Articles

PRODUCING BETTER MILEAGE: ADVANCING THE DESIGN AND USEFULNESS OF HYBRID VEHICLES FOR SOCIAL BUSINESS VENTURES

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Also, we want to give credit to Katherine R. Loft, Purvi B. Maniar, and Tamar R. Rosenberg, for adopting in an article on hybrid organizational forms the hybrid car metaphor, which we have continued in this article. See Katherine R. Loft, et al., Are Hybrids Really More Efficient? A 'Drive-By' Analysis of Alternative Company Structures, BUS. L. TODAY (Sept. 2012), http://tinyurl.com/mkxfdbl.
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I. INTRODUCTION

Since 2008 over half of the states in the U.S. have enacted one or more statutes that authorize formation of hybrid forms of business organization. The term “hybrid” refers to rules in enabling statutes that blend aspects of traditional for-profit ventures (such as private investors) with characteristics normally associated with traditional non-profit entities (such as charitable or other social benefit purposes). In reality, hybrid enterprises have informally existed since there have been enterprises. At a minimum, those who oversaw and managed such companies sometimes had to choose between benefitting owners and hurting those who provided labor or vice versa. What arguably qualified
those enterprises as hybrids was that it was not always the owners who won!

Sometimes owner “losses” were with permission or even at the direction of owners. Other times they were short-term sacrifices made in pursuit of better gains over the long term, possibly connected to employee morale, productivity, community support, customer loyalty, or other reasons that might improve sales and profitability. Sometimes owner losses were concessions to employee action, customer or supplier demands, or other non-owner constituencies. Still other times, owner losses were imposed by law (e.g., wage and hour laws, environmental mandates, workplace safety, and more).

Through it all, mundane and creative uses of traditional organizational forms seemed capable of meeting various demands. That began to change in 2008 with Vermont’s L3C innovation, followed in 2010 by Maryland’s benefit corporation, and again in 2012 by California’s flexible purpose corporation and Washington’s social purpose corporation. Since then other states have enacted laws allowing for the formation of the public benefit corporation, while other states have proposed “low profit” or “multi-purpose” corporations, and there is the potential for new forms on the horizon.

Emerging along with these new forms are numerous questions from across a spectrum, from the theoretical and academic to the practical, legal, and regulatory effects. Among such questions are the following: Why are these forms needed if traditional forms have

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2 VT. STAT. ANN. tit. 11, § 3001(27) (LEXIS through 2013 Adjourned Sess.). The full name of this entity is “Low- Profit Limited Liability Company,” but this form is widely known as the “L3C.” See id.

3 MD. CODE ANN., CORPS. & ASS’NS §§ 5-6C-01, 5-6C-08 (West, Westlaw through 2014 Reg. Sess.).

4 Effective Jan. 1, 2015, California’s Corporate Flexibility Act of 2011 was renamed the Social Purpose Corporations Act, and was codified at CAL. CORP. CODE § 2500 (West, Westlaw through 2014 Reg. Sess.).


6 See DEL. CODE ANN. tit. 8, §§ 361–68 (2015, current through 79 Del. Laws, Ch. 443) (Delaware’s public benefit corporation statute); MINN. STAT. ANN. §§ 304A.001–301 (West, Westlaw through 2014 Reg. Sess.) (effective Jan. 1, 2015; establishing both a public benefit corporation and a specific benefit corporation); MODEL BENEFIT CORP. LEGISLATION § 302(f) (2013), available at http://tinyurl.com/lv7y5od (section of the model statute that, if adopted by a state, would allow for a limited liability company version of the Benefit Corporation); State by State Legislative Status, BENEFIT CORP INFO. CENTER, http://benefitcorp.net/state-by-state-legislative-status (last visited Jan. 9, 2015) [hereinafter B Corp State by State].
successfully served, and can continue to serve, their multi-faceted objectives? Even if the new forms can be more effective or efficient at certain things, is the increased ambiguity, confusion, and potential for misuse and fraud justified? Where or how are these problems likely to arise, and how can they be mitigated, if at all? How well does each new form achieve its purported objectives, and is it more or less likely to create or resolve ambiguity and problems than traditional forms or other hybrids?

Another set of questions seem more targeted to the government, and the role of these new hybrid forms in the marketplace, including the following: How should these entities be treated for tax purposes, including exemptions from various taxes? Do state and federal securities laws apply and, if so, are modifications needed to enhance clarity about what constitutes “profits”? What regulatory oversight regimes are appropriate—charities laws, securities regulation, or consumer protection? If none of those is a good fit, is an entirely new type of government oversight needed to ensure accountability for purposes other than financial profits? Related are questions about enforcement, including the application of civil, criminal, and administrative causes of action and remedies/punishments.

In 2008, the above questions would have been asked in a relative vacuum. In 2015, however, now that hybrid forms have been in use for several years, there is experience from which to draw on. Business owners, and their advisors, are now in a position to recommend or discourage the use of such forms. Those experiences have generated more questions, which provide useful context to answer the preceding questions. For instance: How are professionals—whether lawyers, accountants, or others—advising their clients? Have government regulators received complaints about abuse of the forms?

7 To the best of the authors’ knowledge, there have not been any consumer complaints surrounding the legal form of hybrid entities. There are two reported cases that discuss hybrid entities, yet even these fail to fully clarify the legal scope and breadth of hybrid entities. In fact, both of these cases confuse the issues more than clarify them. See Burwell v. Hobby Lobby Stores, Inc., 573 U.S. ___, 134 S. Ct. 2751, 2771 (2014) (conflating benefit corporations with traditional corporate social responsibility behavior); Gulf Coast Hous. P’ship, Inc. v. Bureau of Treasury of New Orleans, 2013-0556, p. 7 (La. App. 4 Cir. 11/27/13); 129 So. 3d 817, 821 (musing in dicta that an entity organized as an L3C might presumptively satisfy a requirement for property tax exemption even though many scholars believe that simply being an L3C should not grant presumptive tax benefits; see infra note 210 and surrounding text).
In many ways, the questions can seem overwhelming. Yet they need not be paralyzing if the objectives for the hybrid forms advance society generally, if the specific implementation of hybrid forms is consistent with those goals, and if uncertainties can be resolved so that the benefits outweigh any remaining ambiguity.

In this Article we undertake such a multi-layered analysis. First, we consider the primary reasons why formal hybrid forms were proffered. Within the context of each objective, we evaluate the existing corporate and limited liability company forms of the hybrid entity, including how well each form executes on those objectives. The ultimate conclusion is that the present models of hybrid forms are innovative and achieve aspects of the original objectives, but gaps remain. We therefore propose a “Social Primacy Company,” designed to bridge those gaps and better achieve the original vision of hybrid forms, while also reducing ambiguity. The Social Primacy Company would thus present an option with more clarity (when desired) for: investors, entrepreneurs, their respective advisors, creditors, competitors, consumers, regulators, and the marketplace.

A new form is only the first step in filling the gaps. Our form and other varieties of hybrids, whether statutory forms or modified versions of traditional forms, function in the economy, and they have an effect on and are affected by the market as a direct participant. Clarity about government oversight and regulation, including application of tax and securities laws, is necessary to ensure consistency and predictability regarding those market interactions. Without this clarity, hybrid entities risk being abused to perpetrate fraud or being misused in ways that distract attention and resources from social problems instead of helping to solve them. Accordingly, this Article also addresses approaches to regulating the proposed Social Primacy Company.

II. EXAMINING KEY OBJECTIVES FOR HYBRID FORMS AND A COMPARISON TO TRADITIONAL FORMS

To be relevant and useful, formal hybrid forms must more efficiently and more effectively address gaps that exist using traditional forms, whether or not modified, or they must add value in some other distinguishably meaningful way; otherwise there is no need for them. A variety of market signals suggest that demand exists for new forms. Twenty-six states have enacted benefit corporation legislation (including Colorado and Delaware, which adopted a public benefit corporation variation, and Minnesota, which adopted a public benefit
corporation statute with both general benefit and specific benefit corporation options); four states have a social purpose corporation; eight states and three Native American nations have the L3C; and two states, Maryland and Oregon, have the benefit LLC. Many other states are considering proposals. Over 2100 entities have been formed using the L3C and benefit corporation models. Although this number alone does not prove that the forms add value, their prevalence does demonstrate a demand for alternatives.

The demand seems grounded primarily in four objectives. First, people want to attract or contribute new capital to solve or mitigate social problems. Second, they want to more obviously and directly name their enterprise as pursuing social good or public benefits, thereby distinguishing themselves from others in the market. Third, people believe that traditional forms do not permit them to accomplish their goals, at least not without substantial modification that can be cumbersome, expensive, and time consuming, thus, they want more streamlined alternatives. Finally, they believe that modified traditional forms do not adequately protect against liability for prioritizing social purpose over financial profits. Liability aside, people also are concerned

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8 See Brewer, supra note 1 (listing the various hybrid forms adopted by the states discussed; see also Oglala Lakota Sioux Tribe, Ordinance No. 09–23 (July 2, 2009) (on file with author); Crow Tribal Legislature CLB09-02 (2009), available at http://tinyurl.com/mmj2eppu; NAVAJO NATION CODE ANN., tit. 5, §§ 3600, 3601, 3605 (2014) (as amended by CN-56-14) (on file with the authors); Or. Rev. Stat. Ann. §§ 60.750–70 (West, Westlaw through 2014 Reg. Sess.).

9 See B Corp State by State, supra note 6.


11 See Cassady V. Brewer, Gift Horses, Choosy Beggars, and Other Reflections on the Role and Utility of Social Enterprise Law 5 (Oct. 1, 2013), available at http://tinyurl.com/mhbsmvw (“When asked why he converted ThinkImpact into a for-profit social enterprise, Mr. Garlick said that he determined it would be easier to deal with economically-driven investors rather than emotionally-driven donors.”); see also Jacob E. Hasler, Contracting for Good: How Benefit Corporations Empower Investors and Redefine Shareholder Value, 100 Va. L. Rev. 1279, 1281 (2014) (discussing the dual motivations of shareholders who “value both the economic return and the ‘charitable return’ or ‘warm glow’ they feel after contributing to the firm’s non-profit initiative”).


that modified traditional forms do not protect against changing priorities, as people change their minds or their holdings. Accordingly, they want forms with clear, long-term protection against abandonment, erosion, or subordination of their intended purposes.14

A. Naming: Giving Notice re: Good Works and Profits

1. What’s in a Name?

One of the primary benefits that proponents of the L3C tout is its branding potential. For the first time, it was possible to know from an enterprise’s name that it prioritizes charitable purposes because the name must contain “L3C” in the title.15 The first core element of the L3C must be to “significantly further[]” charitable purposes such that the entity “would not have been formed but for” those purposes.16 Therefore, “L3C” being in the entity’s name becomes a shorthand reference to the entity’s prioritization of charitable purposes. No similar designation requirement had been available previously.

We know the charitable essence of the American Red Cross, United Way, and any number of recognizable charitable brands because of the great work that they do in conjunction with their public relations, marketing, and communications efforts. It is not because of their legal name (e.g., “inc.,” “co.,” “corp.,” etc.). For instance, the name “Greed is Good, Inc.” does not actually tell us anything about the company’s activities. The company may be the vilest of profit-at-all-costs enterprises, or it may be a 501(c)(3) charitable organization that enables economic opportunity for blighted, destitute communities. We simply cannot tell from the name. Similarly, we don’t know from the name “Saintly Philanthropy, LLC” whether it is charitable or a for-profit consulting firm that advises high net worth individuals.

14 See Matthew F. Doeringer, Fostering Social Enterprise: A Historical and International Analysis, 20 DUKE J. COMP. & INT’L L. 291, 295–306 (2010) (comparing the roles of nonprofit organizations and for-profit organizations in social entrepreneurship, and how hybrids might fill an apparent gap); see also Brakman Reiser, Theorizing Forms, supra note 13, at 693 (“Unlike a purely for-profit entity, though, a social enterprise organized using a specialized, government-sponsored form should be able to show it prioritizes social good as a general matter and over time.”).
15 See, e.g., VT. STAT. ANN. tit. 11, § 3005(a)(2) (LEXIS through 2013 Adjourned Sess.).
16 See, e.g., id. § 3001(27).
“Greed is Good, L3C” would be required by statute to significantly further a charitable purpose. The entity would also be able to pursue financial profits as long as doing so was not its significant purpose. The name alone, however, does not guarantee that owners and operators are complying with statutory requirements. Those practical problems similarly plague any 501(c)(3) entity that must “exclusively” pursue charitable purposes.

With the intentional incorporation of branding in naming the L3C entity, customers, employees, investors, creditors, and others for the first time can know, rather than merely suspect, from the name that the enterprise has charitable purposes as a statutory priority and that it de-emphasizes distributable profits. That knowledge, however, may attract some while repelling others. The key is that individuals now have more information about the enterprise from its name than they would have had under normal circumstances. Of course, the naming benefit presumes that people understand what “L3C” means.

The benefit and social purpose corporation statutes similarly require that such entities give notice that they are not traditional corporate forms, and that they have modified the normal hierarchy of financial profits and social purpose. The priorities and weighting of profits and purposes, however, are not as clearly defined in the corporate hybrids as in the L3C in at least two respects. First, the corporate hybrids’ permissible purposes are not narrowly “charitable” but rather are more broadly “social purposes,” within which charity is a subset. Second, the corporate hybrids do not mandate prioritization of social purpose over financial profits, which leaves open prospects for profits being “a” or even “the” priority—provided other factors are considered.

The Minnesota public benefit corporation statute similarly require that such entities give notice that they are not traditional corporate forms, and that they have modified the normal hierarchy of financial profits and social purpose. The priorities and weighting of profits and purposes, however, are not as clearly defined in the corporate hybrids as in the L3C in at least two respects. First, the corporate hybrids’ permissible purposes are not narrowly “charitable” but rather are more broadly “social purposes,” within which charity is a subset. Second, the corporate hybrids do not mandate prioritization of social purpose over financial profits, which leaves open prospects for profits being “a” or even “the” priority—provided other factors are considered.

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The Minnesota public benefit corporation statute

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17 See, e.g., id. § 3001(27)(A).
18 See, e.g., id. § 3001(27)(B).
19 See Eden Blair, et al., 'L3C' Designation Doesn't Matter to Consumers, ENTREPRENEUR & INNOVATION EXCHANGE (Feb. 23, 2015), http://tinyurl.com/qja59ju (reporting the results of their empirical study using “330 participants, half of whom were identified as ‘green’ consumers and half from the general population,” and concluding: "[A]t this time the L3C designation alone, without sufficient education and awareness, may not be enough. L3C owners should not assume that [the] general public is aware of the designation or use it in business decisions. This may change if L3Cs, their advocates, and states improve their education and marketing energies.”).
20 See, e.g., CAL. CORP. CODE § 2602(b)(2)(B) (West, Westlaw through 2014 Reg. Sess.) ("The purpose of promoting positive effects of, or minimizing adverse effects of, the social purpose corporation’s activities upon any of the following, provided that the
regarding general public benefit corporations and specific benefit corporations does address the prioritization issue directly, prohibiting directors from giving “regular, presumptive, or permanent priority to: (i) the pecuniary interests of the shareholders; or (ii) any other interest or consideration unless the articles identify the interest or consideration as having priority.” 21 The statute does not require that the general public benefit or a specific purpose be prioritized over the shareholders’ pecuniary interest, and on its face appears to make the obligation to not prioritize such pecuniary interest over the applicable purpose merely a default rule from which a corporation could opt out in its articles.

Consequently, the corporate hybrid naming designations seem to be more about notifying potential investors, customers, and others that financial profits may or may not have a primary role in the decision making of shareholders, officers, and directors. More broadly, the notice is that decision makers may, but are not required to, prioritize corporation consider the purpose in addition to or together with the financial interests of the shareholders and compliance with legal obligations, and take action consistent with that purpose[,]” (emphasis added); see id. § 2602(b) (forcing the social purpose to be considered with the financial interest of the shareholder, but falling short of requiring that action to prioritize the social purpose actually be chosen). As discussed in Brakman Reiser, Theorizing Forms, supra note 13, at 695–96, the New York public benefit corporation statute, which Brakman Reiser characterizes as “an important outlier,” does treat the “general public benefit” purpose as a limitation on other purposes of the benefit corporation that “shall control over any inconsistent purpose of the benefit corporation.” See N.Y. BUS. CORP. LAW § 1706(a) (West, Westlaw through 2014). While, as discussed at infra note 132, we share Brakman Reiser’s call for clear prioritization of social purpose in new legislation and have included such express prioritization as the linchpin of the proposed Social Primacy Company statute set forth in Appendix A, the definition of “general public benefit” in the New York statute is so “general” that the attempted prioritization of it over “inconsistent” purposes is essentially meaningless as a practical matter of interpretation and enforcement; profit generation can rather easily be painted as not inconsistent with general public benefit in many ways. Thus, we would not agree with Brakman Reiser’s characterization of it as an “important outlier” on prioritization issues when considered in its “general benefit” definitional context.

21 MINN. STAT. ANN. § 304A.201 sub. 1(2) (West, Westlaw through 2014 Reg. Sess.). The Minnesota statute also provides that: “The articles of a public benefit corporation may include a provision that any disinterested failure to satisfy subdivision 1 or 2 of this section shall not, for purposes of this section . . . constitute a breach of the duty of loyalty.” Id. § 304A.201 sub. 5. See also Brett H. McDonnell, Committing to Doing Good and Doing Well: Fiduciary Duty in Benefit Corporations, 20 FORDHAM J. CORP. & FIN. L. 19, 42–43 (2014) (discussing the prioritization provisions of the Minnesota benefit corporation law as different from the Model Benefit Corporation Legislation and the Delaware benefit corporation law).
something other than profits and that the “something(s)” is/are generally recognized as benefitting society.

Whether as a way to declare primacy of charitable purpose or to give notice of the possibility of subordinating distributable profits, statutory requirements for naming the entity differentiate these hybrid forms from regular, traditional forms. Notice of these distinctions through entity-type naming is critical to ensure awareness that the specific enterprise does not operate in the same way as a traditional enterprise. That notice can also be an advantage for the hybrid forms because, by statutory mandate, the hybrid’s name is able to say things that the modified traditional form’s name cannot.

2. “Good” Versus “Bad” Entrepreneurship: A Falsely Corrosive Duality

One danger of hybrids naming their charitable or other purposes is that it potentially establishes a false dichotomy between hybrid and traditional business entities. Permitting hybrids to self-designate as operating for “good” implicitly and wrongly suggests that non-hybrid forms must or may operate for “bad.”22 This polar duality approach, whether intentional or incidental, suffers from at least four problems.

First, there have been, are, and will continue to be an extraordinary number of traditional entities that operate for “good.” It would be unfair and inaccurate to taint them (even accidentally or incidentally) as anything but “good.” This artificial duality neglects or ignores the fact that profit motives have contributed more to individual fulfillment, improved standards of living, and advances in human welfare than any other economic system in the history of mankind. Profit motive is not without its problems, but its benefits have been extraordinary, as have the innovations and contributions of those people who have harnessed it. This does not mean we should stop trying to curb or mitigate the downsides of pure profit-seeking, which is part of what has given rise to the hybrid movement. We need to be careful, however, about erecting corrosive barriers to its useful upsides. In reality, neither the for-profit

nor the nonprofit sector has a monopoly on goodness or benefitting the public. Both sectors are at the mercy of the human frailty that contributes to fraud, abuse, misuse, and neglect.

Second, current corporate hybrid statutes do not require prioritizing social purpose over financial profits. Instead, they require consideration of a variety of purposes other than—but not to the exclusion of—pursuing profits. Consequently, the presumption of “goodness” or halo-like connotations that may accompany the corporate hybrids may actually be a misnomer if purpose indicates “good” and profit indicates “bad” or “less than good,” when the corporate hybrid forms still permit profits to be a priority.

Third, neither connotation of this artificial duality is inherently true, as we know from the too many abused and misused 501(c)(3)’s and the innumerable exemplary operations in the business sector. Similar misnomers could arise if hybrids are juxtaposed against 501(c)(3) charities, with the former being considered more business-like, disciplined, and efficient, and the latter, by implication, being incompetent, undisciplined, and wasteful. Again, neither inference is inherently true, as we know from the numbers of well-run charities and of poorly run, abusive entities in the business sector.

Fourth and most complicated, “naming” has both direct and indirect implications. For instance, hybrid forms that focus on charitable purposes could borrow from or build on the “halo” effect associated with 501(c)(3) organizations, which focus on charitable purposes to the exclusion of distributable profits and impermissible private benefit. In essence, temptations exist to apply or draw on the

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24 See, e.g., Ark. Code Ann. § 4-36-301(a)(1) (LEXIS through 2014 Fiscal Sess.); Model Benefit Corp. Legislation § 301(a) (2013), available at http://tinyurl.com/lv7y5od. See the discussion at supra note 20 and accompanying text (including our reasoning that the New York general public benefit corporation statute does not, as a practical matter, effectively prioritize social purpose over financial profit).


26 See Thomas Kelley, Law and Choice of Entity on the Social Enterprise Frontier, 84 Tul. L. Rev. 337, 361 (2009) (discussing the need for social entrepreneurs to differentiate themselves from the rest of the field by using powerful branding mechanisms).
“halo” effect that the charitable sector has cultivated over centuries. But hybrids are neither charities nor replacements for charities, and, therefore, should not be confused with charities.

Such an overreach could be used to justify regulating hybrids under the rubric of charitable trust laws, which would effectively negate their essential hybrid characteristics. Part IV.B., below, discusses this problem further. Also, misapplying the charitable “halo” can confuse the public about the respective roles and abilities of the charitable and business sectors, thereby diluting perceptions of and realities for how each sector fulfills its respective roles and responsibilities in our society. That is part of the reason charity regulators and charitable sector advocates are understandably concerned about hybrid forms.

Just as hybrid forms cannot and should not replace traditional for-profit forms, they cannot and will not replace charitable enterprises. In some circles, advocates of hybrids who do not really understand the charitable sector have a tendency to misrepresent the ability of hybrid forms to accomplish what 501(c)(3) entities achieve daily and over time. In other circles, opponents of hybrids who do not really understand hybrid forms have a tendency to make broad-based attacks on the form itself when their legitimate concerns are focused more narrowly on specific applications of the form and can thus be more narrowly addressed.

The promises and activities of hybrids are not specifically intended to displace money that supports charitable sector efforts or activities. Rather the intention is to attract new money and other resources to non-traditional efforts of addressing social needs and pursuing

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27 See Model Benefit Corp. Legislation § 301(a)(3); Callison, supra note 22, at 95 (opining that the acceptable definition of “good” will be mutated by statutorily enshrining de jure moral positions into for-profit enterprises); Alicia Plerhoples, Whitewashing & The Public Benefit Corporation: An Example, SOCENT L. (Jan. 22, 2014), http://tinyurl.com/ow9pgvt (admonishing an organization for using the generally acceptable social purpose of education as a means to further questionable business practices and how the moniker of “public benefit corporation” lends false legitimacy to that endeavor). But see John Tyler, Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability, 35 VT. L. REV. 117, 123–24 (2010) [hereinafter Tyler, Negating the Legal Problem] (discussing how the L3C does create a statutory requirement to prioritize charitable purposes over profit).


29 See Tyler, Negating the Legal Problem, supra note 27, at 125 n.36.
corresponding opportunities for monetary and social returns. This is not to suggest that some otherwise charitable money may not be redirected to investment in hybrid enterprises; but why is that bad if the result is addressing, mitigating, or potentially even solving certain social problems?

3. Reality?

For some founders and funders of hybrid forms, naming may be the most relevant component because it quickly distinguishes formal hybrid entities from traditional forms and their constraints. Thus, “naming,” as it relates to hybrid forms, seems to capture primarily two perceived statutory promises: (i) that entities organized under the form can pursue both profits and purpose to permissible degrees distinct from unmodified traditional business forms; and (ii) that the entities do so in practice now and will continue to do so into the future. In this context, naming should be neither inherently positive nor implicitly negative but should merely communicate information.

