Governance of the Social Enterprise: Structural and Operational Considerations

Darren B. Moore
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas
dmoore@bwwlaw.com
817.877.1088

DARREN B. MOORE
Bourland, Wall & Wenzel, P.C.
301 Commerce Street
Fort Worth, Texas

Phone: (817) 877-1088
Email: dmoore@bwwlaw.com
Twitter: @darrenbmoore
Blog: moorenonprofitlaw.com

Mr. Moore practices with Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represents individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Moore was born in Lubbock, Texas on December 11, 1973. He earned a B.A., cum laude, from Texas A&M University and his J.D., magna cum laude, from Baylor Law School where he served as Editor in Chief of the Baylor Law Review.

Mr. Moore was admitted to practice law in Texas in 2000 and before the United States District Court, Northern District of Texas and United States Tax Court in 2001. He is a member of the State Bar of Texas; Tarrant County Bar Association; American Bar Association (Business Law Section, Section of Taxation); College of the State Bar; and is a Fellow of the Texas Bar Foundation. He was named a "Rising Star" by Texas Super Lawyers from 2009 – 2013. Mr. Moore was selected as a "Top Attorney" in Nonprofit Law by Fort Worth, Texas magazine in 2013 and 2014.

Mr. Moore's practice focuses on representation of nonprofit organizations and social enterprises. Mr. Moore advises clients on a wide range of tax and legal compliance issues including organization of various types of nonprofit and social enterprise entities, obtaining and maintaining tax-exempt status, risk management, employment issues, governance, and other business issues, as well as handling IRS audits, attorney general investigations, and litigation matters on behalf of his exempt organization clients.

Mr. Moore is an adjunct professor at Baylor Law School where he has taught Nonprofit Organizations since 2001. He has been a guest lecturer at the University of Texas School of Law and Southern Methodist University Dedman School of Law on nonprofit organization topics. Additionally, he writes and speaks regularly on tax and legal compliance issues. Mr. Moore is co-author of the third edition of Bourland, Wall & Wenzel, P.C.'s publication, Keeping Your Church Out of Court.

TABLE OF CONTENTS

GOVERNANCE OF THE SOCIAL ENTERPRISE: STRUCUTRAL AND OPERATONAL CONSIDERATIONS

I. INTRODUCTION TO THE SOCIAL ENTERPRISE CONCEPT

The goal of this article is to introduce the social enterprise, highlight the structural and operational considerations to be analyzed in choosing the right form, and note the concerns to be addressed to put the organization in the position to pursue its income-generating strategies in a legally compliant manner.

A. DEFINING SOCIAL ENTERPRISE

An article setting out to look at structural and operational attributes of a social enterprise should first provide a definition for social enterprise. However, unlike offering a definition of "charitable organization" under federal tax law or "nonprofit corporation" under state business entity law, there is no agreed upon definition of "social enterprise" under federal law, state law, or even among practitioners and commentators. By way of example, and not by limitation, the following definitions are useful:

- "A social enterprise is any entity that uses earned revenue to pursue a double or a triple bottom line either alone (in a private sector or nonprofit business) or as a significant part of a nonprofit's mixed revenue stream that also includes philanthropic and government subsidies."[1]

- "Social enterprises are businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental, and human justice agendas. A social enterprise addresses an intractable social need and serves the common good, either through its products and services or through the number of disadvantaged people it employs. Its commercial activity is a strong revenue driver, whether a significant earned income stream within a nonprofit's mixture of new portfolio or a for-profit enterprise. The common good is its primary purpose, literally 'baked into' the organization's DNA and trumping all others."[2]

- Social enterprises are "business ventures that prioritize their social purpose(s), operate ethically, and promote democratic ownership and governance by primary stakeholders."[3]

- "A social enterprise can be viewed as one not motivated by profit, in that any profit motive takes a backseat to a mission centered on curing an acute social malady."[4]

- "Social enterprise [refers] to any business model that, to a significant degree, has a mission-driven motive."[5]

These disparate definitions bring to mind the story of the six blind men trying to describe an elephant by touching a different part of the elephant.[6] Because none could see the full picture, they could not agree on a definition. Rather than engage in a theoretical debate, for purposes of this article, the best explanation of

---

[1] *See* The Institute for Social Entrepreneurs, "*Social Enterprise Terminology*," available at www.socialent.org/Social_Enterprise_Terminology.htm (last visited July 15, 2016).
[2] *See* Social Enterprise Allowance, "*What's a Social Enterprise?*", available at https://socialenterprise.us/about/social-enterprise/ (last visited July 15, 2016).
[3] *See* Social Enterprise Europe, "*What is Social Enterprise*," available at www.socialenterpriseeurope.co.uk/what-is-social-enterprise (last visited July 15, 2016).
[4] MARK J. LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION DRIVEN ENTREPRENEURS, ABA Publishing (2011), at p.4.
[5] *Id*. at p. 7.
[6] *See Blind men and an elephant*, https://en.wikipedia.org/w/index.php?title=Blind_men_and_an_elephant&oldid=728921891 (last visited July 15, 2016).

"social enterprise" may well be that used by Justice Potter Stewart in seeking to avoid a fixed definition of pornography and simply offering "I know it when I see it."[7] Accordingly, some examples of social enterprise are useful.

B. I'LL KNOW IT WHEN I SEE IT: EXAMPLES OF SOCIAL ENTERPRISE

- Living Machine Systems: A leading provider of innovative and sustainable ecological wastewater treatment and reuse technology with multiple patents and clients as diverse as the United States Marine Corps and the National Audubon Society with products installed around the world.[8]

- New Belgium Brewing Co., Inc.: A Colorado brewery and the third largest craft brewer in the country (maker of Fat Tire beers) seeking to improve and measure its environmental sustainability using clean water, diverting its waste, and reducing its carbon footprint.[9]

- Puzzles Bakery and Café: A bakery in Schenectady, New York with a mission of improving the livelihood of individuals, families, and communities affected by autism spectrum disorders. The Bakery employs individuals with developmental disabilities to provide work in integrated settings with non-disabled colleagues, pays the same wages, and seeks to nurture compassion and understanding by exposing its community to individuals with disabilities.[10]

- Helping the Aging, Needy and Disabled, Inc. (H.A.N.D.): A social service provider in Austin, Texas seeking to provide exceptional, innovative care and support for those who need assistance with daily living while inspiring others to do the same. H.A.N.D. is a Section 501(c)(3) organization, allowing it to accept donations while also providing Medicaid services and private pay and sliding scale services for low income clients.[11]

- Aunt Bertha: A Delaware public benefit corporation based in Austin, Texas with a mission of making human services information accessible to people in programs. Aunt Bertha began with the idea that every person and family should have a place online where they can find help in a time of need. Aunt Bertha seeks to provide the country's most comprehensive online directory of social service organizations providing information to those needing social services and providing the social service organizations with tools and insights to provide the necessary services in the right places. Aunt Bertha is a certified B corp (a designation that will be discussed below).[12]

- Participant Media, LLC: An entertainment company producing feature films, television shows, and digital programs. It was founded by Jeffrey Skoll, one of the founders of eBay, with a purpose of creating entertainment to inspire and compel social change. Participant Media's filmography includes *Spotlight*; *Contagion*; *Lincoln*; *The Help*; *He Named Me Malala*; *The Look of Silence*; *CITIZENFOUR*; *Food, Inc.*; and *An Inconvenient Truth*. Participant Media's films have collectively earned 50 Academy Award® nominations and 11 wins.[13]

The examples provided above include small organizations to multi-national organizations, organizations working in social services to organizations working in the entertainment industry,

[7] *See Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964).
[8] *See* www.livingmachines.com/home.aspx (last visited July 14, 2016).
[9] *See* www.newbelgium.com/sustainabiltiy (last visited July 13, 2016).
[10] *See* www.puzzlesbakerycafe.com/about-us (last visited July 15, 2016).
[11] *See* www.handcentraltx.org (last visited July 13, 2016).
[12] *See* about.auntbertha.com/who-is-aunt-bertha (last visited July 13, 2016).
[13] *See* www.participantmedia.com/company-history (last visited July 16, 2016).

organizations operating in the nonprofit tax-exempt form to the benefit corporation form to the for-profit form. What ties these organizations together is their desire to put mission first. Because social enterprises can be so varied, the balance of this paper will discuss the various structural options and related issues.

