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5-15-2012

## Hype and Hostility for Hybrid Companies: A Fourth Sector Case Study

Ryan J. Gaffney

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### Recommended Citation

Ryan J. Gaffney, *Hype and Hostility for Hybrid Companies: A Fourth Sector Case Study*, 5 J. Bus. Entrepreneurship & L. Iss. 2 (2012)

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# HYPE AND HOSTILITY FOR HYBRID COMPANIES:

## A FOURTH SECTOR CASE STUDY

RYAN J. GAFFNEY\*

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### ABSTRACT

The traditional three-sector ownership model of society grows outmoded. The prevalence of quasi-governmental agencies, public-private partnerships, and government bailouts blurs the line between the public and private sectors. Of

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concern to this article, however, is the blurring between the private and nonprofit sectors. The cross-pollination is so widespread that a call stands to amend the existing model with an “emerging fourth sector.”

The social entrepreneurs attempting to bridge the gap between sectors face limitations from the outset of their venture; legislators did not design traditional legal entities for a “double bottom line” that includes social impact as well as profit. Because the demand exists, and because a lethargic legislative response will not hinder the entrepreneurial spirit, these pioneers have attempted to form hybrids under existing legal frameworks. Complexity and cost, however, significantly deter this avenue of social enterprise. Consequently, state legislatures have begun to address the need for legitimate hybrid alternatives.

The two business forms attracting the most legal, legislative, and media attention are the Low-profit Limited Liability Company (L3C) and the Benefit Corporation (B Corporation). The L3C, a Limited Liability Company (LLC) hybrid, exploits the LLC’s organizational flexibility, while attracting capital for the actual enterprise through Program Related Investments. The B Corporation is a corporation hybrid that permits a company’s board and management to contract around the rule of profit-maximization. While both frameworks have merit, they are at once competing for the same share of public-consciousness and legislative attention. For that reason, I will be contrasting the two against the backdrop of the WorldOne case.

## I. INTRODUCTION

It is a rare experience for a young attorney to address a substantive legal issue on the cutting edge of the law. Specifically, I am referring to the boundaries of the law’s relationship to society—the place where legislation fails to accommodate societal progress. My experience in the George Washington University’s Small Business and Community Economic Development Clinic brought me to such an edge. Our work with WorldOne<sup>1</sup> demonstrates that unique and socially beneficial entrepreneurial ideas require legislators to address a void with an organizational framework for private/nonprofit hybrid organizations.

The traditional three-sector ownership model of society grows outmoded.<sup>2</sup> The prevalence of quasi-governmental agencies, public-private partnerships, and government bailouts blurs the line between the public and private sectors.<sup>3</sup> Of concern to this article, however, is the blurring between the private and nonprofit

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<sup>1</sup> The name of the company—along with discernable factual information—has been changed in order to protect client confidentiality. I have retained the essential elements of the case to demonstrate the hypothetical benefits to this start-up in organizing under different statutes designed for social enterprise.

<sup>2</sup> The three standard sectors in the ownership model—Private Enterprise, Government, and Non-profit—are turning into six sectors as hybrid organizations that straddle the line between the classic model gain influence. That is not to argue that hybrids have overtaken the classic sectors, only that the rules that divide them are no longer adequate. See Thomas J. Billitteri, *Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach?*, 2 (Jan., 2007), [http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New\\_Legal\\_Forms\\_Report\\_FINAL.pdf](http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf).

<sup>3</sup> *Id.*

sectors. The cross-pollination is so widespread that a call stands to amend the existing model with an “emerging fourth sector.”<sup>4</sup>

The social entrepreneurs attempting to bridge the gap between sectors face limitations from the outset of their venture; legislators did not design traditional legal entities for a “double-bottom-line” that includes social impact as well as profit.<sup>5</sup> Because the demand exists, and because a lethargic legislative response will not hinder the entrepreneurial spirit, these pioneers have attempted to form hybrids under existing legal frameworks.<sup>6</sup> Complexity and cost, however, significantly deter this avenue of social enterprise.<sup>7</sup> Consequently, state legislatures have begun to address the need for legitimate hybrid alternatives.

The two business forms attracting the most legal, legislative, and media attention are the Low-profit Limited Liability Company (L3C) and the Benefit Corporation (B Corporation). The L3C, a Limited Liability Company (LLC) hybrid, exploits the LLC’s organizational flexibility, while attracting capital for the actual enterprise through Program Related Investments (PRIs).<sup>8</sup> The B Corporation is a corporation hybrid that permits a company’s board and management to contract around the rule of profit-maximization.<sup>9</sup> While both frameworks have merit, they are at once competing for the same share of public-consciousness and legislative attention. For that reason, I will be contrasting the two against the backdrop of the WorldOne case.

This article follows the development of WorldOne as a business entity in the emerging fourth sector. Part II will elucidate the background and development of social enterprise and WorldOne. I will describe the history of social enterprise and how a similar legislative gap was addressed in the United Kingdom, the current extrapolations used to accomplish social enterprise in the United States and the emerging need for business designations that address such dual-purpose entities, and the route ultimately chosen by WorldOne in a jurisdiction devoid of any hybrid legislation. Part III will then detail the history and current legal status of the L3C alongside the theoretical advantages and disadvantages WorldOne would have met had the L3C business form been available. Finally, Part IV will address the L3C’s primary competitor for legislative and branding attention, the B Corporation. I will also chronicle the development of the B Corporation alongside its theoretical merits to WorldOne.

