

THE ADEQUACY OF LLCs FOR SOCIAL ENTERPRISE

John Adgent*

In her essay, Professor Heminway identifies and outlines challenges faced by practitioners representing social enterprises, which she defines as financially rational businesses that focus their operations on public benefit.¹ However, as noted in her essay, definitions and understandings of social enterprise differ among commentators, organizations, and jurisdictions. As a result, Professor Heminway maintains that the law governing social enterprises encompasses areas of uncertainty that can produce professional responsibility challenges and increased transaction costs. Namely, according to Professor Heminway, these challenges often arise for social enterprises in the contexts of making decisions about entity formation and management. In response to Professor Heminway's essay, this comment discusses how these unique challenges associated with social enterprises could be reduced and perhaps avoided altogether with a familiar, traditional entity—the LLC. This comment first provides a brief overview of social enterprise to be of assistance in understanding the concept. Thereafter, this comment contends that the flexibility afforded by LLCs provides a means to address the challenges associated with entity formation and management for social enterprise. Finally, this comment notes some criticisms and possible drawbacks of using LLCs as a vehicle for social enterprise.

I. BRIEF OVERVIEW OF SOCIAL ENTERPRISE

Ordinarily, a precise definition is necessary to form a basis for understanding a concept. However, as noted by Professor Heminway, the concepts of social enterprise, social entrepreneurship, and impact investing are not well defined and, as a result, are largely misunderstood.² Similarly, the Social Enterprise Alliance acknowledges that defining social enterprise is difficult “in large part because the concept has been evolving

* John Adgent is scheduled to graduate from the University of Tennessee College of Law in 2019. The author was asked to provide a comment in response to Professor Joan MacLeod Heminway's CLE presentation, “Lawyering for Social Enterprise.”

¹ Abstract, Joan MacLeod Heminway, *Lawyering for Social Enterprise*, at 2.

² *Id.* at 1.

rapidly in recent years and increasingly blurs the lines of traditional business, government and non-profit sectors.”³ Nevertheless, synthesizing some frequently cited definitions helps to provide a general understanding to readers who are unfamiliar with the concept.

The Social Enterprise Alliance suggests a working definition for social enterprise as: “Organizations that address a basic unmet need or solve a social or environmental problem through a market-driven approach.”⁴ Professor Heminway uses the definition first provided above for social enterprise along with the definition of “businesses that exist to generate financial and social or environmental benefits.”⁵ Another commentator defines social enterprises as “businesses that intentionally impact societal good.”⁶ Furthermore, yet another definition of social enterprises is “those for-profit businesses whose primary objective is to make social impact and nonprofits that incorporate market-based, commercial strategies to achieve their mission.”⁷ As can be seen and as the name suggests, the various definitions of social enterprise focus on some form of advancement of a public, social, or environmental benefit or good. That is, “[i]t is commonly understood that social enterprises are businesses that generate positive social or environmental welfare in some sense.”⁸ Yet, some disagreement nevertheless remains as to what types of business sufficiently meet that common understanding.⁹ As a result, there are areas of uncertainty in the context of social enterprise that Professor

³ Social Enterprise, *Social Enterprise Alliance*, <https://socialenterprise.us/about/social-enterprise/> (last visited Jan. 10, 2019).

⁴ *Id.*

⁵ Abstract, *supra* note 2, at 1.

⁶ Alina S. Ball, *Social Enterprise Governance*, 18 U. PA. J. BUS. L. 919, 926 (2016).

⁷ *Id.* at 928 (citing Marc J. Lane, *Social Enterprise: Empowering Mission Driven Entrepreneurs* 7 (2011)).

⁸ Joan MacLeod Heminway, *Let's Not Give Up on Traditional for-Profit Corporations for Sustainable Social Enterprise*, 86 UMKC L. REV. 779 (2018).

⁹ Abstract, *supra* note 2, at 2 (“Although commentators agree that social enterprises exist to do well for shareholders by doing good things for society or the environment—i.e., for public benefit—they may disagree on the types of business that satisfy the ‘doing good things’ component of that basic definition of a social enterprise.”).

