

BUSINESS LAW TODAY

The ABA Business Law Section's Online Resource

Are Hybrids Really More Efficient?

A 'Drive-By' Analysis of Alternative Company Structures

By [Katherine R. Lofft](#), [Purvi B. Maniar](#), and [Tamar R. Rosenberg](#)

The evolution of the legal approach to company structure in the United States has generally taken two, largely divergent, paths. Down one path, there is the traditional “for profit,” or business, corporation. A business corporation may take one of many forms and be organized for any legal business purpose, but is generally regarded as being largely, if not exclusively, consumed with maximizing shareholder value. Down the other path, there is the classic “non-profit” organization. A non-profit is generally required to have an educational, scientific, charitable, or other non-commercial purpose(s), and may not be operated for private gain.

For-profit companies can have private owners, raise private capital, and distribute profits to investors. Their profits are taxed and they are not entitled to receive tax-deductible contributions or grant funds, but they are otherwise free to engage in a range of activities both directly and indirectly related to their business purposes, with limited oversight of their activities beyond the exercise of board discretion. Tax-exempt, non-profit organizations generally do not have “owners,” may not distribute profits, are inhibited from raising private capital, and are subject to significant restrictions on their activities, including as to executive compensation, political campaign activities, and lobbying. They are also subject to enhanced oversight by governmental authorities, including the IRS and state at-

torneys general, and to public disclosure of their activities, compensation, and finances.

The conflict presented by this binary approach to organizational structure is best illustrated by the outcry over the sale of Ben & Jerry’s to Unilever in 2000. One of the early practitioners of what we would now call “corporate social responsibility,” Ben & Jerry’s was criticized for agreeing to an acquisition by Unilever, a large multinational corporation. Although Unilever was the highest bidder for the business, it was widely believed (including, according to reports at the time, by certain members of the Ben & Jerry’s board) that Unilever would not continue many of the social benefits which distinguished Ben & Jerry’s as an employer and corporate citizen. However, in view of prevailing law and corporate norms, the board of directors of Ben & Jerry’s felt it had little choice but to favor the high bidder in order to maximize return to its shareholders, to the detriment of “lesser” bidders that were perceived as more likely to continue Ben & Jerry’s unique approach to “doing good.”

The conflict between the traditional for-profit and non-profit structures has become heightened through the market crash of 2008 and the ensuing recession and protracted recovery. Corporate executives are looking for ways to distinguish their companies from the competition, satisfy socially responsible investors, and re-buff notions of “corporate greed” by diversifying their

revenue streams and/or balancing their profitmaking objective with socially responsible motives. Philanthropic leaders are questioning whether some charitable goals could be better accomplished without the constraints of associated with tax-exempt and non-profit status. Socially-minded citizens and investors are wondering whether there are ways to encourage for-profit companies to focus more on the impact of their activities on their employees, communities, and the environment. For a variety of reasons, more people are beginning to question whether there is, or should be, any inherent conflict in the desire to both “do good” and generate a profit.

The market response to this continuing and growing conflict has produced an increasing variety of new models or forms of so-called “hybrid” business organization, which are intended to provide more flexibility, and a measure of legal protection, to organizations that want to “do well by doing good.” None of these hybrid entities qualify for tax exemption; however they incorporate non-profit or social benefit concerns in various ways and are free from the various significant burdens of tax-exempt status. This article takes some of the more common hybrid business structures out for a test drive, and examines the principal benefits and disadvantages of each.

Summary of Common Hybrid Forms

Benefit Corporations

Several states across the country have adopted or are considering adopting legislation introducing the “benefit corporation” as an alternative to the traditional for-profit corporation. States that have passed legislation allowing creation of a benefit corporation include California, Hawaii, Maryland, Louisiana, New Jersey, New York, South Carolina, Vermont, and Virginia. In addition, many states, including Colorado, Illinois, Michigan, North Carolina, Pennsylvania, and Washington, D.C., have introduced legislation that would allow the creation of benefit corporations. According to one recent report, as of February 2012, there are at least 517 registered benefit corporations nationwide, representing almost \$3 billion in revenue.

