURSHIP

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On February 18 and 19, 2010, the Vermont Law Review convened a symposium on “Corporate Creativity: The Vermont L3C and Other Developments in Social Entrepreneurship.” The program focused on new forms of social enterprises, hybrid organizations combining attributes of business and charitable organizations and organized and operated for the dual purposes of achieving profitability and serving a public good.

The subject of the symposium was a natural for Vermont, the first state to introduce one new form of social enterprise, the low profit limited liability company (the L3C),¹ and the second state to pass legislation creating what is called the benefit corporation (the “B Corporation” or “B Company”).² New social enterprise legislation has also been introduced in the European Union. For example, the community interest corporation (CIC) is available in the United Kingdom,³ and other social enterprise forms have also been enacted or are under consideration in Belgium and France.⁴

The creation of these and other forms was the product of several sources of dissatisfaction with the classic for-profit and not-for-profit organizational models and their operations. Financial scandals rocked the for-profit sector during the early years of the twenty-first century. Further, the broad and deep economic crisis precipitated by the near collapse of the world’s financial system exposed business conduct that appeared to be out of control and to lack individual responsibility for seriously flawed decisions. A disproportionate emphasis on maximizing shareholder

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1. Laws, AMS. FOR CMY. DEV., <http://www.americansforcommunitydevelopment.org/laws/htm>. (last visited Oct. 13, 2010) (Demonstrating that as of this writing, the L3C has become law in at least seven states and is a component of the jurisprudence of two Native American tribes. L3C legislation is also under consideration in several additional jurisdictions).

2. Public Policy, Certified B Corporation, <http://www.bcorporation.net/publicpolicy> (last visited Oct. 13, 2010) (identifying Maryland as the first state and Vermont as the second to enact B Corporation or B Company legislation). These jurisdictions passed the legislation in April and May of 2010. Consequently, this new form was not a focus of discussion during the symposium. *Id.*

3. Stephen Lloyd, *Creating the CIC*, 35 VT. L. REV. 31 (2010).

4. Benoit Le Bars, Senior Lecturer, Cergy-Pontoise University Law School, and Avocat à la Cour, Lazareff Le Bars, Panelist at the Vermont Law Review Symposium: Corporate Creativity (Feb. 19, 2010).

investment value seemed to have pushed aside concerns with furthering social values other than those of producing needed goods and services.

While dissatisfaction with the for-profit sector focused on failures of social responsibility, the perceived shortcomings of the traditional not-for-profit company were of a different nature. The economic downturn brought home the realization that charitable organizations could no longer depend significantly on grants, program-related investments (PRIs), and private donations to fund their eleemosynary activities. There was simply not enough money available from these sources alone to pay for the work that needed to be done. Charitable organizations began to explore the extent to which for-profit models of raising capital might be employed to fund the companies' not-for-profit activities. By combining attributes of for-profit and charitable organizations, the social enterprise could facilitate the blending of these two worlds.

Further, it has become clear that in many situations, governments can no longer assume the sole or primary responsibility for solving the world's social problems. Collaboration between the governmental, private, and charitable sectors would significantly increase the human and financial resources available to redress social ills. An organizational structure was needed to stimulate collaboration among these three sectors and encourage the development of social enterprises.

The social enterprise responds to social entrepreneurs' desire to combine, in a single structure, the financial engine of the business enterprise with the mission driven purposes of the charitable organization. Designed to facilitate a company's ability to serve concurrently both social and economic goals, the social enterprise may also prove to be a suitable vehicle for encouraging collaboration between the government, private, and charitable sectors.

The emergence of the social enterprise as an organizational form raises many issues, some of which are introduced in the remaining pages of this introduction. The symposium key note speakers and panelists explored in depth these and other issues raised by the growing popularity of the social enterprise form.

I. WHAT IS A SOCIAL ENTERPRISE?

The first and perhaps most fundamental question is one of definition: What is a social enterprise? Social enterprises could variously be described as mission driven business organizations, enterprises with a soul, businesses that do well by doing good, or businesses that measure their success by a double bottom line—achieving profitability and serving a public good.