## II. BACKGROUND

As of March 2011, the United Kingdom had 4,905 hybrid organizations

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<sup>4</sup> Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 341 (2009). The relative merits of “emerging sector” qualification between private/non-profit hybrids and public/private hybrids is beyond the scope of this article.

<sup>5</sup> *Id.* at 339.

<sup>6</sup> *Id.* at 364.

<sup>7</sup> *Id.* (also noting social entrepreneurs complaints that potential sources of investment capital are inaccessible due to the complexity).

<sup>8</sup> *Id.* at 373–75.

<sup>9</sup> Michael D. Gottesman, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL’Y REV. 345, 357 (2007).

properly registered and in good standing with the central government agency in charge of administering the U.K.'s hybrid statute.<sup>10</sup> In contrast, the United States, which has no federal statute or centralized hybrid administration, claims only 540 L3Cs<sup>11</sup> and 370 certified B corporations.<sup>12</sup> Additionally, because hybrids created under existing laws are registered as standard corporations or non-profits, it is impossible to quantify the number of organizations with hybrid goals but no organizing statute. However, the combination of those entrepreneurs that have developed the idea by makeshift means since its inception, and those that have only recently realized the potential in the double bottom line concept, are now enough to press for change.

### *A . Early Social Entrepreneurship*

The idea of social enterprise first emerged in the early 1960s when lawyer-turned-businessman Bill Drayton began to apply “pragmatic and results-oriented methods” to social change.<sup>13</sup> For decades, however, it merely simmered in the business and legal subconscious, failing to attract the attention of legislators. In 2006, the advent of Google.org brought the idea of social entrepreneurship a great deal of media attention.<sup>14</sup> Google’s unique hybrid administration of its philanthropic arm also spurred the idea of an emerging fourth sector in the United States and prompted the writing of multiple legal articles addressing the issue.<sup>15</sup> Proposals for defining and accommodating this new sector began to emerge.<sup>16</sup>

As the concept grew without legislative attention for more than four decades, the definition of social enterprise in the United States expanded unchecked.<sup>17</sup> Accordingly, “[o]ne of the major obstacles to the discussion and study of the topic is the lack of a clear and concise definition.”<sup>18</sup> Conservative or exclusionary classifications of social entrepreneurship vary wildly from publication to publication; a thorough attempt to analyze the idea’s development and categorize its use in different fields spans hundreds of pages.<sup>19</sup>

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<sup>10</sup> *Community Interest Companies, Annual Report 2010-2011*, BIS (Sept., 2011), <http://www.bis.gov.uk/assets/bispartners/cicregulator/docs/annual-reports/11-p117-community-interest-companies-annual-report-2010-2011>.

<sup>11</sup> *Here’s the Latest L3C Tally*, INTERSECTOR PARTNERS, L3C, [http://www.intersectorl3c.com/l3c\\_tally.html](http://www.intersectorl3c.com/l3c_tally.html) (last visited Jan. 8, 2012).

<sup>12</sup> B Lab, *If Not Now When? The Case for B Corp*, 2011 ANNUAL REPORT (2011), [http://www.bcorporation.net/resources/bcorp/documents/B%20Corp\\_2011-Annual-Report.pdf](http://www.bcorporation.net/resources/bcorp/documents/B%20Corp_2011-Annual-Report.pdf).

<sup>13</sup> Caroline Hsu, *Entrepreneur For Social Change*, U.S. NEWS & WORLD REPORT (Oct. 31, 2005), available at <http://www.usnews.com/usnews/news/articles/051031/31drayton.htm>.

<sup>14</sup> Kelley, *supra* note 4, at 345.

<sup>15</sup> *See, e.g., Id.*; Gottesman, *supra* note 9, at 345.

<sup>16</sup> Kelley, *supra* note 4.

<sup>17</sup> Matthew F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT’L L. 291, 292 (2010) (exploring the difference between an American definition of social enterprise and the European definition, which has evolved to focus on structural unemployment).

<sup>18</sup> *Id.*

<sup>19</sup> *See* PAUL C. LIGHT, *THE SEARCH FOR SOCIAL ENTREPRENEURSHIP* (2008); *see also* Doeringer, *supra* note 17, at n.20 (noting that the United Kingdom, Belgium, Latvia, Lithuania and Finland have legislated an “official” definition of social enterprise).

However, a precise and narrow definition of social enterprise is not requisite to addressing the double-bottom line movement. The problem and solution are easily articulable:

Nonprofits are often constrained by a lack of capital. For-profits are often constrained by legal duties to maximize profit and not social outcomes. Hybrid organizations would address both of these constraints by allowing mission-driven nonprofits to access capital more readily and by allowing for-profits to commit themselves to achieving social goals.<sup>20</sup>

Recognition of this gap in corporate law is not unprecedented. Indeed, the United Kingdom identified and addressed this identical issue in 2004.<sup>21</sup>