It is worth noting that benefit corporations are distinct from “B Corporations” or “B Corps,” with which they are often confused. A benefit corporation is a form of legal entity that is established under state law. In contrast, a B Corporation or B Corp refers to a company that has been certified by a nonprofit organization called B Lab. Any company that meets the standards of overall social and environmental performance established by B Lab may request certification as a B Corporation. A benefit corporation can apply for and become certified as a B Corporation (as can any traditional for-profit or non-profit entity that meets B Lab’s standards), but a benefit corporation (or any other hybrid entity discussed in this article) is not automatically considered a B Corporation, or vice versa.

Benefit corporations in most states share three major characteristics. First, the benefit corporation must pursue a “general public benefit,” which means that it must create “a material positive impact on society and the environment.” In addition to the general public benefit, benefit corporations may also undertake to pursue one or more specific benefits. Second, the benefit corporation expands the fiduciary duties of directors of the corporation to affirma-

tively require consideration and pursuit of such general and specific purposes, rather than focusing only on maximizing shareholder value. Third, the benefit corporation is obligated to report on its overall social and environmental performance as assessed by a recognized third-party standard that is comprehensive, credible, independent, and transparent. Beyond the statutory requirements that are directly applicable to benefit corporations, a benefit corporation is generally subject to the other provisions of the enacting state’s existing corporation code.

Under the corporate statutes of most states, only the company or its shareholders have standing to bring an action against the company’s directors or officers for breach of duty. The benefit corporation statutes also generally limit standing in any enforcement actions to the company or its shareholders; however, many benefit corporation statutes also extend standing to directors of the benefit corporation or any shareholder holding at least 5 percent of the shares of any parent entity of a benefit corporation. Moreover, a benefit corporation may specify other stakeholders in its articles of incorporation or bylaws that can bring an enforcement proceeding.

For the socially conscious business, the benefit corporation form appears to offer some advantages over traditional for-profit and non-profit organizational forms. First, the benefit corporation undertakes an affirmative obligation to pursue a general public benefit and any stated, specific public benefits as verified by an independent third party and reported to stakeholders. This provides a benefit corporation with legitimacy when it markets itself as a socially responsible business. In particular, a benefit corporation that fulfills the audit and disclosure requirements under the applicable statute may be able to resist charges that it is engaged in “greenwashing”; namely, the use of marketing and other devices by a business to create the generally unfounded perception that the its goals and policies are environmentally friendly, whether to attract customers or investors, or otherwise to increase profits.

Second, the benefit corporation also

affords legal protection to its directors and officers in their pursuit of the corporation’s general and specific public benefits. Unlike a for-profit corporation, the directors and officers of a benefit corporation would have less concern about liability for a breach of fiduciary duty in balancing the corporation’s stated general and/or special benefits with its pursuit of profits.

There are also certain other advantages of benefit corporations in comparison to non-profit or tax-exempt entities. These advantages, which are also generally common to other hybrid entities, are discussed below.

Despite the advantages, benefit corporations constitute largely uncharted territory, which creates certain risks and raises certain questions from a legal perspective. As an example, the benefit corporation statutes do not describe or provide clear guidance as to how the directors or officers of a benefit corporation are supposed to balance the pursuit of the company’s general and/or specific purposes as against each other, or how these objectives would weigh against the company’s need (or desire) to generate revenues from operations and/or a profit for investors.

The assessment and reporting requirements applicable to a benefit corporation are fairly extensive (yet still significantly less than for tax-exempt organizations). While these may be necessary or desirable as a means to hold benefit corporations to an “objective” standard, in part to encourage and facilitate transparency, it is possible that this burden will prove too complicated and/or expensive for smaller companies. It is also not yet entirely clear that such assessments or reporting will achieve their desired objectives. As described above, a benefit corporation is obligated to report on its overall social and environmental performance as assessed by a recognized third-party standard that is independent, transparent, credible, and comprehensive. While the model benefit corporation statute does define some of these terms, what it means to be a “recognized” entity and what is “comprehensive” standard, as well as any company’s (or any third party’s) decision-making in

this regard may be subject to disagreement and challenge. Actual standards of measurement to be applied could vary in significant ways from third party to third party. Until there is substantive uniformity of standards or a consensus among stakeholders as to the applicable definitions and standards, this may impact the desirability and attraction of the benefit corporation form of organization.

Flexible Purpose Corporation

As an alternative to the benefit corporation (which has also been adopted in the state), California recently approved another hybrid form of organization called the “flexible purpose corporation.” A flexible purpose corporation shares the overall purpose of the benefit corporation model; namely, to allow a for-profit company to identify, promote and achieve one or more social goals or objectives. However, a flexible purpose corporation is intended to allow companies greater flexibility their pursuit of such goal(s) than is possible under the benefit corporation form.