They may also be characterized as so-called triple bottom line companies, serving the *three pillars* of people, profit, and the planet.⁵ In all cases, *public good* envisions a benefit to society at large, rather than one accruing solely to a company's investors or employees.

The beneficial purposes served by social enterprises may be governmental in type and scope, such as addressing problems of poverty. The eleemosynary purposes served may also be more limited, as, for example, using a significant portion of—or all of—a company's profits to support one or more charitable causes. Social enterprises may be created as either for-profit or not-for-profit enterprises. In either case, these organizations apply market-based strategies to benefit social good. The very name *social enterprise* suggests the hybrid nature of these companies.

Whether a particular company is a social enterprise is often a matter of debate. Definitions vary and this introduction—indeed this issue of the Law Review—could be entirely devoted to this question. Comprehensive definition is not, however, the purpose of either.

The working definition used in this introduction is that a social enterprise is one organized and operated for the dual purposes of engaging in profit-making activity and furthering a social good. The dual purposes must at least be co-equal. If they are not, then the balance between the two must weigh in favor of furthering the charitable goal. Yet, the balance must not be tipped so far that the profit-making activity is only incidental to serving eleemosynary objectives, with the company's revenues depending primarily on grants, PRIs, and private donations.

Social enterprises therefore occupy the middle range of a continuum extending from the traditional for-profit company that only secondarily serves social purposes to the traditional charitable not-for-profit organization that serves social purposes exclusively and relies significantly on grants, donations, and PRIs for funding. Companies at either end of this spectrum are excluded from the definition of social enterprise. For example, many commercial enterprises are not social enterprises even though they donate to charity, provide health and pension benefits to their employees, and in other ways serve the communities in which they do business. In these cases, furthering a social good is secondary to advancing commercial objectives, although these companies may be good corporate citizens and although providing needed goods and services is a social benefit.

5. See JOHN ELKINGTON, CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS (1999) (coining the phrase "triple bottom line" and presenting the underlying idea of evaluating a company's economic performance by taking into consideration its social and environmental impacts).

This definition of social enterprise also excludes not-for-profit enterprises formed for the sole purpose of serving a social purpose and whose financial well being depends primarily on grants, PRIs, and private donations even if the organization occasionally engages in profit-making activities, as, for example, a library that sponsors book sales to raise money. However, a charitable organization engaging in significant profit-making activities to support and further its social mission would be considered a social enterprise.

II. ARE NEW ORGANIZATIONAL FORMS NEEDED OR ARE EXISTING FORMS SATISFACTORY?

The L3C, like its British counterpart the CIC, is a form of social enterprise combining profit-making objectives with serving social goals. The L3C form was originally created for the narrow purpose of facilitating foundations' willingness to make program-related investments⁶ in for-profit companies.⁷ Companies organized as an L3C would meet specified criteria qualifying them as eligible to be the recipient of PRIs made by foundations. L3C legislation makes clear that although the company may make money, its profit-making activities must serve its charitable purpose. However, the legislation does not limit the amount of money the company may make.

Although the L3C form was created to serve a narrow purpose, others soon saw greater possibilities for its use. This type of social enterprise could become a vehicle for transforming business culture. The L3C responded to the needs of social entrepreneurs desiring to make money in a socially responsible way while also using the profits of the enterprise to further a particular social mission. Profit-making companies could do good while doing well financially. These broader goals similarly led to the creation of the CIC in the United Kingdom. From this perspective, the social enterprise could be a harbinger of a new social movement in which values-driven businesses harness the driving forces of capitalism and ameliorate its sharp edges. In this view, the social enterprise represents both a new business form and a new way of doing business.

The introduction of new forms of social enterprises has not uniformly been met with accolades. Some question whether new forms are really needed and, more fundamentally, whether they will accomplish their

6. See Luther M. Ragin, Jr., *Program-Related Investments in Practice*, 35 VT. L. REV. 53 (2010) (discussing the Heron Foundation's experience with making PRIs).