II. UNDERSTANDING THE STRUCTURAL OPTIONS

A. NONPROFIT, FOR PROFIT, OR DUAL PURPOSE[14]

A number of organizational options may be used to accomplish mission-driven activities. This section of the article will introduce the primary options using Texas as its basis but noting where different forms may be available in other states.

B. THE NONPROFIT MODEL[15]

1. Nonprofit Corporations

a. Structure/Purpose

The nonprofit corporate form is available in all 50 states. Nonprofit corporations in Texas are governed by Chapter 22 of the Texas Business Organizations Code ("BOC").[16] The BOC defines a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation.[17] Income may be distributed to individuals performing services on behalf of the corporation in the form of salary as long as those salaries are reasonable and commensurate with the services rendered.[18] Nonprofit corporations in Texas may be organized for any lawful purpose, though to qualify for recognition of exemption the corporation must be organized with an appropriate purpose identified (e.g. religious, charitable, educational, etc. for purposes of organizations seeking recognition under Section 501(c)(3) of the Internal Revenue Code of 1986 [the "Code"]) and otherwise satisfy the requirements for exemption.[19] Pursuant to Chapters 2 and 22 of the BOC, nonprofit corporations have the ability to perpetually exist, to sue and be sued in their corporate name, purchase, lease, or own property in the corporate name, lend money (so long as the loan is not made to a director), contract, make donations for the public welfare, and exercise other powers consistent with their purposes.[20] While having extensive powers, nonprofit corporations remain internally flexible with the power to amend their operations and purposes through board (or member) action. Although nonprofit corporations in Texas do not have shareholders, they may have one or more members which operate to control the organization in a way analogous to for-profit shareholders.[21]

---

[14] For purposes of this article, entities that have a dual purpose of profit and some societal benefit will be referred to as "dual purpose" entities. Some commentators refer to these entities as "hybrid" entities. To avoid confusion between these entities and hybrid situations where a nonprofit is working in conjunction with a for-profit (in some sort of joint venture, for example), the term "dual purpose" will be used throughout.

[15] This section of the article highlights legal forms most often used and thus will not address certain organizational forms rarely used for social enterprise activities such as a tax-exempt nonprofit unincorporated association, tax-exempt charitable trust, nonexempt nonprofit corporation, and various forms of partnerships.

[16] *See* Tex. Bus. Orgs. Code § 22.001 et. seq.

[17] *See id.* § 22.001(5).

[18] *See id.* § 22.054(1).

[19] *See* Treas. Reg. §1.501(c)(3).

[20] *See id.* §§ 2.001-002, 2.101-102, 3.003 and 22.054.

[21] *See id.* § 22.101.

b. Control/Fiduciary Duties

A nonprofit corporation is controlled by its board of directors unless it has one or more members and chooses to be member-managed.[22] The board of directors is elected by its member(s) (if the organization has one or more members) or is self-perpetuating.[23] While the power to act for the organization is typically vested in a board of directors acting collectively, each director owes certain fiduciary duties to the organization.[24] A fiduciary duty is simply a duty to act for someone else's benefit while subordinating one's personal interests to that of the other person.[25] Fiduciary law, including that applicable to corporate directors, has largely developed at common law with various aspects subsequently codified in state trust and corporate statutes.[26] In the charitable context, directors owe fiduciary duties to the corporation they serve and to the public in charity (though not to individual stakeholders).[27] Charitable fiduciaries stand in the unique position of being the keeper of the organization's assets and the guardian of the organization's mission. This unique role plays itself out in the duties of care, loyalty, and obedience.

With respect to nonprofit directors, the duty of care generally obligates the decision maker to act (1) in good faith, (2) with ordinary care, and (3) in a manner he or she reasonably believes to be in the best interest of the corporation.[28]

The law rarely seeks to define "good faith" in the context of fiduciaries. Broadly, the term describes "that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation."[29] In claims for legal malpractice, for example, "good faith" is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances.[30] Thus, at least in the context of legal malpractice (which bears many similarities to breach of fiduciary duty), good faith is measured objectively based on objective facts. "Good faith" can, however, be contrasted with "bad faith." One court has stated that a fiduciary acts in bad faith when the fiduciary acts out of a motive of self-gain.[31] Certainly bad faith would also include an intent to affirmatively do harm to the organization. As a result, good faith would include putting the good of the organization first and seeking to affirmatively benefit the organization.

"Ordinary care" requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances.[32] Where the director has a special expertise (e.g., accounting expertise, legal expertise, etc.), ordinary care means that degree of care that a person with such expertise would exercise in the same or similar circumstances. To satisfy her duty to use ordinary care, the director should be reasonably informed with respect to the decisions she is required to make. A director may delegate decisions (including investment decisions) if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation.[33]

---

[22] *See id.* § 22.202; some states provide for nonprofit corporation issuance of stock which acts as a control mechanism similar to membership.
[23] *See* Tex. Bus. Orgs. Code § 22.206.
[24] *See, e.g., Ritchie v. Rupe*, 443 S.W.3d 856, 868 (Tex. 2014); Tex. Bus. Orgs. Code § 22.221.
[25] *See* BLACK'S LAW DICTIONARY 625 (6th ed. 1990).
[26] *See* Elizabeth S. Miller, *Fiduciary Duties Arising Out of Business Relationships: Overview of Fiduciary Duties, Exculpation, and Indemnification in Texas Business Organizations*, State Bar of Texas 10th Annual Fiduciary Litigation Course (Dec. 2015), at 1.
[27] *See* Tex. Bus. Orgs. Code § 22.221.
[28] *See, e.g., id.* § 22.221(a).
[29] *See* BLACK'S LAW DICTIONARY 693 (6th ed. 1990).
[30] *See Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989).
[31] *See Bohatch v. Butler & Binion*, 905 S.W.2d 597, 602 (Tex. App.—Houston [14th Dist.] 1995) *aff'd* 977 S.W.2d 543 (Tex. 1998).
[32] *See Gearhart Industries, Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 720 (5th Cir. 1984).
[33] *See* Tex. Bus. Orgs. Code § 22.224.

In discharging the duty of care, it is common for state law (as in Texas) to provide that a director may rely in good faith on information, opinions, reports, or statements, including financial statements or other financial data, concerning the corporation or another person that was prepared or presented by officers, employees, a committee of the board of which the director is not a member, or, in the case of religious corporations, (1) a religious authority; or (2) a minister, priest, rabbi, or other person whose position or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented.[34] While a director may rely on the counsel of advisers, the director must nevertheless exercise her own independent judgment in making decisions as to what is in the corporation's best interests. Professionals serving as decision makers, such as attorneys and CPAs, should note that the ability to rely in good faith on others as referenced above will not apply where the professional/decision maker is the source of the information, opinion, report, or statement.[35]

Finally, decision makers must make decisions they reasonably believe to be in the best interest of the organization—a task that links the duty of care to the duty of loyalty discussed below. Reasonableness is based on the objective facts available to the decision maker—not simply what the individual knows but what she should have known as well. Determining whether a proposed action is in the best interest of the corporation requires weighing of many factors, including the short-term interests, the long-term interests, the costs, the benefits, etc.

Decision makers of nonprofit corporations generally have the protection of the business judgment rule so long as those persons exercise their best judgment in making decisions on behalf of the organization.[36] The business judgment rule rests on the concept that to allow a corporation to function effectively, "those having managerial responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of facing liability for an honest error in judgment."[37] In addition to protection of the business judgment rule, Texas law allows for a corporation (nonprofit or for-profit) to eliminate director liability in all but limited circumstances in its certificate of formation.[38] As Professor Elizabeth Miller, a leading commentator on fiduciary law in Texas, has noted, "assuming the standard of liability for a breach of the duty of care is simple negligence [some ambiguity exists with respect to this], this provision obviously provides meaningful protection from liability for such negligence."[39]

The duty of loyalty requires that a director act for the benefit of the organization and not for her personal benefit, i.e. the duty of loyalty requires undivided loyalty to the organization.[40] As the Texas Supreme Court has stated, the duty of loyalty requires an "extreme measure of candor, unselfishness, and good faith."[41] To satisfy her duty of loyalty, a corporate decision maker must look to the best interest of the organization rather than private gain. The director must not usurp corporate opportunities for personal gain, must avoid engaging in interested transactions without board approval, and must maintain the organization's confidential information.