First, unlike a benefit corporation, a flexible purpose need not identify a broad, general public or social benefit to pursue. Instead, a flexible purpose corporation, beyond confirming its general purpose to engage in any lawful act or activity in which a company may engage, is required only to identify one or more special purposes as described in the statute, which may be quite narrow. Also unlike a benefit corporation, a flexible purpose corporation is not required to assess or report against any independent or third party standard, although a flexible purpose corporation is required to provide detailed annual and special reports to shareholders, and other financial information to certain shareholders on request. Flexible purpose corporations with fewer than 100 shareholders can request waivers of compliance with certain aspects of the reporting requirements.

Flexible purpose corporations do share certain attributes with benefit corporations. As with benefit corporations, directors or officers of a flexible purpose corporation who perform their duties in

accordance with the statutory standards are statutorily protected from liability for their decision-making. Shareholders of a flexible purpose corporation may institute and maintain derivative actions to enforce the corporation’s special purpose. As with many benefit corporation statutes, enforcement actions against a flexible purpose corporation may not be brought by anyone other than a shareholder.

The flexible benefit corporation model may hold an attraction for certain companies as compared to the benefit corporation model. Given that a flexible purpose corporation need only identify one or more special purposes it intends to pursue, which may be narrowly drawn, and need not try to pursue a broadly stated general benefit, or balance any actions in pursuit of that general benefit against one or more specific benefits, the directors of a flexible purpose corporation may have a lesser burden and reduced exposure to shareholder lawsuits than the directors of a benefit corporation. The absence of any requirement to assess performance against any third party standard may also make the flexible purpose corporation form of organization more appealing than the benefit corporation form for many companies.

There are, however, some disadvantages to the flexible purpose corporation form. These include detailed reporting and disclosure requirements that may inhibit the widespread adoption of this form of organization. A flexible purpose corporation must provide shareholders with annual reports that include certified financial statements of the corporation, together with a detailed management discussion and analysis (MD&A) regarding the corporation’s stated purpose, which MD&A must discuss a number of issues specifically relating to the company’s pursuit of its special purpose(s), as described in the statute. A flexible purpose corporation must also provide current reports to shareholders on the occurrence of certain specified events, including any expenditure or the withholding of any expenditure in pursuit of the corporation’s special purpose(s), or any determination that the corporation’s special purpose(s) has been satisfied or should no longer be

pursued, temporarily or permanently. The statute allows flexible purpose corporations with fewer than 100 shareholders to avoid the requirement to provide an MD&A or any current report, but only if the corporation holds valid, unrevoked waivers of compliance with such requirements from shareholders representing two-thirds of the outstanding shares of the corporation. Each shareholder waiver is effective only for one year, and the corporation must notify each waiving shareholder annually of the shareholder’s right to revoke the waiver.

The flexible purpose corporation model has been criticized on various grounds, and these criticisms may inhibit adoption of the model by states other than California. For instance, critics of the flexible purpose corporation form of organization have pointed out that, given the special purpose(s) that a flexible purpose corporation may pursue can be limited or narrowly drawn, this form of organization may be particularly susceptible (perhaps more susceptible than the benefit corporation model) to charges of greenwashing. Where the flexible purpose corporation’s special purpose(s) may not only be narrowly drawn, but also achievable over only a short, as opposed to longer, term, some have questioned whether special or preferential (or at least distinctive) status should be accorded to such businesses or their directors under the law.

Social Purpose Corporation

California is not the only state to consider the benefit corporation model and decide to offer an alternative approach. The state of Washington recently approved a new form of organization called the “social purpose corporation.” A social purpose corporation is a for-profit corporation that is organized to pursue one or more social and/or environmental purposes while also creating economic value for shareholders.

A Washington social purpose corporation must be organized to promote the “positive short-term or long-term effects of, or minimize adverse short-term or long-term effects of, the corporation’s activities” upon certain designated constituencies. The corporation, in its or-

ganizational documents, must set forth the general purpose for which it is organized as described above, and any specific social purpose(s) for which it is also organized.

