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PERSPECTIVE

10 considerations for your social enterprise's legal form

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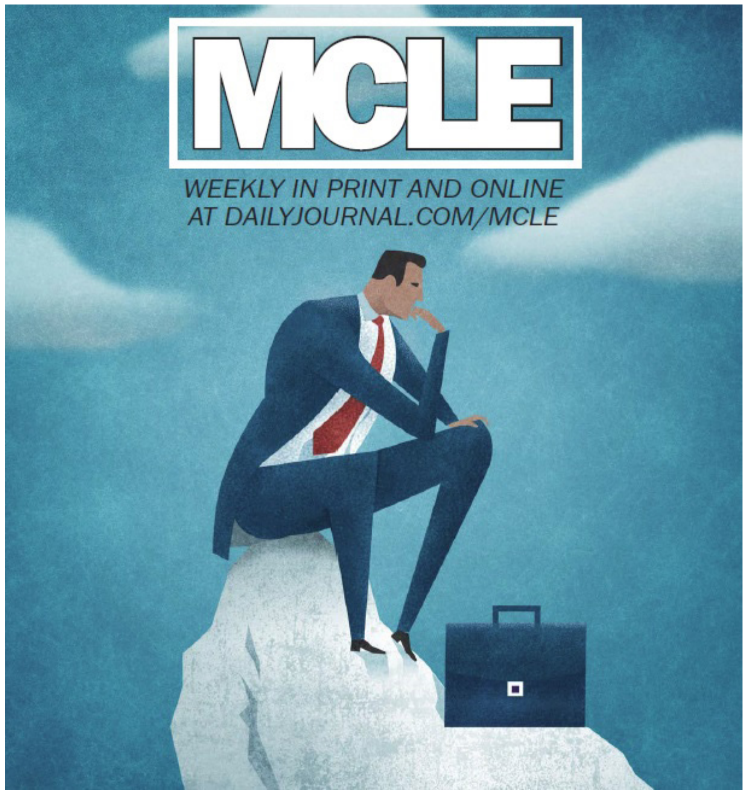

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A company's legal structure establishes the framework and governing rules for operations and growth, which can have a material impact on the ability to balance social, humanitarian, and/or environmental goals with financial sustainability. How does a social enterprise choose between a traditional corporation, Delaware public benefit corporation (PBC), benefit corporation, social purpose corporation (SPC), or any of the other business forms that allow the pursuit of both profit and mission? Instead of merely following the latest trend, founders should weigh the following 10 considerations before formation or conversion of legal form.

What are the entity form options for social enterprises?

Most investors and entrepreneurs understand how a traditional corporation or LLC operate — but mostly in terms of formation and operations going forward. Unfortunately, there is a lot of confusion about the new entity forms. First, a B corporation is not a new corporate form — it is a certification provided after a self-audit pursuant to a license agreement for use of the mark for a fee paid to B Lab. Second, the benefit corporation varies significantly state-by-state. Some states follow the model benefit corporation statute promulgated by B Lab, and include a long list of social and environmental goals in the statute itself. Other states follow the Delaware model (what we refer to as the PBC in Delaware and SPC in California), in which stockholders and management agree to a more specific (or broad) public benefit for the company. Other differences relate to governance, mechanisms for enforcement of mission, and disclosure. Third, as an alternative, many social enterprises utilize a hybrid or tandem structure, which refers to a for-profit that is closely associated with a tax-exempt entity (either public charity or private foundation).

How quickly do you want to scale?

If your social enterprise is and intends to stay small or locally oriented, the limited liability company (LLC), low-profit limited liability company (L3C), or public benefit limited liability (PBLLC) structures are relatively easy and inexpensive to establish and maintain. If your business goals are national or even international and require greater amounts of capital to scale, then the traditional corporation, PBC or SPC may be a better choice to attract mainstream investment that can allow the company to grow more quickly and implement an M&A strategy. The corporate form is permissive (allowing a focus on ESG goals) while the PBC and SPC feature a fiduciary duty in favor of the mission (requiring a focus on shareholder-agreed environmental, social or governance goals).

What are your most viable sources of financing?

Certain social enterprises require significant upfront investment — for example, a company that needs to fund research and development, build infrastructure, or manufacture and distribute a product. These enterprises will not be successful without outside investment, and your business form could have a significant impact on the sources of funding available to your company. Certain forms may attract or deter certain types of investments. Mainstream capital markets still generally hold the notion that "impact" will generate lower returns, so a social enterprise with a traditional corporation form might be more attractive to traditional investors. On the flipside, businesses that have adopted one of the new forms, like the SPC/ PBC or benefit corporation, might attract impact-focused investors who would otherwise not consider the same business structured using one of the traditional forms. If your enterprise would benefit most from program-related investments made by foundations, you may want to create an LLC, L3C or PBLLC. Lastly, if your social enterprise might require capital in the form of both private investment and charitable contributions, you may want to consider a hybrid or tandem corporate structure, featuring a for-profit entity combined with a tax-exempt entity.

Will you prioritize mission over financial returns?

Embedding social or environmental mission into your company is possible in all entity forms, but some forms are better suited to allow the company to prioritize mission over profit. If profits will take a back seat to promotion of mission, consider an L3C, LLC or PBLLC, as the company's public benefit can be prioritized over pursuit of profit without breaching fiduciary duties in most states. As noted above, this makes these forms more attractive to foundations or family offices that are dedicated to promoting positive impact with their funding.