The promises of hybrids connect to naming in important ways that can facilitate access to capital. A study by Duke University’s Fuqua School of Business found that entities that best integrate purpose into their operations are more successful at raising capital and, most importantly, they also have substantially more access to capital. For instance, third-party certified companies had better access to capital than organizations that were not certified, suggesting that certification of purpose helped convince investors that the organization was what it claimed to be, which meant that the organization had made appropriate social purpose promises and lived up to them.

Among the lessons from the Duke study are that specific, measurable promises of the types noted above more effectively boost investor confidence than do mere statements of intent. The validity of

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31 See CLARK ET AL., supra note 30, at 13.
those promises seems to be strengthened by certain third-party certification processes that are exacting, rigorous, and detailed.\textsuperscript{32} Although clearly useful, third-party certifications and naming alone only go so far. Lawyers, regulators, and policymakers cannot responsibly abdicate their duties to third-party certification processes and providers no matter how accurate, exacting, or respected they might be. Moreover, those who provide capital ultimately also want accountability and the ability to enforce how their expectations are pursued and met—which for profits or purpose! Those expectations generally are met privately using principles of contract and fiduciary duty with reasonable reliance on consistent and predictable regulation and enforcement.

B. Attracting New Capital that Leverages Traditional Capital to Target Social Problems

All enterprises require financial capital, whether for startup, operations, or expansion. For traditional 501(c)(3) entities, startup capital often comes from charitable donations or as advances on performance contracts. Depending on the enterprise, operational and expansion capital may be generated by donations, earned revenue, or from extensions of credit. For traditional taxable, for-profit entities, operational and expansion capital likewise can come from revenue and credit, but the other source is investors. Our focus here is on donors and investors. The type of capital, whether startup, operational, or expansion, matters less than the source of the capital because of the similar issues involved with attracting that capital to social causes.

Donors make contributions to solve social problems that are then addressed by the charitable sector. They do not expect or desire (nor can they have) their money back, nor can they receive a financial return on their donation. Often times there is not even revenue, much less a surplus of revenue over expenses.

\textsuperscript{32} See Brakman Reiser, Theorizing Forms, supra note 13, at 707–11. Among the most respected and regarded certification entities are GIN’s IRIS B Analytics (the certification mechanism for B Labs), and Social Return on Investment (SROI). IRIS uses over fifty different metrics to measure environmental impact of a business. See Viewing the IRIS Metrics that are Right for You, IRIS, http://iris.thegin.org/metrics/list (last visited Jan. 10, 2015) (click on “view full metric catalog”).
Investors make contributions to enterprises based on which one they believe will generate a better return on their money, at an acceptable risk relative to that return and its potential. Some investment decisions, however, are primarily driven less by desire for personal financial returns but instead by a belief in the potential for other returns, in the form of social benefits if the underlying product, process, or service advances society. In fact, a growing pool of investors seems to be more interested in advancing society than in financial performance.33

The question then arises: Why not permit informed investors to invest in enterprises that make profits while prioritizing social purposes? In many ways that is already happening as traditional for-profit education companies, health care systems, nursing homes, child care centers, and other entities operate in what could be viewed as the charitable space. Traditional taxable forms clearly fill these purposes without need for hybrid forms. Concern exists, however, about whether traditional taxable forms can most effectively resolve inevitable conflicts between financial profits and social purpose in favor of profits, to the detriment of purpose. Certain for-profit higher education companies have come under attack for precisely that reason.34 Even so, there are market opportunities available to make profits while focusing on purpose, particularly in education and health care, where the government’s intervention as payor, guarantor, or contractor has made markets more robust.35

33 "[Investors] report that they committed USD 8bn to impact investments in 2012, and plan to commit USD 9bn in 2013[.]” YASEM IN SALTUK ET AL., JP MORGAN & GIIN, PERSPECTIVES ON PROGRESS: THE IMPACT INVESTOR SURVEY 3 (2013) (“Impact investments are investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return. They can be made in both emerging and developed markets, and target a range of returns from below market to market rate, depending upon the circumstances.”). About forty-two percent of respondents reported they had made “impact invests” for over a decade, but only now were those investments called “impact investments.” Id.; see also Hasler, supra note 11, at 1314 & n.202 (citing authority in support of the statement that: “‘Socially responsible investing,’ as it is called, has grown over the past thirty years and was recently estimated to represent 11.3% of U.S. assets under management, or roughly $3.74 trillion.”); Brakman Reiser, Theorizing Forms, supra note 13, at 734–36.

34 See Alicia Plerhoples, supra note 27; see also David Halperin, Some Pending and Recent Government Investigations and Actions Regarding Career Colleges, REPUBLIC REP. (Feb. 17, 2014), http://tinyurl.com/m9dskpn (discussing various investigations into different for-profit colleges).

35 A little over eighty percent of Rasmussen’s total revenue was comprised of federal education funds. S. COMM. ON HEALTH, EDUC., LABOR, & PENSIONS, 112TH CONG., FOR PROFIT HIGHER EDUCATION: THE FAILURE TO SAFEGUARD THE FEDERAL INVESTMENT AND
Hybrid advocates assert two primary advantages that hybrid entities have over traditional forms of business organization. One advantage is the purported ability to ensure that the entity’s purpose can predominate without legal exposure for breaching fiduciary duties, which is discussed in the next section. Another advantage is the potential for mutual, complementary leverage, as social purpose investors fund efforts to prove concepts and markets at early stages, and profit-oriented investors then engage to scale workable solutions, with both sets of investors thus receiving returns.36

Do hybrid forms actually add value over traditional forms in those ways? That question has two parts—one grounded in law and another in practice. As a matter of law, the hybrid forms are subsets of the traditional corporate or LLC structures. Consequently, the hybrids share the same benefits and problems inherent in their progenitors, including transferability, classes of ownership, ability to serialize, and more. As a matter of practice, it seems less likely that any particular form will have advantages over any other form purely for purposes of attracting capital, absent special regulatory relief, as discussed in Part IV.B., below. What is more likely to matter is how any given enterprise is managed, operated, and perceived among target audiences.

At the form level, the value proposition is inextricably linked in practice to the brand each particular enterprise cultivates.37 The value under law is derived from how the forms approach and solve the invariable conflicts between fiduciary duties and interests.38 Diverting investment grade capital that is historically unlikely to be directed to solving intractable social ills or scaling social solutions will require prioritizing eventual profitability and returns. If social purpose is over-emphasized, that capital will remain elsewhere.39 A hybrid form’s relevance for many of these investors will depend on demonstrating that

36 See supra Section II.A.2.
37 See Kelley, supra note 26, at 361; Brakman Reiser, Theorizing Forms, supra note 13, at 734–35.
there is or will be a market willing to buy that which entities adopting the form are selling.

Convincing holders of otherwise purely charitable funds to redirect some resources from their grant programs is likely to require ensuring that the hybrid recipient’s purposes are primarily or nearly exclusively charitable. The hybrid form’s relevance for grant makers will require demonstrating that their funds can and will achieve charitable purposes to degrees greater than alternative uses of the money—in other words, showing that the hybrid entity will achieve a high degree of charitable purpose success because of the ability to leverage “investor” capital to fund replication and scale.\(^40\)

There is an ever-growing group of potential investors in the middle who are interested in both financial profits and social purpose, although within this group it is likely that there are further distinctive degrees and tolerances.\(^41\) The hybrid’s relevance for these investors may depend on

\(^{40}\text{Some initially positioned the L3C as having simplified matters for foundations wanting to make program related investments (PRI) because the elements of the L3C mirror those of the PRI, but the reality has been different. Doug Batey, North Carolina Becomes the First State to Drop L3Cs, LLC L. MONITOR (July 9, 2013), http://tinyurl.com/ovoktt9. For the elements of a PRI see I.R.C. §§ 4942(g)(1), 4944(c) (2012); Treas. Reg. § 53.4944–3 (2012). Very few L3Cs have any foundation involvement, and foundations will continue to exercise the same due diligence and document the same terms, rights, and expectations when considering PRIs, or other types of organizations. As a result, and as a practical matter, the L3C does not have advantages purely for the purpose of attracting capital—unless clarity of charitable purpose and fiduciary remedies are important to investors.}\)

\(^{41}\text{See Lai et al., supra note 30, at 13; Brakman Reiser, Theorizing Forms, supra note 13, at 706–11; Tyler, Negating the Legal Problem, supra note 27, at 122; Model Benefit Corp. Legislation § 301(a)(1)–(3) (2013), available at http://tinyurl.com/lv7y5od (affording a manager the ability to prioritize profits over purpose or purpose over profits, depending on what the manager believes is in the best interest of the company). With regard to benefit corporations, the best interest of the company is invariably determined when the manager considers what the owners desire and what the immediate situation’s effect is on the purpose and profit. Remember, the shareholders purchased shares of this company with the expectation that both social good and profit would be possible (perhaps likely) outcomes of the business operation. Thus, the commitment of the company is dependent, in large part, on the appetite of the shareholders and the directive from the board; so long as the manager fulfills what the shareholders believe to be the “correct” balance, the manager has satisfied her duty. Regardless of the whether this is a breach of duty or a breach of contract, the boundaries of the choices the manager may make are explicitly and implicitly set by the expectations of the shareholders, not an outside statutory duty. Also, while prioritization of interests can be set in the articles of incorporation under the cited provisions, that is different than a statutory mandate to make social purpose primary. Within these provisions there is no statutory duty outside of the articles of incorporation and, thus, the degree of commitment to the purpose is solely dictated on the appetite of the shareholder, as expressed through incorporation documents. Therefore, the consumer will see a litany of “benefit corporations”
the enterprise having at least some flexibility to assess circumstances and make adjustments in priorities and weighting as circumstances change.\textsuperscript{42} The extent of that flexibility may depend on a willingness to tolerate ambiguity and uncertainty, to trust the judgment of directors/managers to correctly assess circumstances and appropriately adjust how profits and purpose are prioritized and weighted, and to accept risks of fraud and abuse that such flexibility might permit. Related to that tolerance, trust, and acceptance are questions about whether the flexibility should be determined by law, practice, or some combination of both.

For both traditional forms and their hybrid progeny, approaches to fiduciary duties will be a main differentiating factor, and the confidence of investors in those approaches ultimately may be most important for attracting capital to social solutions. Some investors may be discouraged by the flexibility provided by the corporate hybrid forms because of the potential to dilute social purposes. Some may be comfortable relying on contract language as a supplement to traditional or hybrid forms to evidence the desired level of commitment to social purposes, which also reflects comfort with contracts law causes of action and remedies for ensuring corresponding accountability to those purposes. Recognizing limits to solely relying on a contract, other investors may want delineated fiduciary duties serving social purposes and the expanded set of tools for ensuring accountability. Investors are not the only ones who undertake such analyses: officers, directors, managers, employees, and others are also concerned with clarity, commitment, and degrees of both as evidenced by approaches to accountability.\textsuperscript{43}

\textbf{C. Traditional Forms: Fiduciary Duties and Remedies}

The new forms are called hybrid because they seek to permit owners to derive financial profits and appreciated value while also pursuing purposes other than (but likely in addition to) distributable

\textsuperscript{42} See Lai et al., supra note 30, at 13.

\textsuperscript{43} Clark et al., supra note 30; Lai et al., supra note 30; see also Model Benefit Corp. Legislation § 301(a); Brakman Reiser, \textit{Theorizing Forms}, supra note 13, at 694–705; see generally McDonnell, supra note 21; Tyler, \textit{Negating the Legal Problem}, supra note 27.
profits. At one end of the traditional continuum, 501(c)(3) charitable entities cannot have owners; therefore, no one is eligible to receive distributed profits and no ownership interest may be sold. Such entities must be organized and operated in furtherance of purposes recognized as charitable by taxing authorities, and in addition to not having owners, such entities may not disburse resources for impermissible private purposes.44 Thus, a 501(c)(3) entity can have a surplus of receipts over expenses as it pursues its charitable purposes, but it must devote those resources to its charitable operations and cannot distribute them.

This “non-distribution constraint” ensures against profit/purpose hybrids being at or near the charitable entity end of the traditional continuum. There is no way to contractually or otherwise modify that constraint other than by law.45 Consequently, when refrains sound that hybrids are not necessary because “traditional” forms can accomplish all of the objectives of the hybrid forms, the choir is referring to taxable business forms.

Unlike charities, taxable, for-profit entities have owners who can (and even expect to) receive distributed profits and gain from the increased value of the enterprise when they sell their ownership interest. As examined below, however, the law generally presumes that the duties of officers and directors/managers include pursuing the interests of the owners in what has become known as “profit maximization”—sometimes referred to as “shareholder primacy” or the “property theory” (as opposed to “social entity” theory) of U.S. companies.46 Owners can agree among themselves to modify that presumptive priority of profits, for example, by empowering a certain class of owners to deviate from legal presumptions while ensuring disclosure to other current and prospective investors. Certain states also have constituency statutes that narrowly permit—but do not require—directors to consider the effects of their decisions on individuals other than the owners and to subordinate the interests of the owners in certain circumstances, which normally involve takeovers.47 Of course, directors risk having the owners replace them if the owners have enough votes.

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45 The most likely “hybrid” enterprises on the charitable end are much more likely to be those that sew charities together with government, a COMPLICATED topic for another day!
46 See MODEL BENEFIT CORP. LEGISLATION § 301(a)(1)(i); Brakman Reiser, Theorizing Forms, supra note 13, at 683.
47 See Tyler, Negating the Legal Problem, supra note 27, at 132.
The various interests that intersect in taxable, for-profit enterprises generally align over the long term in that employees, communities, taxing authorities, and owners all are vested in the business being profitable. In that way, they get to keep their jobs, tax base, distributions, and other pertinent benefits. These interests will collide at some point, or even several points, over time, and the collision(s) will leave trails of compromise and even winners and losers. Those circumstances are frequent enough under “normal” conditions, but they are exacerbated by a business that intentionally purports to favor broader social benefits over owner financial interests.

There must be a predictable, reliable, consistent means by which to reconcile those conflicts and to responsibly minimize decision-maker exposure. Unless everyone agrees with re-ordering priorities, conflict will produce winners, losers, and maybe even liability. Even if everyone agrees in the beginning, changed circumstances can alter needs and desires, which then can lead to changed priorities. As a result, purpose may no longer trump or even equate with profit for the original, later-entering, or successor owners.

A number of traditional for-profit entities have resolved these dilemmas in recent decades by using contracts and owner classes to establish the priority and the weighting of distributable profits and social purpose. In many ways, de facto hybrids have existed for some time, and such uses of traditional forms will not and should not disappear, even with the advent of formal hybrid forms. Notably, such forms exist closer to the end of the continuum involving profit-oriented enterprises than to the end of traditional charities.

There are ways in which the belief that traditional forms can “do it all anyway” is mistaken. First, the forms need to be modified. Second, although traditional businesses earn their brand recognition, none of the traditional forms permits brand identification based solely on form. The hybrid forms can help streamline that process.

Another difference between the new hybrid and modified traditional for-profit forms is in how they approach fiduciary duties. Ultimately, modified traditional forms depend on contractual approaches to fiduciary duties. In the corporate context, all of the owners can agree to customized duties, à la Newman’s Own or early

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48 See generally LAI ET AL., supra note 30, at 12–13 (discussing the “impact investing spectrum”).
incarnations of Craigslist. There may be a special class of shareholders à la Google with clear authority to adapt traditional fiduciary duties as long as they all agree with each other.

On the other hand, the limited liability company (LLC) is tailored for using contracts to maximize flexibility in all sorts of ways, including fiduciary duty. Although there is an emerging debate about whether default duties exist in an LLC, general practices have suggested that fiduciary duties in the LLC exist as provided for in the operating agreement or articles of organization, or only in egregious circumstances such as intentional misconduct, gross negligence, or criminal behavior.49

1. Breach of Fiduciary Duties Derived Under Contract

To the extent that they are grounded in contract, the underlying fiduciary duties, or conditions on which they might be based, are subject to revision with impunity if the parties change their minds. In addition, causes of action and remedies to enforce the contracted duties depend on what is available under breach of contract, which requires that the plaintiff prove damages that are normally described in terms of financial loss. But what if the decision to neglect purpose and to prioritize profits contrary to the agreement between the parties results in

49 See Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1213, 1218–19 (Del. 2012) (“[W]e pause to comment on one issue that the trial court should not have reached or decided. We refer to the court’s pronouncement that the Delaware Limited Liability Company Act imposes ‘default’ fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, sua sponte, the default fiduciary duty issue as a matter of statutory construction. . . . Indeed, reasonable minds arguably could conclude that the statute—which begins with the phrase, ‘[t]o the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties)’—is consciously ambiguous. That possibility suggests that the ‘organs of the Bar’ (to use the trial court’s phrase) may be well advised to consider urging the General Assembly to resolve any statutory ambiguity on this issue.”) (second alteration in original) (footnotes omitted)). But see Feeley v. NHAOCG, LLC, 62 A.3d 649, 663 (Del. Ch. 2012) (“The Delaware Supreme Court is of course the final arbiter on matters of Delaware law. The high court indisputably has the power to determine that there are no default fiduciary duties in the LLC context. To date, the Delaware Supreme Court has not made that pronouncement, and Gatz expressly reserved the issue. Until the Delaware Supreme Court speaks, the long line of Court of Chancery precedents and the Chancellor’s dictum provide persuasive reasons to apply fiduciary duties by default to the manager of a Delaware LLC.”); see generally Miller, supra note 38.
financial gains? Has the plaintiff been “damaged”? If not, then the cause of action may not survive and the matter of remedies is not reached.

Breach of contract remedies strive to return parties to the position they would have been in had the agreement been followed.\textsuperscript{50} Money is not recoverable if no financial damages exist.\textsuperscript{51} Specific performance may be available for a shareholder in a singular instance (assuming that the court finds that there is a contract that has been breached), but it only serves as an equitable remedy for that particular incident in which financial profit was prioritized over social purpose—a prospective injunction against a future hypothetical violation of priority may not be available.\textsuperscript{52} Punitive damages are not readily available under contract law, and most courts use disgorgement of profits sparingly and with reluctance.\textsuperscript{53}

Even if disgorgement is available, who should get the profits—the plaintiff who asserts that purpose has been illicitly violated? That result could improperly incentivize opportunistic plaintiffs. Even without disgorgement of a defendant’s gains, permitting the plaintiff to retain profits from improperly executed priorities could result in a basic hypocrisy. Why should the plaintiff be financially enriched as a result of the defendant’s wrongful elevation of financial profits over social purpose? Of course, the plaintiff should not be made to suffer because

\textsuperscript{51} See 3 \textit{Restatement (Second) of Contracts} § 346 (1981).
\textsuperscript{52} See \textit{id.} at § 357 cmt. a; Farnsworth, \textit{supra} note 50, at 1150–54. Injunction could be brought by the shareholder to prevent a prospective breach, but that would require the shareholder to have notice of the action and be able to assess the consequences of the action prior to the breach. \textit{See id.} at 1150–51 & n.22; Richard R.W. Brooks & Warren F. Schwartz, \textit{Legal Uncertainty, Economic Efficiency, and the Preliminary Injunction Doctrine}, 58 \textit{Stan. L. Rev.} 381, 389–90 (2005) (discussing the traditional considerations the courts undertake before granting an injunction, namely that the plaintiff is likely to suffer damages and will likely succeed at the end of litigation; both require a specific controversy).
\textsuperscript{53} See Brown v. Coates, 253 F.2d 36, 39 (D.C. Cir. 1958) (finding that a breach of duty, flowing from a breach of contract, was a tort and thus awarded punitive damages); Newton v. Hornblower, Inc., 582 P.2d 1136, 1149 (Kan. 1978) (approving “recovery of punitive damages as well as actual damages where a breach of a fiduciary duty is involved”); Ernest J. Weinrib, \textit{Punishment and Disgorgement as Contract Remedies}, 78 \textit{Chi.-Kent L. Rev.} 55, 71–75, 81 (2003) (enumerating the miscellaneous application of disgorgement by the courts and generally finding that disgorgement stands in contrast to both the concept of efficient breach and corrective justice regarding the normative duties and rights stemming from the contract).
of the switch either. Should it be a condition of bringing the suit that the plaintiff already have relinquished the profits, possibly putting them in a trust that permits funding the lawsuit but otherwise has purpose-oriented beneficiaries? Or can the plaintiff wait and see such that if the defendant wins, at least the plaintiff has the profits as a “consolation prize” for his or her efforts?

Perhaps profits from both plaintiff and defendant should go to a charity that operates in the same general space, but that approach generates its own questions: who gets to decide—the plaintiff? The court? What should be done if the agreement is to pursue social good but not not the narrower, more specific concept of charitable purposes, and thus there isn’t a clear charitable recipient? In that case, a non-charitable recipient would get a windfall, possibly redounding to the benefit of its owners!

Many of the above questions and scenarios will apply to problems that arise under the new hybrid forms, and the responses and applications need to evolve. Clearer prospects for causes of action and remedies other than in breach of contract, would expand the scope of available considerations and solutions. As the field of social enterprise grows, bedrock principles must be established, such as widely accepted fiduciary duties, to ensure broader acceptance of social enterprise as presenting workable solutions.

Ultimately, the terms of an agreement are only as good as the will and ability to enforce them. Requiring a super-majority or signed writing is meaningless if those involved neglect or ignore the set conditions, or otherwise do not enforce fiduciary duties, particularly the

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54 A court could find itself in a difficult situation: (a) if it disgorged profits earned by the defendant from his/her breach but allowed the plaintiff to keep profits earned from the same breach or (b) if it disgorged all profits from both parties. Both options violate generally accepted principles of compensatory damages and economic efficiency. See, e.g., Weinrib, supra note 53, at 71–73; Farnsworth, supra note 50, at 1147.

55 Breach of contract only permits recovery of attorneys’ fees if specifically provided for in the contract. See 3 RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. d. Incentives to include such a provision, however, may not exist because the plaintiff seeking to enforce purpose over profits, as in the type of case contemplated here, may not win because there are no financial damages. The prospect for paying the defendant’s legal fees in a pure breach of contract scenario built on a “loser pays” motif will likely deter bringing the cause of action at all.

56 See Miller, supra note 38, at 323–25 (discussing how investors may fail to properly protect themselves at the outset of an investment because of optimism bias and how empirical data proves that agreements skew towards pro-management).
conditions or duties that target the enterprise’s scope of chosen priorities and weighting.\textsuperscript{57}

2. Breach of Innate Fiduciary Duties

Although the types of provisions discussed above may be adequate in most instances, they are different from fiduciary duties that arise independently of contract, which are not so easily modified. Fiduciary duties that permeate the enterprise—“genetic” duties—are more commonly understood as applying generally, whereas no common base exists for appreciating contracted duties that depend on the explicit language of a private document and on the privately decided application of that document’s nuances.\textsuperscript{58} Genetic duties may also have more expansive enforcement and legal accountability than is available under contract.\textsuperscript{59}

Consequently, relying on modified traditional forms may be, and likely will be, fine in many instances, but that approach is inextricably linked to principles of contract, including modification, notice, enforcement, and remedies. The modified traditional forms approach has limits, among which are insufficient accountability, weak protection against founders changing their minds or successors-in-interest being of a different mindset, and questionable ability to preserve social purpose over financial profits through time and changes in owners themselves. If those matters are important, then a new hybrid form that can achieve these objectives may be preferable in some instances. If so, then

\textsuperscript{57} See id.

\textsuperscript{58} Even a publicly traded company that uses different shareholder classes may only be required to generally summarize the agreement’s provisions rather than make them publicly available. Even if made publicly available, individual inspection and understanding is unlikely. Although transparency can be a powerful and meaningful tool, its actual merits should not be over-appreciated. See Tyler, Transparency in Philanthropy, supra note 23, at 56, 58; Rick Cohen, The Need for Philanthropic Champions of Transparency, NPQ (July 26, 2012, 12:31 PM), https://nonprofitquarterly.org/philanthropy/20716. Sometimes common, core standards and understandings of duty, priority, and weighting are more useful than public disclosure, not as a replacement for the benefits of privately negotiated, closely held agreements such as are available in the LLC, but as what may be a more efficient alternative.