Heminway explains can present lawyering challenges and increased transaction costs in entity formation and management decisions.¹⁰

II. USING LLCs FOR SOCIAL ENTERPRISE

When considering the various entity structures, a key feature that draws social entrepreneurs to LLCs is a high degree of organizational flexibility.¹¹ The flexibility afforded by LLCs provides a means to achieve the goals of social enterprise while avoiding the uncertainty that accompanies other choices of entity in formation and management decisions.

A. Entity Formation

In the context of entity formation decisions, LLCs provide social entrepreneurs the benefit of simplicity in an otherwise complex process. One component of the complexity involved in the entity formation process in this context is that social enterprises can take a variety of forms. As Professor Heminway notes, social enterprises can take the form of a sole proprietorship, a partnership, limited partnership, a limited liability company, or a corporation.¹² Additionally, a social enterprise can be organized under the law of multiple jurisdictions as a non-profit organization or a for-profit organization.¹³ Another factor contributing to the complexity in the entity formation process for social enterprises is the availability of multiple for-profit organizational options.¹⁴ Some states permit social enterprises to organize as a non-profit corporation, a for-profit benefit corporation, or a traditional for-profit corporation. Notably, “B-Corp Certification” is also available by B-Lab, which is often used interchangeably with the term “benefit corporation” even though the terms refer to two distinct entity structures.¹⁵ This confusion is another

¹⁰ Abstract, *supra* note 2, at 1.

¹¹ Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 370–71 (2009).

¹² Abstract, *supra* note 2, at 3.

¹³ *Id.*

¹⁴ *Id.* at 4.

¹⁵ Kennan Khatib, *The Harms of the Benefit Corporation*, 65 AM. U. L. REV. 151, 173 (2015).

source of complexity in the social enterprise context. Moreover, other states offer social enterprises the option of organizing as a low-profit limited liability company, which is commonly known as a “L3C.”¹⁶ Thus, considering all of the options for organizing a social enterprise, Professor Heminway observes that making entity formation decisions has become more challenging as the “business entity selection matrix has recently gotten progressively complex. . . .”¹⁷ As a result, Professor Heminway asks how lawyers can provide ethically appropriate and valuable advice to clients in this environment, considering that rational legal analyses do not produce clear choices.¹⁸ However, the LLC may in fact provide a clear choice to answer that question.

The utility of the LLC as a vehicle for social enterprise is derived through simultaneously providing the advantages offered by other “traditional” entity choices¹⁹ while avoiding areas of uncertainty associated with “non-traditional” entity choices.²⁰ First, outside the context of social enterprise, LLCs provide the benefit of a hybrid legal form that achieves the dual aims of both a corporation and a partnership. LLCs are like corporations in the sense that their owners enjoy the protection of limited liability. Additionally, LLCs are like partnerships in the sense that they provide “practically unlimited organizational flexibility.”²¹ Moreover, LLCs are also comparable to partnerships for tax purposes by providing the benefit of pass-through taxation, rather than double taxation like a corporation. Pass-through taxation means that the income and expenses of the organization are reported and taxed as though the members incurred them directly, with no tax consequences at the entity level.²² Notably, these advantageous traits of LLCs outside the context of social enterprise remain present in the context social enterprise. As a result,

¹⁶ Kelley, *supra* note 12, at 371.

¹⁷ Abstract, *supra* note 2, at 5.

¹⁸ *Id.*

¹⁹ “Traditional” entity choices refers to those not designed specifically for purposes of social enterprise.

²⁰ “Non-traditional” entity choices refers to those designed specifically for purposes of social enterprise.

²¹ Kelley, *supra* note 12, at 370.

²² *Id.* at 370–71.

LLCs provide an attractive alternative to partnerships and corporations for social enterprises for the same reasons.