Or will you focus on both financial and impact returns?

Other new corporate forms, like the PBC or SPC, allow the board to consider both shareholder value and ESG goals when making company decisions. However, if maximizing shareholder value takes priority over the public benefit (or if the founders believe that the mission can directly enhance return on investment), consider the traditional corporation form, as it is arguably easier to raise capital and negotiate a profitable exit as a corporation — although that is changing as the benefit corporation forms gain greater traction in the market. Expansion into public markets where margins are lower but needs greater can be accomplished through hybrid or tandem forms.

What is your risk tolerance (and that of your investors)?

There are many new entity forms for social enterprises, but these forms remain relatively untested by the courts. Adopting one of the new forms will require additional effort by the board and investors to fully understand and support the new fiduciary duties in the context of both daily operations and in change-ofcontrol situations. There is currently no case law to guide boards and management on how to weigh competing fiduciary duties, which may translate into greater risk for the new entity forms if and when there is a tradeoff between mission and profitability. Therefore, some founders may also choose a traditional form, because the rules of the road are well understood and there is lower risk that investors (in public or private markets) will translate a focus on environmental, social, and governance factors (particularly with fiduciary duties tied to a mission) into a lower valuation.

How sensitive are the buyers of your product or service?

For consumer-facing businesses or companies facing backlash from customers or shareholders because of a perceived absence of adequate focus on the impact that the business has on stakeholders, adopting one of the new business forms — SPB/PBC or benefit corporations — would signal a commitment to the greater good. This improved public perception can improve relationships with stakeholders and boost revenue. Note that use of a third-party certifier of mission, such as B Lab, can also help with public image, as companies that take a self-audit and license the mark can become B-Corps.

Does your business plan require long-term investments?

For enterprises that want to make greater capital investments for longterm growth, or need significant time and capital in order to shift their business strategy (for example, from fossil to renewable fuels), the PBC and SPC forms are a better option than the traditional corporation. These new forms can offer additional protection from liability for management and boards in the event of a negative impact on short-term stock price as a result of significant expenditures to benefit the longterm strategy.

What about mission dilution through M&A?

Companies can consider converting to a PBC as an effective "sweet pill" alternative to traditional "poison pill" strategies. This is because conversion into or out of a PBC form requires the approval of two-thirds of the voting stockholders. Following a conversion into a PBC, the board and management are required to consider the shareholder-defined mission in addition to the price when evaluating and negotiating bids in a sale or responding to a hostile takeover. With this form, the board could reject offers based on failure by a potential acquirer to maintain and promote mission.

What's your exit plan: IPO or sale?

To date, there has only been one publicly traded PBC: Laureate Education. The new corporate forms (particularly the PBC and SPC) were designed to protect the mission of the company post-IPO, but this has been largely untested by mainstream investors. The two primary reasons that more PBCs have not gone public are (1) the impact of the mission on valuation and pricing, given there is still a perception that focus on mission will detract from profitability; and (2) the lack of case law and guidance on dual fiduciary duties. About half of all publicly traded companies in the United States are incorporated as Delaware corporations, so if your end goal is to IPO, you may want to incorporate as such.

Traditional forms such as the corporation or LLC can be more appealing to buyers than a new form, as the sale transaction will be more straightforward. Selling a social enterprise that's a new entity form will raise questions of how the mission will impact valuation, as there have been few sales of these businesses to date. Having a social or environmental mission has positively impacted valuations in certain sectors, like consumer goods. In fact, large public companies like Nestlé and Unilever have opted to maintain a PBC form in subsidiaries post acquisition. If your goal is to sell the company but you want to retain the impact focus following the sale, you could also consider establishing a hybrid structure to lock the public benefit purpose in an exempt entity, or adopting various strategies through the sale process — like tying earnouts or option grant vesting to mission, and/or establishing oversight over mission at the parent level.

Finally, how difficult will it be to convert to a new legal form?

If your enterprise is already established but you want to change its legal form, consider the process and implications of converting. For an SPC or PBC, two-thirds of the shareholders must vote to approve the conversion and mission language; otherwise, the process is very straight forward. But note that, even after the company receives the approvals required, any shareholder who objects may make a claim for appraisal rights, requiring the company to cash them out at the fair market value. This is why it is usually better to effect a conversion in connection with a financing transaction or at an early stage.

Navigating the array of legal forms available to social enterprises can be confusing, and selecting the most appropriate structure should involve consideration of these factors, at a minimum. Keep in mind that your company can convert into or out of one of the new corporate forms (PBC/SPC/benefit corp) if desired, and some social enterprises choose to begin as a traditional corporation and later convert into a new form (with approval from investors, which may be facilitated through drag-along rights) after certain milestones are met.

By finding the right organizational structure, you'll take the first step toward allowing your social enterprise to maximize business opportunities and impact goals.

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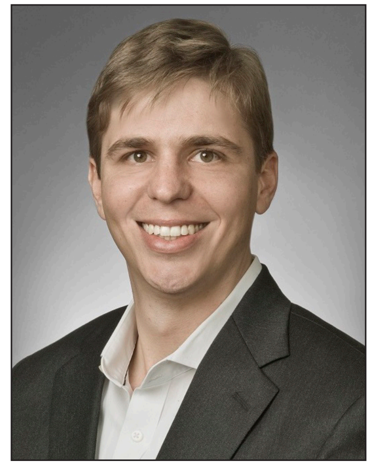

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