\textsuperscript{59} See Miller, supra note 38, at 327–28 (discussing how implied covenants of good faith and fair dealing are no substitute for fiduciary duties); John Tyler, Analyzing Effects and Implications of Regulating Charitable Hybrid Forms as Charitable Trusts: Round Peg and a Square Hole?, 9 N.Y.U. L. & Bus. 535, 579 (2013) [hereinafter Tyler, Analyzing Effects]; Tyler, Negating the Legal Problem, supra note 27, at 156–57.
modified traditional business forms may be a lesser choice for those circumstances.

Key questions then are: (i) whether the current fleet of formal hybrid forms makes (or is likely to make) pursuing social purpose over (or in addition to) financial profits more widely accessible and (ii) whether such forms provide greater certainty of how to prioritize, weigh, and enforce purposes and profits.

III. ARE THE DESIGN FEATURES OF EXISTING HYBRID FORMS WELL-SUITED TO ACHIEVING THEIR PURPORTED OBJECTIVES?

A. Modifying Fiduciary Duty: Social or Legal Accountability—Both, One, the Other, or Neither?

Success in accessing capital, naming, and modified traditional approaches depends on reliable changes to the “normal” or “traditional” scope of fiduciary duties and their relative priorities and weighting. Consequently, the usefulness of the hybrid forms ultimately requires clarity in addressing fiduciary duties, including (i) whether the forms permit meaningful legal redress, or rely mostly on social accountability, and (ii) the extent to which the public understands the opportunities and limits of both approaches.

1. Corporate Hybrid Accountability: Light on Legal—Heavy on Social

The corporate hybrid forms maximize the flexibility of directors to make choices between competing purposes, including financial profits and shareholder value. They do not impose priorities and relative weights. As part of ensuring that flexibility, very little legal accountability is required by the statutes, with enforcement largely being a matter of what a majority of shareholders will permit or tolerate before voting to remove a director(s). Thus, the corporate hybrid forms rely first on shareholder tolerance, and second on social accountability by combining transparency with a relatively expansive scope of which stakeholders and what interests directors must consider when making decisions.
Benefit corporations modify fiduciary duties in three ways. First, benefit corporations must pursue “[g]eneral public benefit” by having “[a] material positive impact on society and the environment, taken as a whole” as self-assessed against an independent third-party standard.60 The underlying discipline, relevance, thoroughness, and credibility of third-party standards—or the lack thereof—are matters of social or reputational pressure rather than legal enforcement.61 Second, benefit corporation directors must consider the effects of their decisions on a variety of delineated stakeholders, among whom are shareholders.62 The statutes do not impose or prevent preferences nor do they require consistency from one circumstance to the next. Third, benefit corporation founders and subsequent shareholders may also choose to pursue “special public benefits” from a list of permitted stakeholders and interests, some of which may pass muster as “charitable” under the Internal Revenue Code and state law.63

An alternative corporate hybrid form is the “social purpose corporation” that is available through two states. California social purpose corporations must declare one or more “specific purposes” from among a list of pre-approved stakeholders and interests, including those that might count as “charitable” under the Internal Revenue Code and state law.64 In discharging duties, directors of a social purpose corporation must balance financial profit and its chosen purposes.65 Washington’s social purpose corporation statute goes a bit further and requires that the articles of incorporation state: “‘The mission of this social purpose corporation is not necessarily compatible with and may be contrary to maximizing profits and earnings for shareholders . . . .’”66

62 Model Benefit Corp. Legislation, supra note 6, at § 301(a)(1)(i). In comparison, Delaware’s Public Benefit Corporation requires that the managers “balance[] the stockholders’ pecuniary interests, the best interests of those materially affected by the corporation’s conduct, and the public benefit or public benefits identified in its certificate of incorporation.” Del. Code Ann. tit. 8, § 362(a) (2015, current through 79 Del. Laws, Ch. 443). This may prove marginally more demanding than the Model Benefit Corporation, but still does not provide a fiduciary duty to the public benefit itself.
63 See Model Benefit Corp. Legislation § 102.
65 Id. § 2700(a).
Both the California and Washington statutes explicitly retain flexibility by allowing the directors to choose if and when to prioritize shareholder interests, and do not require, and even implicitly forbid, a previously agreed to fixed approach.  

Thus, the corporate hybrid forms’ standards enhance, if not maximize, director flexibility to prioritize social purpose over financial profits—or not—as circumstances may suggest in his or her judgment at that time. Those standards then inform, if not dictate, much of what is included in required reports and information disclosures.  

For it to have meaning at all, social accountability invariably depends on at least some degree of transparency. That is why benefit corporations must post reports on their activities and compliance with applicable standards, including those of the independent third party. 

67 CAL. CORP. CODE § 2602(b)(1)(B) (Westlaw) (“‘The purpose of this social purpose corporation is . . . for the benefit of the overall interests of the social purpose corporation and its shareholders and in furtherance of the following enumerated purposes . . . .’”); WASH. REV. CODE ANN. § 23B.25.020 (Westlaw) (“Every [social purpose] corporation . . . must be organized . . . in a manner intended to promote positive short-term or long-term effects of, or minimize adverse short-term or long-term effects of, the corporation’s activities upon any or all of (1) the corporation’s employees, suppliers, or customers; (2) the local, state, national, or world community; or (3) the environment.”). Recently added to the list of states with social purpose corporations statutes are Florida (following closely the Washington and California models), FLA. STAT. ANN. §§ 607.501–513 (West, Westlaw through 2d 2014 Reg. Sess.), and Texas, TEX. BUS. ORGS. CODE ANN. §§ 1.002(82-a), 3.007, 21.101, 21.401 (West, Westlaw through 3d 2013 Sess.). It should be noted that Texas’s statute merely requires that the directors consider the social purpose, but provides no other requirement. Id. §§ 21.401(b)–(e) (“(d) Subject to direction by the board of directors of the corporation, in discharging the duties of an officer under this code or otherwise, an officer is entitled to consider: (1) the long-term and short-term interests of the corporation and of the corporation’s shareholders, including the possibility that those interests may be best served by the continued independence of the corporation; and (2) any social purposes specified in the corporation’s certificate of formation.”). The specific statutory provisions on the public benefit corporations are substantially different from each other. See DEL. CODE ANN. tit. 8, § 365(a) (2015, current through 79 Del. Laws, Ch. 443) (allowing directors to balance shareholder interests and social purpose), contra MINN. STAT. ANN. § 304A.201 sub. 1(2), sub. 2(2)–(3) (West, Westlaw through 2014 Reg. Sess.) (creating a default restriction on directors from presumptively prioritizing the pecuniary interests of the shareholder, however, this may be waived by agreement within the formation documents).  

and why social purpose corporations also must report to the public.\textsuperscript{69} The information to present, and how to present it, is generally up to those who manage each individual enterprise and, presumably, their public relations counsel.\textsuperscript{70}

Social accountability can be meaningful, but it depends on the depth, quality, and accuracy of the information, which then needs to be available for the right reasons at the right time.\textsuperscript{71} It can facilitate decision making by investors, suppliers, employees and prospective employees, policy makers, regulators, customers and prospective customers, community members, and others who might be interested in the enterprise. It also can persuade or shame others in their decision making, particularly if a given shareholder or director is more interested in a specific purpose(s) than financial profits and has the stature and pulpit to promulgate such views, including removing directors who are not adhering to the shareholder’s desired standards.\textsuperscript{72}

In the benefit corporation, for example, perhaps a “benefit officer” has been appointed but one is not necessary.\textsuperscript{73} A shareholder might pursue a “benefit enforcement proceeding” even though one is not required to do so.\textsuperscript{74} Even if someone does garner fortitude (and

\textsuperscript{69} See, e.g., CAL. CORP. CODE § 3500 (Westlaw) (requiring report to include a detailing of success in pursuing public benefit and that it be made publicly available to the shareholders on the company website, or through similar electronic means.) Notably, recent amendments to the California statute eliminate a previous exemption from the filing requirement for closely held corporations. Corporate Flexibility Act of 2011 § 64; 2014 Cal. Legis. Serv. Ch. 694 (S.B. 1301) (West, effective Jan. 1, 2015); see also HAROLD MARSH, JR. ET AL., MARSH’S CALIFORNIA CORPORATION LAW § 24A.07 (2014), available at Westlaw (“The key component to the benefit report is the comparative use of a ‘third-party standard’ which provides a method for ‘defining, reporting, and assessing overall corporate social and environmental performance.’”).

\textsuperscript{70} See MODEL BENEFIT CORP. LEGISLATION §§ 402(a)–(b); N.J. STAT. ANN. § 14A:18-11(a)(2) (West, Westlaw through L. 2014, c. 90 & J.R. No. 6) (“An assessment of the social and environmental performance of the benefit corporation, prepared in accordance with a third-party standard applied consistently with any application of that standard in prior benefit reports or accompanied by an explanation of the reasons for any inconsistent application[.]”); see also Md. CODE ANN., CORPS. & ASS’NS § 5-6C-08 (LEXIS through 2014 Legislation); VT. STAT. ANN. tit. 11A, § 21.14 (LEXIS through 2013 Adjourned Sess.); VA. CODE ANN. § 13.1-791 (LEXIS through 2014 Reg. Sess.); HAW. REV. STAT. ANN. § 420D-11 (LEXIS through 2014 Legislative Sess.).

\textsuperscript{71} See Brakman Reiser, Theorizing Forms, supra note 13, at 707–11; TYLER, TRANSPARENCY IN PHILANTHROPY, supra note 23, at 58–61; Cohen, supra note 58.

\textsuperscript{72} See TYLER, TRANSPARENCY IN PHILANTHROPY, supra note 23, at 41.

\textsuperscript{73} See MODEL BENEFIT CORP. LEGISLATION § 304(a). A benefit director, however, is required of a benefit corporation that is a publicly traded corporation. See id. § 302(a).

\textsuperscript{74} See id. § 305(c).
finances) enough to invoke recourse to the law, what is the cause of action? Failure to achieve general or special public benefit is not actionable by itself because outcomes are not required. Although benefit corporations must assess themselves against a third party standard (which may or may not be weak or meaningful) and publish a benefit report, failure to comply with the underlying standards is not actionable legally.

The “duty of care” is diluted to the point of not being legally actionable if directors have merely “considered” the effects of their decisions on the listed stakeholders. There is no obligation to prioritize or give more or less weight to any one or more purposes over others—including a retained ability to favor the shareholders who appoint, retain and could remove them. Provided that directors can document that they considered those effects with some presumptive degree of reasonableness and good faith, they are exempted from liability.

The extent to which this same analysis applies to the social purpose corporation will depend on how the particular form is implemented. Adopting all of the possible specific purposes will create a duty of care situation largely indistinguishable from the benefit corporation. If more deliberate in choosing a specific purpose, directors may still prioritize shareholder interests, even after duly considering the chosen purpose. If the shareholders who elect, retain, and can replace directors generally agree that profits are not important (or as important), then the identified purposes may be given priority, but once the shareholders change their minds, the directors may accede to profit maximization. Thus, subject to potential for social and reputational harm, shareholder interests may remain supreme in the social purpose

75 Id. § 401.
76 See DEL. CODE ANN. tit. 8, § 102(b)(7) (2015, current through 79 Del. Laws, Ch. 443) (prohibiting eliminating the duty of loyalty for directors); Smith v. Van Gorkom, 488 A.2d 858, 872–74 (Del. 1985) (establishing there is no substantive duty of care, but that duty of care can only be discharged through process), overruled on other grounds by Gantler v. Stephens, 965 A.2d 695 (Del. 2009); Thomas C. Lee, Limiting Corporate Directors’ Liability: Delaware’s Section 102(b)(7) and the Erosion of the Directors’ Duty of Care, 136 U. PA. L. REV. 239, 241–42 (1987) (discussing Delaware law, which has a provision “enabling corporations to insert in their certificates of incorporation a provision limiting or eliminating directors’ liability for breach of their duty of care” (footnotes omitted)); Miller, supra note 38, at 338–43 (listing all of the jurisdictions with rules permitting some form of contractual elimination of the duty of care and loyalty).
corporation and arguably not much different than under traditional forms.

None of the corporate hybrid statutes require that reports be filed with the government, or any type of oversight enterprise, nor is there a central repository for those reports. Even if such a requirement existed, the duty of care seems to have been refined to the point that, absent securities fraud, regulators have no ability to intercede in the corporate hybrids. What will they enforce? And based on what cause of action? Perhaps an attorney general might be able to assert that a given benefit corporation’s activities are ultra vires if they did not consider the effects of their decisions on the designated interests, and two thirds of the shareholders did not vote to ratify the actions or convert to regular corporate status. There are a lot of “ifs” there and, unless the behavior is particularly egregious, the attorney general may not have the resources or inclination to run the risk of losing.

To give some perspective, the beleaguered for-profit education company Rasmussen is a benefit corporation and could presumably qualify as a social purpose corporation so long as it offers education and is moderately equitable to its employees. There is no additional legal recourse beyond what already exists under traditional forms and applicable laws if officers, directors, managers, and shareholders choose to prioritize financial profits over quality education, as long as its directors considered other required interests. Regulators do not have any new claims. On the plus side, the Rasmussen situation may illuminate the extent to which social and reputational pressure can be a meaningful vehicle for accountability to an adopted purpose.

The Model Benefit Corporation Legislation requires only an overview of general business operations, including consideration of the

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78Keierleber, supra note 77 (“Though Ms. Waite [current president of Rasmussen and granddaughter of the founder] said criticism of for-profit higher education was not a factor in making the transition, Mr. Urdan [analyst at Wells Fargo Securities] said he suspected that Rasmussen’s experiment may in part be a response to a call from its accreditor, the Higher Learning Commission of the North Central Association of Colleges and Schools, for institutions to demonstrate a commitment to serving the public good.”). Rasmussen only recently incorporated under Delaware’s Public Benefit Corporation statute. See Plerhoples, supra note 27.
effect of business operations on employees, the community the business is located in, and the local and global environment. As no government mechanism exists to enforce the publication of a report by a third party, it is difficult for transparency to thrive.

2. L3C Accountability: Heavier Legal but No New Social Accountability

Unlike the corporate hybrid forms, L3C statutes do not require that any specific information be made available to the public. Of course, no L3C is prohibited from preparing and presenting its own reports on its charitable and other activities.

To the extent the L3C as a form invokes social accountability, it is because of the branding associated with the name. Presumably, legitimate L3Cs will not want rogue operators to tarnish the brand, and they will be inclined to police how the brand is being used, although there is no legal requirement that they do so; nor can it be presumed that they will have the time or resources to do so.

Therefore, the L3C depends less on the vagaries of “transparency” and more on statutorily delineated priorities and weighting. Members and managers of L3Cs are required by statute to ensure that the enterprise significantly further “charitable” purposes as defined by the Internal Revenue Code—not broadly social or public purposes—and that “but for” the connection to those purposes the entity would not have been created. The statutes also prohibit distributable profits or appreciation in the company’s overall value from being a significant purpose. Thus, L3C statutes make the priorities and weighting clear: charitable purposes must dominate and a purpose of maximizing the economic interests of owners cannot be “significant.”

80 There has been legislation introduced in Congress that would require that certain L3Cs annually file an information-like return with the IRS if the entity availed itself of other parts of the bill that require the IRS to act on enterprise-wide requests for program related investment status, rather than investor level determinations, as currently happens. See H.R. 2832, 113th Cong. § 4 (2013), available at http://congress.gov/bill/113th-congress/house-bill/2832.
81 See, e.g., VT. STAT. ANN. tit. 11, § 3001(27)(A) (LEXIS through 2013 Adjourned Sess.).
82 Id. § 3001(27)(B).
Not everyone agrees that the L3C statutes establish priorities or weighting of the applicable purposes. Professor Dana Brakman Reiser suggests that the statutory language offers only a “reasonable purposive interpretation by sophisticated experts” but requires “reading between statutory lines.” She concludes that fiduciary duties can arise only if the language “clearly and explicitly instruct[s] these leaders to prioritize social good,” and she cites two others who likewise disagree that the L3C regime creates enforceable duties. Professor Brakman Reiser suggests no alternatives for what the language in the statutes should mean or how it should apply.

Rules of statutory construction require judges to presume meaning and give deference to the legislature’s language when doing so can be done without ambiguity. Just because the statute could be clearer does not justify essentially reading the applicable purpose provisions out of the L3C statute, which is the logical conclusion to Brakman Reiser’s position. The provisions can be reasonably read and understood as imposing enforceable duties by those who do not have law degrees or even legal counsel.

Although not requiring particular outcomes, the L3C standards seem to inject opportunity for legal actions to enforce duties by establishing priorities and weightings with regard to charitable purposes and investor profits. Any given owner or manager should be able to hold others accountable for deviations based both on breach of contract and breach of fiduciary duty. For the latter, aggrieved owners or managers may not need to show economic damages, as is generally required for contractual remedies. They also can pursue punitive damages and possibly even disgorgement of profits obtained with unclean hands, neither of which is available under contract claims.

83 Brakman Reiser, Theorizing Forms, supra note 13, at 696.
84 Id.
85 Id. at 696 n.61.
86 See Pike v. Commodore Motel Corp., 12 DEL. J. CORP. L. 1121, 1127 (1987) (advocating that acts of conscious wrongdoing and breaches of a fiduciary’s duty of loyalty will best be deterred by requiring the wrongdoer to disgorge any profit made as a result of such wrongful conduct); John C. Kairis, Disgorgement of Compensation Paid to Directors During the Time They Were Grossly Negligent: An Available but Seldom Used Remedy, 13 DEL. L. REV. 1, 6 (2011) (“While Delaware courts have not ordered disgorgement for breaches of the duty of care, they have ordered that remedy for breaches of the duty of loyalty. In these decisions, disgorgement is described and applied as an equitable, rather than legal, remedy, designed to prevent the wrongdoer from profiting from the wrongdoing, rather than as a way to compensate the plaintiff for any losses.” (footnotes omitted)).
Fraud claims and remedies, under securities laws and otherwise, may also be available to owners and managers as private claimants.

Regulators may also have legal recourse if owners or managers of an L3C fail to adhere to statutorily mandated priorities and weightings. Among their weapons could be criminal charges for securities or other fraud, consumer protection claims, and declaring that acts are *ultra vires* and thus void, which could lead to piercing the veil of limited liability and even disgorgement of profits. If circumstances are bad enough, even criminal and civil enforcement tools under the Racketeer Influence and Corrupt Organizations Act might be available, including treble damages and prejudgment forfeiture.\(^87\) Given at least some degree of market orientation and a lack of exclusivity regarding charitable purposes, the Federal Trade Commission might also be inclined to act in some instances. Accountability in the L3C thus seems to depend less on social stigma, and more on legal process, than is the case with the existing corporate hybrid forms.\(^88\)

Actual legal accountability in the L3C is threatened by statutory provisions that, on the surface, appear to provide for automatic conversion of the enterprise with impunity to a regular limited liability company upon non-adherence to the L3C purposes mandates.\(^89\) It is, however, hard to believe legislatures intended to allow an ease of converting that essentially renders the specifically and carefully delineated criteria (and the entire form and statute) irrelevant. That ease would fundamentally negate any and all enforcement mechanisms. Such an outcome would be illogical and unfortunate, and need not be the result if conversion must be premised on complying with statutory priorities and weightings and if the “automatic” language refers to the absence of administrative filing requirements rather than activity or lack


\(^{88}\) Once the L3C name becomes better known, understood, and used on a widespread basis, as intended by the form’s advocates, the stigma associated with changing from L3C to regular LLC status upon failure to continue to satisfy the L3C purposes rules may serve as a public notice with its own social consequences—but that may be of little solace to members of the L3C seeking more substantial forms of redress against managers or other members who caused the company to abandon its originally contemplated core missions.

thereof. Even so, the potential for confusion supports a call for design modifications, as proposed in Part IV.A., below.

B. What Are The Lawyers Saying and Doing?

Despite the above-described design weaknesses and the fact that the existing hybrid forms explored in this article have been around for only a few years, over 2100 ventures have eschewed traditional approaches and have chosen to operate as formal hybrids.90 They also have generated a substantial amount of commentary and debate that provide a base for meaningful observations about how these forms are faring to date and what modifications to their design and associated regulation might yield more impactful and predictable use of these vehicles. En route to our proposals along those lines in Part IV., the following discussion presents “early reviews” on current hybrid entity forms from a key group—lawyers who advise clients on whether a hybrid is an appropriate vehicle for their venture and, if so, how to keep it well-maintained over the long haul. As might be expected, those reviews are mixed with significant numbers of both opponents and proponents.

One need only look at some of the titles of published articles and essays to conclude that certain lawyers and law professors approach hybrid forms with a great deal of skepticism and even derision.91 Those opposed to, suspicious of, or concerned about the hybrid forms generally rely on some combination of the following six arguments: (1) concern with the lack of case law to guide actions of entity directors/managers and resolve disputes with stakeholders; (2) uncertainty about the ability to operate a hybrid entity in a state that does not have statutes authorizing the same type of entity; (3) insufficient showing of need for new business forms to allow both a potentially profitable business and pursuit or promotion of social good;

90 See supra note 10 and accompanying text.
(4) rejection of the proposition that hybrid forms are simpler and less expensive to organize than modified traditional for-profit forms; (5) prospects for new forms to be misused to mislead socially-conscious investors and consumers about the true degree of public/social benefit the entity will pursue or, especially with respect to L3Cs, to attract tax-favored sources of capital (most notably program related investments (PRIs)) in a streamlined fashion; and (6) weaknesses in hybrid form statutes that point to, among other things, insufficiently defined terms and inadequate ground rules and mechanisms to clearly circumscribe and enforce duties to various stakeholders and intended social beneficiaries while ensuring pursuit of social missions on a long-term basis. 92

The remainder of this subsection addresses the above concerns as voiced by lawyers reluctant to counsel their clients to use hybrid entities. That focus, however, is not intended to de-emphasize or

92 A notable example of several of those themes is reflected in the following excerpt from an abstract of a 2012 letter in opposition to L3C legislation issued by the Business Law Section of the American Bar Foundation on behalf of its committees on LLCs and Nonprofit Organizations:

- The L3C is no better than any other business form for receiving program related investments from private foundations. L3C legislation implies otherwise and we believe is therefore misleading.
- Using a program related investment as part of the type of tranched financing promoted by L3C advocates portends serious risk of improper “private benefit” – i.e., using charitable assets to the benefit of private interests such as for-profit investors. “Private benefit” transactions are improper for a private foundation and imperil a foundation’s tax-exempt status. A private foundation cannot remain qualified as a tax-exempt charitable entity if the foundation has transgressed the private benefit doctrine.
- In addition:
  - enacting L3C legislation inadvertently but dangerously signals that state law can streamline and simplify compliance with federal tax law requirements and that program related investments can be accomplished simply, quickly, and almost “off the rack;”
  - it is inappropriate and unnecessary to use state entity law to provide a new and potentially misleading “brand” to mark private business ventures as socially beneficial;
  - the L3C legislation contains a technical flaw that renders the legislation self-defeating in most instances; and
  - current LLC law already permits the type of ventures contemplated by the L3C legislation.

neglect the fact that many other lawyers and law professors are active proponents of formal hybrid forms and dispute the proposition that traditional forms suffice to attract untapped or sub-optimally tapped markets of socially-conscious investors, especially in the face of profit maximization “shareholder primacy” concerns. These latter commentators maintain that the hybrid corporate forms and the L3C fill gaps and provide much-needed flexibility for creative mixes of profit-generating endeavors and pursuit of social benefits.

1. The “Dearth” of Case Law

Literature from practicing lawyers has, predictably, cited the “dearth” of interpretive case law as a reason to be cautious about recommending hybrid entities to clients. Respondents to an informal survey of law school entrepreneurship and community economic development clinics, undertaken in conjunction with research for this article, reflected similarly. There are well over 100 such clinics at U.S. law schools, many of which take on engagements for both for-profit ventures and nonprofit entity formations. Several of them reported receiving client requests for advice on enterprises that propose mixed financial and social objectives. Although the “newness” aspect was mentioned in a few survey responses, many indicated they either have been including hybrids in their choice of entity discussions or are open to including them.

The absence of on-point case law is inherent in the creation of any new form of business organization. When LLCs were introduced as a “hybrid” of corporate and partnership attributes, and even after federal income tax classification options were clarified, many practitioners and

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93 See, e.g., Hasler, supra note 11, at 1299–1301; Brakman Reiser, Theorizing Forms, supra note 13, at 685–92; Tyler, Negating the Legal Problem, supra note 27, at 138–43.