The path to legislation for social enterprise in the United Kingdom began in October 2001.<sup>22</sup> The Social Enterprise Unit (SEU), created by the government under the purview of the Department of Trade and Industry, was tasked with “creat[ing] a dynamic and sustainable social enterprise sector as part of an inclusive and growing economy.”<sup>23</sup> The newly created unit wasted little time. In less than three years, the SEU recognized the growth in—and barriers facing—the new sector, proposed the creation of a business entity to accommodate social enterprise, and saw its legislation adopted by Parliament.<sup>24</sup> The fruit of that labor is the Community Interest Company (CIC).<sup>25</sup>

The SEU carefully created and then reinforced the CIC to promote the growth of an entirely new economic sector in the United Kingdom:

The CIC is similar to a limited company, but has restrictions guaranteeing that the company will serve a social interest. A CIC may be a company limited by guarantee, where all profits are reinvested in the enterprise, or a company limited by shares, where the company can raise equity and issue limited dividends to its shareholders.<sup>26</sup>

The CIC thoroughly addresses the legislative gap because the statute permits social goals within a for-profit and easier capital access for the income driven nonprofit.<sup>27</sup> Further, the United Kingdom government supported its new creation with programs designed to generate public faith in social enterprise: (1) “the government created the CIC Regulator to register and monitor compliance with CIC regulations,”<sup>28</sup> (2) “each CIC must pass the ‘Community Benefit Test,’ and

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<sup>20</sup> Gottesman, *supra* note 9, at 346.

<sup>21</sup> See Doeringer, *supra* note 17, at 311.

<sup>22</sup> KMU Forschung Austria, *Study on Practices and Policies in the Social Enterprise Sector in Europe*, 43 (June, 2007), available at [http://ec.europa.eu/enterprise/newsroom/ctrl\\_getdocument.cfm?doc\\_id=3408](http://ec.europa.eu/enterprise/newsroom/ctrl_getdocument.cfm?doc_id=3408).

<sup>23</sup> *Id.*

<sup>24</sup> See CABINET OFFICE, OFFICE OF THE THIRD SECTOR, PRIVATE ACTION, PUBLIC BENEFIT: A REVIEW OF CHARITIES AND THE WIDER NOT-FOR-PROFIT SECTOR (Sept., 2002), available at <http://www.cabinetoffice.gov.uk/media/cabinetoffice/strategy/assets/strat%20data.pdf>.

<sup>25</sup> *Id.*

<sup>26</sup> See Doeringer, *supra* note 17, at 312.

<sup>27</sup> See *id.*

<sup>28</sup> *Id.* at 312–13 (“The CIC Regulator’s role is only to be that of a ‘light-touch regulator’ that

annually submit a public report confirming that the Test is being met,”<sup>29</sup> and (3) “[t]o ensure that money invested in a CIC reaches the community if the CIC is dissolved, there is an ‘asset-lock’” which—after the dissolution of a CIC—transfers remaining assets to other charitable organizations.<sup>30</sup> The SEU anticipated the necessity of these features for growth in social enterprise; Parliament carried them out uncompromisingly.<sup>31</sup>

National control of business regulatory legislation by the British Parliament was extremely important to the speed with which social enterprise developed in the United Kingdom.<sup>32</sup> Conversely, because the United States government delegates choice of business entity issues to the states, a social entrepreneur in a state without legislation designed to accommodate hybrid organizations faces limited and *un-accommodating* alternatives.

### *B. American Reaction to Entrenched Principles of Business Entity*

The early American reaction to the increased popularity of social enterprise stands in stark contrast to the prevailing British system. Impatient social entrepreneurs in the United States seeking the double-bottom line have begun to employ two vehicles for operating hybrid social enterprise under the framework of standard corporate forms: the “multiple-entity” enterprise and the “not-for-loss” enterprise.<sup>33</sup>

#### *1. The Multiple-Entity Approach*

The multiple-entity social enterprise employs a complex structure to ford the river of complications that flow against a makeshift hybrid:

With this approach, the social entrepreneur and her lawyers establish a for-profit entity to carry out the revenue-generating aspects of the mission and a related nonprofit tax-exempt organization to house the social benefit activities. With sophisticated legal and accounting advice, the nonprofit entity can preserve its exempt status and attract support from private foundations, governments, and charitable donors, while simultaneously receiving tax-advantaged cross subsidization from the related for-profit. At the same time, the for-profit entity can seek access to venture capital, bank financing, and other investors accustomed to operating in the open market. The main disadvantage to such multiple-entity strategies is that they are expensive to create and administratively burdensome to

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monitors but does not engage in proactive scrutiny of CICs. However, if the Regulator discovers a major problem, he or she has the authority to appoint or remove directors and managers and also take steps to protect the CIC’s property.”)

<sup>29</sup> *Id.* at 313 (“The basic test is whether a ‘reasonable person might consider that [the CIC’s] activities are being carried on for the benefit of the community.’ This test is generally not satisfied if the CIC aims to benefit a small number of people or if it intends to support a particular political party.”).

<sup>30</sup> *Id.*

<sup>31</sup> See CABINET OFFICE, *supra* note 24, at 52–53.

<sup>32</sup> See KMU Forschung Austria, *supra* note 22, at 43 (“[A]s a central government policy initiative, the SEU acts as a focal point and coordinator for policy making affecting social enterprise, as well as promoting and championing social enterprise.”).