The Washington statute also modifies the fiduciary duties of the directors and officers of a special purpose corporation by allowing them, in the discharge of their duties, to “give weight” to one or more of the corporation’s social purpose(s). Any action taken by a director or officer that he or she believes promotes a social purpose is deemed in the “best interests” of the company, and the directors and officers are not liable for actions taken in accordance with such requirements. As with the other hybrid models described above, only shareholders have standing to bring actions in the right of special purpose corporations.

Like a flexible purpose corporation (and unlike a benefit corporation), a social purpose corporation need not subject itself to an assessment against any independent or third-party standard. The publication and reporting requirements for a social purpose corporation are also fairly modest—more so than for benefit corporations and flexible purpose corporations. However, unlike a flexible purpose corporation, a social purpose corporation is not required to submit reports or financial statements directly to its shareholders; it need only publish on its website an annual report describing the corporation’s efforts to promote its social purpose.

Generally speaking, many of the same disadvantages of the benefit corporation form of organization, and some of the same criticisms that have been levied against the California flexible purpose corporation, as described above, would apply to the Washington social purpose corporation model as well.

Low-Profit Limited Liability Company (L3C)

The “low-profit limited liability company,” commonly called the “L3C,” came into existence in 2008 as a new type of limited liability company. The L3C was originally designed to achieve narrower objectives than the other hybrid entities described above; namely, to attract

investments from private foundations for socially beneficial ventures.

Private foundations are a specific category of tax-exempt charitable organizations. Their main function is to make grants to other tax-exempt charities, like hospitals, soup kitchens, universities, and museums. However, private foundations are also permitted to make certain investments in for-profit ventures that are intended to benefit the public and that are generally too risky or provide too low return to entice private investors, known as “program related investments” or “PRIs.”

Private foundations in the United States have a tremendous wealth of assets that could be used for socially beneficial ventures. However, private foundations often avoid PRIs because the legal rules are complex, require extensive due diligence and oversight and impose significant risks to the foundation and its managers for non-compliance. Given the risk of legal non-compliance, private foundations that do enter into PRIs often seek IRS approval or a legal opinion beforehand, which can be expensive and time-consuming.

The concept behind the L3C was to incorporate the PRI rules into the legal framework of the L3C entity to avoid the need for a private foundation to obtain a legal opinion or IRS approval for a PRI and to reduce the risk of legal non-compliance. The objective was that L3Cs would make it easier and more attractive for private foundations to invest in for-profit ventures that produce a meaningful public benefit. To date, the IRS has not issued the formal guidance recognizing L3Cs that its founders hoped for, and there has been debate on whether there is a need for or meaningful advantages to L3Cs. However, in April of this year, the IRS released the first new guidance on PRIs in decades, which may give private foundations more confidence to invest in L3Cs and other PRIs.

Vermont was the first state to recognize L3Cs, followed by a handful of other states, and several more states have legislation pending to authorize L3Cs. Legislation authorizing L3Cs is generally enacted as an amendment to a state’s general limited liability company laws.

As a type of limited liability company, the L3C offers the same principal advantages as a traditional limited liability company—limited liability of its members, like a corporation, and flow-through taxation, like a partnership. Even in states whose laws do not authorize L3Cs, an L3C can qualify to do business as an LLC.

An L3C is generally required to satisfy three main criteria: (1) it must significantly further a charitable purpose as defined under the tax law; (2) its significant purposes may not include producing income or appreciating property; and (3) it may not conduct lobbying or political campaign activities. Despite the integration of charitable tax law requirements into the L3C structure, L3Cs do not qualify for tax exemption. However, unlike a tax-exempt charity, L3Cs are free to distribute the profits, after taxes, to investors.

A key advantage of L3Cs is that they may help attract capital for social ventures where the profit-making potential may be too low to entice investment by traditional private investors. Investments in an L3C may be in layers (or “tranches”). A private foundation could serve as an early investor, taking on riskier positions subordinated to other investors and with a lower rate of return, with the objective of advancing the charitable purposes of the venture rather than maximizing its investment return. With such initial capital from private foundations, an L3C may appear more stable and attractive to socially responsible investors and traditional private investors. These types of investors could then make a later stage investment that could be designed to provide a higher monetary rate of return than to the foundation.