An opportunity properly belongs to the corporation where the corporation has a "legitimate interest or expectancy in and the financial resources to take advantage of" the particular opportunity.[42] Where the

---

[34] *See, e.g.,* Tex. Bus. Orgs. Code §§ 3.102, 22.222.
[35] *See id.* § 3.102(a)(6), (b).
[36] For an overview of the business judgment rule, *see Sneed v. Webre*, 465 S.W.3d 169, 173 (Tex. 2015).
[37] *See* MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY, 3d Ed. 113 (2007) (citing *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973)).
[38] *See* Tex. Bus. Orgs. Code § 7.001.
[39] *See* Miller, *supra* note 26 at 6.
[40] *See Imperial Group (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 865 (Tex. App.—Tyler 1986, writ ref'd n.r.e.).
[41] *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963).
[42] *See, e.g., Landon v. S&H Marketing Group, Inc.*, 82 S.W.3d, 666, 681 (Tex. App.—Eastland 2002, no pet.).

opportunity properly belongs to the entity, the fiduciary has an obligation to disclose the opportunity and offer the opportunity to the corporation.[43] The decision maker accused of usurping a corporate opportunity can raise three primary defenses (in addition to simply denying the factual basis of the claim): (1) the entity lacked the financial resources to pursue the opportunity; (2) the entity abandoned the opportunity; or (3) the opportunity constituted a different line of business than that pursued by the entity.[44] Importantly, the fiduciary bears the burden to show abandonment or lack of financial ability.[45]

A common transaction implicating the duty of loyalty is the interested transaction, broadly characterized as a contract between the corporation and a decision maker. In the corporate context, a director is "interested" if he or she (a) makes a personal profit from the transaction with the corporation; (2) buys or sells assets of the corporation; (3) transacts business in the director's capacity with a second corporation of which the director has a significant financial interest; or (4) transacts corporate business in the director's capacity with a member of his or her family.[46] In Texas, interested transactions between corporate fiduciaries and their corporations are presumed to be unfair on the part of the director, fraudulent on the corporation, and are thus generally voidable.[47] Texas law, as well as the majority of states, provides a safe harbor of sorts for interested transactions similar to that found in standard conflict of interest policies. Where the material facts are disclosed and a majority of the disinterested directors, in good faith and the exercise of ordinary care, authorize the transaction, the transaction is not void or voidable solely because of the director's interest or the director's participation in the meeting at which the transaction is voted on.[48] Further, such a transaction will not be void or voidable if it is fair to the corporation when it is authorized, approved, or ratified by the board.[49] However, a transaction from which a corporate fiduciary derives personal profit is "subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about."[50] Significantly, if there has been no approval after full disclosure, the transaction is presumed unfair and the director bears the burden to show fairness. Factors considered in evaluating the fairness of a transaction include "whether the fiduciary made a full disclosure, whether the consideration (if any) is adequate, and whether the beneficiary had the benefit of independent advice."[51]

Finally, the duty of loyalty requires a decision maker to maintain confidentiality and therefore prohibits disclosure of information about the corporation's business to any third party, unless the information is public knowledge or the corporation gives permission to disclose it.

A third duty is often (though not always separately) recognized – the duty of obedience.[52] The duty of obedience is the duty to remain faithful to and pursue the goals of the organization and avoid *ultra vires* acts.[53] In practice, the duty of obedience requires the decision maker to follow the governing documents of the organization, laws applicable to the organization (including reporting and regulatory requirements), and restrictions imposed by donors. The duty of obedience thus requires that decision makers see that the corporation's purposes are adhered to and that charitable assets are not diverted to non-charitable uses. There continues to be scholarly debate regarding the duty of obedience and whether it should be separately identified as a distinct fiduciary duty. The American Law Institute's Principles of Law of Nonprofit

---

[43] *See id.*
[44] *See id.*
[45] *See id.*
[46] *See Loy v. Harter*, 128 S.W.3d 397, 407-08 (Tex. App.—Texarkana 2004, pet. denied).
[47] *See General Dynamics v. Torres*, 915 S.W.2d 45, 49 (Tex. App.—El Paso 1995, writ denied).
[48] *See, e.g.,* Tex. Bus. Orgs. Code § 22.230.
[49] *See id.*
[50] *See Holloway*, 368 S.W.2d at 577.
[51] *See Miller v. Miller*, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.).
[52] *See, e.g.*, Johnny Rex Buckles, *How Deep are the Springs of Obedience Norms that Bind the Overseers of Charities?*, 62 Cath. U. L. Rev. 913 (2013).
[53] *See* Tex. Bus. Orgs. Code § 20.002; *see also Governing Bd. v. Pannill*, 561 S.W.2d 517, 524-25 (Tex. App.—Texarkana 1977, writ ref'd n.r.e.).

Organizations decline to separately identify the duty of obedience.[54] However, those Principles recognize the concepts widely understood to be concepts of obedience (e.g., following the law, fidelity to the purposes of the corporation, following gift restrictions) as applicable components of the duties of care and loyalty.[55] Although case law is limited with respect to specific discussion of the duty of obedience, decision makers are well-advised to understand and appreciate the duty of obedience if for no other reason than because the charity regulators, charged with enforcing nonprofit director compliance with fiduciary norms, often recognize the duty.[56]

Enforcement of the duty of obedience is somewhat unique to the nonprofit context and particularly tax-exempt organizations. Because tax exemption rests in the first part on being organized for an appropriate tax-exempt purpose (be it charitable or social), these organizations more specifically identify their purposes in their governing documents compared to a for profit business which may be organized to conduct all lawful operations of whatever kind or nature or all lawful business. One court has noted the distinction stating that "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization."[57] With the additional level of specificity as to purpose, the decision maker faces a more defined realm of permissible actions and thus more opportunity to make decisions that are *ultra vires*. That realm can be even more narrowly defined when funds are raised for specific purposes.

c. Federal Tax Issues

Nonprofit corporations are taxable entities under federal tax law unless they qualify for recognition of exemption.[58] While there are limited exceptions to the filing requirement related to recognition of exemption, most nonprofit corporations will file Form 1023 seeking to obtain recognition of their Section 501(c)(3) status.[59] The nonprofit corporation must show that it is organized and operated exclusively [defined under the Treasury Regulations as primarily] for appropriate exempt purposes (religious, charitable, scientific, educational, etc.), must prohibit its assets from inuring to the benefit of insiders, and must avoid substantial lobbying and political intervention.[60] A nonprofit corporation will be organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities which are not in furtherance of one or more exempt purposes.[61] To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose.[62] Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the nonprofit corporation will be distributed for exempt purposes or to the federal government, or to a state or local government, for a public purpose.[63] Details regarding the operational test in the context of a nonprofit corporation pursuing social enterprise activities are set out below at II.B.2.