94 See sources cited supra note 93.

95 See, e.g., Lofft et al., supra note 91, at 5.

96 Survey of Legal Clinic Directors, conducted by Anthony Luppino using SURVEY MONKEY (2014).


98 See Survey of Legal Clinic Directors, supra note 96.

99 Id.
law professors bemoaned the “dearth” of case law.100 Even after the use of LLCs mushroomed over the last few decades, some continue to contend that “many institutional and other investors have still not fully embraced the LLC form.”101 Yet statistics show that new company formations across the U.S. are heavily lopsided in favor of LLCs over corporations.102 Moreover, the growing body of case law on LLCs that has developed is, not surprisingly, based on well-established concepts from corporate and partnership cases sensibly applied to interpretations of corporate-like or partnership-like aspects of the LLC statute as applicable. That is part of the beauty of rule of law being a learning, dynamic system—albeit often slowly.

Lack of directly-on-point case precedent is an understandable concern, but one that may well be overridden by a lawyer’s ethical duties of competence and acting in the best interest of the client within the bounds of the law, using the available tools the law affords. By itself, the absence of common law precedent should not drive a lawyer to cross hybrid forms off of the choice of entity menu in advising clients when otherwise relevant, especially when the underlying business model involves a commercial enterprise with social benefit objectives.

2. What If My State Doesn’t Have a Hybrid Statute?

Some lawyers, both in responses to our survey of law school clinics and in informal conversations, have pointed to the absence of a hybrid entity statute in the state in which they practice as a factor that

101 Lofft et al., supra note 91, at 5.
gives them pause in recommending a hybrid form to their clients. The “internal affairs doctrine,” typically built into corporate and LLC statutes, directly addresses this objection. This doctrine provides that the laws of the state in which the entity was formed (the “domestic” state) govern matters that involve the company’s internal affairs, including rights and duties among the owners, directors, officers, and other managers, as well as the liability of owners to third parties.

That is not to say that the lack of a hybrid form statute in the state in which a lawyer practices and advises clients on choice of entity matters is of no concern. Three primary issues immediately come to mind. First, one needs to verify that each state in which the entity will conduct business will indeed allow “foreign registration” of a hybrid entity looking to conduct business in the state. So far, it appears that has not been a problem as many L3Cs and benefit corporations formed in states with enabling statutes are shown as registered to do business and in good standing in public records.

Another consideration is whether a lawyer licensed to practice in a state without a hybrid entity statute is competent and authorized to provide legal services and opinions on the formation of an entity under the laws of another state. This of course is not a new issue or one unique to hybrid forms—for example, lawyers practicing in states across the country have assisted clients in forming Delaware corporations for quite a long time. It does mean that the lawyer must ensure that he or she is knowledgeable about the applicable laws of the domestic state and is not engaging in the unauthorized practice of law.

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103 See Survey of Legal Clinic Directors, supra note 96; see also Lofft et al., supra note 91, at 5 (“Finally, it is worth noting that not all states have authorized any, much less the same, form of hybrid organizational structure(s). While there is no reason to believe that a company organized, by way of illustration, as a benefit corporation or flexible purpose corporation would not be able to qualify to do business generally as a traditional for-profit corporation in any other state(s) that did not recognize a corresponding hybrid model, the fact that the states have not yet adopted a uniform approach to these hybrid models may nonetheless inhibit their widespread adoption.”).

104 See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971), available at Westlaw (last updated Oct. 2014). Note that while the internal affairs doctrine is embodied in many state’s corporate (and many unincorporated) business organizations statutes and is generally followed, some states do not absolutely follow it, at least in some circumstances. See, e.g., Matt Stevens, Internal Affairs Doctrine: California Versus Delaware in a Fight for the Right to Regulate Foreign Corporations, 48 B.C. L. REV. 1047, 1048–49 (2007).

105 See Latest L3C Tally, supra note 10; Find a Benefit Corp, BENEFIT CORP INFO. CENTER, http://www.benefitcorp.net/find-a-benefit-corp (last visited Jan. 12, 2015).
through the entity-formation work. Thus, engaging local counsel in the domestic state may be in order.

Perhaps the thorniest of the three concerns involves conflict of laws regarding matters other than those governed by the internal affairs doctrine. The lawyer must consider the extent to which laws of the domestic and various foreign states will apply to the activities of the entity. Again, this area of inquiry is not new or unique to hybrids as evidenced by the nature of the issues to be considered, including the need to analyze the contracts, torts, tax, and securities laws of the various states touched by the venture. One significant difference is the uncertainty about whether hybrid forms’ connections to public purposes/social benefits implicate state-level regulation as charitable trusts or other special regulatory treatment to protect the interests of the public generally, along with various constituencies the entity may purport to be designed to help. That complex matter is analyzed in Part IV.B., below.

3. Aren’t Traditional Forms with Well-Drafted Organizational Documents Good Enough?

Many lawyers and law professors also argue that hybrid forms are unnecessary because traditional for-profit forms with well-crafted organizational documents adequately serve the objectives of hybrids. They most often assert the following: (i) the risk of director/manager liability for deviation from profit maximization/shareholder primacy is exaggerated and something of a “red herring”;106 (ii) the proposition that the complexity and consequent legal fees associated with a tailored traditional form will significantly exceed the complexities and costs of organizing a formal hybrid venture is questionable or distorted;107 and (iii) hybrid forms (particularly the corporate hybrids) are more prone to

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106 See, e.g., Blount & Nunley, supra note 22, at 304–08. A variation of this argument presented by Blount and Nunley is the contention that the dichotomy between financial profits and social purpose is false, not because all companies can choose to do either, but because companies that want to stay in business must do both anyway if they want to succeed. Id. at 310. They also assert that, “the main issues raised by advocates of hybrid entities are operational ones.” Id. at 312. As a matter of business operations, we agree that well-run businesses pay attention to both profits and purpose, but as a matter of legally enforceable duties, they understate the need for clarity about the priority of one over the other or the lack thereof. Good business practices and fiduciary duties are not the same.

107 Gaffney, supra note 91, at 342–43.
abusive misleading of investors and consumers as to the degree to which a company is pursuing financial profits for its owners under the cloak of an entity type generally associated with doing good; that is, hybrids may be more susceptible to “green washing” than traditional forms.\textsuperscript{108}

The literature on “profit maximization” and “shareholder primacy” is voluminous, as scholars of U.S. corporate law have continued the famous “Berle-Dodd Debate” of the late 1920’s/early 1930’s.\textsuperscript{109} Commentators have for decades since, rightly or wrongly, often attributed to Adolph Berle the “property theory” of the corporation,\textsuperscript{110} and to E. Merrick Dodd, the “social entity” theory of the corporation.\textsuperscript{111} William Allen, a New York University law professor and former Chancellor in the Delaware Court of Chancery, has said that “our law and our society had been schizophrenic on the subject of corporation law for a long time” and that “[t]wo inconsistent conceptions have dominated our thinking about corporations since the evolution of the large integrated business corporation in the late nineteenth century.”\textsuperscript{112}

Regardless of the correct starting point of the debate, this tug of war has been going on for quite a while, and there are several notable judicial opinions that support concluding that the property theory, a/k/a the shareholder primacy/profit maximization view, is winning.\textsuperscript{113} A

\textsuperscript{108} Plerhoples, supra note 27.
\textsuperscript{109} For an interesting, relatively recent analysis of the Berle-Dodd debate, see Fenner Stewart, Jr., Berle’s Conception of Shareholder Primacy: A Forgotten Perspective for Reconsideration During the Rise of Finance, 34 Seattle U. L. Rev. 1457 (2011).
\textsuperscript{110} See id. at 1463–66. Assets of the corporation are the property of the shareholders to which corporate directors/managers owe fiduciary duties akin to those owed by trustees to trust beneficiaries. See id.
\textsuperscript{111} See id. at 1477–79. As a creature of society’s laws, directors/managers owe duties to shareholders but also rightly act with a social conscience in carrying on the company’s business. See Stewart, supra note 109, at 1477–79.
\textsuperscript{113} See, e.g., Revlon, Inc., v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (“A board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders.”); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954; Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. . . . The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.”); eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 33 (Del. Ch. 2010) (“Promoting, protecting, or pursuing non-stockholder considerations must lead at
2012 case from Delaware’s Chancery court unequivocally re-emphasized the point:

The corporate form in which craigslist operates, however, is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The “Inc.” after the company name has to mean at least that.\footnote{eBay Domestic Holdings, 16 A.3d at 34.}

So, proponents of hybrid forms rightly worry that some owners could successfully prosecute claims against directors/managers of traditional for-profit entities based on a duty to see that profit maximization trumps social benefit objectives if the directors/managers deploy company resources to pursue social purposes.

At the same time, critics of hybrid forms who argue that the strength of the asserted profit maximization roadblock to social initiatives has been exaggerated have some support. Law professor David Millon, for instance, recently argued: “In fact, shareholder primacy is not a legal doctrine. Beyond the anomalous case of \textit{Dodge v. Ford}, it is virtually impossible to find authority for it.”\footnote{David Millon, \textit{Shareholder Primacy in the Classroom After the Financial Crisis}, 8 J. BUS. & TECH. L. 191, 192 (2013) (footnotes omitted). \textit{But cf.} generally Cassady V. Brewer et al., \textit{Social Enterprise by Non-Profits and Hybrid Organizations}, 489-1st Tax Mgmt. (BNA) Estates, Gifts, and Trusts, at § IV(C)(1)(b) (2014) (discussing, in addition to \textit{Dodge v. Ford}, other cases cited at \textit{supra} note 113 and finding support for a shareholder primacy/value maximization doctrine therein).} Similarly, in 2013, business law professor Justin Blount and in-house corporate attorney Kwabena Offei-Danso, in an article critical of the benefit corporation and the Model Benefit Corporation Legislation, concluded:

The direction a corporation takes depends heavily on its managers; corporate law is not to blame for their malfeasance. Shareholder primacy and shareholder wealth maximization are merely convenient scapegoats upon some point to value for stockholders. When director decisions are reviewed under the business judgment rule, this Court will not question rational judgments about how promoting non-stockholder interests—be it through making a charitable contribution, paying employees higher salaries and benefits, or more general norms like promoting a particular corporate culture—ultimately promote stockholder value. Under the \textit{Unocal} standard, however, the directors must act within the range of reasonableness.” \textit{(footnote omitted).}
which to place the blame for wrongful conduct. The reality is that
corporations can maximize shareholder wealth while still considering the
interests of all stakeholders; by pursuing a wealth maximization goal in a
socially responsible manner, all stakeholders can be benefited. Moreover, the
traditional business corporation’s structure does not require shareholder
wealth maximization as the primary goal of the corporation, and thus provides
social entrepreneurs with ample flexibility to pursue a social mission.\footnote{Blount & Offei-Danso, supra note 91, at 669 (footnotes omitted).}

Such commentators have questioned the underlying authority and
practical significance of the shareholder primacy theory in the context
of the ability of traditional for-profit corporations to have and pursue
social objectives clearly stated and prioritized in carefully drawn
organizational documents.\footnote{See id. at 637–44; Millon, supra note 115, at 193–94.}
They also challenge shareholder wealth maximization by distinguishing cited cases on their facts and asserting
that the holdings should not apply beyond the limited facts before the
court.\footnote{The Michigan Supreme Court in \textit{Dodge v. Ford} noted that: “The record, and
especially the testimony of Mr. Ford, convinces that he has to some extent the attitude
towards shareholders of one who has dispensed and distributed to them large gains and that
they should be content to take what he chooses to give.” 170 N.W. at 683.}
For instance, they can argue that \textit{Revlon} and \textit{eBay Domestic Holdings}
narrowly involve only a takeover context, which leaves room
for varying opinions on the ability of directors to properly protect
unique corporate culture, as discussed at some length in \textit{eBay Domestic Holdings}, albeit with some skepticism.\footnote{See \textit{eBay Domestic Holdings}, 16 A.3d at 32 (discussing Chancellor Allen’s opinion in \textit{Paramount Comm’ns, Inc. v. Time, Inc.}, 571 A.2d 1140 (Del. 1990)).}
In any event, they conclude
that such cases are not indicative of how a court will respond to a case
involving organizational documents in which all affected parties clearly
prioritize social benefits above some level of financial rewards to
shareholders.

We need not referee that debate here. Absent explicit and
unanimous consent among owners that adheres through time and
changed minds and owners, there is sufficient uncertainty as to the
ability of directors/managers to avoid claims of breaching a fiduciary
duty grounded in shareholder wealth maximization to at least give one
pause as to the advisability of using a traditional for-profit corporation
or LLC to operate a venture with significant subordination of
distributable profits and capital appreciation for the owners in order to

\footnote{118 See \textit{eBay Domestic Holdings}, 16 A.3d at 32 (discussing Chancellor Allen’s opinion in \textit{Paramount Comm’ns, Inc. v. Time, Inc.}, 571 A.2d 1140 (Del. 1990)).}
enable the production of public/social benefits.\textsuperscript{120} In addition, a court or later owners might have different views on how to balance competing objectives as ownership becomes more diffused and distant from the “founders” who negotiated and signed the initial carefully-crafted organizational documents. The collective weight of these uncertainties suggests that traditional for-profit entity forms—even if modified—will often not be the best vehicles for social enterprise, and, therefore, alternative forms are indeed in order.

4. Are Hybrid Forms Really Simpler/Less Expensive to Organize than Traditional For-Profit Forms?

Some observers argue that one drawback of reliance on modified traditional business forms is that doing so assumes or requires a readily available pool of resources, particularly because modifying traditional business forms requires engaging lawyers, which is expensive and may involve varying expertise of many lawyers, which increases the expense.\textsuperscript{121} It may involve the ongoing engagement of lawyers with diverse expertise to advise on, or document how, conflicts between purpose and profits are resolved. It may involve that engagement again when owners’ minds change or actual ownership changes and the new owners are not aligned with the former owners’ decisions about how those conflicts should be resolved.

These expenses, they argue, mean that the “traditional” forms that can do everything the hybrids can do are available primarily to highly capitalized and well-represented founders.\textsuperscript{122} Should that be the case? Shouldn’t opportunities to pursue profits and purpose also be available to less well-capitalized or connected entrepreneurs and founders? We do not believe that lack of money, or an unwillingness to spend money on lawyers rather than the business, is an adequate answer. Surely, it

\textsuperscript{120} Cf. Hasler, supra note 11, at 1291 (stating, in the midst of a good discussion of various perspectives on the shareholder wealth maximization debate, “According to Professor Ian Lee, advocates from both sides of the debate exaggerate their claims about ‘the state of corporate law’ when, in fact, the situation is ‘persistently ambiguous.’”) (citing Ian B. Lee, Corporate Law, Profit Maximization, and the “Responsible” Shareholder, 10 STAN. J.L. BUS. & FIN., Spring 2005, at 31, 41) (noting as in accord, Allen, supra note 112). See also Brakman Reiser, Theorizing Forms, supra note 13, at 686–89.

\textsuperscript{121} See, e.g., Brakman Reiser, Theorizing Forms, supra note 13, at 689. The authors also have anecdotal experiences with this argument through conversations with proponents of hybrid forms in various settings.

\textsuperscript{122} See id.
isn’t only the sophisticated and wealthy that are capable of having business ideas or models for which hybrid structuring may be appropriate.

Formal hybrid forms are intended by many proponents to help make those opportunities more readily available to all—essentially democratizing that which might otherwise be an elitist pursuit. That being said, lawyers and the accompanying expense of employing them are still needed for using the new hybrid forms. All of these forms have complexities, and their nuances are substantive and not necessarily conducive to reliance on common sense. These observations are true with regard to formation and operations, and to address changing minds or the changing of owners. Acceptance and broader use of the forms may eventually generate reliable templates as starting points, as well as plenty of examples in the courts and case studies of decision-making and conflict resolution. Over time, knowledge about what the forms mean and how to use them will expand and, in turn, associated expenses may decrease. Lawyers and their costs will still be needed but the circumstances will be more normalized as they often are now with the traditional, unmodified forms.

In response to that line of reasoning about legal fees, we and other observers note that model L3C and benefit corporation statutes do not themselves constitute a complete set of ground rules for either such hybrid form. Rather, they piggyback on existing LLC and corporation statutes, adding the special definitions and provisions that make them hybrids, but otherwise rendering the entity subject to the balance of the pre-existing LLC or corporate statutes, unless overridden by the special hybrid definitions and provisions. Such observers agree that the issue of access to legal services is a serious problem that appears to preclude members of society of limited financial means from forming or investing in business ventures, but they contend that it is a problem across all business entity forms in the complex and highly regulated environment that exists under federal, state, and local laws, and conclude that we need to address the problems across the board.

123 See id. at 689–90 (“These specialized forms...provide a forum for social entrepreneurs to safely proclaim their blended missions proudly. Each does so by starting with an established for-profit legal form and adding a social mission component to it.” (footnote omitted)).

124 These observations are based on conversations, which one or more of the authors of this article have had with lawyers and law professors regarding business organizations planning and access to qualified counsel. Cf. FRANKLIN A. GEVURTZ, BUSINESS PLANNING
Lawyers with that viewpoint to the formation of an L3C expected to have two or more owners. They argue that a counselor providing advice in that circumstance should counsel his or her client(s) to address several issues, including such matters as the fundamental decisions of whether the L3C will be member-managed or manager-managed (which can have significant implications in terms of agency authority, analysis of whether the L3C will be issuing securities, and income and employment tax consequences), and the tax status desired for the entity, which will often be elective, at least at the federal level. Preferably before giving advice on those fundamental decisions, the lawyer would discuss the internal agreements to be reached: obligations or rights of owners to make mandatory or optional contributions or loans (including preemptive rights); distribution rights; levels of approval for company decisions and the manner of voting; mechanisms for resolving disputes between owners on their visions of the company’s mission and objectives that may emerge over time; authority to act on behalf of the company; potential restrictions on transferring economic and voting rights; possibility of mandatory or optional buyout of a member’s interest; circumstances under which the company may be dissolved, merged or converted into another entity form; and, if the L3C is to be taxed as a partnership, provisions on the allocation of profits and losses, for book and tax purposes, under provisions of Subchapter K of the Internal Revenue Code and the Treasury regulations thereunder, which are widely regarded as among the more complex in U.S. tax law.

91–92 (3d ed. 2001) (1991) (comments of attorney Dale Schedler) (explaining that the type of thorough analysis needed in planning a business organization for a limited liability company is really not markedly different than what should be done in planning other business organizations).

125 In other words, because an L3C is a form of limited liability these typical LLC issues must be addressed. See generally LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES (2d ed. 2014). On the federal tax classification issue see Treas. Reg. §§ 301.7701-1–301.7701-3 (2014).

126 See, e.g., Partnership Audit—Technique Guide—Chapter 6—Partnership Allocations, IRS (Dec. 2007), http://tinyurl.com/m7cmrwc (“The rules governing partnership allocations (IRC section 704(b) and its accompanying regulations) have been criticized as being some of the most difficult and complex.”); Letter from Jeffrey A. Porter, Chair, American Institute of CPAs Tax Exec. Comm., to The Honorable Douglas H. Shulman, Comm’r, IRS (Nov. 2, 2012), available at http://tinyurl.com/phewthw (“The section 704(b) regulations are extremely complex and roughly 100 pages in length.”).
In other words, some lawyers point out that L3C organizers face the same basic list of planning issues as with a traditional for-profit LLC and they presumably need a similarly detailed written operating agreement. They might even argue that the L3C presents additional challenges when one factors in the desire to attract PRIs (which likely would involve special precautions in the operating agreement) and with the distinct possibility of the L3C with partnership tax status generating net taxable income (albeit not as the result of a “significant purpose” of generating distributable returns on investment)—meaning a so-called “tax distribution” agreement may be needed, which would be a complex matter, especially for tax exempt members.

The comparison is largely the same for organizational documents of a traditional for-profit corporation versus a corporate hybrid form. A lawyer doing his or her job should be asking many of the same basic questions and drafting many of the same provisions in either case. There of course will be differences in how the social purposes find their way into the organizational instruments, but there is no particular reason to believe that drafting job is materially easier for a hybrid corporation than for a traditional corporation. Indeed, the special reporting, benefit enforcement proceeding, and other bells and whistles associated with some corporate hybrids could, at least arguably, create extra work.127

The hybrid movement is seeking to generate useful templates that appeal to social entrepreneurs, including those of modest financial means, who crave relatively simple organizing documents.128 The same, though, is true of those seeking to craft simple templates for for-profit entrepreneurs forming modified forms of traditional LLCs or corporations. In any such scenario, it can be risky and inappropriate to assume one size fits all. The complexity and attorneys’ fees issue thus,

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127 Commentators have noted that the reporting requirements for various corporate hybrids are seen as a disadvantage of that form. See, e.g., Lofft et al., supra note 91, at 2. At least some responses in our survey of law school clinics cited the same concern. See Survey of Legal Clinic Directors, supra note 96.
128 See, e.g., Brakman Reiser, Theorizing Forms, supra note 13, at 689 (“For those without counsel, let alone ambitions of publicly traded shares, highly adjustable forms may be difficult to manage. Small and legally unsophisticated founders will have neither expertise nor counsel to engage in complex contract drafting. Instead, they will want an off-the-rack legal form for dual-mission entities.”); Operating Agreements, AMERICANS FOR COMMUNITY DEV., http://tinyurl.com/n5wthj9 (last visited Jan. 12, 2015) (listing a variety of templates for the L3C).
some lawyers assert, may be a neutral factor in the choice between a traditional or a hybrid form.

5. Are Hybrid Forms Overly Prone to Mislead Investors or Consumers?

Some lawyers maintain that it is potentially misleading, and therefore potentially abusive, to have statutorily branded hybrid forms that connote a social enterprise when in fact such entities can generate a profit for their owners. In frank discussions with such lawyers, it is easier to demonstrate that the L3C’s mandated charitable purpose and prohibition of any significant purpose being financial rewards for its owners have some meaningful safeguards against such abuse than is true of the corporate hybrids. The “flexibility” touted as part of the attractiveness of the latter creates a substantial risk of false impressions or confusion about the relative emphases that will be placed on public/social benefits and financial returns. With all of the hybrid forms, prospects for relatively painless abandonment of the social mission can create uncertainty about the likely duration of such mission.

None of the hybrid forms are immune from at least some justifiable concern about possibilities of “green washing” and hoodwinking of investors and consumers. This circumstance calls for new design features, including clearer definitions, transparency with accountability through meaningful enforcement mechanisms, safeguards against unjustified selling out of the entity’s original purposes, and regulatory initiatives well-suited to promote true social enterprise.

Despite criticisms, thousands of hybrids have been formed, and many lawyers are recommending their use to clients when appropriate. According to our survey of law school clinics, some have formed multiple L3Cs, benefit corporations, flexible-purpose corporations, or social purpose corporations.129 Several respondents reported receiving inquiries from clients about hybrids, and nearly half indicated that they regularly include hybrid forms among the list of choice of entity alternatives they discuss with their clients.130 One indicated that, although not highly recommending hybrids, there was utility in benefit

129 See Survey of Legal Clinic Directors, supra note 96.
130 Id.
corporations as a subsidiary of nonprofits. Even so, the gaps, information, and misinformation could be preventing hybrid forms from having maximum effect.

IV. PROPOSALS FOR A HYBRID FORM DESIGNED TO PRODUCE BETTER MILEAGE

Hybrid entity forms have arisen in part to transform a legal structure historically successful at deriving active capital from investors seeking financial profits to one that provides additional organizational vehicles in which investors can pursue “social profits” while preserving prospects for personal financial benefit as owners. That latter group of potential investors had been shackled by the combination of prohibitions on private ownership in traditional 501(c)(3) organizations and tensions faced by seekers of primarily social objectives when confronted with the law’s emphasis on requiring for-profit managers to serve the “primary” mission of generating financial benefits for their owners. In 21st century technology terms, hybrid forms represent a massive software update and addition to the capitalism platform to better accommodate social ventures as a new application of the system, thereby enlarging the fleet of vehicles to address social needs in creative and impactful ways.