7. See Robert Lang & Elizabeth Carrott Minnigh, *The L³C, History, Basic Concept, and Legal Framework*, 35 VT. L. REV. 15 (2010) (providing a history of the L3C and explanation of its origins).

purposes.⁸ Advocates of this view argue that current organizational structures can easily be adapted to the purposes of a hybrid organization without special legislation or the blessing of an outside auditor confirming that a particular profit-making company is also serving a broad social purpose.

From this perspective, the social enterprise is simply the newest manifestation of historically recurring efforts to use business forms and methods to achieve public goals. For example, during the post-colonial period of the United States, privately-owned enterprises built many of the country's turnpikes and bridges—projects too large to be financed by the fledgling country's economy. Twentieth century business enterprises financed employee medical insurance and pensions—governmental responsibilities in most other western industrialized countries. In this view, the modern impulse to use private enterprise to achieve social goals is simply a recent incarnation of a long standing tradition.

III. HOW WILL MANAGEMENT RESOLVE CONFLICTS BETWEEN PROFIT-MAKING AND SOCIAL GOALS?

The governance structure of a social enterprise is complicated regardless whether new or existing forms are used.⁹ At its simplest level, the fundamental question of social enterprise governance is how does management balance the company's profit-making endeavors with furthering company social objectives when the two conflict or when furthering one may impede progress toward the other? The biblical admonition against serving two masters could have been written with social enterprises in mind.

The problems of governance raised by the dual goals of the social enterprise may emerge in several contexts. The most obvious occurs when company management must concurrently provide a return to investors and advance the company's social mission. These issues, however, also arise when the profit-making objective is solely to raise money to support the

8. See J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 275 (2010) (questioning whether new organizational forms are necessary to produce greater social benefits).

9. See Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105 (2010) (elaborating on the complexities of social enterprises' dual mission and the extent to which the governance structures of several social enterprise forms are amenable to resolving the dual mission dilemma); See also John Tyler, *Negotiating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117 (2010) (addressing governance issues concerning the dual mission of social enterprises).

public purpose. Consider, for example, a micro-finance company that currently lends money to 1,000 impoverished people. The long-term ambitions of the company are to be able to service 100,000 micro-finance loans on an annual basis. Expansion requires additional capital. If the company raises interest rates on its micro-finance loans, the people the company was formed to serve will bear the financial burden of the enterprise's growth. If a social enterprise identifies potential investors willing to accept a below-market return on investment, what level of return is appropriate? The higher the return paid to investors, the less money will be available to make low-cost loans. If the return is too low, investors may place their money elsewhere.

The question of what process will be used to make these decisions is also significant, as is that of what data will be available to inform the decision-making process. Metrics are readily available for comparing investments in and measuring potential outcomes of profit-making activities. Appropriate metrics will also be required to assess the value of and return from investing in social good.

IV. HOW WILL SOCIAL ENTERPRISES BE FINANCED?

Current methods of financing companies can generally be grouped into two broad categories: those intended to provide the company's equity investors with a share of the profits and those not distributing any company earnings to investors.¹⁰ Business organizations' financing instruments provide returns to investors; charitable organizations, by law (or by definition), cannot provide a return of net earnings to their officers, directors, trustees, members, or others who exercise control over the enterprise.

Equity investors in a business corporation are regarded as owners of the company. They provide the enterprise with risk capital. Equity investors expect to share in the company's profits. When an enterprise discontinues its business operations, company assets are first used to repay outstanding loans. Any remaining assets are distributed to equity investors. Thus, equity investors may receive a return on their investment through payment of company profits, through appreciation in the value of their equity interest, and through distribution of company assets when the business terminates.

10. The issues raised in this section are based on Brakman Reiser, *supra* note 9 (raising issues concerning financing), and Arthur Wood, *New Legal Structures to Address the Social Capital Famine*, 35 VT. L. REV. 45 (2010) (discussing the struggle to encourage greater investment in social enterprise and suggesting possible new structures).