Once recognition of exemption has been achieved, a nonprofit corporation will be exempt from payment of federal income taxes and will be eligible to receive donations that are deductible to the donor with such deductibility based on the private foundation/public charity status of the nonprofit corporation,

---

[54] *See* PRINCIPLES OF THE LAW OF NONPROFIT ORGANIZATIONS, § 300, cmt. (g)(3) (American Law Institute).
[55] *See id.*
[56] *See, e.g.*, John W. Vinson, *The Charity Oversight Authority of the Texas Attorney General*, 35 St. Mary's L. J. 243, 272-73 (2004).
[57] *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999).
[58] *See* 26 U.S.C. § 11(a) (hereinafter referenced as "IRC").
[59] *See* IRC § 508(a).
[60] *See id.* § 501(c)(3).
[61] *See* Treas. Reg. § 1.501(c)(3)-1(b)(1)(i).
[62] *See id.* § 1.501(c)(3)-1(b)(4).
[63] *See id.*

the donor's adjusted gross income, the amount of the donation, and whether the donor itemizes his or her deductions.[64]

d. State Tax Issues[65]

Nonprofit corporations, as filing entities under the BOC, are subject to the Texas Margin Tax, a tax on an entity's revenue less the greatest of: (a) total revenue times 70%; (b) total revenue minus cost of goods sold; (c) total revenue minus compensation; or (d) total revenue minus $1 million.[66] However, if the nonprofit corporation obtains recognition of exemption under Section 501(c)(3), it qualifies for exemption from the Margin Tax and must simply apply by filing Form AP-204 along with a copy of its federal determination letter with the Texas Comptroller.[67]

2. Tax Exemption Issues

a. Operational Test

As referenced above, to qualify for tax-exemption under Section 501(c)(3), a nonprofit corporation must satisfy an operational test. For purposes of the operational test, an organization must show that it is (or shall be) operated exclusively (read: primarily) for exempt purposes.[68] Said differently, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of such exempt purposes specified in the relevant section of the Code.[69] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.[70] The purpose(s) of the organization must be closely evaluated to determine if they are exempt or if they are non-exempt, and if non-exempt, whether the non-exempt purpose is substantial. A single nonexempt purpose, if substantial, destroys eligibility for exemption.[71] In determining whether an organization is operated to further a substantial nonexempt purpose, the decision maker looks to the purposes furthered by an organization's activities rather than the nature of those activities.[72] As one court noted, "[u]nder the operational test, the purposes towards which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a)…[I]t is possible for … an activity to be carried on for more than one purpose … [T]he critical inquiry is whether … [an organization's] primary purpose for engaging in its … activity is an exempt purpose ... ."[73]

Nonprofit corporations operating as social enterprises must concern themselves with demonstrating the nexus between their business activities and the accomplishment of their exempt purposes. The fact that an organization engages in a trade or business does not result in denial of tax-exempt status if the trade or business is in furtherance of such organization's exempt purposes.[74] The question is whether the trade or

---

[64] *See* IRC § 170.
[65] State income taxes (where they exist), property taxes, and other state taxes of course vary from state to state. This article will not seek to analyze those variations. Because the author is a Texas practitioner, and because Texas is unique in its state taxes, those tax rules will be discussed.
[66] *See* Tex. Tax Code §§ 171.001(a), 171.1011; certain exceptions apply to the imposition of the Texas Margin Tax that are not applicable to this discussion. For example, where all owners of a general partnership are natural persons, the general partnership will not be subject to the Texas Margin Tax. Where an entity is involved (such as is discussed in this article), each of the entity types is subject to the Texas Margin Tax.
[67] *See id.* § 171.063(a)(1).
[68] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1).
[69] *See id.*
[70] *See id.*
[71] *See id.*; *Better Business Bureau*, 326 U.S. 279, 283 (1945).
[72] *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 356-357 (1978).
[73] *Id*.
[74] *See* Treas. Reg. § 1.501(c)(3)-1(e)(1).

business is pursued in furtherance of the organization's purposes. If the trade or business is unrelated to the organization's purposes (i.e. not pursued in furtherance of those purposes) and is a substantial activity, the organization would not be entitled to exemption.[75] This primary purpose test as it relates to the conduct of a trade or business is further influenced by the commerciality doctrine below.

b. Private Benefit

The Regulations further provide that to be operated for one or more exempt purposes the organization must serve a public rather than a private interest.[76] An organization will be found to primarily serve a private interest as opposed to a public interest unless the private interest served is merely incidental to the public interest.[77] Whether the private interest is incidental to the public interest is determined on a case-by-case basis depending upon the nature of the activities undertaken and the manner by which the public interest is derived.[78] Any private interest must be incidental to the public interest both quantitatively and qualitatively.[79] To be qualitatively incidental, "the private benefit must be a necessary concomitant of the activity which benefits the public at large; in other words, the benefit to the public cannot be achieved without necessarily benefiting certain private individuals."[80] To be quantitatively incidental, the activity must not provide a substantial benefit to a private person in the context of the overall benefit conferred by the activity to the public.[81] For example, with respect to educational organizations, the dissemination of information and/or training of individuals serve a public interest by increasing the capabilities of those receiving instruction which thereby serves to better the public welfare. Although all educational activities result in private benefit (i.e. students at any school at any level are necessarily benefited), such private benefit is incidental; the ultimate benefit is to the public absent the educational focus being to train students for a single employer.

c. Private Inurement

Within this broad concept of a prohibition on private benefit is the doctrine of private inurement. The private inurement doctrine is meant to ensure that a tax exempt organization's "insiders" (i.e. persons in a position to influence the organization's affairs) do not use such position to siphon off any of a charity's income or assets for personal use. Common cases of private inurement revolve around payment of excessive compensation, certain rental arrangements, certain lending arrangements, and the sale of assets for more than fair market value to the organization.

There is an absolute prohibition on allowing assets to inure to the benefit of the organization's insiders.[82] "Insiders" include the organization's founders, directors, officers, key employees, and members of the families of these individuals, as well as certain entities controlled by these individuals.[83] If such action occurs, the Service may revoke the organization's tax exempt status.[84] However, as an alternative measure in the context of public charities and social welfare organizations, the Service can impose intermediate sanctions, which excise taxes assessed directly against the insiders and other decision makers who approved the transaction in question.[85] For example, if an insider were paid an excessive salary, rather

[75] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1).
[76] *See* Treas. Reg. § 1.501(c)(3)-1(d)1(ii).
[77] *See* GCM 37789, (12/18/78).
[78] *See* GCM 38459, (7/31/80).
[79] *See* GCM 37789, (12/18/78).
[80] *See id.* (referencing Rev. Rul. 70–186, 1970-1 C.B. 128); *see also* Ltr. Rul. 9615030 (1996).
[81] *See* Rev. Rul. 72–559; Rev. Rul. 73–313.
[82] *See* Treas. Reg. § 1.501(c)(3)-1(c)(2).
[83] The concept of "insider" for inurement purposes includes disqualified persons identified under § 4958(f)(1) for purposes of the intermediate sanction rules but an "insider" for inurement purposes more broadly includes others who because of a unique position have the ability to influence or control the organization. *See American Campaign Academy v. Comm'r*, 92 T.C. 1053 (1989).
[84] *See* Treas. Reg. § 53.4958-8(a).
[85] *See* IRC § 4958.

than revoke the organization's tax exempt status (which would be within the purview of the Service), an excise tax sanction could be assessed against the insider in the amount of twenty-five percent (25%) of the excess benefit (which, if not corrected in a timely manner, will result in a second tier tax of two hundred percent (200%) of the excess benefit) as well as excise tax in the amount of ten percent (10%) of the excess benefit (not to exceed $20,000.00) imposed against decision makers of the charity who knowingly participated in the transaction.[86]

d. Commerciality Concerns

While it is well-recognized that unrelated business activities can generate unrelated business taxable income and potentially risk exempt status, even related business activities can at times prove problematic. Where the related business is undertaken in a way the Service deems to have a "distinctively commercial hue," the organization may risk its exempt status.[87] The terminology of an organization having a "distinctively commercial hue" is most often referenced in the context of the commerciality doctrine – a non-Code doctrine examining whether an organization operating a business is truly doing so in furtherance of an exempt purpose.[88] Clearly, the concept of a charitable organization operating with a commercial hue is troubling for charities engaging in social enterprise activities which are, by their nature, revenue driven.