<sup>33</sup> Kelley, *supra* note 4, at 364.

maintain.<sup>34</sup>

This multi-tiered approach is similar to the one employed by Google.org, which is understandable given its initial capitalization of \$1 billion.<sup>35</sup>

## 2. *The Not-For-Loss Approach*

In plainer contrast, a not-for-loss social enterprise is operated by a corporation that is formed under state nonprofit law but does not file for federal tax-exempt status under § 501(c)(3) of the Internal Revenue Code.<sup>36</sup> It aims to achieve the same goals as the multiple entity approach through a significantly less complicated business structure:

Once formed, the organization pursues its multiple-bottom-line mission and, for corporate income tax purposes, simply treats its money-losing social benefit activities as business losses . . . limit[ing] profits generated by the organization's commercial activity and thereby keep[ing] corporate income tax liability to a minimum. This strategy works for some organizations, but relatively few hybrid social enterprises are based on a business model that permits them to forgo outside sources of investment and support.<sup>37</sup>

From the perspective of a for-profit businessperson, this approach could easily work for a philanthropic subsidiary or a successful for-profit parent company—and a route Google.org could have chosen if its social causes were less venture capital based—with tax liability being the only major concern. From the perspective of a nonprofit entrepreneur, however, this does not address the core issue of easier access to capital. The unmistakable drawbacks of both approaches call out for an entity designed for hybrid use like the CIC. Fortunately, state legislatures have begun to identify the limitations with these two amalgamations; two CIC-like business forms are gaining traction in state legislatures.<sup>38</sup>

## C. *The WorldOne Case*

The George Washington University Law School's Small Business and Community Economic Development Clinic provides free legal assistance to start-ups in the District of Columbia (D.C.) metro area. Generally, clients of the clinic are businesses with less than \$35,000 in start-up capital and that would be otherwise unable to afford legal advice.

WorldOne sought legal advice and counseling on the choices of legal entity availability to it and help with its organizing documents. Started by two young

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<sup>34</sup> *Id.* at 365–66.

<sup>35</sup> *Id.* at 344.

<sup>36</sup> *Id.* at 364–65.

<sup>37</sup> *Id.*

<sup>38</sup> See Carter G. Bishop, *Fifty State Series: L3C & B Corporation Legislation Table*, SUFFOLK UNIVERSITY LAW SCHOOL (May 26, 2011), [http://www.intersector13c.com/goopages/pages\\_download\\_gallery/download.php?filename=14430.pdf&orig\\_name=50\\_state\\_series-l3c\\_and\\_bcorp\\_legislation.pdf&cdpath=/files/50\\_state\\_series-l3c\\_and\\_bcorp\\_legislation.pdf](http://www.intersector13c.com/goopages/pages_download_gallery/download.php?filename=14430.pdf&orig_name=50_state_series-l3c_and_bcorp_legislation.pdf&cdpath=/files/50_state_series-l3c_and_bcorp_legislation.pdf); *2011 Annual Report*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/B-Media/2011-Annual-Report> (last visited Mar. 30, 2012).



women with years of experience in international development, the company offered worldwide volunteering opportunities through a network of local partners. Because of their years of experience, the entrepreneurs were able to identify a gap in the market. The founders believed that, despite their nonprofit status, other volunteering organizations offering worldwide programs were passing an unnecessary share of the cost onto the volunteers. This presented the opportunity to create a more efficient competitor.

They also recognized the potential benefit of *not* pursuing nonprofit status. Easier access to capital coupled with less administrative cost in maintaining the status were important factors, considering the founders' opinions on the potential to generate revenue. However, the fundamental concept of the entire organization is based on international development. Philanthropy in these communities leads to partnerships. The partnerships allow WorldOne to offer programs to a volunteer at a lower cost than if the volunteer had pursued the venture on their own. Providing a social benefit is tied very closely to the business model. Consequently, a philanthropic arm to the overarching organization is indispensable.

Although a myriad of factors always influence choice of entity for a new business, ultimately, the founders decided to build their social enterprise under the framework of existing D.C. LLC law. As noted earlier, complexity and cost are an issue when creating a hybrid entity without the support of a hybrid statute. The WorldOne founders expressed precisely these concerns. The opportunity cost of the not-for-loss enterprise and the administrative complexity of the multiple-entity enterprise eliminated those possibilities, and a simple LLC was finally chosen because of the founders' desire to move forward with the project as soon as possible. A more financially efficient philanthropic entity would be created after the business was up and running. However, had D.C. already adopted a type of hybrid statute, the WorldOne founders would have been able to address more of their choice of entity issues at the time the organizational documents were drafted.

### III. L3C

The flexibility of a traditional LLC is its most important feature. The L3C is merely an extrapolation LLC, focused on delivering social impact through its increased ability to raise capital. For WorldOne, other streams of capital could have accelerated growth in its formative years, avoiding much of the struggle of maturing through a period as a micro-business with international goals.

#### *A. The Background and Basis for the L3C Designation*

The L3C concept sprang from a series of meetings at the Mary Elizabeth & Gordon B. Mannweiler Foundation in 2005.<sup>39</sup> Its originators were seeking, "the integration of business and mission in a self-sufficient, profit making venture."<sup>40</sup> By 2007, Robert Lang, Marcus Owens, and Arthur Wood had developed the idea

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<sup>39</sup> Robert M. Lang, Jr., *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations*, 5 A.L.I.-A.B.A. 251, 253 (2007).