Like their business counterparts, charitable organizations may raise money by producing goods and services, although their ability to engage in these activities is subject to restrictions. Charitable organizations may also raise capital by securing government or private grants, PRIs, and donations from individuals and other organizations. Although they may be required to account for the use of the funds, grant recipients are not expected to repay the funds to the donor. Donations from private individuals and entities are gifts. If a donation is made to a charitable organization meeting certain criteria, the donor will receive a tax deduction.

Investors providing equity capital to business organizations do so with the expectation of making money on their investment. As a general rule, funders providing capital to charitable organizations do not expect their donations to be repaid or to make money. The two financing systems described above have traditionally operated independently of each other, with one raising money from investors expecting a market return and the other raising money from donors not expecting any return.

Because of its hybrid nature, the social enterprise presents new opportunities for financing mission-driven businesses and for infusing new capital into this sector of the economy.¹¹ Social enterprises may be able to attract investors who want to receive a return on their investment, but who, because of their interest in furthering the company's social mission, may also be willing to accept a lower than market return. Further, the hybrid nature of the social enterprise may facilitate collaboration among governmental entities, the private sector, and the charitable sector. Collaboration is needed to address the most pressing social problems in a meaningful way. Such collaboration can be accomplished by financing social enterprises with different financial tools adapted to the needs of a particular sector and to the level of risk its participants are willing to assume.

V. WHAT IS REQUIRED TO ASSURE THE PERPETUATION OF THE COMPANY'S MISSION ?

The issue of perpetuating the company's mission may arise in a variety of situations as, for example, when a company's founding managers and investors change, when the company is sold, or when it closes its doors. During any transition period, the question arises how best to make sure that the use of the company's operations and assets will continue to serve its social mission.

11. See Wood, *supra* note 10.

The Internal Revenue Code has answered this question for charitable organizations qualifying for tax deductible contributions. The company's assets must be used to further the company's mission. If a charitable company closes its doors, it must transfer its assets to another charitable organization. This restriction assures that the assets will continue to be used for charitable purposes.

The answer is less clear with respect to social enterprises. The reason is that unlike charitable organizations, social enterprises may raise risk capital by selling equity interests in the company. The status of *equity investor* typically brings with it the power to elect the managers responsible for setting company policy and exercising oversight of company operations. Equity investors may also be eligible to vote on significant company matters. They may use their powers to influence or change how the company conducts its affairs and the definition of its long term goals. The exercise of this power may become particularly problematic when investors' equity interests are transferred or sold, as is likely to occur when the company's founders retire,¹² receive a lucrative financial offer for their holdings, or die. In these situations, controlling shares may be acquired by someone who wants to give greater weight to the for-profit aspects of the business or who even may want to convert the company into a traditional for-profit enterprise.

Traditional business enterprise law provides some tools for maintaining the balance between earning money and furthering the company's social mission. A company's charter may require the company to serve both purposes. Similarly, transfers of equity interests may be restricted to investors committed to furthering the social good. The problem is that all of these provisions may be modified by a vote of the equity investors. Further, unduly restrictive limitations on transfer of shares would negatively affect the company's ability to raise money. Even investors committed to the company's social mission would be put off by having to involve themselves in an overly-restrictive arrangement.

A legislative solution to the succession problem, similar to that imposed by the tax code, may be effective with respect to controlling the distribution of social enterprise assets when the company ceases operations.¹³ It would likely be unworkable with respect to oversight of

12. Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211 (2010) (reviewing the sale of the well-known Vermont ice cream company).

13. One could imagine a social enterprise dissolution scheme using this model, but with the limitation that equity investors are entitled only to a return of the capital originally invested and not to the excess value of the company's assets. Assets not needed for the return of capital could be transferred

company operations and the exercise of investors' votes. In addition, legislative review of individual corporate charters has already proved to be inefficient. The nineteenth century development of general corporate laws was largely stimulated by the cumbersome and inefficient process of requiring legislative approval for the formation of a company.