The commerciality doctrine uses a counterpart analysis looking at factors such as whether the organization sells goods and services to the public for a fee, whether the organization is "in direct competition" with for-profit organizations, whether the organization set prices based on pricing formulas common in the industry, whether the organization utilizes promotional materials normally utilized by for-profit organizations, whether the organization advertises its services in a commercial manner, whether the organization has activities and hours that are basically the same as for-profit enterprises, how the organization calculates payment for its management, and whether the organization receives charitable contributions.[89]

For example, in *Easter House v. United States*, the Court of Claims considered qualification for exemption of an adoption agency.[90] After reciting the operational test, the court noted that "the key to determining whether an organization, which at first blush might appear to be engaged in commercial activities that would disqualify it from exemption under section 501(c)(3), is qualified for exemption is whether the business purpose of the activities is incidental to the charitable purpose or vice versa."[91] In agreeing with the Service and finding that the business purpose was primary, the court noted the agency's competition with commercial adoption agencies, the accumulation of substantial profits, a fee schedule intended to derive a profit, and a lack of any support from solicitations.[92]

Likewise, in a case frequently cited in the commerciality area, the Seventh Circuit Court of Appeals affirmed the determination of the Service and the holding of the Tax Court in holding that an organization operating restaurants and health food stores ostensibly for the purpose of furthering the religious work of the Seventh-Day Adventist Church did not qualify for exemption.[93] There, the court explained that in considering the effect of substantial commercial purposes on qualification for exemption, a court looks to "various objective indicia" including the "manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of

[86] *See* IRC § 4958(a)(1); (d)(2).
[87] *See, e.g., Airlie Foundation v. IRS*, 283 F. Supp. 2d 58 (D.D.C. 2003).
[88] For an in-depth look at the commerciality doctrine, *see generally* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS, § 4.11 (John Wiley & Sons, Inc., 11th ed. 2011).
[89] *See, e.g., Living Faith, Inc. v. Commissioner*, 950 F. 2d 365 (7th Cir. 1991).
[90] 12 Cl. Ct. 476 (1987).
[91] *See id.* at 484.
[92] *See id.* at 485-486.
[93] *See Living Faith, Inc.*, 950 F. 2d at 376-77.

annual or accumulated profits … ."[94] The Seventh Circuit noted that the entity was in direct competition with other restaurants, had a price structure set competitively with other businesses and a lack of any below-cost pricing, used promotional materials to enhance sales, and lacked any plans to solicit contributions.[95] Noting that the corporation did not accumulate net profits, the court considered that but one factor that was outweighed by the other "indicia" of commerciality.[96]

In *Airlie Foundation v. I.R.S.*, the District Court for the District of Columbia agreed with the Service that the subject organization failed to qualify for exemption as its activities evidenced a primary commercial purpose.[97] The organization was organized for educational purposes and carried out its mission through organizing, hosting, conducting, and sponsoring educational conferences.[98] The organization additionally provided certain administrative support for environmental studies conducted at its facility.[99] In clearly setting out the commerciality doctrine, the court stated that "[i]n cases where an organization's activities could be carried out for either exempt or nonexempt purposes, courts must examine the *manner* in which those activities are carried out in order to determine their true purpose."[100] The court analogized the facts in *Airlie* to the organization in *BSW Group* noting that the organization did not directly benefit the public (rather, it benefited other organizations that benefited the public) and did not limit its activities to tax-exempt organizations.[101] The court balanced the fact that the entity's fee structure and willingness to subsidize certain attendees (both indicative of a non-commercial purpose) against the nature of the entity's clients (both taxable as well as tax-exempt), competition with commercial organizations, advertising expenditures, and significant revenues derived from weddings and special events, ultimately determining that the entity was organized for a substantial commercial purpose.[102]

What is, perhaps, most concerning about these commerciality doctrine cases is their inconsistency in recognizing the nexus between the commercial activity and the exempt purpose. The Tax Court has made clear that in determining whether an organization is operated to further a substantial non-exempt purpose, the decision maker (IRS or court) is to look to the purposes furthered by an organization's activities rather than the nature of those activities.[103] The commerciality doctrine, in looking at the manner in which an organization carries out its activities in order to determine purpose, sets up a logical fallacy where purpose is the lens through which activities are viewed, yet those same activities somehow serve as an indication of purpose.[104] This circular argument is exemplified by the decision in *Living Faith* where the court initially noted that it must "focus on 'the purposes toward which an organization's activities are directed,' and not the nature of the activities" but subsequently stated that "[a]n organization's activities … determine entitlement to tax exemption," and that "[w]hile 'the inquiry must remain that of determining the purpose to which the … business activity is directed,' the activities provide a useful indicia of the organization's purpose or purposes."[105]

This type of ambiguity creates uncertainty and can lead to disparate results. No clear guidance exists to allow an organization comfort that its operations will show that its charitable or other exempt purpose trumps profit-making. Indeed, in the hospital context (another situation in which taxable and tax-exempt organizations exist in the same space), Congress enacted Section 501(r) setting forth specific areas

---

[94] *See id.* at 372.
[95] *See id.* at 373-374.
[96] *See id.* at 374.
[97] 283 F. Supp. 2d 58 (D.D.C. 2003).
[98] *See id*. at 60.
[99] *See id.*
[100] *See id.* at 63 (emphasis in original).
[101] *See id.* at 65.
[102] *See id.*
[103] *See B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352 (1978).
[104] *See* Edward T. Chaney, "*Commerciality, Charter School Management Organizations, and Social Enterprise*," 27 Exempts 5, page 3 (Mar/Apr 2016).
[105] *Living Faith, Inc.*, 950 F. 2d at 370, 372.

for hospitals to provide demonstrable evidence that charitability trumps profit.[106] Outside of the hospital context, however, exempt organizations are left with the commerciality doctrine, discussions of a "commercial hue," and trying to ascertain indicia of commerciality. Rather than exist in this state of unknown, organizations at risk of violating the commerciality doctrine may choose to spin such activities off into a taxable subsidiary or related organization to avoid such risk and entrepreneurs may choose to eschew the nonprofit form in favor of a for profit or dual purpose option.

While the commerciality doctrine is not new, the continuing increase in charitable organizations seeking sustainability through commercial activities or seeking to operate as social enterprises has given the commerciality doctrine increased exposure. While greater license may be given to tax-exempt organizations operating social enterprise subsidiaries, it would be unwise to ignore the application of the commerciality doctrine altogether in this context.[107] There is a clear tension that exists between a doctrine that seeks to define charity as acting in a non-commercial manner and the idea of social enterprise where charitable purposes are achieved directly through commercial activities. Because the commerciality doctrine is court-created rather than legislatively crafted, no bright line or safe harbor exists to guide the charitable entrepreneur.

C. FOR-PROFIT OPTIONS

1. For-Profit Corporation

a. Structure/Purpose

All 50 states provide for the creation of a for-profit corporation. Standard business corporations in Texas may be formed under Texas law for any lawful purpose or purposes (unless otherwise provided by the BOC).[108] For-profit corporations are governed by Chapter 21 of the BOC.[109] Like nonprofit corporations, for-profit corporations have the ability to perpetually exist, sue and be sued in their corporate name, purchase, lease or own property in the corporate name, lend money, contract, and exercise other powers consistent with their purposes.[110] Once the corporation has been created through filing a certificate of formation with the Texas Secretary of State's office, a corporate liability shield protects the owners.[111] Through the BOC and the development of Texas case law, the laws regarding the operation and management of corporations are well established and provide a relatively clear operational structure for the entity. Texas statutory law with respect to corporations was modified in 2013 to provide that a for-profit corporation may include one or more social purposes in addition to the purpose or purposes required to be stated in the corporation's certificate of formation.[112] This Texas manifestation of a "social purpose corporation" will be discussed at II.D.3 below.

b. Control/Fiduciary Duties

For-profit corporations are controlled through owning a majority of the stock in the corporation.[113] Within the for-profit context, the shareholders elect the board of directors.[114] As a result, the shareholders,

---

[106] *See* IRC § 501(r).

[107] *See, e.g., Council for Bibliographic and Information Technologies v. Commissioner*, T.C. Memo 1992-364 (ignoring the Service's arguments concerning the commercial hue of certain activities noting that the organization at issue was formed by and controlled by a tax-exempt organization). In addition to the fact that the organization was formed by a tax-exempt organization, it should not be overlooked that the organization was providing services that the court viewed as necessary and indispensable exclusively to tax-exempt organizations.

[108] *See* Tex. Bus. Orgs. Code §§ 2.001; 2.003; 2.007.

[109] *See id.* § 21.001 *et seq.*

[110] *See id.* § 2.101.

[111] *See id.* § 21.223.

[112] *See id.* § 3.007(d).

[113] Unlike S corporations, a C corporation may have multiple classes of stock to effectuate control.