<sup>40</sup> *Id.* at 253.

enough to circulate a paper among the American Law Institute.<sup>41</sup>

The structural concept envisioned by Lang is what truly bridges the gap between profit and non-profit organizations. While branding a corporation “low-profit” provides benefits regarding the visibility of a new business’s social goals, the L3C offers a tangible benefit as well.<sup>42</sup> This tangible benefit was designed “to ameliorate social entrepreneurs’ capital formation concerns by making the entities attractive vehicles for program-related investments by foundations.”<sup>43</sup> This new stream of capital is what sets the L3C apart as an important tool in the development of hybrid organizations.

The PRI is not a typical form of capital investment. “The PRI is defined as an investment made by a foundation or trust to support a charitable project or activity. . . . Income and appreciation are acceptable, but not intended or required outcomes.”<sup>44</sup> The lack of a *requirement* for proper return on investment parallels the double-bottom line requirement of the social entrepreneur. PRIs are the solution to the problem of capital in “profit as a secondary interest” businesses. However, while PRIs hold great potential for social enterprises, they “have been underutilized because their risks and transaction costs make them unappealing to most private foundations.”<sup>45</sup> The originators of the L3C specifically designed it to solve those problems.

The language of the Internal Revenue Code governing PRIs is the active ingredient that separates the L3C from the traditional LLC. Marcus Owens’ idea was to:

[D]raft model legislation . . . that closely tracked the language of the PRI requirements laid out in § 4944(c) of the Internal Revenue Code. In other words . . . any social enterprise that qualified for L3C status under state law would ipso facto qualify for program-related investments under the IRS code.<sup>46</sup>

The designation under state law would remove the transactional cost of an investigation or letter ruling from the IRS.<sup>47</sup>

The text of adopted L3C statutes is the key element in creating the presumption of legitimacy and trustworthiness for foundations. For example, the Vermont statute requires that the company furthers the accomplishment of a charitable or educational purpose within the meaning of the Internal Revenue Code.<sup>48</sup> The statute goes on to mirror other specific requirements for PRI reception.<sup>49</sup> The adoption of such language paves the way for a greater ease of use for the L3C.

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<sup>41</sup> *Id.* at 253.

<sup>42</sup> Kelley, *supra* note 4, at 372.

<sup>43</sup> *Id.* at 372.

<sup>44</sup> Lang, *supra* note 39, at 254.

<sup>45</sup> Kelley, *supra* note 4, at 372.

<sup>46</sup> *Id.* at 372–73.

<sup>47</sup> *Id.* at 373.

<sup>48</sup> H. 775, 106<sup>th</sup> Gen. Assemb., Reg. Session (Vt. 2008), available at <http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2008/acts/ACT106.HTM>.

<sup>49</sup> *Id.*

## *B. An Alternate History: The L3C Applied to WorldOne*

### *1. Advantages*

The L3C could have been the perfect solution to the unique needs of WorldOne. Organizing as an L3C would have offered the identical advantages that it received by choosing an LLC, but with the addition of a new source for capital.<sup>50</sup> The additional language required under L3C statutes, such as the furtherance of some charitable purpose,<sup>51</sup> would have not effected the business model of WorldOne because charitable donations are already an important element in its development.

### *2. Shortcomings*

The lack of blanket approval for the reception of PRIs by recognized L3Cs is the biggest shortcoming regarding its use. Just because the D.C. passed a bill permitting L3Cs, does not mean that WorldOne could avoid the expense of receiving a letter ruling for permission to receive PRIs. Although the L3C statute somewhat streamlines this process, WorldOne would only choose this course if it saw PRIs as an important element in its development.<sup>52</sup>

## *C. State of the L3C*

### *1. L3Cs in the Federal System*

Recognition in the federal system remains the biggest obstacle to widespread L3C use. The IRS has not allowed foundations to direct PRIs to L3Cs without an extensive investigation or letter ruling expressly permitting it. Until the IRS grants the approval envisioned by the business form's founders or Congress passes a law mandating the same, and thereby easing the transactional cost to potential foundation investors, the L3C will be missing an important component of its complete adoption.

### *2. L3Cs in the States*

The struggle for acceptance of the L3C in state legislatures is ongoing. The number of states recognizing this hybrid form is growing, and consideration of the L3C entity arises often in many state assemblies.<sup>53</sup> However, the opinions of the legislators are not unanimously pro-L3C; the form's limitations have called into

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<sup>50</sup> See Kelley, *supra* note 4, at 372.

<sup>51</sup> See H. 775, *supra* note 48.

<sup>52</sup> For example, a large charity that supported international volunteering opportunities and that was structured to take advantage of PRIs could be a significant source of capital for WorldOne. If this opportunity for tax-advantaged capital contribution exceeded the cost of a letter ruling, or if the IRS were to grant the blanket authorization, the L3C would allow the young business to flourish during the normally difficult early stages of development.