We, and several other commentators, see opportunities to build on and improve the current hybrid options, including by addressing counter-productive uncertainties in terms of how hybrids will be regulated to properly reconcile facilitating social business ventures with
protecting investors and consumers from deception and abuse. We present the following proposal for a new type of hybrid form and suggestions on accompanying regulatory policies.

A. A “Concept Vehicle” Suitable for Production Now

Reflecting on the potential of hybrid forms to access and apply capital in ways either precluded or impeded in traditional forms, and considering the strengths and weaknesses of available hybrid forms, we propose provisions for a new generation of hybrid designed to do the following:

1. require that one or more designated and clearly defined social purpose(s), not necessarily limited by the narrow definition of “charitable” used in the Internal Revenue Code, have an innate and near permanent primacy within the managers’ decision making and the owners’ minds;

2. facilitate access to capital for social enterprises by allowing distribution of financial profits to investors to be an important purpose of the enterprises so long as that purpose is subordinate to its designated social purpose(s);

3. expressly provide for a fiduciary duty to maintain the primacy of the entity’s social purpose(s) and explicitly prevent its improper renunciation;

4. establish meaningful remedies for breaches or deviations from that social primacy duty that can be enforced in legal actions by owners (including “dissenter’s rights”) or by government to protect investors and the public; and

5. promote transparency and accountability through: (a) mandatory periodic reporting of activities to a regulatory oversight office that will be publicly available; and (b) public notice of entity conversion to another form akin to what in other contexts is called a “noisy withdrawal.”

Our proposal for a “Social Primacy Company” statute based on those objectives is set forth in Appendix A. As with the existing fleet of

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hybrid forms statutes it is not a complete business organizations statute but in essence proposes adding provisions to the state general business corporation, limited liability company, or other applicable business organization statutes.

There are very good reasons for the current division between hybrid entities couched in the LLC form and those nestled within general corporate law. As in the case of traditional forms and the Model Benefit Corporation Legislation,\(^\text{134}\) offering a choice of the corporate or unincorporated format best serves the needs of different types of ventures, thereby increasing the chance entrepreneurs will find the best fit for them. Some may prefer the predominantly “freedom of contract” approach associated with the LLC form, while others may desire the customarily more formal corporate structure. If “going public” is planned or reasonably foreseeable, the greater familiarity of trading markets with corporations and “stock” can alone be determinative.

In presenting a next generation hybrid form, we reviewed examples of potentially pertinent statutory language from a variety of sources, among which were state charitable/nonprofit statutes, tax credit statutes, federal and state administrative regulations, traditional for-profit state statutes, the existing array of hybrid forms statutes, and third-party metrics. Sources from which we drew particularly useful guidance were state statutes governing Missouri’s “Urban Redevelopment Corporation”\(^\text{135}\), Vermont’s L3C statute\(^\text{136}\), Pennsylvania’s “Purely Public Charity”\(^\text{137}\), and Washington’s “Social Purpose Corporation.”\(^\text{138}\) Following is a summary of choices we made and our underlying rationale.

1. The Purposes Clause as the Key to Accessing Capital for Creative Social Ventures

All too often access to capital is the biggest concern and complaint of many entrepreneurs, social or otherwise, but capital is far more expensive for social ventures than it is for more traditional for-profit


ventures.\textsuperscript{139} The relatively high cost of capital for social ventures is due at least in part to the reality that social ventures are inherently risky—if they weren’t, the market would already be filling the niche. Moreover, there is evidence suggesting that uncertainty about what the hybrid entity intends to do, and whether the entity will do it, effectively inhibits access to capital.\textsuperscript{140} Thus, the practical essence of existing hybrid forms is contained in how they address required, permitted, and prohibited purposes—financial and otherwise.

The purpose provisions of current hybrid form statutes have aspects that may actually frustrate the desired flow of capital. The L3C, for example, restricts the range of permissible endeavors by focusing on a narrow band of activities tied to federal tax law treatment of 501(c)(3) entities.\textsuperscript{141} Benefit corporation laws maximize flexible decision-making about financial profits and social purpose, and almost entirely abdicate to self-assessment under third party standards that may or may not be rigorous and, along with the other corporate hybrids, defer almost entirely to social accountability given the lack of meaningful ability to impose or pursue legal consequences.

L3C rules that require a charitable purpose and prohibit generation of financial benefits for the owners as a significant purpose are relatively clear, but the Internal Revenue Code’s definition of “charitable” will be too restrictive for many legitimate social ventures.\textsuperscript{142} There are many public benefit purposes that do not necessarily fall within the definition but nonetheless might appeal to entrepreneurs and investors interested primarily in deprioritizing financial gains and emphasizing social good. Although the IRS has provided some guidance about how to identify or prevent financial gains as a “significant purpose” for a PRI,\textsuperscript{143} such a tight and potentially

\begin{footnotesize}
\begin{enumerate}
\item Heminway, \textit{supra} note 39, at 308–09.
\item CLARK ET AL., \textit{supra} note 30, at 11; \textit{see also} SALTUK ET AL., \textit{supra} note 33, at 4, 15.
\item See Lofft et al., \textit{supra} note 91, at 4.
\item Exempt Purposes—Internal Revenue Code Section 501(c)(3), IRS, http://tinyurl.com/mm74ked (last visited Jan. 13, 2015) (“The term charitable is used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.”).
\end{enumerate}
\end{footnotesize}
vague standard might nevertheless unfairly ensnare well-intentioned, thoughtful promoters of social enterprises whose ventures happen to generate distributable profits or appreciation in value of the ownership interests.\textsuperscript{144} Without denigrating the L3C as an alternative form for discrete circumstances, broader permissible purposes and a clearer approach to weighing financial benefits may appeal to many socially-minded investors and fill other gaps in the social venture paradigm.

The purpose provisions of the Model Benefit Corporation Legislation are more extreme in their permissiveness, breadth, and uncertainty.\textsuperscript{145} Benefit corporations must “have a purpose of creating general public benefit,” which is defined as having “[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation.”\textsuperscript{146} The Model Legislation includes an option but no obligation to also adopt a specific public benefit.\textsuperscript{147} In addition, it requires that directors consider shareholder interests and permits such interests as a legitimate priority over other interests if consistent with general and specific public benefit purposes.\textsuperscript{148}

The California social purpose corporation more narrowly must designate at least one specific purpose from a menu of charitable and social purposes, in addition to or at the expense of shareholder interests. As with the benefit corporation, the California social purpose corporation statute does not prioritize social purposes over financial benefits for investors, which both statutes permit.\textsuperscript{149} Similarly, the Florida, Texas, and Washington versions of the social purpose corporation do not mandate prioritization of social purposes over financial benefits.\textsuperscript{150}

\textsuperscript{144} See Callison & Vestal, supra note 91, at 283–84.
\textsuperscript{145} See Model Benefit Corp. Legislation §§ 201(a)-(b) (2013), available at http://tinyurl.com/lv7y5od. The essence of the company is not determined by a statutorily enforceable duty but by an outside source with questionable legal enforceability.
\textsuperscript{146} Id. §§ 102, 201(a).
\textsuperscript{147} Id. § 201(b).
\textsuperscript{148} Id. § 301(a).
\textsuperscript{149} Cal. Corp. Code § 2602(b) (West, Westlaw through 2014 Reg. Sess.). Even with the new language from S.B. 1301 making the enumerated social purpose necessary factors in the decision making of the corporation and the officers, the California statute still does not require prioritization of social purposes over financial benefits. See Corporate Flexibility Act of 2011 § 64; 2014 Cal. Legis. Serv. Ch. 694 (S.B. 1301) (West, effective Jan. 1, 2015).
The Delaware Public Benefit Corporation comes closer to elevating social purpose by requiring that such a corporation “[i]dentify within its statement of business or purpose . . . 1 or more specific public benefits to be promoted by the corporation” and that “a public benefit corporation shall be managed in a manner that balances the stockholders’ pecuniary interests, the best interests of those materially affected by the corporation’s conduct, and the public benefit or public benefits identified in its certificate of incorporation.” The Delaware statute, however, isn’t specific on the “balance” and does not require social benefit primacy, which may be what certain entrepreneurs and investors want and need, as long as all involved understand the limits. The Minnesota public benefit corporation statute similarly does not mandate social purpose primacy.

Accordingly, approaches to purpose taken by corporate hybrid forms are extraordinarily broad, and vague, about how purposes relate to each other, and thus susceptible to financial profit motives overtaking or at least being on par with social purposes. The same is true of the unincorporated Maryland benefit LLC form. There is a place for

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152 As noted supra note 21 and accompanying text, the Minnesota statute contains two options (general benefit corporation and specific benefit corporation). Depending on the choices made, the statute can be used to promote a general public benefit (defined as “a net material positive impact from the business and operations of a general benefit corporation on society, the environment, and the well-being of present and future generations”) and/or a specific public benefit (defined as “one or more positive impacts, or reduction of a negative impact, on specified categories of natural persons, entities, communities, or interests, other than shareholders in their capacity as shareholders, as enumerated in the articles of a public benefit corporation”). Minn. Stat. Ann. § 304A.201 sub. 3, sub. 9 (West, Westlaw through 2014 Reg. Sess.). Although it includes a default rule that prohibits prioritizing shareholder pecuniary interests over the designated purposes, it falls short of mandating prioritization of social purposes. See note 67 supra and accompanying text.
maximizing that type of flexibility, provided all involved are fully aware of and consent to the lack of purposes discipline. That flexibility or ambiguity may make them less distinguishable in actual operation from traditional profit-oriented approaches. 154

In essence, the social enterprise movement is striving to redefine “profit” to mean more than financial returns and value, and to incorporate returns and outcomes not measurable in dollars for investors. The potential in the corporate hybrids for financial considerations to remain a (or the) primary priority frustrates that purpose. There is still a need for a crystalized concept of a hybrid form of entity with a social purpose mandate as the dominant purpose.

To that end, the Social Primacy Company (SPC) we propose must designate as primary one or more specific social purposes from a list that includes both those permitted for an entity eligible to receive tax-deductible contributions under the Internal Revenue Code and other delineated social purposes, including many available in the corporate hybrid forms. 155 No list of this sort can perfectly capture all of the social purposes that may exist or develop over time. We offer our proposed list as a range of specific public purposes that could be expanded or narrowed by appropriate legislation.

More than merely identifying such purposes, the SPC requires a declaration that such social purpose(s) is/are its primary purpose(s) and that financial profits and appreciated value for investors are permissible only if subordinate to such chosen social purpose(s). Those declarations provide critical clarity about responsibilities of the SPC’s managers.

2. Duties and Liabilities of Managers

The success of social ventures as such depends on a clearly established priority and weighting of fiduciary duties. That regimen must negate the primacy of financial profit seeking associated with traditional for-profit organizations and, more than only encouraging good intentions regarding “purpose,” provide meaningful remedies for

breaches of duty that cause the company to pursue distributable financial profits or realizable financial value over its social purpose(s). The current hybrid form statutes move toward those objectives but are hampered by vague standards and generally weak enforcement options.

The proposed Social Primacy Company statute expressly embeds fiduciary duties consistent with the pursuit of the specified social purpose(s) adopted by the entity that can be neither contracted around nor waived, but must persist—regardless of convenience—within the entity.156 Unlike the existing corporate hybrid forms, by design there is no flexibility for the SPC entity or its managers to subordinate the chosen social purpose(s) by seeking financial benefits for its owners. Immutable and utilitarian are not mutually exclusive and must be reconciled if hybrid forms are going to establish replicable expectations and flourish in the larger market.157

To further the goal of unlocking capital for social ventures, we propose three types of legal accountability for manager breaches of the SPC’s genetic duties158: (1) the range of remedies customarily available to owners for breaches of fiduciary duty by managers;159 (2) potential personal liability of managers and complicit owners to guarantee payment of dissenter’s rights if they have committed a “frustration of purpose act”160 and (3) potential personal liability to pay damages (including compensatory, consequential, and punitive damages, and/or disgorgement of personal profits) to (a) the organization, (b) its non-complicit owners, or (c) after the organization and its non-complicit owners are made whole, to one or more government instrumentalities or 501(c)(3) organizations designated by the court.161

156 See infra Appendix A, §§ 3, 4.
157 CLARK ET AL., supra note 30, at 38; Heminway, supra note 39; Kelley, supra note 26, at 367.
158 The use of the term genetic is not an accident. The fiduciary duties must replicate and spread as these organisms grow in number, yet for the species to survive the duties must remain identical throughout each generation.
159 See supra notes 51–59 and accompanying text.
160 Defined as “intentional or reckless disregard of the requirements related to pursuit of the social purpose(s) of the organization as stated in its articles.” See infra Appendix A, § 1(d).
161 See infra Appendix A, § 10(c)(ii). In the SPC, payments to government instrumentalities or 501(c)(3) entities require a judicial finding that the recipients are performing functions or carrying out activities reasonably related to providing benefits to a substantial class of social purpose beneficiaries previously identified by the SPC in an annual report of the organization from within the preceding three years. See infra Appendix A, § 10(c)(ii). The court is further bounded by making determinations that further the interests
3. Required Reporting and “Noisy Withdrawal”

In addition to legal accountability, the proposed Social Primacy Company relies on and appeals to social accountability. SPC managers must give an annual report to the entity’s owners, as do directors of corporate hybrids, but SPC managers also must file it with the secretary of state, of the state in which the SPC is formed.162 The report must include narrative descriptions of how the entity has pursued and furthered its social purpose(s) and any circumstances that materially interfered with accomplishing such purposes.163 The report also must provide information about the compensation of its managers, its lobbying activities, and “a description of each substantial class of social purpose beneficiaries that the social primacy company endeavored to benefit during the reporting year,” along with “such additional information as the secretary of state determines appropriate to facilitate monitoring of compliance with the provisions” of the SPC statute.164 The annual report must be posted publicly by the secretary of state and by the entity if it has a website or uses social media, but such public postings shall omit the manager compensation information unless the entity elects to have it included.165

Also, as one of the conditions to a statutory transformation of the SPC to a regular for-profit entity, the SPC must file a public notice of
intent to abandon SPC status in accordance with such publication requirements as the secretary of state may designate. Thus, the entity’s abandonment of its SPC status will be a “noisy” event that provides notice to regulatory officials, creditors, customers, suppliers, and others who might have acted in reliance on or given consideration to the SPC’s statutory purposes, priorities, and weighting.

4. Dissenter’s Rights

Several of the triggering event concepts in the dissenter’s rights provisions of the proposed SPC statute are somewhat derived from Washington’s social purpose corporation statute. The triggering events for dissenter’s rights under the SPC statute are: transformation to a regular for-profit entity; amendment of the organization’s articles to remove or to materially modify one or more of its social purposes or to add a social purpose (although removing a social purpose that has been achieved will not be a triggering event); or an action that has the effect of causing the organization, or its successor by way of merger or consolidation, to not be a SPC.

Dissenter’s rights only arise in the SPC if the dissenter did not participate in causing the triggering event and meets requirements regarding objection and other conditions typical for dissenter’s rights provisions. Thus, attempts by managers or owners to override social mission and “cash in” by converting the SPC entity into, or merging with, a traditional for-profit or causing it to conduct business in a manner leading to forced loss of SPC status would be risky and a potentially costly proposition in general, especially if the directors, managers, and complicit owners could be personally liable for a frustration of purpose act.

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166 See infra Appendix A, § 9(a)(ii).
167 See infra Appendix A, § 7.
168 WASH. REV. CODE ANN. § 23B.25.120 (West, Westlaw through 2014 Legislation); see also CAL. CORP. CODE §§ 3201, 3002(c), 3302(b) (West, Westlaw through 2014 Reg. Sess.) (granting shareholders dissenting rights only when the entity changes status, be it from traditional entity to social purpose company, merger involving a social purposes corporation where the survivor is not a social purpose corporation, or conversion of a social purpose corporation to a traditional entity).
169 See infra Appendix A, § 7(a).
170 See infra Appendix A, § 7(a)(ii).
This deterrent to veering from the social mission is not without complexities. A key challenge will be determining the “fair value” of the dissenter’s ownership interests in the SPC in the absence of agreement. The proposed SPC statute proposes a definition of fair value that strives to fairly compensate the qualifying dissenter for the deviation from such investor’s expectations in investing in a SPC and avoid unjust enrichment of the managers and complicit owners from a deviation from the social purpose(s) that attracted the investor. In addition, the SPC statute borrows from a provision in Missouri law on payments to withdrawn members of a limited liability company by including a mechanism for court-approved deferred payouts in certain situations where up-front payment could cause unreasonable hardship to the payor organization and adequate security is pledged to secure the deferred payments.

5. Transformation to Traditional For-Profit

Transition from hybrid entity to traditional for-profit should balance preventing opportunistic abuse of hybrid forms with recognition that purpose might be achieved and/or that the hybrid form might not be the best form to pursue those purposes after all. This is accomplished in the SPC statute by requiring that a voluntary abandonment of that status and “transformation” to regular for-profit entity status is conditioned on: (i) approval by super-majority vote of all owners and classes of owners; (ii) filing a notice of intended abandonment of SPC status; (iii) satisfying all proper dissenters’ rights claims; (iv) paying all debt obligations owed to tax-exempt entities if leaving them outstanding would create a material risk of such entity losing tax-exempt status or being liable for certain excise taxes; and (v)

Brakman Reiser and Dean propose a hybrid financial vehicle called FLY Paper, which incorporates the idea of using a poison pill type provision (in this case a convertible debt vehicle) that would be triggered in the event of total abandonment of specific purpose. FLY Paper could be an effective means for investors to ensure compliance with specific purpose but would not enable state regulatory intervention. Id.

172 Appendix A, §§ 7(c)(i)(A)–(B), proposes that fair value be the greater of “the fair value of such ownership interests as of the close of business on the day before the dissenter’s right” triggering event or “the fair value of such ownership interests at the close of business on the day within the fifteen-day period immediately following the date of such [triggering] event which had the highest fair value at the close of business of any of such fifteen days.”

173 See MO. ANN. STAT. § 347.103 (West, Westlaw through 2014 2d Reg. Sess.).

174 See infra Appendix A, § 7(c)(iv).
after all of those conditions are met, filing articles of transformation with the secretary of state.\textsuperscript{175}

6. Private and Public Enforcement of Social Primacy Obligations

The proposed SPC presents a range of meaningful deterrents to improperly abandoning or minimizing designated social purpose(s), including the dissenter’s rights and transformation provisions described above. In addition, the SPC statute borrows from and combines concepts of \textit{ultra vires} and “piercing the corporate veil” to impose personal liability and prevent financial windfalls from decisions to deprioritize social purpose or to prioritize financial profits. The SPC statute also supplements causes of action under the SPC primary organizational statute with other applicable laws by authorizing actions to enforce \textit{ultra vires} acts by the SPC, its owners, or the state attorney general.\textsuperscript{176}

The proposed SPC regime also includes remedies that, without prejudice to dissenter’s rights, authorize the court to (i) allow a reasonable cure period to avoid an \textit{ultra vires} declaration, (ii) allow claims against one of more of the SPC’s managers or complicit owners to be joined with the \textit{ultra vires} claim, and (iii) upon a finding of breach of fiduciary duty by such manager(s) and/or complicit owners, give special consideration to damages.\textsuperscript{177} Compliant managers and owners can recover compensatory, consequential, and even punitive damages; they also can pursue disgorgement of the non-compliant managers’ and owners’ financial profits.\textsuperscript{178} Once those damages are satisfied, the SPC statute directs the court to balance potential for unjust outcomes and misaligned priorities by including a mechanism by which a court can redirect financial recovery to one or more governmental instrumentalities or 501(c)(3) tax exempt entities providing benefits to “a substantial class of social purpose beneficiaries” identified in recent annual reports of the SPC\textsuperscript{179} when doing so is in the interest of justice

\begin{footnotes}
\textsuperscript{175} See infra Appendix A, § 9.
\textsuperscript{176} See infra Appendix A, §§ 10(a)–(b).
\textsuperscript{177} See infra Appendix A, § 10(c).
\textsuperscript{178} See infra Appendix A, § 10(c).
\textsuperscript{179} See infra Appendix A, § 10(c)(ii); see also note 161 supra and accompanying text. The “substantial class of social purpose beneficiaries” approach, see infra Appendix A, § 1(n), is derived from the Pennsylvania Purely Public Charity Institute, see 10 PA. CONS.
\end{footnotes}
and giving due regard to the SPC’s social purposes and reasonable expectations of its compliant owners in that regard.\textsuperscript{180}

7. Summary of SPC Assumptions and Approach

Some may perceive the totality of the proposed statutory provisions for an SPC to be potentially overly rigorous for social

\textsuperscript{180} The possibility of directing damages payments to one or more governmental instrumentalities or 501(c)(3) tax-exempt organizations related to providing benefits to a “substantial class of social purpose beneficiaries” requires special explanation. First, we intentionally did not provide in the proposed statute that a substantial class of social purpose beneficiary, or any member(s) thereof, has standing to bring an action under the statute; in fact, our proposal expressly negates such standing. See in fra Appendix A, § 6. This is consistent with some existing hybrid statutes’ positions against non-investor “standing” in private enforcement actions, which we feel properly avoids a morass of practical problems. See Brakman Reiser, Theorizing Forms, supra note 13, at 718–20. Second, the limiting language included in § 10(c) should cause courts to be appropriately “judicious” in applying this alternate remedy. See infra Appendix A, § 10(c). And, the fact that government instrumentalities, and tax-exempt entities with missions related to aiding an SPC’s intended social beneficiaries, might be receiving funding in an appropriate exercise of judicial discretion, may inspire such instrumentalities/entities to keep a watchful eye on the SPC’s commitment to its designated social purpose(s) and perhaps bring an SPC’s abandonment of such purpose(s) to the attention of that state attorney general. Also, we are more confident in the ability of judges to engage in this type of beneficiary-minded enforcement of intended social purpose and to craft appropriate remedies than we would be with private organizations being given essentially equitable enforcement powers—an approach we do not advocate for policing the Social Primacy Company or other hybrids. But cf. Brakman Reiser, Theorizing Forms, supra note 13, at 728–32 (suggesting that direct enforcement by private regulators might be worthy of consideration in new legislation). Of course, nothing should prevent organizations from voluntarily consenting to such enforcement mechanisms if that is their preference. Finally, there are fundamental and important distinctions between enforcement and “ratings agencies” whose purposes should be limited to facilitating social accountability outside of direct enforcement mechanisms.
entrepreneurs, and perhaps unduly “scary” to prospective managers of such entities. We believe those are not bad things but actually can be affirming of the underlying discipline and desired commitment that social entrepreneur owners and managers already have vested in their own business plans. In addition, observation of the nonprofit sector demonstrates that exacting statutes and regulations do not necessarily stump imagination and can instead encourage both attention to detail and ingenuity to achieve an organization’s objectives in compliance with the applicable tax and other laws, including when commercial activities are part of the means of pursuing those objectives.

Will SPC directors or other managers and owners knowingly expose themselves to the risks of personal liability built into the SPC proposal? The answer may be “no,” unless that is what investors want. The risk is a trade-off for the clear, unambiguous freedom from a profit maximization mandate. Being a director or manager of any business organization comes with pressure to perform. Although the risk of failing to properly cause the company to promote the social purpose(s) designated in its articles as a genetic fiduciary duty is novel, it does not mean it is inherently more risky than holding the position of director or manager in a traditional for-profit company. Whether the profits sought by investors are financial benefits or social benefits, the risk of breach of fiduciary duty is mitigated by a director or manager working diligently and in good faith to deliver on what was promised to the investors and what the directors/managers presumably also desire anyway.

B. Regulating the Social Primacy Company

The “hybrid” nature of the proposed Social Primacy Company naturally presents special oversight challenges. Approaches to regulating hybrid forms are just beginning to evolve. How well a new hybrid form achieves its overtly stated social purpose(s) is only one part of addressing its relevance, usefulness, or desirability. There are also real world regulatory contexts in policy and practice to take into account. Among the key regulatory arenas are general or “core” oversight of compliance with the hybrid entity’s statutory “charter,” taxation, securities law, and related enforcement regimes. Having a relatively clear conception of the interrelationships among a hybrid’s statutory structure and activities, those bodies of regulation can be essential to the creation and evolution (or expiration) of such a new organizational form. Notwithstanding the ambiguity, some organizers
are adopting hybrid forms and operating them in the marketplace despite the lack of regulatory clarity, while other social entrepreneurs are waiting for better indications of, or even certainty regarding, how regulators will approach hybrids.