Advantages and Disadvantages of Hybrid Entities

Despite the key elements that distinguish them from one another, there are certain advantages and disadvantages that are common to the various hybrid organizational models described above, and there are certain attributes these models share with both traditional for-profit and non-profit structures. Unlike a traditional for-profit corporation, any business that organizes

under any of these hybrid models is making a statement to its owners, directors, officers, employees, customers, and other stakeholders that it is driven by purposes that are broader than the single-minded pursuit of profit. Organizing under one of these forms may allow a company to more readily distinguish itself in a competitive marketplace, whether to attract consumers looking to make socially responsible or environmentally friendly purchases, or to attract investors, particularly one of the myriad new socially responsible investment vehicles. While in theory any company (including any for-profit enterprise) can choose to pursue any general or specific public benefit(s) without organizing as a hybrid entity, the various hybrid forms of organization are generally intended to offer board members and/or officers statutory protection to facilitate the pursuit of such benefit(s) without fear of liability in the event such pursuit jeopardizes or lowers shareholder returns.

Unlike non-profit or tax-exempt organizations, the hybrid entities described above are able to have private owners, raise capital and distribute profits to private persons, in addition to having the goal of achieving a social, environmental, or other public benefit(s). Unlike tax-exempt entities, hybrid entities are not constrained in how they can pay to attract and retain talent, and are not required to disclose executive compensation and other sensitive information to the public. Finally, the hybrid entities described above (other than the L3C) are not restricted from lobbying or prohibited from any political campaign donations or activities like tax-exempt charities. Free from such restrictions, these hybrid forms may sometimes be a better vehicle than a traditional non-profit to achieve certain socially beneficial and philanthropic goals.

However, these new hybrid models pose some risks as well. Perhaps the biggest risk is that there is currently a dearth of case law regarding these new forms of organization. This means there is very little to guide these companies, and their directors and officers, in their activities and decision-making, and in balancing the

public purpose(s) or benefit(s) of these organizations with their profit motives. Unlike more traditional for-profit and tax-exempt structures, which can in most respects draw from a wealth of case law for guidance, hybrid entities are new and untested, and there is not much case law in areas that would clarify or expand on the requirements and conditions for these hybrids. It is not entirely uncommon for new or novel forms of organization to be introduced and eventually become more broadly accepted. For example, the limited liability company (LLC) form of organization has become more widely adopted, and accepted, since its introduction in the late 1970s. However, the case law regarding LLCs is still not firmly or uniformly established, some 30-odd years after their inception, and, as a result, many institutional and other investors have still not fully embraced the LLC form. For similar reasons, established investors may shy away from funding new hybrid businesses, at least in significant amounts, until the case law is better developed.

While transparency may be key to ensuring the unique general or special purpose(s) of a hybrid entity are met on an effective and timely basis, it is possible that the assessment, reporting and/or disclosure requirements of the various hybrid forms may prove too subjective, expensive, and/or burdensome for many companies, or may outweigh the actual or perceived benefits of adopting one of these models.

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.

Conclusion

Existing legal constraints on for-profit and non-profit entities, coupled with market forces, are causing many states to revisit a binary or “either/or” approach to organizational structures. Various hybrid models, intended to offer characteristics of both for-profit and non-profit entities as well as provide a safe harbor for board decision-making that encompasses the interests of constituencies beyond a company’s shareholders, have been introduced in and approved by many states. However, there are key distinctions and differences among the various hybrid models, and no preferred approach has yet emerged. Organizing as a hybrid entity may offer some advantages, including the ability to distinguish and promote the company’s business and social purposes and objectives from other competing interests, which may facilitate the company’s fundraising efforts, enhance its marketing appeal and/or encourage greater customer loyalty. However, these models remain untested in comparison to more traditional or widely accepted forms of organization, such as the for-profit or non-profit corporation, or LLC.

At present, and much like their automotive counterparts, hybrid organizational forms may be most attractive to and have the greatest utility for early adopters—those who are passionate about advancing the cause and objectives of corporate social responsibility. That’s not to say it’s too early to get behind the wheel and drive one of these hybrids, but companies that do so would be well advised to chart their route ahead of time, and keep their eyes on the road.

Katherine R. Lofft and Purvi B. Maniar are members, and Tamar R. Rosenberg is an associate at Epstein Becker & Green, P.C.

Additional Resources

*For other materials on this topic,
please refer to the following.*

Business Law Today

The Single-Member Limited Liability
Company as Disregarded Entity
Now You See It, Now You Don't
By Daniel S. Kleinberger and Carter G.
Bishop
August 23, 2010