[114] *See* Tex. Bus Orgs. Code § 21.405.

unless the corporation is managed by its shareholders, will not have direct involvement either in the governance decisions or in the day-to-day operations.[115] Rather, the input into those matters is accomplished through the election of the board.[116] The board then generally elects officers to handle the day-to-day operations of the corporation.[117] Of course, the same individuals may be owners, directors, and officers and, in effect, wear three different hats. Despite the existence and role of shareholders, directors continue to owe fiduciary duties only to the corporation.[118] The common law fiduciary duties of for-profit corporate directors are the same as those of nonprofit corporate directors—care, loyalty, and obedience.[119]

The application of the duty of care in the for-profit context is not clearly defined. Nevertheless, it is safe to assume that a for-profit corporate director's duty of care will require the individual to act in good faith, using due care, and looking to the best interest of the organization.[120] Because of the strength of the business judgment rule in Texas and the ability to eliminate director liability for duty of care violations, there are few cases discussing the actual parameters of the duty of care. Rather, most of the cases in this area discuss the limits of the business judgment rule.[121] In that respect, there is some ambiguity as to whether the business judgment rule in Texas protects against negligent decision making or goes so far as to protect against grossly negligent conduct.[122] In a 2015 case, the Texas Supreme Court noted that the business judgment rule "generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."[123] This "honest exercise" language does not appear to clarify the parameters of the business judgment rule, though it could certainly be argued that gross negligence does not fit within "honest exercise" of one's judgment. Thus, despite the court's description of the standard of care, there is some basis to believe that the standard of liability based on the business judgment rule is protection only from negligent decision making. It is worth noting that the ability to rely on reports, experts, etc. and to delegate certain decision making applies to for-profit directors as well.[124]

Directors of for-profit corporations additionally owe the same duty of loyalty as their nonprofit counterparts.[125] The same rules regarding interested-director transactions apply and the same prohibitions on usurpation of corporate opportunities apply.[126] Likewise, the ability to limit or eliminate a breach of the directors' duty of loyalty is unavailable in the for-profit context as it is in the nonprofit context.[127]

The duty of obedience typically has no real application in the for-profit context. The duty of obedience forbids *ultra vires* acts; however, because most for-profit corporations have a very broad purpose statement (all lawful activities or all lawful business activities), courts are reluctant to find that an action is *ultra vires*, particularly without fraud or self-interest being present.[128]

Finally, a potentially significant difference between for-profit corporations and nonprofit corporations in the context of control is the ability of shareholders of a for-profit corporation to enter into a shareholders agreement.[129] Such agreement can not only dictate who controls the entity and to what extent,

---

[115] Within the for-profit context, a similar result to a nonprofit corporation being "member-managed" can be obtained through the use of a shareholders' agreement and direct management by the shareholders. However, this situation is less common.
[116] *See* Tex. Bus. Orgs. Code § 21.401.
[117] *See id.* § 21.417.
[118] *See Ritchie*, 443 S.W.3d at 868.
[119] *See Loy*, 128 S.W.3d at 407-08.
[120] *See Gearhart Industries, Inc.*, 741 F.2d at 720-21.
[121] *See* Miller, *supra* note 26 at 1-3.
[122] *See id.* at 2-3.
[123] *See Sneed*, 465 S.W.3d at 173.
[124] *See* Tex. Bus. Orgs. Code § 3.102.
[125] *See supra* notes 40-52 and accompanying text.
[126] *See id*.
[127] *See* Tex. Bus. Orgs. Code § 7.001.
[128] *See Resolution Trust Corp. v. Norris*, 830 F. Supp. 351, 357 (S.D. Tex. 1993).
[129] *See* Tex. Bus. Orgs. Code §§ 21.101-21.109.

it arguably can modify the fiduciary duties owed by the directors.[130] Specifically, Section 21.101(a)(12) provides that the agreement may govern "the exercise of corporate powers, the management of the business and affairs of the corporation, or the relationship among the shareholders, directors, and the corporation as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners and not contrary to public policy."[131] At least one commentator has noted that as a result of this provision, "it appears that fiduciary duties of those in a management role of a corporation governed by such an agreement may be modified or waived in ways not generally permitted by corporate law so long as such provisions would be permissible in the context of a partnership."[132] While partnership agreements do not allow for the complete elimination of fiduciary duties of care and loyalty, they may modify the duties subject to a "not manifestly unreasonable" standard which provides greater flexibility than the BOC provisions applicable to corporations.[133]

c. Federal Tax Issues

Taxable corporations are classified as regular C corporations or small business S corporations. Absent an affirmative S corporation election, a taxable corporation is taxed as a C corporation.[134] S corporations operate as flow-through entities with shareholders receiving allocations of income and loss and paying tax at the shareholder level only.[135] C corporations are taxable on their net income at rates of up to 35%.[136] After-tax profits are taxable to the shareholders leading to what is described as double taxation.[137] However, a tax-exempt shareholder will not be taxed on income distributed to it unless such income is classified as UBTI to the tax-exempt shareholder.[138] For purposes of an entity that will be owned solely or in part by a charitable organization, S corporations are not the preferred option because all income and gain are taxable as unrelated business income to the charitable shareholder.[139]

d. State Tax Issues

For-profit corporations in Texas are subject to the Margin Tax discussed above.[140]

2. Limited Liability Company

a. Structure/Purpose

Although newer to the scene, all 50 states have legislation governing the formation of a limited liability company ("LLC"). The LLC was originally enacted as a hybrid entity combining features of corporations and partnerships.[141] It is a single entity in which all of the owners (called members) have liability protection from the operations of the LLC.[142] However, for federal tax purposes, it is treated as a partnership unless an affirmative election is made to be taxed as a corporation or unless it has a single member, in which event it is disregarded absent an election to be treated as a corporation.[143] Therefore, it combines the benefits of limited liability of a corporation for all the owners of the LLC while retaining tax

---

[130] *See, e.g., id.* § 21.101(a)(12).
[131] *Id.*
[132] *See* Miller, *supra* note 26 at 7.
[133] *See* Tex. Bus. Orgs. Code § 152.002(b)(2), (3), (4).
[134] *See* IRC § 1361(a)(2).
[135] *See id.* § 1366.
[136] *See id.* § 11(a)-(b).
[137] *See id.* § 61(a)(7).
[138] *See* IRC § 512(b)(13).
[139] *See id.* § 512(e)(1). This is a quite different result than taxable owners who would prefer to avoid C corporation status generally to avoid double taxation.
[140] *See supra* note 67 and accompanying text.
[141] *See* 725 T.M., *Limited Liability Companies* (Bloomberg BNA Tax Management Portfolio 725-3).
[142] *See* Tex. Bus. Orgs. Code § 101.114.
[143] *See* Treas. Reg. § 301.7701-2(c)(2).

advantages of a partnership. This has caused it to be a popular entity choice. LLCs are governed by the BOC and specifically Chapter 101.[144] LLCs are created through the filing of a certificate of formation to obtain the benefit of limited liability company status.[145] Instead of bylaws, the LLC normally has an operational document called a company agreement (sometimes alternatively called an operating agreement or regulations) which is a hybrid of bylaws (for the corporation) and a partnership agreement (in a partnership). As with for-profit corporations, LLCs in Texas can generally be formed for any lawful purpose or purposes, notably, not simply "business purposes."[146]

The operational aspects of LLCs are flexible under Texas law. Unlike corporations which have a somewhat rigid operational structure (e.g., annual shareholder meetings, annual board of director meetings, election of officers, evidence of authorization of corporate acts, minute books, etc.), LLCs require much less with regard to "maintenance" of the entity, which is often attractive to small businesses.

b. Control/Fiduciary Duties

Limited liability companies under Texas law may be member-managed or manager-managed.[147] This management structure is similar to (though often less formal than) being managed by the member/shareholder or the board of directors of the corporation. While a limited liability company may choose to have officers, it is often the case that the managers carry out the day-to-day operations for the LLC.[148] The details of these arrangements are contained in the LLC's company agreement.