Accordingly, we are accompanying our proposal for a new hybrid form with a review of existing regulatory policies and recommendations for principal components of how the SPC might be regulated. We start with core regulatory oversight of the form as a business organization that will likely conduct commercial activities in pursuing its social purpose(s), addressing in particular the roles of the state secretary of state and attorney general. We then suggest approaches to federal and state tax and securities regulation policies. Although our primary focus is on our proposed SPC form, we also offer suggestions that might apply to existing hybrid forms as well.

1. Core Regulatory Oversight

The core oversight regimen for hybrid forms has critical implications for all involved, including owners, investors, creditors, employees, volunteers, businesses, charitable entities, donors to charities, consumers, various regulatory agencies, legal advisors, and accountants/auditors. There may not be just one approach that applies to each of the forms. As examined in detail in prior publications by one of the co-authors of this article, three approaches to core regulation and government oversight seem to be emerging: (i) regulate hybrids like charities/charitable trusts; (ii) establish a special registration regime for soliciting investments in hybrids; or (iii) regulate as commercial entities. Following is an assessment of the suitability of each of those approaches, and a suggested core oversight approach for the proposed SPC.

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181 See Tyler, STATE ATTORNEY GENERAL, supra note 89, at 10–12; Tyler, Analyzing Effects, supra note 59; Tyler, Negating the Legal Problem, supra note 27; see generally Dana Brakman Reiser, Regulating Social Enterprise, 14 U.C. DAVIS BUS. L. J. 231 (2014). But cf. Brakman Reiser, Theorizing Forms, supra note 13, at 721, 722 & n.155 (acknowledging the opposition to state attorney general charitable trust division regulation of hybrid forms explained in Tyler, Negating the Legal Problem, supra note 27, but implying she might favor a significant regulatory role for such division if not for concerns of lack of sufficient resources).
a. Regulate Hybrids Like Charities?

Here, and throughout our discussion of regulatory policies, we assume that we are not talking about an enterprise formed under a hybrid statute, i.e., a “Traditional Tax-Exempt Entity,” that exclusively pursues charitable purposes and prohibits distributions to owners or other impermissible private benefits. Instead, we focus on hybrid organizations that may pursue social purposes that do not necessarily fall solely within the purpose restrictions for 501(c)(3) status and that may distribute profits and permit capital appreciation to private investors in the company. We posit that treating these latter hybrids like charities, whether trusts or corporations, is a seriously flawed proposition.

First, state charities regulation laws that eliminate the potential to distribute profits to owners\(^{182}\) thwart a key and desirable objective of hybrid forms—tapping into the market potential to attract new capital from socially conscious investors to apply to the pursuit of social benefits. Charities laws, however, frustrate that purpose because they require disbursements exclusively or primarily for charitable purposes, thus prohibiting owners and other insiders from benefiting financially, including upon dissolution, because those laws require that a charity’s assets remaining after satisfying liabilities be distributed to similarly situated charitable enterprises.\(^{183}\) Among the mismatch problems is that the corporate hybrid forms by design allow permissible scope and reach of activities to extend well beyond what is recognized as “charitable” under state and federal law.\(^{184}\)

Conscripting hybrids into the realm of charity law also would diminish the ability of owners to modify purposes, convert to traditional

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\(^{182}\) State laws forbid those who manage or operate charitable trusts and corporations to realize any personal gain (other than reasonable fees) from the underlying operation. Thus, charitable trusts and corporations cannot distribute profits to owners or allow owners to gain from the increased value of the underlying venture. Tyler, State Attorney General, supra note 89, at 8–9; Tyler, Analyzing Effects, supra note 59, at 552.

\(^{183}\) See, e.g., N.Y. NOT-FOR-PROFIT CORP. § 1001(d)(3) (West, Westlaw through L. 2014, chapters 1–550); Treas. Reg. §§ 1.501(c)(3)-1(b)(4) (2013) (“An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose. . . . However, an organization does not meet the organizational test if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders.”).

\(^{184}\) As noted previously, the L3C limits significant purposes of the organization to charitable purposes normally associated with 501(c)(3) status. See supra Part IV.A.1.
forms, and merge with or acquire other entities. For example, requirements for notice or preapproval by the state charity regulator or a court could decimate the ability of hybrid organizations to make strategic decisions quickly. Those delays could materially interfere with the ability of underlying enterprises to participate in the marketplace and pursue either their purpose or profit objectives. Again, this would be particularly troublesome for the corporate hybrid forms for which state legislatures have provided rather extensive and detailed processes for making these types of decisions.

The ultimate effect of applying charity laws to hybrids merely because of their form is to create a regulatory veto or override of both the legislative branch’s enactment and the governor’s approval. It also may threaten to constitute a taking by government without due process of law or just compensation. Thus, at least two elemental characteristics of our republican democracy are impacted by regulators imposing charitable trust or corporation law—separation of powers and sanctity of property as a reflection of liberty. Moreover, subjecting such hybrids to charities laws, whether trust or corporate, imposes all of the burdens of such laws with none of the benefits. As discussed further below, they are not and should not be tax exempt, and contributions to them are not and should not be deductible as charitable. Because the benefits are not available, the burdens ought not apply either.

b. Impose Registration Requirements for Soliciting Investments?

A second approach to governmental oversight of hybrid forms modifies the first by imposing only those requirements that apply to regulate charitable fundraising by requiring hybrids that solicit investments to register with state regulators. Perhaps this is what the Illinois Attorney General was seeking when advocating that the General Assembly include language in the state’s L3C law declaring that L3Cs and their members and managers are trusts or trustees, respectively, and therefore subject to the state’s charitable trust laws. As enacted,

185 See TYLER, STATE ATTORNEY GENERAL, supra note 89, at 8–9; Tyler, Analyzing Effects, supra note 59, at 554–60.
186 See 805 ILL. COMP. STAT. ANN. 180/1-26(d) (West, Westlaw through 2014 Reg. Sess.) (“Any company operating or holding itself out as a low-profit limited liability
however, the Illinois L3C enabling legislation is explicitly not so limited, and subsequent attorney generals, courts, and others may not interpret the expansive language as narrowly as may have been originally intended.

Reasonable registration and filing requirements of some sort are unlikely to be as intrusive as comprehensively applying charitable trust or charitable corporation laws to all hybrids. Such requirements could even be justified as furthering legitimate regulatory interests without unduly hampering how hybrid entities operate in the marketplace and pursue their various objectives. Such registrations can facilitate social accountability and may not differ dramatically from requirements that might apply under securities laws in any event. As explained below, however, regulation of solicitation of investments in hybrid enterprises that are not de facto Traditional Tax-Exempt Entities is best left to federal and state securities regulators. Doing so avoids redundancy and takes advantage of the regulators’ greater experience, relative to a state attorney general’s charitable division, with regulation of investments in companies that regularly have profit-seeking investors.

Beyond soliciting investments, one area where a filing requirement might serve regulator concerns and the corresponding public interest could be when hybrid forms convert from their hybrid state to a traditional corporate or unincorporated counterpart. Such a conversion is likely, but not necessarily certain, to formally elevate financial profits over social purpose and may even result in subverting purpose entirely. The public and appropriate regulators should have formal notice of such material changes. Once again, though, we propose that a different state regulatory body—the secretary of state’s office rather than the attorney general’s charities bureau—can and should be the initial recipient of such public notice. We built that into the SPC statute to facilitate social accountability and, in appropriate circumstances, legal remedies.

company in Illinois, any company formed as a low-profit limited liability company under this Act, and any chief operating officer, director, or manager of any such company is a ‘trustee’ as defined in Section 3 of the Charitable Trust Act.”; TYLER, STATE ATTORNEY GENERAL, supra note 89, at 5–6 (“Illinois has explicitly made all L3Cs that operate in the State subject to its charitable trust regimen and its requirements and restrictions.”).
c. Regulate as Commercial Entities?

A third approach to regulating hybrids that are not Traditional Tax-Exempt Entities is to regulate them like their traditional for-profit counterparts, without applying special provisions or oversight. This approach is more consistent with the fact that such hybrid organizations (i) will have owners who have put capital at risk, can receive profit distributions, and can benefit from gains in the value of the enterprise; (ii) like traditional for-profit commercial enterprises, must participate in the marketplace, sell something, earn revenue and pay attention to expenses; and (iii) are subject to the taxation regimes generally applicable to for-profit companies.

Consequently, such hybrids must convince others to buy what they are offering. They must compete in the market with others who are offering alternative goods, services, or approaches on price, quality, and otherwise. To impose an additional, likely draconian, layer of regulatory oversight as the first approach would place hybrids at a competitive disadvantage. Why erect unnecessary barriers to solving or mitigating social problems—particularly the subset of problems that are charitable—especially when legitimate regulator and public concerns can be addressed using less onerous means?

Of course, giving hybrids a competitive advantage would also be improper, particularly if part of the impetus for the forms is to enable certain market efforts to be redirected towards solving social problems. Market participants should not be put at a disadvantage as a result of government oversight.

There is little or no reason to regulate or oversee the formal hybrid forms any differently than has been done for modified traditional forms and joint ventures among for-profits and charities that have been operating as hybrid enterprises for decades. In fact, to impose a new regime on the formal hybrid forms would require rethinking how to treat organic hybrid entities like Newman’s Own, Google.org, Tom’s Shoes, Ben & Jerry’s, the Body Shop, for-profit hospitals and schools, program related investments, and others that have operated for decades subject only to non-charitable, regular commercial regulatory oversight.\(^{187}\)

\(^{187}\) History evidences that such an approach does, can, and will work, including by ensuring that regulators have tools that protect the public from unscrupulous solicitors and safeguard the charitable sector’s goodwill from being tarnished by confusion of the sectors.
General regulatory oversight corresponding to oversight that is applicable to traditional commercial enterprises, perhaps with a few modest additions that do not unduly disrupt fair competition, seems most consistent with the intent of legislatures and governors that have embraced formal hybrid forms for their states while also serving legitimate regulator and public expectations. It is also consistent with how hybrid endeavors have been treated prior to the emergence of the formal forms. Absent evidence that this approach is deficient, it seems to be an unnecessary and dangerous over-reach to reject this approach and not give it a chance to show that it can work.**188**

### d. Recommendations on Core Oversight of SPCs

Existing hybrid forms should not be regulated by the charitable trust or charitable corporations divisions of state attorney generals’ offices, except when a given hybrid enterprise is structured as a de facto Traditional Tax-Exempt Entity. The same is true of the proposed SPC. Instead, the SPC and other hybrids should be presumptively regulated as commercial business entities.

Core regulatory oversight for issuing a charter to the SPC and monitoring maintenance of its organizational status as such under the laws of the domestic state should be vested in that state’s secretary of state, or such other state official normally responsible for business formations. The domestic state’s attorney general would be the agent of the state to bring ultra vires actions for failure to comply with conditions of SPC status, including abandonment of proper priorities and primacy of social purpose.

Like other commercial business enterprises, the SPC should be subject to: federal and state securities regulation to protect investors; federal and state regulation of trade practices and protection of

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**188** A close cousin to this approach would require that all public companies, regardless of form, report on their impact on social responsibility. See Blount & Nunley, *supra* note 22, at 311 (“[I]f widely accepted reporting measures for social responsibility are eventually developed, society would be better served by requiring all public corporations to publicly report on such measures along with their financial reports rather than only requiring this reporting from a subset of special entity forms.”). Thus, instead of fitting social enterprises into the market, this approach would fit the market into social purpose, essentially injecting social purpose as a requirement for all publicly traded companies and fundamentally changing the nature of what it means to be “for profit.” We disagree with theories or suggestions that would lead to such an outcome.
consumers; employment laws; federal, state, and local tax laws; and other laws, which would include regulation by appropriate agencies in every state in which it conducts business.

We do propose some special rules to assist the secretary of state and attorney general in identifying circumstances when regulatory intervention with meaningful consequences will be in order. In the spirit of Justice Brandeis’s observation that “[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman,” the SPC statute requires public posting of annual reports and notice of proposed and completed transformation of the entity to a regular for-profit company. Furthermore, when ultra vires conduct is brought to the attention of the state attorney general, the proposed statute expressly authorizes actions that afford the court a range of possible remedies to deliver justice to wronged investors and, albeit indirectly, to substantial classes of intended beneficiaries of the SPC’s designated social purpose(s).

2. Tax Policies

Unlike Traditional Tax-Exempt Entities, hybrid forms allow equity owners to have distributions made to them based on their ownership interests. Even if they have charitable purposes, that distribution feature precludes hybrids from qualifying for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. This means that donations to hybrids are not and should not be tax-deductible. It also means that hybrids are subject to the same basic patterns of federal income taxation as traditional for-profit entities, and that property and sales tax exemptions afforded to tax-exempt organizations by various taxing jurisdictions generally should not apply to hybrids.

From a federal income tax perspective, under the Internal Revenue Code and Treasury Regulations on tax classification, hybrids are subject

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189 Louis D. Brandeis, Other People’s Money and How the Bankers Use It 62 (Nat’l Home Library Found. 1933). Brandeis made this observation in the specific context of regulating banks that literally held and invested “other people’s money.” As such, care must be taken lest his metaphor be over-extended.

to the same tax status possibilities and restrictions as typical for-profit business entities. Thus, a corporate hybrid will be treated as either a “C” corporation or, if it meets the eligibility requirements and makes a proper election, an “S” corporation. C corporations pay entity-level tax on their taxable income, and shareholders are also subject to tax on dividend distributions they receive from the corporation. Subject to special rules for S corporations that were previously C corporations, an S corporation does not pay entity-level federal income tax; rather, its income, gains, losses and deductions are allocated to its shareholders, in proportion to their stock ownership, for them to report on their respective income tax returns in a “pass-through” manner.

An L3C (or benefit LLC) formed in the U.S., as an unincorporated type of entity, might be treated as a partnership, C corporation or S corporation for federal income tax purposes; or, if it has only one owner, possibly as a “disregarded entity.”

A threshold question is whether the unincorporated entity is per se a corporation for federal tax purposes under the Treasury Regulations. In most cases a domestic (formed in U.S.) limited liability company will not be a per se corporation and will be eligible to elect its tax treatment under the so-called “check-the-box” regulations. Where that electivity applies the entity will by “default classification” be a “partnership” for federal tax

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192 See I.R.C. § 1361.
193 A shareholder that is a corporation may be eligible for a deduction for dividends received from a domestic corporation, thus reducing the burden of that second level of tax. See I.R.C. § 243.
194 The eligibility requirements for S corporation tax status can severely limit the company’s capital-raising opportunities. Those requirements limit the number of shareholders and types of eligible shareholders, and preclude more than one class of stock in terms of distribution rights. See I.R.C. § 1361(b)(1). In addition, certain types of financial institutions, insurance companies, and certain types of corporations with income from foreign sources are ineligible to elect S corporation tax treatment. Id. § 1361(b)(2). Despite the general exclusion of taxable entities from the list of eligible S corporation shareholders, it is possible to have an S corporation wholly own another S corporation under “qualified subchapter S subsidiary” rules. Id. § 1361(b)(3)(B).
196 See Treas. Reg. § 301.7701-2(b) (mandating corporation tax status for, in addition to entities formed as corporations or joint stock companies, insurance companies; state-chartered business entities conducting banking activities and having any federally insured deposits; certain governmentally-owned entities; entities treated as corporations for tax purposes under special provisions of the Internal Revenue Code (such as, for example, certain publicly-traded partnerships under I.R.C. § 7704); and certain types of entities formed in foreign countries).
purposes if it has two or more members, or, if it has only one member, as a disregarded entity (essentially a sole proprietorship). Neither partnerships nor disregarded entities pay entity-level federal income tax (both are instead “pass-through” entities). If such an entity wants to be classified as a corporation for tax purposes it must make an election to that effect—in which case it will be treated as a C corporation—unless it meets the S corporation eligibility requirements and makes an S corporation election.

Notably, “LLC” is not a federal income tax classification. When people refer to a two or more member limited liability company as being “taxed as an LLC,” they generally mean the default classification of “partnership,” which can have a number of advantages. In addition to the one level of tax/pass-through attribute shared with S corporations, entities with partnership tax status can generally retain such status even if they have more than 100 owners, have other business entities as owners, or have multiple classes of equity owner distribution rights. Partnerships differ from S Corporations in many other tax respects as well.

A comparison of the projected tax consequences of establishing a venture as a C corporation, S corporation, or partnership for federal income tax purposes is a complex, multi-factored part of entity formation planning. Among the many issues to consider in such a comparison are: (i) tax consequences of contributions to and distributions from the entity of non-money property; (ii) tax effects of shifts of liabilities from owners to the entity (or vice versa) and the tax effects of entity-level liabilities; (iii) character issues (e.g., capital gain versus ordinary income) on various types of transactions (including sales of ownership interests); (iv) timing of recognition of income.

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197 See Treas. Reg. § 301.7701-3.
198 Though mandated corporation tax status may apply to certain “publicly-traded” partnerships. See I.R.C. § 7704(a) (2012).
199 For example, a partner in an entity with partnership tax status can include their properly allocable shares of liabilities to third parties in the tax basis of their partnership interests, which can have beneficial tax effects. See I.R.C. §§ 704(d), 705, 722, 731, & 752.
200 For taxable owners of equity interests in a pass-through entity, one prominent concern is the possibility of income tax liability for company taxable income for a given tax year with insufficient cash distributions to the owners to fund the payment of the tax on that income. This could easily occur, for example, in a corporate hybrid with S corporation tax status, or in an L3C with partnership or S corporation tax status, in situations where net earnings are being reserved or applied to capital expenditures for mission-related reasons. A possible solution might be a “tax distribution” provision in the entity’s organizational
and deductions for owners; (v) tax treatment of retirement payments; (vi) whether applicable states will follow the federal income tax classification in question; (vii) effects of an entity’s tax classification on the potential responsibilities of the company and the owners for employment taxes; and (viii) where an owner of an interest in the entity is a Traditional Tax-Exempt Entity, a variety of special considerations to be carefully evaluated.

A full exposition of those and other tax factors in entity formation planning is beyond the scope of this article. Many sources already canvass that area. But below are observations on some key planning considerations under current tax law of particular relevance to hybrid forms looking to attract capital from both taxable and tax-exempt socially-conscious investors.

For taxable owners of equity interests in a pass-through entity, one prominent concern is the possibility of income tax liability for company taxable income for a given tax year with insufficient cash distributions to the owners to fund the payment of the tax on that income. This could easily occur in a corporate hybrid with S corporation tax status, or in an L3C with partnership or S corporation tax status, when net earnings are being reserved or applied to capital expenditures for mission-related reasons. A possible solution might be a “tax distribution” provision in the entity’s organizational documents, similar to what is often used in traditional for-profit pass-through entities that mandate a minimum level of distributions to owners to pay their income tax—provided such distribution is consistent with the entity’s purposes, does not significantly impair its ability to achieve its objectives, does not disrupt the business deal among the owners, and avoids undesirable tax consequences to both taxable and tax-exempt investors (for example, tax-exempt owners that may not get a distribution because they do not

domains (of the type often used in decidedly for-profit pass-through entities) mandating a minimum level of distributions to owners to pay their tax—provided such distribution is consistent with the entity’s purposes, does not significantly impair its ability to achieve its objectives, does not disrupt the business deal among the owners, and avoids undesirable tax consequences to taxable or tax-exempt investors. Lawyers who have had to draft or review such provisions know that crafting “tax distribution” provisions that accomplish all of those goals is no simple matter.

201 See, e.g., BRUCE P. ELY ET AL., PRACTICING LAW INSTITUTE, STATE TAXATION OF SUBCHAPTER C, SUBCHAPTER S, AND SUBCHAPTER K ENTITIES AND THEIR OWNERS—AN OVERVIEW; WILLIAM P. STRENG, CHOICE OF ENTITY, 700-3d Tax Mgmt. (BNA) U.S. Income (2014); BREWER ET AL., supra note 115; KELLEY, supra note 26; MAYER & GANAH, supra note 190; WEXLER, supra note 190.
pay taxes must ensure that such provisions do not disadvantage them or inadvertently create a private benefit problem).

Another notable consideration of potential concern to taxable investors in a hybrid is identifying whether, particularly during start-up phases, the entity may generate net tax losses (or tax credits) that such investors might be able to utilize to reduce their personal income tax liabilities. In such a scenario, planning issues would include weighing the pass-through of tax benefits potential against possible disadvantages of S corporation or partnership tax classification in other respects, and determining the likelihood that the taxable investor could be properly allocated such tax benefits by the entity and be able to use them after applying other restrictions in the Internal Revenue Code—for example, might there be disallowance of losses flowing through from an L3C under the so-called “hobby loss” (activities not engaged in for profit) rules202 given the L3Cs prohibition of a significant purpose of generating profits or capital appreciation for investors?

More attention seems to have been paid in the hybrid forms literature on planning for investment by Traditional Tax-Exempt Entities, and particularly private foundations, in hybrid social ventures. In general, a 501(c)(3) organization planning to get involved in a venture with commercial activity and/or arrangements with for-profits must attend to two key tax-related factors. One is the need to identify and address the prospects for such involvement leading to tax liability for “unrelated business taxable income” or “debt-financed unrelated business taxable income,” which could threaten exempt status if too large.203 The second is to safeguard against threats to its tax-exempt status from arrangements that might represent impermissible conferring of private benefit on others involved, including by allowing for-profit owners to use tax advantages without corresponding benefits to the tax-exempt owners or by tranching investments without proper attention to private benefit considerations.204

In some cases, equity ownership in an entity with pass-through tax status may not be a good choice for an exempt organization because of rules that impute the character of partnership activities and income to the owners and special rules on the unrelated business income tax

203 I.R.C. § 512.
204 See Brewer et al., supra note 115, at § II; Mayer & Ganahl, supra note 190, at 418–19, 429–31.
treatment of a tax-exempt’s income from an S corporation. One implication of these tax considerations is that, even if the L3C form is viewed as the best choice for a social venture for non-tax reasons, it might, in some cases, want to consider forgoing the “partnership” default classification and elect to be taxed as a C corporation.

The most discussed tax issue in published L3C literature, though, is whether that hybrid form is achieving what is widely acknowledged as a key design objective—to make them an essentially pre-approved “expressway” to qualifying PRIs by tax-exempt private foundations. That presumed intent among some is evidenced in L3C statutory language prohibiting a significant purpose of generating profits or capital appreciation, which tracks language from the Treasury Regulations on PRIs. The answer to date on achieving that objective is clearly “no,” as well described in a recent article on “Taxing Social Enterprise”:

[T]he supporters of the L3C form also hoped it could simplify the making of program-related investments (PRIs) by private foundations. To date, however, the IRS has not indicated any willingness to issue rulings that would treat investments in either L3Cs generally or any given category of L3C as automatically a PRI simply because of the recipient’s L3C status under state law. Federal tax law therefore does not currently treat L3Cs differently even for this limited purpose.

That is not to say that the Treasury Department and the IRS do not and would not recognize that L3Cs may, on proper facts, be suitable recipients of program-related investments by private foundations. But such recognition is not a prerequisite to the validity or usefulness of the L3C form generally or even for receiving PRIs, and suggestions to the contrary are tantamount to finding federal preemption in the absence of federal action, a literal impossibility given that preemption necessarily and unequivocally depends on some action having been taken rather than on any failure to act. Proposed regulations offering guidance on

205 Mayer & Ganahl, supra note 190, at 410 & n.106, 411–12.
PRIs through new examples include a loan to a social venture conducted in LLC format that, on the facts presented, was deemed to qualify for PRI treatment. Yet, that example, while describing a venture for which the L3C form may have been a good vehicle, does not actually say that the limited liability company was formed as an L3C. The L3C is simply not, under current law, an “automatic” route to approval of an investment as a PRI; rather, and not surprisingly, the IRS and interested private foundations will look at the substance of the facts and circumstances and apply the generally applicable provisions of the PRI regulations.