Further, perpetuating a company's social mission is not the same as perpetuating the company, itself. It is easy to confuse the two when the organization is seen as the embodiment of the company's social philosophy.¹⁴ At times, however, perpetuating the company's mission and perpetuating the enterprise lead to different outcomes. For example, a social enterprise may develop an innovative product that reflects its social philosophy and also creates a new product market or alters or expands an existing market. If the social enterprise is ultimately purchased by a traditional for-profit company with the ability to sell the same product at a lower cost and to distribute it more widely than was originally possible, is it preferable to perpetuate the social mission by selling the social enterprise company to the for-profit? Or, in doing so, will the mission have been sold out?

VI. WHAT ARE THE TAX IMPLICATIONS OF FORMING A SOCIAL ENTERPRISE?

Tax issues have long been a driving force in choice of organizational form. For many types of endeavors organized to serve a public good, such as hospitals, entrepreneurs may choose to do business as either a for-profit or not-for-profit organization. Tax treatment is an important component in the decision concerning which form to choose, as is the extent of regulation and the opportunity for private ordering of form.

For-profit organizations are subject to one of two possible taxing schemes on the revenues the company earns. One approach is referred to as the *double taxation* scheme in which company income is taxed twice: once when earned by the business entity (the business entity is the taxpayer) and again when profits are distributed to equity investors (the individual equity investor is the taxpayer). The other is called the *pass-through taxation* scheme in which the business itself does not pay taxes on the money it earns. Instead, revenues are taxed only at the equity investor level. Companies formed as general corporations and those publicly traded on securities exchanges are subject to double taxation. Privately-owned corporations meeting certain criteria may elect a form of pass-through

to another social enterprise entity.

14. See Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59 (2010) (arguing for advantages of using a regulatory framework to support social enterprises).

taxation. Other privately-owned businesses, such as limited liability partnerships and limited liability companies, may elect either double or pass-through taxation. The attractiveness of one scheme or the other depends on the business form used, applicable individual and corporate tax rates, and other similar considerations.

Equity investments in a for-profit company are not tax deductible. Further, the type of business the company can engage in and the particular structure of the enterprise are generally matters of private ordering so long as the company is not a member of a regulated industry. In most respects, participants have significant freedom to conduct business as they see fit.

The Internal Revenue Code establishes several categories of not-for-profit organizations and subjects them to taxing regimes that differ from those applicable to business enterprises. For example, not-for-profit charitable organizations qualifying as 501(c)(3) organizations are exempt from federal income tax (subject to certain limitations) and contributions to the company may qualify as tax deductions for the donor. Another category is non-charitable not-for-profits. Although these organizations may, under limited circumstances, qualify for a federal income tax exemption under § 501(c), donations to these companies will not qualify as charitable deductions. The tax provisions creating these benefits also impose limitations on the ways the charitable company conducts its operations.

Since social enterprises embody attributes of both charitable and for-profit enterprises, the extent to which the hybrid form will be able to take advantage of or be limited by the application of a particular taxation scheme is not always clear. Also in question is the extent to which applying current taxation regimes may limit the social enterprise's ability to accomplish its mission.¹⁵ For example, there is a question whether a newspaper could be organized as a social enterprise instead of a for-profit business.

Other issues of tax policy arise with respect to social enterprises. One must consider the extent to which new taxation regimes are required for these hybrid organizations or whether it is preferable to accord them formal recognition within current taxation regimes. One also must consider to what extent, if at all, the social mission of such enterprises should receive the favorable tax treatment accorded to some charitable organizations. Exemptions from income taxation constitute taxpayer subsidies of non-profit organizations. The Internal Revenue Code encourages donations to tax-exempt charitable organizations by treating these donations as tax deductions. For-profit organizations are excluded from this favorable tax

15. See Richard Schmalbeck, *Financing the American Newspaper in the Twenty-First Century*, 35 VT. L. REV. 253 (2010) (identifying newspapers as enterprises potentially able to take advantage of social enterprise forms).

treatment. Thus, a charitable organization engaged in the same business as a for-profit enterprise may have a competitive advantage as a result of the applicable tax structure.¹⁶ That circumstance raises the question whether and to what extent social enterprises should be accorded tax advantages comparable to those currently enjoyed by charitable organizations.