<sup>53</sup> See *Here's the Latest*, *supra* note 11.

question the necessity of its adoption.<sup>54</sup>

The time and debate intensive nature of the democratic process makes the approval of new laws a difficult task. However, since its proposal in late 2007, seven state legislatures have created a new statute authorizing the use of the L3C.<sup>55</sup> These efforts have not been in vain: 153 L3Cs have been created in Vermont, 81 in Michigan, 57 in Illinois, 32 in Utah, 22 in Wyoming, 18 in North Carolina, and 8 in Louisiana.<sup>56</sup> It is also in consideration in fourteen other states as well: Arkansas, Arizona, Hawaii, Indiana, Iowa, Kentucky, Maryland, Montana, New York, Oklahoma, Oregon and Rhode Island.<sup>57</sup> This leaves the L3C just shy of the tipping point of adoption or consideration in a majority of states.

Adoption in the consideration states is not guaranteed, however, because the L3C has not met with unanimous approval. “The lack of a major initiative to change the laws relating to the duties of the directors of for-profit corporations in order to foster the intentional pursuit of below-market returns on behalf of for-profit corporation shareholders tends to support the premise that such investors may be few.”<sup>58</sup> Furthermore, “[m]any regulators are simply unwilling to sign off on the premise that the elimination of private letter rulings is a compelling regulatory goal.”<sup>59</sup> These problems stem from the transactional cost of achieving letter rulings from the IRS for permission to grant PRIs to L3Cs because the IRS does not distinguish between an L3C and a traditional LLC.<sup>60</sup>

Several states have determined that the potential benefits of the L3C statute outweigh the questions of its usefulness. It has been stated that, “the L3C community concedes that a change in state law . . . standing alone does not create new opportunity” because the IRS has yet to grant blanket approval of PRIs to L3Cs.<sup>61</sup> However, watershed acceptance from the majority of state legislatures would demonstrate a consensus among the states and put pressure on the IRS to grant blanket approval, eliminating the transactional cost of the letter ruling.

#### IV. B CORPORATION

While the ultimate goal of a hybrid organization is to bridge a gap in legal framework, these organizations generally find their basis on one side of the gap. Just as the L3C is best understood as an extrapolation of the LLC, the B Corporation is best understood as an extrapolation of the C Corporation. That extrapolation would have offered tangible benefits to WorldOne, but again like the L3C, its progression through state legislatures is still in its infancy.

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<sup>54</sup> David Edward Spenard, *Panacea or Problem: A State Regulator's Perspective on the L3C Model*, 65 TAX EXEMPT ORG. REV. 36, 39, 40 (2010).

<sup>55</sup> See *Here's the Latest*, *supra* note 11.

<sup>56</sup> See *id.*

<sup>57</sup> Bishop, *supra* note 38.

<sup>58</sup> Spenard, *supra* note 54, at 38.

<sup>59</sup> *Id.* at 40.

<sup>60</sup> See, e.g., Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 646–47 (2010).

<sup>61</sup> *Id.* at 38.

*A. The Background and Basis for the B Corporation*

The B Corporation concept is a product of the early 2000s.<sup>62</sup> The B Corporation idea was conceived by Jay Coen Gilbert and Bart Houlihan, former Co-Founder and President, respectively, of the “AND 1” basketball footwear company.<sup>63</sup> The purest description of their vision is the double-bottom line: the expansion of corporate responsibilities beyond profit-maximization to include social interest.<sup>64</sup> However, marketing of the B Corporation brand is also a crucial element: the idea’s founders created B Lab in order to certify certain corporations as truly socially beneficial.<sup>65</sup>

The implementation of a double-bottom line is the most legally distinguishable feature of operating a B Corporation. Articles of Incorporation must define the best interests of the company to include social consideration—which may be employee, community, or environmentally based—in addition to profit consideration.<sup>66</sup> Such a structure immunizes for-profit-based social entrepreneurs from liability to shareholders for decisions that may sacrifice profit for social benefit.<sup>67</sup> The element of social benefit may allow nonprofit-based social entrepreneurs to seek capital in the form of PRIs, although this theory has yet to be tested in court.<sup>68</sup>

The B Corporation is not exclusive to new businesses. If financially feasible, existing corporations may amend their articles of incorporation to adopt the B Corporation framework.<sup>69</sup> To become a true B Corporation, however, more is required than the creation or adjustment of organizing documents.<sup>70</sup>

Public consciousness of a corporation’s social benefit is important to the growth of social enterprise. Beyond a double-bottom line legal structure, a company must submit to a set of standards regarding their tangible social impact to qualify officially as a B Corporation.<sup>71</sup> To protect this vision, the idea’s founders opened B Lab.<sup>72</sup> B Lab is an independent nonprofit organization that, “functions as an impartial third-party that certifies and rates B corporations on how well they actually meet the[] standards.”<sup>73</sup> There are considerable parallels between B Lab’s

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<sup>62</sup> See CERTIFIED B CORPORATION, <http://www.bcorporation.net> (last visited Mar. 30, 2012).

<sup>63</sup> *Management*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/team> (last visited Mar. 30, 2012).

<sup>64</sup> *The Legal Framework*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/become/legal> (last visited Mar. 30, 2012).

<sup>65</sup> See *B Corp Certification Overview*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/index.cfm/fuseaction/content.page/nodeID/08c9dc4d-6064-48cb-af04-4fd9d4ced055/externalURL/> (last visited Mar. 30, 2012).

<sup>66</sup> *The Legal Framework*, *supra* note 64.

<sup>67</sup> See Gottesman, *supra* note 9, at 356.

<sup>68</sup> *Id.*

<sup>69</sup> *The Legal Framework*, *supra* note 64.