The PRI issue is emblematic of the pivotal tax policy question surrounding hybrid forms—should they, by virtue of the parameters of the enabling statute governing their form, be afforded special tax benefits? We again turn to that matter of regulatory policy with respect to the proposed SPC, but with observations applicable to existing hybrid forms noted as well.

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209 That being the current state of affairs, some proponents of the L3C form are supporting proposed legislation that would better position the L3C form as recipients of PRIs—even though IRS approval is not required for PRIs generally or for PRIs to L3Cs more specifically. The proposed “Philanthropic Facilitation Act,” introduced as H.R. 2832 in the House by Representative Cory Gardner (Colorado) on July 25, 2013, would amend the Internal Revenue Code to:

(1) expand the definition of, and requirements relating to, ‘program-related investments’ made by private foundations to for-profit entities to further certain charitable purposes; (2) allow a judicial determination (i.e., declaratory judgment) as to whether investments in any entity qualify as program-related investments; (3) require expanded reporting by for-profit entities that receive program-related investments of their gross income, expenses, disbursements, and other information; and (4) allow public inspection of any petition seeking a determination that an investment by a private foundation is a program-related investment and of any information reported by organizations receiving program-related investments.

H.R.2832—113th Cong. (2013–2014): Philanthropic Facilitation Act, CONGRESS.GOV, available at http://tinyurl.com/onyyvvn (last visited Jan. 15, 2015). The language of the bill indicates that part of the strategy is to allow an entity to petition for a safe harbor determination that investments in it qualify as PRIs and that foundations may rely on that determination (as far as it goes) unless and until the Secretary of the Treasury publishes notice of revocation of such determination. H.R. 2832, 113th Cong. § 2 (2013), available at http://tinyurl.com/pjs592e.
a. Income Tax Status/Classification of the Social Primacy Company

Two threshold tax policy recommendations flow from the fact that the SPC is designed (a) to have owners who may receive returns on and of their investments and (b) to conduct any level of commercial activity that does not conflict with the primacy of their stated social purpose(s). First, we do not feel a new federal (or state) income tax classification should be created for the SPC or, for that matter, for any of the existing hybrid forms. Such hybrids can compete with traditional for-profit entities in the marketplace for consumer and investor dollars, are not compatible with the fundamental premises that historically support tax-exempt status, and should have the same income tax status options as traditional commercial enterprises.\(^{210}\)

Second, it follows then that the law should not be modified to allow deductible “charitable” contributions to such hybrids absent IRS recognition of exempt status under I.R.C. §170. The prospects for distributions to owners of the SPC (and of the existing hybrid forms) are simply antithetical to the basis for charitable deductions.\(^{211}\)

b. Entity-Level Federal Charitable Deduction Limitation

Under current federal income tax law, an entity with C corporation tax status would generally be subject to a limit of 10% of its taxable income in deducting charitable contributions made by the entity.\(^{212}\)

\(^{210}\) See Mayer & Ganahl, supra note 190, at 438–39; Tyler, Analyzing Effects, supra note 59, at 581–86; cf. Mystica M. Alexander, Benefit Corporations—The Latest Development in the Evolution of Social Enterprise: Are They Worthy of A Taxpayer Subsidy?, 38 SETON HALL LEGISLATIVE J. 219, 279 (2014) (“The failure of Benefit Corporations to fulfill the long-standing requirements of nonprofit organizations and the lack of carefully articulated standards to assess fulfillment of social mission lead to the conclusion that Benefit Corporations, as currently designed, do not warrant special tax treatment.”). But cf. Dana Brakman Reiser & Steven A. Dean, SE(c)(3): A Catalyst for Social Enterprise Crowdfunding, 90 Ind. L.J. (forthcoming 2015) (proposing a special tax regime for hybrids with corporation tax status under which mission driven expenditures (tied to 501(c)(3)-type purposes) could result in an up to $500,000 exclusion from the corporation’s income, therefore financial profits for investors would, in essence, be penalized by denial of capital gains treatment on sales of stock and denial of qualified divided favorable tax rates for shareholders receiving distributions of earnings by way of dividends from such SE(c)(3)).

\(^{211}\) See Mayer & Ganahl, supra note 190, at 422, 438–39; Tyler, Analyzing Effects, supra note 59, at 539, 581–86.

Some commentators addressing possible tax law changes relating to hybrid forms have advocated that consideration be given to increasing that percentage limitation,213 noting that there had been a failed legislative proposal in 2005 to increase it to up to 20% for all C corporations.214

Given the potential of an SPC to make charitable contributions connected to advancing its social mission(s),215 we propose that I.R.C. § 170 be amended to allow an SPC that is a C corporation for tax purposes, to deduct charitable contributions up to the same percentage limitations as apply to an individual, but for the corporation substituting “taxable income” (as defined in I.R.C. § 170(b)(2)(C)) for “adjusted gross income.”216 We would also advocate applying such increased percentages to an L3C with C corporation tax status. We are hesitant, however, to support extending that tax benefit to any of the other existing hybrids, or to traditional for-profit corporations if based on notions of parity with hybrids, as we see too much potential conflict with their permissible for-profit purposes and their fiduciary duties to their owners.

c. I.R.C. Section 183—The So-Called “Hobby Loss” Provision

Section 183 of the Internal Revenue Code—the so-called “hobby loss” provision—places limits on the deductions that may be claimed by an individual or S corporation from an “activity . . . not engaged in for profit.”217 The deduction of a net loss from an activity in a given tax

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213 See Mayer & Ganahl, supra note 190, at 439 nn.247–50. These commentators also suggest that consideration be given to modifying the business expense deduction language of I.R.C. § 162(b) “to allow hybrids to deduct amounts expended in pursuit of their charitable ends over and beyond the ten percent limit of § 170(b)(2)(A)” and to modify the Code to allow hybrids “to expense, rather than depreciate, assets dedicated exclusively to charitable ends to avoid the trap of § 263.” Id. at 440; see also Tahk, supra note 190, at 532 (advocating consideration of increasing percentage limits on charitable contributions by individuals and corporations either “generally” or, alternatively, “only for taxpayers participating in cross-sector [non-profit/for-profit] collaborations”; and, similarly to Mayer and Ganahl, suggesting consideration of modifications to business expense deduction and capitalization rules to facilitate “cross-sector collaborations”).

214 Mayer & Ganahl, supra note 190, at 439 n.250 (citing the Charitable Giving Act of 2005, H.R. 3908, 109th Cong. § 103(b) (2005)).

215 See infra Appendix A, § 3(b)(ii)(M).


217 I.R.C. § 183(a).
year can be precluded if the activity is not: (1) a trade or business for purposes of the business expense deduction provisions of I.R.C. § 162; (2) or an activity for the production of income for purposes of the provisions of I.R.C. § 212 regarding the deduction of related investment expenses. The IRS has posted on its website an informational page addressing the question “Is Your Hobby a For-Profit Endeavor,” which strongly indicates that expenses of an activity without indicia of actively seeking financial profit or appreciation in financial value will not satisfy the deductibility provisions of §§ 162 or 212 and thus will face the deduction limitations of § 183.

In the context of an SPC that is an S corporation, a partnership with flow-through to one or more individuals or S corporations, or a disregarded entity for federal income tax purposes, it seems quite possible that the subordination of profit and appreciation in value purposes to social purposes might trigger the deduction limitation of Section 183—meaning that the underlying taxpayer(s) could not claim a net loss from the activities of the SPC on their tax returns. If social benefits, however, were treated as a type of “profit,” then activities engaged in for the production of social benefits would be engaged in for profit and thus not subject to the hobby loss rule. We suggest that § 183 or the regulations thereunder be applied (or, if necessary, amended) such that the “hobby loss” rules would not apply to SPCs, in effect recognizing that social purposes can be a substitute for another type of “profit.” This approach might create the possibility of a taxpayer writing off a net loss for a personal agenda endeavor in the nature of a “hobby”; accordingly, the rules and their application need to include anti-abuse provisions to ensure that relief from the § 183 deduction limitations is predicated on both good faith intent and sustained activity by the SPC to conduct a business venture that will

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218 See id. §§ 183(b)–(c).
220 The risk of such denial of net loss deductions seems even greater with respect to an L3C with flow-through to one or more individuals or S corporations given the L3C requirement that “no significant purpose” of the entity be the generation of financial profit/appreciation in value for owners. A benefit corporation with S corporation tax status might have much less of a risk of creating such unfavorable tax treatment in situations in which having a significant purpose of generating financial returns are not necessarily forbidden or subordinated to social purpose.
advance one or more of the social purposes allowed under its governing statute.

d. Issues Related to Tax-Exempt Investors

In the case of an SPC that is a partnership for tax purposes, we do not propose any change in existing tax law on the imputation of the character of business activity of the partnership to its partners, including partners who may be tax-exempt entities and need to be concerned about unrelated business taxable income.221 We do, however, join with others who have argued that consideration be given to altering the rule of I.R.C. § 512(e) that tax-exempt stockholders in S corporations automatically have unrelated business taxable income treatment for all of their income in respect of their stock ownership in the S corporation.222 In both cases, a look-through to the nature of the underlying activities of the entity is in order to get to the true substance of the uses to which the tax-exempt’s investment are being made—whether the pass-through entity is an SPC or another hybrid.

With regard to “program related investments,” neither the SPC nor any of the existing hybrids should be given special status that would automatically qualify investments in them by private foundations as PRIs based on entity type rather than specific activities. Analysis of the particular facts and circumstances on a case-by-case basis is needed for each enterprise.

e. State and Local Sales and Use, and Property Taxes

Given the wide range of permitted social purposes included in the ground rules for the proposed SPC223 and the potential for profit to private investors, it is inappropriate to grant a blanket exemption to SPCs from sales and use, or property taxes. At the same time, it is not at all uncommon for state and local governments to fashion specific exemptions, abatements, or payments in lieu of taxes arrangements, tax credits, and various special kinds of financing or subsidies to support

221 For discussion of the federal tax law rules relating to tax-exempt partners in partnerships, see Brewer et al., supra note 115, at § II; Mayer & Ganahl, supra note 190, at 408 n.95 and accompanying text, 411–12 nn.114–16 and accompanying text.
222 See I.R.C. § 512(e); Mayer & Ganahl, supra note 190, at 440 & nn.254–55.
223 See infra Appendix A, § 3(b).
socially beneficial projects and activities that lessen the burdens of government. SPCs and other hybrids might be good candidates for support from such measures based on an assessment of their particular activities as opposed to merely their entity type.

3. Securities Regulation Policies

Within the large and rapidly expanding body of published literature on hybrid forms in the U.S., relatively little attention has been given to how federal and state securities laws might apply to the capital-raising activities of hybrids. Noting this void, Joan MacLeod Heminway, a corporate law scholar and professor at the University of Tennessee College of Law, nicely frames some pivotal issues on this topic:

Together with state-based entity law and federal and state tax law, federal and state securities regulation plays an important and under-appreciated role in the ongoing viability of for-profit social enterprise. Specifically, securities regulation establishes critical rules of the game for social enterprise financed through the issuance of securities and, in doing so, imposes various types of costs on for-profit social enterprise. Accordingly, it is important to the future of for-profit social enterprise to resolve uncertainties in securities regulation, especially (but not exclusively) at the key and leading federal level.

The fundamental securities law consequences for a hybrid business entity issuing securities are actually rather clear under current laws. At the federal level, as an issuer of securities, it must either register the securities offering under the Securities Act of 1933 (1933 Act) (an expensive and time-consuming process) or establish a valid exemption from such registration. The same register-or-establish exemption pattern applies in each state in which an offer or sale of such securities

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225 Heminway, supra note 39, at 304.
226 Id. at 310.
227 See MARC I. STEINBERG, SECURITIES REGULATION 75 (5th ed. 2008).
is to occur, except to the extent state regulation of the offering is preempted by federal law.  

If a securities offering is registered under the 1933 Act or the entity reaches a point that it has over $10 million in assets and at least 2000 equity owners (or at least 500 equity owners who are not “accredited”), it will become a “reporting company” under the Securities & Exchange Act of 1934 (1934 Act) and, for at least some time period, required to file detailed, publicly available, periodic reports with the Securities & Exchange Commission. In addition, any issuer of securities will be subject to several anti-fraud provisions under both federal and state laws.

While the JOBS Act of 2012 took steps to streamline some aspects of securities law compliance in capital-raising activities, the required disclosure and procedures can, nonetheless, still be burdensome and costly. Many commentators have concluded that, despite good legislative intentions, the JOBS Act did not do enough to spur capital investment in startup and growth ventures and, in some areas, the SEC’s implementation of regulations seemed to thwart purposes of certain provisions of the Act.

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232 See, e.g., Kurtis Urien & David Groshoff, An Essay Inquiry: Will the JOBS Act’s Transformative Regulatory Regime for Equity Offerings Cost Investment Bankers’ Jobs?, 1 TEX. A&M L. REV. 559, 578 (2014) (“[A]spiring business people may cringe while thinking about how much the cost of compliance with the JOBS Act would be, because the startup would have to maintain records of the new investors and make sure that the startup maintains an exempt status.”); James J. Williamson, Comment, The JOBS Act and Middle-Income Investors: Why It Doesn’t Go Far Enough, 122 YALE L.J. 2069, 2075 (2013) (“When the JOBS Act was passed, the final version included a little-discussed provision that will limit the ability of middle-class investors to participate in venture investing. Section 302(b) prohibits ‘investment companies’ from operating under the Act, preventing companies that
From the investor’s perspective, a finding that investment in a hybrid entity is a security raises potential resale constraints posed by securities laws. If the securities were acquired under an exemption from registration, they are typically restricted and their sale prohibited unless registration occurs or the seller establishes a then-applicable exemption from registration. Special resale restrictions apply to sales by affiliates (“control persons”) of an issuer.

Although the basic ramifications to the issuer and holder of offers and sales of securities are pretty clear, the threshold question—whether a “security” is indeed involved to trigger those ramifications—is a bit muddy. It is complicated and difficult to determine whether investment instruments issued by a corporate hybrid, L3C or benefit LLC can be properly excluded from “securities” treatment because seeking profits or capital appreciation for investors is truly insignificant or is subordinated to the pursuit of social benefit objectives. The ambiguity of priorities and weighting inherent in the corporate hybrids elevates the complexity still further.

Heminway provides a thorough exposition of which types of debt, equity, or other investment units constitute securities before concluding that, in most cases, investments in hybrid entities probably are securities under applicable federal laws. She rightly concludes that “while a court is likely to determine that non-bank debt, stock, and investment contracts that afford holders the right to financial return are securities under the 1933 Act and 1934 Act, there may be some room for argument to the contrary in specific cases.” Because the securities regulation or “blue sky” laws of many states essentially follow the federal approaches to defining securities, and the ones that don’t tend to be more expansive in defining the risk capital investment situations in which their citizenry need protection, the conclusion will most likely be the same at the state level.

The “room for argument” is rather narrow. Regarding equity investments, it is almost impossible to successfully assert that corporate...
stock with more than *de minimis* prospects for the receipt of dividends or the capture of appreciation in value by shareholders is not a security.\(^{238}\)

The mandated charitable purpose and prohibition of a “significant purpose” being financial gain for its owners better positions L3Cs to contend that the fundamental nature of a security—potential for profit—is lacking when it issues membership interests. But even in the L3C there can be some presumed expectations of profits or the organizers would likely have formed a Traditional Tax-Exempt Entity. Current law still appears intolerant to a weighting of purposes analysis and more inclined to label as a security an investment by a passive investor with any expectation of profit.\(^{239}\) Moreover, an owner who *invests* in an L3C with a view toward generating social benefits apart from (or in lieu of) personal financial rewards should be able to convince a court that such investor had a reasonable expectation of *those types* of social benefit “profits” and accordingly deserves protection under securities laws.\(^{240}\) A regulator also justifiably might use similar arguments to subject the investments to relevant regulatory and procedural requirements.

A court is very likely to hold that debt issued in a capital raising mode, by a corporate hybrid or an L3C or benefit LLC, constitutes a security under *Reves v. Ernst & Young*, the seminal case setting forth the test for determining whether “notes” (a term used in the federal definition of securities under the 1933 Act and the 1934 Act) are the types of “notes” the statute intended to be treated as securities.\(^{241}\)

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\(^{238}\) The most notable case in which stock was held not to be a security under federal law was one in which stock was issued as a voting mechanism for tenants in a state-subsidized nonprofit housing cooperative, where the tenants had virtually no prospect of financial return beyond just getting back, upon leaving the complex, the small dollar amount paid per share. See *United Hous. Found., Inc. v. Forman*, 421 U.S. 837 (1975). How many corporate hybrids will be able to show that type of complete lack of profit potential?\(^{239}\)

\(^{240}\) Heminway, *supra* note 39, at 318.

\(^{241}\) It should also be noted that in an L3C comprised of only members active in the company’s business, it may be possible to successfully argue that the equity interests are not securities under the “expectation of profits solely from the efforts of others” prong of the three-part test applied to determine if ownership interests in unincorporated arrangements are securities applied in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298–99, 301 (1946). See also *Robinson v. Glynn*, 349 F.3d 166, 174–75 (4th Cir. 2003) (concluding that degree of control by an active investor in an LLC precluded characterizing his membership interest as a security—but this fact-specific “control” inquiry would be essentially the same whether the company was a regular LLC or an L3C).
Heminway points out that a loan to a hybrid by an investor with low-profit motivation might lend support for non-security status under one element of the *Reves* test. She further recognizes that statutorily mandated disclosure (but with a private enforcement mechanism for faulty disclosure) by a hybrid might meet another *Reves* factor. Ultimately, though, Heminway concludes that, absent risk limiting protections such as insurance and collateralization, a court is very likely to find that a social venture’s capital-raising debt (as distinguished from a simple bank loan or installment purchase obligation) is a security.

Having concluded that hybrid forms, with the possibility of some very limited exceptions, are unlikely to be spared in their capital-raising activities the broad sweep of applicable definitions of “security” and the associated compliance burdens and costs, the question then becomes whether there are valid reasons to change those laws to facilitate capital formation by social ventures and, if so, what those reforms should be. Should they include the creation of special “exchanges”? Might securities regulators, and especially state securities law administrators, possibly be among the best protectors of the interests of socially-conscious investors and watchdogs of disclosures by hybrids? Thoughts on such policy issues in the context of regulating the proposed SPC (again accompanied by some observations applicable to existing hybrid forms as well) follow.

### a. Definition of “Securities” and Application of Anti-Fraud Provisions

Regarding equity interests in unincorporated SPCs (e.g., LLCs) and other unincorporated hybrids, the federal-level “Howey Test” for securities status should be applied in a manner that treats the term “expectation of profits” as including not just financial profits but also social benefits that an objective investor would believe the entity is promising to pursue. The same would apply to the many states that essentially follow the *Howey* Test for state securities regulation purposes. For states that have a non-*Howey* approach, the same concept should still govern—i.e., treat an investment for social profit as an investment meriting protection of reasonable investor expectations.

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243 *Id.* at 313–14.
244 *Id.* at 314.
Similarly, for both federal and state securities regulation purposes, stock in a corporate SPC or other corporate hybrid should always be treated as a “security” when a reasonable expectation of either financial or social profits, or both, is inherent in investment in such stock.

Turning to debt investments, we see no reason to afford special treatment for SPCs or other hybrid forms due to their entity type. The Reves test for determining whether debt obligations issued by a traditional for-profit company are securities should also apply to hybrids. If federal or state law provides exclusion from the securities definition for specific types of debt issued for specific purposes, hybrids should be eligible for such exclusion—but because of the particulars of the debt and its purposes, not because of their hybrid entity status.

As with many other issues raised in this article, a culture shift is occurring in which the pursuit of profits is being redefined in the marketplace to include social as well as personal financial objectives. We view that as a positive development that might contribute to the rapidly growing number of socially-conscious investors. Securities regulators are charged with protecting investors generally and policing misconduct in investment markets, and socially-conscious investors are properly among the parties they should serve and protect.

If equity and debt investments in SPCs and other hybrids are found to be securities, it follows that they should be subject to the same federal and state anti-fraud laws that apply to the offering, purchase, and sale of securities issued by traditional for-profit entities and traded in primary offerings or as re-sales. Deceptive and manipulative practices that distort markets and deprive investors of the bargain they thought they were getting are no less wrongful because the bargain includes expectation of social benefits instead of, or in addition to, personal financial profits.

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245 See, e.g., Brakman Reiser, Theorizing Forms, supra note 13, at 734–36 (discussing the varied motivations of “socially responsible” or “impact” investors, as well as what she calls “quasi-donors”); Hasler, supra note 11, at 1318 (stating, with regard to his view of the value of benefit corporations: “By creating a tailored investment option that prosocial shareholders are excited about, states can ‘unlock’ more capital than was previously in the market. Additionally, if prosocial shareholders are better off receiving a dual return, they should be willing to pay a premium for stock that caters to their preferences.”).
b. Registration and Exemptions from Registration of Securities Offerings

As described above, and notwithstanding some facilitation of capital raising measures in the JOBS Act of 2012, a pivotal question in capital raising by a business organization is whether its offering of securities must be registered at the federal and/or state level, or can qualify for an exemption from registration based on the type of security or the type and manner of the offering transaction. Continued study of possible reforms is appropriate to better promote capital raising by entrepreneurs while properly balancing protection of investors. Such study should apply to social entrepreneurs, as well as traditional for-profit entrepreneurs, regardless of the state law business organization format they choose for their ventures. Consistent with our position that hybrids do and should operate in and subject to the market, we do not, however, believe any entity-type-based special relaxation of registration requirements or special exemption from registration for SPCs or other hybrids is warranted, desirable, or reasonably administrable at the federal level.

As for state regulations of securities offerings, where not preempted by federal law, we similarly do not generally advocate special relief from registration requirements or special exemptions for an SPC or other hybrid based on entity type; nor should such entities be punished for their hybrid status. In one limited situation, however, we might support a special state-level exemption. Section 3(a)(11) of the Securities Act of 1933, and SEC interpretations thereof, may apply to an SPC such that an offering in one state, by an entity formed in that state, and with the predominance of its assets and business in that state, is exempted from federal registration. In short, the idea is that if all of those conditions are met, decisions on how to regulate such an offering are essentially “that state’s business.” In such a case, a state with confidence in its SPC statute, including its primacy of social purpose(s), annual report requirements provisions, and associated enforcement mechanisms, might choose to exempt an SPC’s offerings of its securities in a § 3(a)(11) situation from registration with the state’s securities regulators. The offering would still be subject to anti-fraud provisions to protect investors.

V. Conclusion

At the risk of introducing a sphinxian riddle or Zen koan, it is entirely possible that opponents and proponents of formal hybrid forms are both right—at least to degrees: we probably don’t need new hybrid forms except to the extent that we do and they are helpful. Of course, this debate ignites further study and discussion about whether the forms are, or can be, helpful.

As long as there are entrepreneurs and investors who want both financial profits and social good, and there is ambiguity about director/manager duties to maximize profits and potential liability for deviating from that duty, there is a need for hybrids of some sort. To the extent that entrepreneurs and investors, or some subset of them, can change their minds about equating social purpose and financial profits (or even prioritizing the former over the latter), hybrid forms done right can ensure consistency of purpose over time, if desirable. If new investors can join the enterprise, hybrid forms done well can ensure preservation of purpose as interests of owners as a group might change.

Entrepreneurs and investors will create and operate hybrid vehicles. They want directors/managers to have the ability to weigh both social purpose and financial profit without fear of liability for doing so beyond what is permitted by purely traditional forms. They also want to attract capital, financial and human, to problems not normally within the bailiwick of ordinary market opportunity. Society also seems to want these conditions. Both desires justify, and are served by, using naming to differentiate these forms from traditional forms, whether modified or not. Naming thus becomes a vehicle for helping to attract new capital to social problems if the naming accurately signals restructuring of fiduciary duties as both an indicator of purposes and protections for directors/managers.

Opponents of the new hybrid forms may be right if the new forms do not provide for those opportunities. They also may be right if their attacks are founded on difficulties associated with applying the “hobby loss” rules as written or on strict application of federal and state securities laws solely to financial profits, which restriction minimizes opportunities for accountability and expands opportunity for mischief and fraud. None of those problems, however, are unique to the new hybrid forms. Those problems also plague modified traditional forms, and the historical and growing use of other than purely traditional
vehicles requires that these problems be addressed with consistency for both hybrid and modified traditional forms.