Whereas in the corporate form the board of directors must elect officers in order to bind the corporation to any act or obligation, an LLC may act directly through its members or managers (depending on what type of governance structure it has) to bind the company.[149] Furthermore, whereas a corporation must show appropriate resolution, meeting minutes or consents in lieu of meetings, an LLC generally can rely on any "reasonable method" in order to evidence a particular person's authority to act on behalf of the LLC.[150] Presumably, this can include meetings, resolutions, or consents in lieu of meetings, but may also include simple representations. Furthermore, LLC members and managers are not required to have annual meetings. These attributes cause the LLC to be an attractive form of business, especially for those that desire a lower-maintenance option to the rigidities of corporate law. Nevertheless, for protection of the separate status necessary to avoid having activities of the subsidiary attributed to the parent tax-exempt organization, some level of documented formality should be followed.[151]

c. Federal Tax Issues

As referenced above, the LLC is unique in that it can be classified as a disregarded entity, a partnership, or an association (taxed as a corporation) for federal income tax purposes.[152] Where the LLC is a single member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded, meaning that the LLC does not need to separately apply for tax-exempt status (discussed below) but rather will effectively take on the tax attributes of its parent member absent an affirmative election to be taxed as a corporation under the "check the box" regulations.[153] If there are two or more owners of the LLC, then the LLC is treated as a partnership for federal income tax purposes unless

[144] *See* Tex. Bus. Orgs. Code § 101.001 *et seq.*
[145] *See id.* § 3.001.
[146] *See id.* §§ 2.001; 2.007.
[147] *See id.* § 101.251.
[148] *See id.* §§ 101.251-101.253.
[149] *See id.* § 101.052.
[150] *See id.* § 101.359.
[151] *See* Darren B. Moore, *Commercial Activities of Tax-Exempt Organizations: Issues in Structural Considerations in the Use of Subsidiary or Related Organizations*, Taxation of Exempts (forthcoming).
[152] *See* IRC §§ 1361(b)(1); 1362(a); Treas. Reg. § 301.7701-2(c)(2).
[153] *See* Treas. Reg. § 301.7701-2(c)(2).

the owners elect to be treated as an association (taxed as a corporation).[154] Being able to be treated as a partnership for federal income tax purposes can be advantageous to an LLC in that it allows it to take advantage of the flexibility in the partnership tax area discussed below while still retaining limited liability for all of its owners in a single entity. While this is a common benefit to LLCs, tax-exempt organizations participating in a multi-member LLC should be cautious about being taxed as a partnership as the income may flow through as unrelated business income and the activities of the LLC may affect the exempt status of the tax-exempt member.[155]

Should a single member LLC wish to apply for exemption from federal income tax (as opposed to being a disregarded entity) or should the LLC have multiple exempt members and wish to be recognized as exempt, separate conditions apply. The Service has indicated that it will recognize the 501(c)(3) exemption of an LLC if the LLC otherwise meets the qualification for exemption (which will be discussed below) and meets 12 additional conditions as follows[156]:

1. The original documents must include a specific statement limiting the LLC's activities to one or more exempt purposes.

2. The organizational language must specify that the LLC is operated exclusively to further the charitable purposes of its members.

3. The organizational language must require that the LLC's members be Section 501(c)(3) organizations or governmental units or wholly owned instrumentalities of a state or political subdivision thereof ("governmental units or instrumentalities").

4. The organizational language must prohibit any direct or indirect transfer of any membership interest in the LLC to a transferee other than a Section 501(c)(3) organization or governmental until or instrumentality.

5. The organizational language must state that the LLC, interests in the LLC (other than a membership interest), or its assets may only be availed of or transferred to (whether directly or indirectly) any nonmember other than a Section 501(c)(3) organization or governmental unit or instrumentality in exchange for fair market value.

6. The organizational language must guarantee that upon dissolution of the LLC, the assets devoted to the LLC's charitable purposes will continue to be devoted to charitable purposes.

7. The organizational language must require that any amendments to the LLC's articles of organization and operating agreement be consistent with Section 501(c)(3).

8. The organizational language must prohibit the LLC from merging with, or converting into, a for-profit entity.

9. The organizational language must require that the LLC not distribute any assets to members who cease to be organizations described in Section 501(c)(3) or governmental units or instrumentalities.

10. The organizational language must contain an acceptable contingency plan in the event one or more members cease at any time to be an organization described in Section 501(c)(3) or a governmental unit or instrumentality.

---

[154] *See id*. §§ 301.7701-3(b)(1)(i); 301.7701-3(a).
[155] *See* Rev. Rul. 98-15, 1998-1 C.B. 718.
[156] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

11. The organizational language must state that the LLC's exempt members will expeditiously and vigorously enforce all of their rights in the LLC and will pursue all legal and equitable remedies to protect their interests in the LLC.

12. The LLC must represent that all its organizations document provisions that are consistent with state LLC laws and are enforceable at law and in equity.

d. State Tax Issues

Limited liability companies (regardless of whether they are disregarded entities of a tax-exempt organization for federal income tax purposes) are subject to the Margin Tax.[157] Texas does NOT follow the federal check-the-box regulations. In the event an LLC obtains recognition of exemption as discussed at C.2.e. above, it will qualify for exemption from the Margin Tax. [158]

D. DUAL PURPOSE ENTITIES

1. Low Profit Limited Liability Company (L3C)

a. States with L3C Legislation

The first L3C legislation was passed in 2008 in Vermont.[159] Currently, there are a total of eight states with L3C legislation: Illinois, Louisiana, Maine, Michigan, Rhode Island, Utah, Vermont, and Wyoming.[160] While these are currently the only states with L3C legislation, it is, of course, possible for an interested party in Texas to form an L3C under the laws of one of these states and register to do business in Texas as a foreign entity.

b. Structure/Purpose

The structure of an L3C is no different than that of a standard LLC. Specifically, it is structured as a limited liability company with one or more members and can either be member-managed or manager-managed as set forth in the organizing document and company agreement. What makes the L3C unique is the requirement that the governing documents contain specific provisions related to the purpose of the entity. Specifically, L3C legislation will require that, in addition to the state's standard LLC formation requirements, language be added to the governing document that shows the entity is organized and is at all times to be operated in a way that demonstrates that the LLC significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Code and would not have been formed but for the entity's relationship to the accomplishment of these purposes.[161] Further, the documentation must specify that no significant purpose of the L3C is the production of income or the appreciation of property, although the fact that the entity produces significant income or capital appreciation is not, in the absence of other factors, conclusive evidence of a significant purpose involving the production of income or the appreciation of property.[162] Additionally, the L3C governing documents must specify that no purpose of the entity is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Code.[163]

---

[157] *See supra* note 67 and accompanying text.
[158] *See* Tex. Tax Code § 171.063(a)(1). Note, that while the statute speaks in terms of "nonprofit corporations," the Comptroller's Publication 96-1045, "*Guidelines to Texas Tax Exemptions*," and AP-204 refer only to "organizations" with federal exemption.
[159] *See* Vt. Stat. Tit. 11, Ch. 21, §§ 3001 (23), 3005(a), 3023(a).
[160] *See* Brewer, Minnigh & Wexler, 489 T.M., *Social Enterprise by Non-Profits and Hybrid Organizations*, (Bloomberg BNA Tax Management Portfolio 489-1) at note 270 and accompanying text.
[161] *See id*. at IV.B.3.a.
[162] *See id.*
[163] *See id*.

These additional requirements are intended to track the requirements for a private foundation's ability to make a program-related investment which serves as an exception to the jeopardizing investment rules under Section 4944 of the Code and associated Treasury Regulations. [164] It was initially hoped that legislation would be passed at the federal level providing that organizations formed as L3Cs would streamline the ability to receive program-related investments.[165] No such legislation has been passed; however, the fact that an organization has undertaken to form itself as an L3C can be useful in coordinating program-related investments from private foundations as well as embedding a social purpose into the structure of the entity.