VII. WHAT ARE THE PRACTICAL ISSUES OF OWNING AND OPERATING A SOCIAL ENTERPRISE?

Whether one engages with social enterprises as a social entrepreneur,¹⁷ a lawyer,¹⁸ an accountant,¹⁹ or a consultant,²⁰ the *on the ground* issues that arise are extensive and complex. Participants must contend with the usual range of concerns associated with organizing and operating any type of company. They must also address the additional layers of complexity and uncertainty caused by the hybrid nature of social enterprises, and, in many cases, the general public's lack of understanding of what these companies are and what they do. Effectively combining profit-making and social goals in a single enterprise will require more than using a patchwork approach to stitching together elements of existing forms of enterprises. Entrepreneurs, lawyers, accountants, business people, and other professionals will be required to reconsider in a fundamental way the operations and governance of these hybrid companies.

Entrepreneurs must understand what can and cannot be accomplished with each form of social enterprise²¹ in order to ascertain whether a particular form will advance their objectives. They will need to consider new forms as well as adaptations of existing forms. In addition, clients may

16. See Le Bars, *supra* note 4 (providing one example of the competitive consequences of applying different taxation schemes to companies engaged in similar businesses).

17. See Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163 (2010) (discussing the social enterprise based on data derived from interviews Professor Schmidt conducted with the early users of the L3C business form).

18. Brian Murphy, Partner, Dinse, Knapp & McAndrew, Panelist at Vermont Law Review Symposium: Corporate Creativity (Feb. 19, 2010).

19. Sanders Davis, Partner, O'Connor Davies Munns & Dobbins, LLP, Panelist at Vermont Law Review Symposium: Corporate Creativity (Feb. 19, 2010).

20. Professor Elizabeth Schmidt is also a principal in Southpoint Social Strategies, a consulting firm for not-for-profit companies.

21. See Schmidt, *supra* note 17 (basing the article on interviews with selected social entrepreneurs). They chose the L3C form because they wanted to obtain foundation PRI funding and because the L3C form offered significant flexibility while permitting them to retain control of the company. They were also attracted by the branding associated with this form of doing business, signaling that this was not profit-making business as usual. Additionally, they wished to avoid the complexity, restrictiveness, and lack of control associated with operating a company as a charitable organization. *Id.*

view the social role of their company very differently from what the law requires or allows. In many cases, clients' understanding of what constitutes a social or charitable purpose does not accord with the applicable legal definitions.²²

Clients should also understand the message that using a new social enterprise form may send to the public. It is important for the company actually to operate as a social enterprise rather than merely be a social enterprise in form or name only. Determining the extent to which a company meets its social enterprise objectives may be difficult because of the absence of or the inadequacy of appropriate metrics. The development of metrics to assess mission-related goals is essential.²³ Although *double* and *triple bottom line* accounting represents progress, more is needed in this area.

CONCLUSION

Currently, when applied to for-profit and not-for-profit organizations, company law, tax, finance, and accounting regimes operate independently of each other and, in many cases, have frustrated rather than facilitated cooperative endeavors between for-profit, charitable, and governmental organizations. It is hoped that new social enterprise legal forms like the L3C, the CIC, and the B Corporation may help bridge the gap between for-profit and charitable organizations. It is also hoped that these new organizational forms will lead to the creation of tax, accounting, and financing regimes responsive to the needs of social entrepreneurs and to cooperative efforts between the business, charitable, and government sectors. The published comments and papers of the Vermont Law Review symposium are intended to stimulate and facilitate ongoing exploration of these and other issues.

22. See Murphy, *supra* note 18 (observing that in many cases, clients' understanding of what constitutes social or charitable purposes is very different from the operative legal definitions).

23. Sanders, *supra* note 19.