<sup>70</sup> *The B Impact Assessment*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/become/BRS> (last visited Mar. 30, 2012).

<sup>71</sup> *Id.*

<sup>72</sup> *B Corp Certification Overview*, *supra* note 65.

<sup>73</sup> Gottesman, *supra* note 9, at 356.

protective or promotional role for the B Corporation brand of social enterprise and the United Kingdom government's regulation of the CIC. B Lab acts as a monitor to ensure tangible social impact in the same fashion as the CIC Regulator.<sup>74</sup> B Lab's "Impact Rating System" requires a B Corporation to demonstrate sustained commitment to the social element of the bottom line through recertification, which is required every two years.<sup>75</sup> Beyond protecting the B Corporation's integrity, these safeguards also promote trust in the integrity of social entrepreneurship.

Also important to the B Corporation idea is the concept of branding as it relates to the promotion of social enterprise:

[T]he primary benefit of the B designation will be to create a brand for corporations that are truly and fundamentally committed to socially beneficial outcomes. Through this brand, and the rigorous standards that organizations must meet to earn it, socially conscious consumers and investors will have confidence that a corporation's expressed commitment to nonfinancial bottom lines is more than mere marketing.<sup>76</sup>

The social responsibility of each of the 370 certified B Corporations is even loudly trumpeted on B Lab's website.<sup>77</sup> While it is clearly a more private or free-market approach, again the branding goal is essentially the same as the CIC's supplemental programs: to increase public knowledge and confidence in social enterprise.

Beyond marketing and press relations, B Lab promotes legislative adoption of the B Corporation as an alternative choice of entity.<sup>78</sup> This lobbying is important not only to the wide spread acceptance and recognition of the B Corporation, but also to an argument that the B Corporation is more than just a seal of approval by an independent organization. The model legislation, which forms the basis for its proposed entity in each legislature, offers legal protection to the directors of an organization in the pursuit of a double bottom line.<sup>79</sup> The cost of this new right, however, is increased oversight on the corporation to make sure a tangible social benefit exists.<sup>80</sup>

### *B. An Alternate History: The B Corporation Applied to WorldOne*

If D.C. had adopted a B Corporation statute, the founders of WorldOne would have had an attractive alternative to the LLC entity they ultimately chose. B

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<sup>74</sup> *B Corp Certification Overview*, *supra* note 65. It should be noted, however, that because B Lab approval is a private enterprise, they are not limited by the "hands-off" approach that the CIC Regulator is as a government entity. *Id.*

<sup>75</sup> *The B Impact Assessment*, *supra* note 70.

<sup>76</sup> Kelley, *supra* note 4, at 367.

<sup>77</sup> *2011 Annual Report*, *supra* note 38.

<sup>78</sup> *B Corp Legislation*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/publicpolicy> (last visited Mar. 30, 2012).

<sup>79</sup> *Amendments to the Pennsylvania Consolidated Statutes With Official Source Notes and Committee Comments*, CERTIFIED B CORPORATION, [http://www.bcorporation.net/resources/bcorp/documents/Draft\\_Pennsylvania-Legislation.pdf](http://www.bcorporation.net/resources/bcorp/documents/Draft_Pennsylvania-Legislation.pdf) (last visited Mar. 30, 2012).

<sup>80</sup> *Id.*

Lab is willing to certify other corporate forms, such as an LLC. In that sense the founders could have maintained their original choice of entity, but would still receive their own benefit. The basic idea behind the B Corporation, granting the directors of a for-profit business the right to a double-bottom line, would have allowed WorldOne to conduct the philanthropic elements of its venture without issue.<sup>81</sup> However, this choice would not have been made without drawbacks. The B Corporation designation does little outside of the double-bottom line flexibility and the notoriety as a social-benefit driven business, and that designation is not free.

### *1. Advantages*

The fundamental idea behind the B Corporation solves the primary issue facing WorldOne: how to create both profit and social impact without the expense and complexity of administering multiple organizations. The B Corporation would allow WorldOne to fund its relationships with overseas partners without concern for the effect on total profits or the legal rights of investors to maximize profits. Further, because the B Corporation regulations permit the WorldOne founders to maintain the flexible LLC underneath the B Corporation label, all underlying corporate entity issues would be addressed.

Beyond the structural benefits, the “seal of approval” that goes along with the B Corporation status is a benefit that cannot be ignored. B Lab offers an independent assessment of the tangible social impact of a corporation. Specifically, as the recognition of the B Corporation increases through national exposure of the entity—and through B Lab’s own trumpeting<sup>82</sup>—WorldOne would receive free advertising in a positive spotlight. For a fledgling business, cost-free publicity is invaluable.

### *2. Shortcomings*

The most obvious shortcoming of pursuing B Corporation certification for WorldOne during their start-up would be the cost. B Corporation requires a licensing fee in order to be certified.<sup>83</sup> While the fee is generally very small in proportion to profit—only \$500 for a corporation with less than \$2 Million in annual sales<sup>84</sup>—any outlay for a business with start-up capital of less than \$35,000 is an important consideration. Administrative costs for B Lab certification exist as well, as continued monitoring of tangible social benefit is a requisite. This may have been difficult to prove during WorldOne’s formative years.

Beyond direct cost, it is unclear if the positive attention received by B Corporation status and protection for the board overcomes the opportunity cost of

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<sup>81</sup> See Gottesman, *supra* note 9, at 356.