Next, LLCs also allow social entrepreneurs to avoid the uncertainty that accompanies non-traditional entity choices for social enterprise because LLCs are simply better established. LLCs were first introduced in the United States by Wyoming in 1977,²³ and by 1996 every state and the District of Columbia had passed limited liability statutes.²⁴ As a result, LLCs have the benefit of at least twenty-three years of case law interpreting their enabling statutes across every jurisdiction.²⁵ The significance of this case law is additional clarity on permissible conduct and guidance on what can be achieved with LLCs. Consequently, social enterprises organized as LLCs can operate confidently and efficiently to achieve their organizational goals and reduce transaction costs. Another benefit of LLC's well-establishment is recognition from investors. As a result, potential investors in a social enterprise would not be deterred due to unfamiliarity or experience with an LLC. To contrast by example, benefit corporation legislation was first adopted in Maryland in 2010,²⁶ and only thirty-four states have enacted benefit corporation legislation since that time.²⁷ Considering the shorter lifespan and lower popularity of benefit corporations, one could assume less availability of case law interpreting the enabling statutes for benefit corporations than for LLCs. Based on that assumption, social enterprises that choose to organize as benefit corporations may experience increased risks of operating their organizations with less certainty and guidance than with LLCs. Further, their organizations may operate inefficiently due to a lack of guidance and experience additional transaction costs as a result. Moreover, the novelty of benefit corporations could deter potential investors due to a lack of experience with that entity structure. Likewise, the L3C was first adopted

²³ WYO. STAT. ANN. § 17-15-101 (repealed 2010).

²⁴ Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1, n.1 (1997).

²⁵ Granted, partnerships and corporations also enjoy ample case law and significant popularity; however, LLCs may be more advantageous for the reasons discussed in the previous paragraph.

²⁶ Khatib, *supra* note 16, at 153.

²⁷ *State by State Status of Legislation*, B LAB, <http://benefitcorp.net/policymakers/state-by-state-status> (last visited Jan. 8, 2019).

by Vermont in 2008,²⁸ and B Lab provided the first B-Corp Certification in 2007.²⁹ Accordingly, similar issues may also arise for social enterprises that choose to organize as other non-traditional entity choices that are less established than the LLC. Therefore, by reducing the risks associated with uncertainty, LLCs are more appealing to social enterprises than the non-traditional alternatives. Thus, overall, lawyers can confidently advise clients on the sufficiency of LLCs for social enterprise when compared to both traditional and non-traditional entity choices.

B. Management

Another area of uncertainty that Professor Heminway identifies is associated with social enterprise management decisions that involve conflicts between the financial interests of investors and the social enterprise's mission.³⁰ Specifically, she focuses on the for-profit social enterprise context in which management must make decisions involving trade-offs between maximizing the financial wealth of the venture for its owners and serving the firm's missions.³¹ In determining those trade-offs, Professor Heminway states that corporate officers and directors risk transgressing statutory management mandates or breaching their fiduciary duties.³² Thus, similar to entity formation decisions, social enterprise management decisions present professional responsibility and professionalism challenges. Accordingly, counsel must exercise "reasoned discretion" to adequately assist clients in this context.³³ Yet, as with entity formation decisions, LLCs can again provide a solution. Specifically, the flexibility provided by LLCs provides a means to avoid the uncertainty and trade-offs associated with management decisions for social enterprises discussed by Professor Heminway.

As noted in the previous section, a key feature of LLCs is extreme flexibility. The source of the LLC's flexibility comes from the discretion afforded to its members to allocate organizational power in the

²⁸ VT. STAT. ANN. tit. 11, § 3001 (repealed 2014).

²⁹ *Frequently Asked Questions*, B LAB, <https://bcorporation.net/faqs> (last visited Jan. 8, 2019).

³⁰ Abstract, *supra* note 2, at 5.

³¹ *Id.*

³² *Id.* at 6.

³³ *Id.* at 6.

membership agreement.³⁴ Through the membership agreement, the members in LLCs have the ability to determine management powers, profits, and losses among themselves in any fashion they determine to be appropriate.³⁵ In the social enterprise context, this ability could be used by the LLC's members to address potential conflicts between investors' financial interests and the firm's mission. For example, if a social enterprise commits to a social outcome and also needs for-profit capital investment, the LLC can provide a means to bring those parties together.³⁶ The membership agreement can provide the for-profit investors with a larger share of the profits and the social benefit or nonprofit parties can retain control over the firm's management decisions.³⁷ Thus, both parties' interests are adequately addressed on the front-end in the membership agreement, reducing the risk of subsequent conflicts.