To the extent opponents are content claiming that ability to adapt traditional forms is enough to achieve any purposes served by formal hybrid forms, they neglect at least three realities. First, tax and securities laws are not likely to change to address customized, one off scenarios, which leaves an extraordinary gap in potential for addressing or mitigating certain social problems and creates certain financial exposures and opportunities for abuse. Second, traditional forms essentially are modified by contract and thus are subject to amendment when parties change their minds or new parties with different goals or priorities join the enterprise. Third, because grounded in contract, enforcement is limited to causes of action and remedies available under breach of contract, which also has implications for regulatory oversight that risks being too intrusive or too permissive, with the former interfering with innovation and problem solving and the latter essentially eliminating meaningful accountability.

All of which points to proponents of new hybrid forms also being right, at least to degrees. The current offerings of forms all serve their purposes, present opportunities, and fill gaps, which have brought and will continue to bring funding, innovation and creativity to addressing social problems. But they also have their issues relative to fulfilling the primary purposes for which hybrid forms have been extolled. As a result, the current fleet of forms only goes so far, and there are opportunities for a hybrid form that more thoroughly and completely achieves objectives for hybrids while reducing ambiguity and other problems.

The proposed Social Primacy Company is not perfect; however, it does provide clarity and weighting of priority regarding purposes so that legal accountability can be more meaningful, especially when supplemented with social accountability. The SPC facilitates a tax, security, and regulatory regime that encourages private decision-making, ensures against intrusive regulatory oversight, and protects the public (and charitable sector) from abusive practices. Thus, the proposed SPC offers another set of points for debate and should contribute more to informed policy and professional advice, better-served clients, and maybe even improved execution on ideas or strategies for solving social problems.
APPENDIX A: PROPOSED STATUTORY PROVISIONS FOR A
“SOCIAL PRIMACY COMPANY”

The following provisions are designed for use in both incorporated and unincorporated (e.g., LLC) formats. Although we assume that the proposed provisions would be included in a distinct “chapter” of a state’s business organizations statutes (and incorporate by reference non-inconsistent provisions of the state’s statutory chapters on regular business organizations—defined below as the “primary statute”), there could be different indexing and numbering systems in any given state to which the following provisions would have to be conformed with appropriate cross-references and defined terms. Alternatively, a state could insert the following provisions, with appropriate modification, separately in its applicable business organization statutory chapters. In addition, we offer the following proposed set of statutory provisions as a starting place for a new Social Primacy Company form, fully appreciating that such a proposal should be exposed to vetting and likely further iterations before a state would, or should, enact such provisions.

SECTION 1: DEFINITIONS

As used in this chapter:
(a) “Articles” means the articles of incorporation of an organization formed as a corporation or the articles of organization of an organization formed as a limited liability company, or a similar entity creation filing with the secretary of state for [insert additional references, as applicable for chapters on professional corporations/associations, cooperatives, and/or other types of organizations the particular state legislature proposes to be eligible for social primacy company status].
(b) “Dissenter’s rights events” means an event described in clause (i) or (ii) of Section 7(a).
(c) “Dissenting owner” has the meaning set forth in Section 7(b).
(d) “Frustration of purpose act” means intentional or reckless disregard of the requirements related to pursuit of the social purpose(s) of the organization as stated in its articles.
(e) “Lobbying activities” has the following meaning:
   (i) any attempt to influence any legislation through an attempt to affect the opinions of the general public or any segment
thereof by encouraging recipients to take action with respect to such legislation; or
(ii) any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of the legislation;
except that the following shall not be considered “lobbying activities”:
(A) making available the results of nonpartisan analysis, study, or research;
(B) providing general examinations and discussions of broad social, economic, and similar problems;
(C) providing technical advice or assistance to a governmental body, committee, or other subdivision thereof, in response to a written request by such body, committee, or subdivision, including, but not limited to, appearing before the body or subdivision;
(D) communications regarding decisions of such body, committee, or subdivision that might affect the existence of the organization or its powers or duties; or
(E) communications with bona fide members, provided that such communications do not encourage members to encourage non-members to have communications that violate Section 1(c)(ii).

(f) “Manager” means: in the case of a corporation, a director or officer of the corporation; in the case of a manager-managed limited liability company, a manager of the limited liability company; in the case of a member-managed limited liability company, a member of the limited liability company; and [address other applicable entity managers].

(g) “Organization” means a corporation, limited liability company, or [insert additional references, as applicable for chapters on professional corporations/associations, cooperatives, and/or other types of organizations the particular state legislature proposes to be eligible for social primacy company status], as applicable.

(h) “Owner” means a shareholder in an organization that is a corporation, or a member or assignee of a member holding an ownership interest in an organization that is a limited liability company or other unincorporated entity.
(i) “Ownership interest” means ownership of stock in an organization that is a corporation, or an equity interest in an organization that is a limited liability company or other unincorporated entity.

(j) “Primary statute” means chapter [insert applicable reference] if the organization is a corporation, chapter [insert applicable reference] if the organization is a limited liability company, [insert additional references, as applicable for chapters on professional corporations/associations, cooperatives, and/or other special types of organizations the particular state legislature proposes to be eligible for social primacy company status].

(k) “Social primacy company annual report” means a report filed by a social primacy company with the secretary of state pursuant to Section 5(a) of this chapter.

(l) “Social primacy company” or “SPC” means an organization that satisfies the requirements of Section 3 of this chapter.

(m) “Social purpose” means a purpose that is described in Section 3(b) of this chapter and is identified as a purpose of the organization in its articles.

(n) “Substantial class of social purpose beneficiaries” means a group of persons, communities, or environmental or other conditions or circumstances, whether or not determinable in number, which the organization has identified in one or more of its social primacy company annual reports as an intended beneficiary or beneficiaries of its pursuit of a social purpose.

(o) “Successor entity” means an entity into which the organization is converted or an entity that succeeds to ownership of assets of the organization as the result of a merger or consolidation to which the organization is a party.

(p) “Transformation” has the meaning set forth in Section 9.

SECTION 2: COORDINATION WITH CORPORATION AND LIMITED LIABILITY COMPANY STATUTES

An organization desiring to be a social primacy company must be formed, before or simultaneously with its adoption of social primacy company status in accordance with this chapter, as an entity governed by a primary statute. When such organization becomes a social primacy company, it shall be subject to all of the provisions of this chapter and to all of those provisions of the primary chapter that do not conflict with the provisions of this chapter.
SECTION 3: REQUIREMENTS FOR SOCIAL PRIMACY COMPANY STATUS

(a) An organization is a social primacy company only if
   (i) the organization is organized as such by including in its articles:
       (A) a statement that it is to operate as a social primacy company under and subject to the provisions of this chapter and
       (B) the other statements and provisions required by subsections (b) through (d) below;
   (ii) the organization operates consistently with its articles; and
   (iii) the organization’s status as a social primacy organization is not in revocation or suspension as the result of an action brought pursuant to Section 5(d) or Section 10.

(b) The organization must designate in its articles and pursue at least one of the following specific purposes:
   (i) furthering one or more purposes provided for in Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B) (whether or not such purpose is also a purpose described in clause (ii) below); or
   (ii) furthering any of the following purposes (whether or not such purpose is also a purpose described in clause (i) above):
       (A) relief of the poor, the distressed, or the underprivileged and/or providing such individuals with products, services, or technologies that improve the quality of their lives and circumstances;
       (B) promoting economic opportunity for individuals or communities that are considered economically disadvantaged, blighted, or otherwise neglected;
       (C) improving human or animal health;
       (D) promoting the arts, sciences, or advancement of knowledge;
       (E) advancing religion;
       (F) increasing access to technology for underserved communities or individuals;
       (G) protecting or restoring the environment;
       (H) erecting or maintaining public buildings, monuments, or works;
       (I) lessening neighborhood tensions;
(J) eliminating prejudice and discrimination;
(K) defending human and civil rights secured by law;
(L) combating community deterioration and juvenile delinquency; or
(M) making one or more (1) charitable contributions as defined in Section 170(c) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c); or (2) investments in other entities with the primary purpose of accomplishing one or more of the purposes described in the foregoing provisions of this Section 3(b), provided that production of income or appreciation of property is not a significant purpose and that lobby activities, or taking part in political campaigns on behalf of candidates, is not a purpose of any such investment.

(c) The organization must state in its articles and operate such that (i) its social purpose(s) is/are the substantial purposes of the enterprise, not necessarily to the exclusion of generating and distributing profits or appreciated value, but at least as a priority over such profits and value; and (ii) it is subject to any and all restrictions on making distributions to its owners provided for in the primary statute.

(d) The organization must state in its articles that it may engage in lobbying activities only if and to the extent such activities are substantially related to advancing one or more of its social purposes.

(e) The organization must include in its articles the following provisions:

(i) A manager of this organization shall discharge the duties of a manager, including duties as a member of any committee delegated the duties of any board or committee of managers on which such manager may serve, in good faith, with the care an informed and ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner the manager reasonably believes to be in the best interests of the organization in accordance with its continued status as a social primacy company in compliance with its articles and this chapter.

(ii) If the organization has more than one social purpose it shall be presumed that managers have discretion to
prioritize among potentially competing social purposes of the organization as circumstances arise, and any decision of the managers as to an action or forgoing of action which reflects such a prioritization made in good faith, based on reasonably available information, and on an otherwise reasonable basis shall be deemed to be in the best interests of the organization except to the extent that such decision conflicts with a prioritization of interests expressly set forth in the organization’s articles.

(iii) A manager of the organization may be liable to the owner(s) and other managers for any action taken as a manager, or any failure to take any action, if the manager failed to perform the duties of a manager in compliance with the Section 3(e)(i), or participated in a prioritization of social purposes that conflicts with the prioritization of such purposes expressly set forth in the organization’s articles, and any such failure or conflicting prioritization shall be deemed a breach of a fiduciary duty, without regard to the outcomes or results of such action.

SECTION 4: RELATIONSHIP TO OTHER STANDARDS AND RULES REGARDING MANAGERS’ CONDUCT; NON-WAIVABILITY; PROHIBITED INDEMNIFICATION

The standards and rules for manager duties and liability set forth in Section 3(e) above are in addition to the standards and rules for the duties and liabilities of a manager of the organization under the primary statute and other applicable law, provided that:

(a) in the event of a conflict between a standard or rule in Section 3(e) and any such otherwise applicable standard or rule, then the standard or rule in Section 3(e) shall control; and

(b) the duties and liabilities of managers under Section 3(e) may not be waived, in whole or part, by the organization or by action of its managers or owners on behalf of the organization or by or on behalf of any owner.
SECTION 5: REQUIRED REPORTING

(a) In addition to any registration, report, or renewal required of it by the primary statute, no later than one-hundred twenty days after the end of each of its fiscal years, a social primacy company must deliver to each of its owners and file with the secretary of state an annual report of activities in accordance with rules or regulations prescribed by the secretary of state, which report shall include:

(i) a narrative description in reasonable detail of:

(A) the ways in which the social primacy company pursued and the extent to which it furthered each of its social purposes during the reporting year and the extent to which its activities benefitted one or more substantial classes of social purpose beneficiaries; and

(B) any circumstances that have materially interfered with the social primacy company’s pursuit or accomplishment of its social purpose(s);

(ii) the following information in such detail as is required by the secretary of state:

(A) the compensation paid by the social primacy company during the reporting year to each of its managers;

(B) a description of all of the social primacy company’s lobbying activities during the reporting year;

(C) a description of each substantial class of social purpose beneficiaries that the social primacy company endeavored to benefit during the reporting year; and

(D) such additional information as the secretary of state determines appropriate to facilitate monitoring of compliance with the provisions of this chapter; and

(iii) such additional information, if any, as the organization voluntarily chooses to include in such report, provided that such information is reasonably related to demonstrating its level of compliance with the requirements for social primacy company status under this chapter.

(b) If the social primacy company maintains a website or engages other comparable social media, it shall post each of its social primacy company annual reports on such website or make it available through posting in other social media within ten business days after its submission to the secretary of state and shall maintain such posting of each such report on its website or
in such other social media for not less than five years from the initial date of posting, but may exclude from such posting the information regarding compensation required by clause (a)(ii)(A) above.

(c) No later than thirty days after filing with it of a social primacy company annual report, the secretary of state shall post such report on the secretary of state’s website, but, unless otherwise expressly elected by the social primacy company, shall exclude from such posting the information regarding compensation required by clause (a)(ii)(A) above; provided that upon order or request for the report from the state attorney general or other government agency or court of competent jurisdiction with due process, the secretary of state shall not exclude such compensation information from the report delivered in response to such order or request.

(d) If the secretary of state determines that an organization that is a social primacy company has not timely filed its annual report of activities with the secretary of state pursuant to the foregoing provisions of this Section 5, the secretary of state shall serve the organization’s registered agent with written notice of such determination. If the organization has not filed such annual report within thirty days (or such within such longer period of time, but in any event no longer than sixty days, as the secretary of state allows in its discretion upon its finding of reasonable cause) after such service of the notice is perfected by posting with the United States Postal Service, the secretary of state shall cause revocation of the organization’s social primacy company status by signing a certificate of revocation of social primacy company status that recites the grounds for such revocation and its effective date. The secretary of state shall file the original of such certificate and serve a copy thereof on the organization by posting with the United States Postal Service.

SECTION 6: SUBSTANTIAL CLASS OF SOCIAL PURPOSE BENEFICIARIES DOES NOT HAVE STANDING

No substantial class of social purpose beneficiaries or member thereof shall have or be deemed to have any independent standing to enforce any of the provisions of this chapter solely by virtue of being such class or a member of such class.
SECTION 7: DISSENTER’S RIGHTS

(a) Subject to the terms and conditions of subsections (b), (c), and (d), a dissenting owner of the organization shall be entitled to payment from the organization of the fair value of such dissenting owner’s ownership interests in the organization upon the occurrence of any of the following “dissenter’s right events”:

(i) approval of the organization (A) undertaking a transformation to other than a social purpose company, or (B) amending its articles to remove (other than for the reason that all material objectives of such purpose have been accomplished) or to materially modify one or more of its social purposes or to add a social purpose;

(ii) any action or omission that has the effect of causing the organization, or its successor by way of merger or consolidation, not to be a social primacy company, provided that such action or omission (A) did not involve a frustration of purpose act by such owner and (B) was not an action (other than the assertion and prosecution of claim under Section 10) or omission in which such owner materially participated or for which such owner was materially responsible alone or in concert with others.

(b) A owner shall be considered a “dissenting owner” entitled to appraisal under this section only if such owner:

(i) held one or more ownership interest(s) in the organization at the time of the occurrence of a dissenter’s right event, or whose ownership of such ownership interest(s) devolved on such owner by operation of law from an owner who held such ownership interest(s) the time of such dissenter’s right event;

(ii) objected to the action creating such dissenter’s right event on a timely basis after receipt of proper notice of a vote on such action, or, if no such notice was given, has not consented in writing to the taking of such action;

(iii) files with the organization or successor entity no later than fifteen business days after actual notice of the occurrence of such dissenter’s right event an election to sell to the organization or successor entity all of such owner’s ownership interests in the organization held at the time of such election for the fair value thereof (as determined under
subsection (c)), which election must identify the dissenter’s right event on which it is based.

(c) The organization or successor entity, as applicable, shall pay the fair value for all of the dissenting owner’s ownership interests in the organization or successor entity in accordance with the following provisions:

(i) The “fair value” for such ownership interests shall be deemed to be the greater of:

(A) the fair value of such ownership interests as of the close of business on the day before the dissenter’s right event identified in the election; or

(B) the fair value of such ownership interests at the close of business on the day within the fifteen-day period immediately following the date of such dissenter’s right event which had the highest fair value at the close of business of any of such fifteen days.

(ii) If within thirty days after the delivery of the election described in subsection (b)(ii) the fair value of such ownership interests is agreed upon between the dissenting owner and the organization or successor entity, payment therefor shall, subject to clause (iv) below, be made by the organization or successor entity within sixty days after the date of such agreement on fair value, upon the surrender by the dissenting owner of such dissenting owner’s ownership interests therein.

(iii) If agreement on the fair value of the dissenting owner’s ownership interest in the organization is not made as described in clause (ii) by the date which is thirty days after the date of the election described in subsection (b)(ii), then the dissenting owner may, within sixty days after the expiration of such thirty-day period, file a petition in any court of competent jurisdiction within the county in which the registered office of the organization or successor entity is located asking for a finding and determination of the fair value of such shares (as defined in clause (i) above), and shall be entitled to judgment against the organization or successor entity for the amount of such fair value, together with interest thereon to the date of such judgment. Subject to clause (iv) below, the judgment shall be payable only, but promptly, upon and simultaneously with the surrender
to the organization or successor entity of the dissenting owner’s ownership interests therein on a date specified by the dissenting owner. Unless an agreement on fair value was reached as described in clause (ii) or the dissenting owner files the petition described in this clause (iii) within the time herein limited, such dissenting owner and all persons claiming under or through such dissenting owner shall be conclusively presumed to have waived the exercise of the rights to payment for their ownership interests pursuant to this section with respect to the specific dissenter’s rights event identified in the election described in subsection (b)(ii).

(iv) The organization or successor entity may defer payment of the amount to which the dissenting owner is entitled under clauses (ii) or (iii) below for such period, and shall secure the same by such collateral, as may be approved by a court in order to prevent unreasonable hardship to the organization or successor entity.

(d) When the remedy provided for in this section is available with respect to a dissenter’s right event, such remedy shall be the exclusive remedy of an owner as to that event, except in the case of breach of duty provided for in Section 3(d), fraud, or lack of authorization for the event.

(e) Managers or owners of the organization who committed a frustration of purpose act that was a significant factor in the occurrence of the dissenter’s rights event giving rise to the dissenting owner’s rights under this section shall be jointly and severally personally liable as guarantors of the obligation of the organization or successor entity to pay to such dissenting owner the fair value for such dissenting owner’s ownership interests.

SECTION 8: ELECTION BY EXISTING ORGANIZATION TO BECOME A SOCIAL PRIMACY COMPANY

An organization formed and in good standing under the primary statute but which is not a social primacy company may become a social primacy company only upon (i) obtaining the approval to do so from each class and series of ownership interest in the organization, in each case by vote in favor of such approval from the owners of at least seventy-five percent of the outstanding ownership interests in such class or series entitled to vote, and (ii) satisfying the requirements of
Section 3 of this chapter by amendment of its articles. For purposes of this Section 8, each record owner of an ownership interest in a class or series as of the record date in respect of such vote shall be entitled to vote regardless of any limitation stated in the organization’s articles or other organizational documents.

SECTION 9: TRANSFORMATION TO REGULAR ORGANIZATION STATUS

(a) An organization that is a social primacy company may voluntarily abandon its status as a social primacy company and continue as a corporation or limited liability company without social primacy company status that is subject to the primary statute but not to the provisions of this chapter (hereinafter a “transformation”) by satisfying the following requirements:

(i) obtaining the approval of such transformation from each class and series of ownership interest in the organization, in each case by vote in favor of such approval from the owners of at least seventy-five percent of the outstanding ownership interests in such class or series entitled to vote (with each record owner of an ownership interest in a class or series as of the record date in respect of such vote entitled to vote regardless of any limitation stated in the organization’s articles or other organizational documents);

(ii) filing a public notice of intent to abandon social primacy company status in accordance with such publication requirements as are designated by the secretary of state, and, if the social primacy company maintains a website or engages other comparable social media, posting a copy of such notice on such website and in such other social media;

(iii) satisfying all claims (if any) of dissenting owners arising under Section 7 and all rights of dissenting owners available under the primary statute or the organizational documents or other agreements to which the organization is subject;

(iv) satisfying any and all debts, obligations, debentures, and loans of the organization that, if left outstanding after abandonment of the organization’s social primacy company status, would create a material risk of jeopardizing the tax-exempt status of any holder of any such debt, obligation, debentures, or loan; which is a tax-exempt entity under the Internal Revenue Code of 1986 or subject such tax-exempt
entity to excise taxes under Section 4944 of the Internal Revenue Code of 1986, 26 U.S.C. § 4944; and

(v) after completion of (i) through (iv), filing articles of transformation with the secretary of state.

(b) Upon and effective as of the date of the filing described in subsection (a)(v) of this Section 9, the secretary of state shall issue a certificate of abandonment of social primary company status with respect to the filing organization and if the social primacy company maintains a website or engages other comparable social media, require that the filing organization post a copy of such certificate of abandonment of social primacy company status on such website and in such other social media no later than five days following the issuance thereof and continuously maintain such posting for not less than one-hundred eighty days.

SECTION 10: ACTIONS FOR NON-COMPLIANCE WITH SOCIAL PRIMACY OBLIGATIONS

(a) If a social primacy company:
   (i) is not significantly pursuing at least one social purpose; or
   (ii) is acting in a manner which contravenes the provisions of its articles required by subsections (b) or (c) of Section 3 of this chapter, it shall be deemed to lack the capacity or power to conduct any further business (other than satisfying obligations to dissenting owners under Section 7 of this chapter) unless and until neither of such circumstances exists, and any manager who conducts such prohibited business on behalf of the social primacy company in contravention of this subsection (a), and those managers and owners who knowingly support, or who fail to object, in a writing delivered to all managers and owners, to the conduct of such prohibited business after receiving actual notice thereof, shall be jointly and severally personally liable for any obligations incurred in the conduct of such business.

(b) In addition to any rights of action and remedies available under the organization’s primary statute or other applicable law, a claim of lack of capacity or power of a social primacy company based on the provisions of subsection (a) may be asserted:
(i) in a proceeding by an owner of an ownership interest in the organization to declare the organization no longer a social primacy company and to enjoin the doing of any act or acts or the transfer of real or personal property by or to the organization in contravention of subsection (a). If the unauthorized acts or transfer sought to be enjoined are being, or are to be, performed or made pursuant to any contract to which the organization is a party, the court may, if all of the parties to the contract are parties to the proceeding and if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing may allow to the organization or to the other parties to the contract, as the case may be, compensation for the loss or damage sustained by either of them which may result from the action of the court in setting aside and enjoining the performance of such contract, but anticipated profits to be derived from the performance of the contract shall not be awarded by the court as a loss or damage sustained;

(ii) in a proceeding by the organization, whether acting directly or through a receiver, trustee, or other legal representative, or through owners in a representative suit, against the incumbent or former managers of the organization;

(iii) in a proceeding by the attorney general to enjoin the organization from the transaction of unauthorized business or to obtain an order of judicial dissolution (and winding up and liquidation) of the entity, which the court shall have the power to grant upon a finding that the organization has ceased to satisfy the requirements for social primacy company status under this chapter whether or not grounds for such dissolution would otherwise exist under the primary statute.

(c) In a proceeding brought pursuant to subsection (b) the court shall, in addition to its other applicable powers in law or in equity, have the power to, at its discretion, do any one or more of the following, but without prejudice to the rights of dissenting owners with unsatisfied claims under Section 7 of this chapter or under the primary statute or the organizational documents or other agreements to which the organization is subject:
(i) grant the organization and its managers a reasonable period of time to cause the organization to not be in either of the circumstances described in clauses (i) and (ii) of subsection (a) and refrain from making a declaration that the organization is no longer a social primacy company or granting injunctive relief if such cure is effected by the end of such time period; or

(ii) allow the joining in such proceeding of claims against one or more of the organization’s managers for breach of fiduciary duty under Section 3(e) of this chapter; and, if the court finds with respect to any such claim that the manager has breached such fiduciary duty, award damages (which may include compensatory, consequential, and punitive damages, and/or disgorgement of personal profits) to be paid by such manager to the organization, to its owners, or (after the organization and its owners are made whole) to one or more government instrumentalities or organizations exempt from federal income tax pursuant to Section 501(c)(3) of the Internal Revenue Code of 1986, 26 U.S.C. § 501(c)(3) that are performing functions or carrying out activities that the court finds reasonably related to providing benefits to a substantial class of social purpose beneficiaries previously identified in an annual report of the organization from within the preceding three years, as the court determines to be appropriate in the interest of justice, and after giving due regard to the social purpose(s) of the organization and the reasonable expectations of its owners who did not participate or acquiesce in a frustration of purpose act.