<sup>82</sup> See *B Community*, CERTIFIED B CORPORATION, <http://www.bcorporation.net/community> (last visited Mar. 30, 2012).

<sup>83</sup> *Corporate Client Alert: B Corporations & L3Cs*, MORRIS, MARTIN & MANNING, LLP (Apr. 21, 2010) <http://www.mmmlaw.com/media-room/client-alerts/untitled-resource1>.

<sup>84</sup> *Id.*

alternative ways to spend the money. If the cost of licensing, administrating, and maintaining WorldOne's B Corporation status were used early in its development to instead receive a letter ruling from the IRS permitting the reception of PRIs, the budding hybrid corporation would have an entirely new avenue of capital. If the founders are forced to choose how to best grow their business—which they believe provides a social benefit regardless of entity—the sacrifice of a “seal of approval” and free advertising must be weighed against the potential for capitalization. WorldOne's aggressive international plans required capitalization from many sources, and PRIs could have significantly accelerated their growth.

### C. State of the B Corporation

A review of the current standing of the B Corporation reinforces the idea of a competition between the two newest business forms. Of all corporations that have considered the new hybrid business entities, Vermont is the only state to enact legislation for both corporate forms<sup>85</sup> Furthermore, in direct comparison to the L3C, the B Corporation appears to be at a disadvantage in terms of legislative acceptance.<sup>86</sup> However, this perspective does not account for the B Corporation's unique situation.

Currently, B Corporation legislation has passed in Maryland, Vermont, and New Jersey.<sup>87</sup> Additionally, B Corporation bills are currently in consideration in Colorado, Hawaii, New York, North Carolina, Pennsylvania, Virginia, California, and Michigan.<sup>88</sup> In contrast, the L3C has been passed by nine legislatures and is in consideration by fourteen more.<sup>89</sup>

However, focusing purely on B Corporation sponsored legislation does not tell the whole story. B Corporation sponsored legislation is not required to create a pure B Corporation-type form. Thirty-one states have passed a precursor rule known as a “constituency statute.”<sup>90</sup> A state constituency statute allows the addition of outside interests to articles of incorporation.<sup>91</sup> While the B Corporation statute seeks to grant rights to the beneficiaries against the corporation, a constituency statute does not clearly address those rights.<sup>92</sup> Furthermore, the constituency statutes and B Corporation statutes remain untested in court.<sup>93</sup>

## V. CONCLUSION

Scientists have routinely demonstrated that monetary reward is the best

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<sup>85</sup> See Bishop, *supra* note 38.

<sup>86</sup> *Id.*

<sup>87</sup> *B Corporation Legislation, supra* note 78.

<sup>88</sup> *Id.*

<sup>89</sup> *The L3C – Three Years Later*, NONPROFIT LAW BLOG, <http://www.nonprofitlawblog.com/home/2011/08/the-l3c-3-years-later.html> (last visited Jan. 23, 2012).

<sup>90</sup> Hannah Clark Steiman, *A New Kind of Company: A “B” Corporation*, INC. (Jul. 1, 2007), available at <http://www.inc.com/magazine/20070701/priority-a-new-kind-of-company.html>.

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Id.*



motivator for mechanical or heuristic work.<sup>94</sup> However, scientists have also routinely demonstrated that when a task requires even *rudimentary* cognitive skill, higher monetary incentives lead to poorer performance.<sup>95</sup> This seemingly counterintuitive result raises a surprisingly simple question: what really motivates workers?<sup>96</sup> Alongside self-determination and mastery, purpose was found to be one of the primary factors that leads to better performance and personal satisfaction. Simply put, workers tend to be more motivated by a purpose they believe in, such as a social benefit, than pure profit for either themselves or their employer.

As entrepreneurs begin to recognize the value of employees that are motivated by the social purpose of their job, more so than by the pure competitiveness of their salary against the private sector, those entrepreneurs will turn to business structures that allow them to operate for both a profit and a social goal. The evolution of entrepreneurial needs requires the promotion of hybrid business entities. The simplicity and visibility of the L3C and B Corporations provide an easy solution to that requirement.

In a sense, the L3C and B Corporations are not competing, because it is possible for a properly organized business to be both. However, some semblance of recognition by state governments is important to the expanded use of each entity, and it is doubtful that the majority of state legislatures will spend the time approving two statutes that aim to accomplish the same goal. Discussions suggesting that either hybrid model may be prevailing as the accepted social entrepreneurship entity belie the fact that a majority of the states have not accepted either hybrid model. Furthermore, both hybrid types stand just short of the critical mass necessary for a majority of state legislatures to take notice. Only time will tell whether the B Corporation's strong branding approach or the L3C's flexibility and structural potential can ride the crest towards mainstream acceptance.

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<sup>94</sup> TheRSAorg, *RSA Animate - Drive: The Surprising Truth About What Motivates Us*, YOUTUBE (Apr. 1, 2010), <http://www.youtube.com/watch?v=u6XAPnuFjJc&feature=channel>; see also DANIEL PINK, *DRIVE: THE SURPRISING TRUTH ABOUT WHAT MOTIVATES US* (2009).

<sup>95</sup> TheRSAorg, *supra* note 94.

<sup>96</sup> *Id.*