The LLC's flexibility can also provide a way to avoid the potential fiduciary duty issues mentioned by Professor Heminway. In Delaware for example, to the extent that a member or manager has duties to the LLC or to another member or manager, those duties may be expanded, restricted, or eliminated by provisions in the LLC agreement; provided, that the implied covenant of good faith and fair dealing may not be eliminated.³⁸ By expanding managers' fiduciary duties, a social enterprise formed as a LLC could enable management to operate the firm without having to make trade-offs involving the parties' interests. Instead, management could be placed under a duty to both maximize returns for investors and serve the firm's mission. In doing so, management could be permitted to consider the interests of internal and external parties of the firm in which case the firm would operate similar to a corporation formed under a constituency statute.³⁹ A drawback, however, could be a prolonged decision-making process on account of managers having to

³⁴ Kelley, *supra* note 12, at 370.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ DEL. CODE ANN. tit. 6, § 18-1101(c) (2013).

³⁹ Edward S. Adams & John H. Matheson, *A Statutory Model for Corporate Constituency Concerns*, 49 EMORY L.J. 1085 (2000) (“[Constituency] statutes transform the obligations of corporate directors by expanding the groups to which boards of directors are accountable in decisionmaking [sic], greatly impacting the management decisions of business firms.”).

consider multiple interests. As a result, this approach could lead to inefficiencies and additional transaction costs. Alternatively, a social enterprise formed as a LLC could also restrict or eliminate its managers' fiduciary duties of loyalty and care. The benefit of this approach would be that managers could operate the firm in a manner they view best to maximize returns while simultaneously advancing the firm's mission without the risk of a breach. The discretion afforded to the LLC's managers under this approach could provide social enterprises the benefit of increased efficiencies and reduced transaction costs. On the other hand, the members' ability to hold managers accountable to advancing the firm's mission would likely be undermined without the ability to bring claims for a breach of the fiduciary duties of loyalty or care. Notably, however, members would still retain the ability to bring claims for a breach of the implied covenant of good faith and fair dealing as that duty may not be eliminated. With these options in mind, a social enterprise should carefully examine the firm's goal in order to properly align the parties' interests. After doing so, a social enterprise could take advantage of the flexibility of the LLC to serve that purpose and avoid potential fiduciary duty issues.

II. CRITICISM OF USING LLCs FOR SOCIAL ENTERPRISE

Along with the advantages outlined above, there are also possible drawbacks of using LLCs as a vehicle for social enterprise. Some critics argue that LLCs do not address all of the practical and legal challenges faced by social enterprises. Specifically, LLCs are "generic" entities in the sense that they are employed in the market for a wide array of purposes in various types of business. As a result, LLCs may not assist social enterprises in creating a recognizable "brand" to distinguish their organizations from non-social enterprises.⁴⁰ Therefore, consumers may not be able to differentiate a social enterprise's products or services from those offered by a non-social enterprise as easily. Likewise, socially-conscious investors may have similar difficulty in identifying social enterprises suitable for investment. However, social enterprises could adequately address these potential issues with LLCs through initiatives to set themselves apart from ordinary businesses in the market. These initiatives could take the form of traditional marketing and advertising campaigns to help consumers identify their products and services. Additionally, capital investment could be encouraged through similar efforts. On balance, these drawbacks seem readily addressable with

⁴⁰ Kelley, *supra* note 12, at 371.

ordinary business practices. Therefore, the possible drawbacks of using LLCs for social enterprise do not appear to outweigh the benefits outlined above.

CONCLUSION

Considering the various entity structures available, LLCs provide a viable vehicle for social enterprises to address the areas of uncertainty identified by Professor Heminway. By encouraging the use of LLCs for social enterprise, practitioners could avoid the professional responsibility challenges and increased transaction costs associated with other alternatives. Additionally, from the perspective of a social enterprise client, LLCs are also appealing in the contexts of making decisions about entity formation and management. Regarding entity formation decisions, LLCs provide the advantage of being a popular, well-known structure with predictability. As a result, social enterprises formed as LLCs could provide a clear understanding of the capabilities of that structure without risking unfamiliarity with investors at the same time. As for management decisions, LLCs provide social enterprises the flexibility to address the interests of both investors as well as social benefit parties in the membership agreement to reduce potential conflicts. The LLC's flexibility also permits social enterprises to avoid possible fiduciary duty issues by expanding, restricting, or eliminating those duties as the parties deem appropriate. Finally, though the generic nature of LLCs may present some branding issues for social enterprises, the associated shortcomings do not seem to outweigh the benefits. Therefore, the LLC provides a traditional and familiar entity structure that could avoid the issues that accompany other entity choices for social enterprise.