As indicated above, Texas does not have L3C legislation; however, in addition to the ability to form the entity under the laws of an L3C state, there is no prohibition in the BOC to prevent a party organizing a standard limited liability company under Chapter 101 of the BOC from including these provisions. Unlike some states which statutorily require that a limited liability company be formed for a lawful business purpose, Section 2.001 of the BOC provides that "[a] domestic entity has any lawful purpose or purposes, unless otherwise provided by this Code."[166] While Section 2.008 of the BOC requires that a corporation formed for the purpose of operating a nonprofit institution may only be formed and governed as a nonprofit corporation (a provision that has been tempered by the social purpose legislation added in 2013), because a limited liability company is not a corporation, Section 2.008 will not apply in this context.

c. Control/Fiduciary Duties

In those states with L3C legislation, the statutes do not impact upon the control aspects or fiduciary duties of the managing parties (whether members or managers). As with a standard for-profit LLC, the control mechanisms and the applicable fiduciary duties are largely a matter of contract between the parties as dictated by the company agreement.[167] However, where fiduciary duties exist in the LLC context, those obligations will require the managing parties to make decisions they reasonably believe to be in the best interest of the entity; where an entity has formed under L3C legislation the special provisions will necessarily be the focus of consideration of the fiduciary seeking to act in the entity's best interest. Because of the way the L3C legislation is written to require the primary purpose be a charitable or educational purpose and no significant purpose be profit maximization, the social entrepreneurship nature of the entity is effectively fixed in place as the focused consideration of the managers so long as the entity operates as an L3C. Rather than merely consider these purposes, the fiduciaries must ensure the charitable or educational purpose is actually pursued.

d. Federal Tax Issues

As indicated above, the L3C was initially formulated in hopes that federal legislation would be passed allowing it to more easily attract program-related investments. That legislation has not been passed, which makes the L3C no different from any other LLC for federal tax purposes. As such, it will be taxed either as a disregarded entity (if it has a single member), as a pass-through entity (if it has multiple members), or as a C corporation (if it so elects).[168] If it has tax-exempt members, those members will generally want the organization to be taxed as a C corporation so that they are not receiving allocations of unrelated business income but rather passive dividends. Private investors will typically prefer the pass-through taxation.

---

[164] *See* Treas. Reg. § 53.4944-3(a)(2).
[165] *See, e.g.,* Philanthropic Facilitation Act (2013; 113th Congress H.R. 2832).
[166] Tex. Bus. Orgs. Code § 2.001.
[167] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.B.3.C.
[168] *See supra* note 153 and accompanying text.

e. State Tax Issues

All limited liability companies operating in Texas (whether foreign L3Cs or domestic LLCs that have utilized the same language) are subject to the Margin Tax absent a specific exception.[169] Because Texas does not follow the federal check-the-box regulations for LLC taxation, the general exception for charitable organizations exempt under Section 501(c)(3) will not apply to these organizations even if they are a disregarded subsidiary of a tax-exempt parent. Rather, only a specific statute covering specific activities would potentially be applicable.

2. Benefit Corporation

a. States with Benefit Corporation Legislation

Benefit corporation legislation has been adopted in 31 states and the District of Columbia.[170] Maryland and Oregon, in addition to providing for the formation of benefit corporations, offer the benefit LLC based on their benefit corporation legislation.[171] An additional seven states have legislation under consideration.[172] Texas is not among those 38 jurisdictions. Accordingly, this article will highlight the key features of the benefit corporation legislation nationally. The majority of states with benefit corporation legislation follow the Model Benefit Corporation Act ("Model Act") drafted by B Lab, a nonprofit organization providing certification for "B Corps" which may or may not actually be organized as true benefit corporations under benefit corporation legislation.[173] A minority of states with benefit corporation legislation follow what has been referred to as the "Delaware Act" based on benefit corporation legislation passed in the state of Delaware.[174] Applicable differences will be noted below.

b. Structure/Purpose

In each of the jurisdictions with benefit legislation, the benefit corporation statutes do not create an entirely new type of entity but rather highlights certain provisions that cause a regular for-profit corporation to be classified as a benefit corporation.[175] As a result, there is no real structural difference between a for-profit corporation and a benefit corporation. However, one of the key features of the benefit corporation is the purpose to which it dedicates itself. Rather than any lawful purpose or purposes, both the Model Act and the Delaware Act require public benefit to be at the core of the corporation.

Under the Model Act, the benefit corporation must have a purpose of creating general public benefit, which is defined as "[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation."[176] In addition to the general public purpose, a benefit corporation formed under the provisions of the Model Act may (but is not required to) identify one or more specific public benefits that it intends to accomplish.[177] The term "specific public benefit" includes the following:

---

[169] *See supra* note 67 and accompanying text.
[170] *See* B Lab, "*State by State Status of Legislation*," available at www.benefitcorp.net/policymakers/state-by-state-status (last visited July 15, 2016).
[171] *See* MD. CODE ANN; CORPS. & ASS'NS §§ 4A-1101-1108 (2013); OR. REV. STAT. §§ 60.750-770.
[172] *See supra* note 172.
[173] *See* B Lab, "*The Model Legislation*," available at benefitcorp.net/attorneys/model-legislation (last visited July 15, 2016); "*Benefit Corporations & Certified B Corps*," available at benefitcorp.net/businesses/benefit-corporations-and-certified-b-corps (last visited July 15, 2016).
[174] *See* Del. Code Ann. Tit. 8, §§ 361-368.
[175] *See* Model Act § 101.
[176] *See* Model Act §§ 102 ("General Public Benefit"); 201(a).
[177] *See id.* § 201(b).

1. Providing low-income or underserved individuals or communities with beneficial products or services;

2. Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;

3. Protecting or restoring the environment;

4. Improving human health;

5. Promoting the arts, sciences, or advancement or knowledge;

6. Increasing the flow of capital to entities with a purpose to benefit society or the environment; and

7. Conferring any other particular benefit on society or the environment.[178]

The comments to the Model Act explain that the provision requiring creation of general public benefit and/or specific public benefit effectively requires directors to consider these purposes in exercising their duty of care, as will be discussed below.[179]

In addition to being formed to provide a general public benefit and choosing to identify one or more specific public benefits, the standard of conduct for directors (i.e. how fiduciary duties are satisfied) differs for the benefit corporation. While this information will be more fully discussed below, it is worthwhile to consider inclusion of the standard of conduct in the governing documents so as to put the directors on notice of their obligations. Finally, as has been referenced, the term "general public benefit" under the Model Act requires the impact of the benefit corporation to be assessed against an independent third-party standard that is a comprehensive and credible "recognized standard for defining, reporting, and assessing corporate social and environmental performance … ."[180] The result of that assessment under the Model Act is issuance of an annual public report on the methods and results of accomplishing the general public benefit and specific public benefit (as applicable), any circumstances that hindered the benefit corporation's ability to create the desired public benefit, and the results of the assessment against the third-party standard.[181] This report must be sent to shareholders and be made publically available on the Internet to promote transparency and accountability.[182] Again, because this is a part of the Model Act and thus a requirement of benefit corporations organized in states following the Model Act, it is useful to consider placing this requirement directly into the governing documents as a reminder to the directors of their obligations in this regard.

While the Delaware Act is based on the Model Act, it does contain certain differences.[183] One of the most notable differences is the mandatory requirement of identifying one or more specific public benefits that is intended to be accomplished.[184] At least one commentator has noted that this distinction does not seem to be present in a number of certificates of incorporation filed in Delaware with the specific public benefit only parroting the language describing general public benefit.[185] In other words, it may be that specifying the general public benefit will satisfy the specific public benefit test. However, due to the language of the statute, it is advisable (at least to the author of this present article) for a specific public benefit to be identified.

---

[178] *See id.* § 102 ("Specific Public Benefit").
[179] *See id.* § 201, Comment.
[180] *See id.* § 102 ("Third Party Standard").
[181] *See id.* § 401(a).
[182] *See id.* § 402.
[183] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.C.3.d.
[184] *See* Del. Code Ann. Tit. 8 § 362(a).
[185] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.C.3.d., notes 443-444 and accompanying text.

In addition to this difference, the Delaware Act does not require the same type of third-party standard for assessment but rather allows the board of directors to adopt standards "to measure the corporation's progress in promoting such public benefit or public benefits in interest … ."[186] Note however, that under the Delaware Act, the certificate of incorporation or bylaws may require that the corporation utilize a third-party standard.[187] Finally, whereas the Model Act requires the assessment to be provided to shareholders and posted publically on an annual basis, the Delaware Act requires the assessment and report no less than biennially, and the report must only go to the stockholders, though there is, of course, no prohibition on its online publication.[188]

c. Control/Fiduciary Duties

Neither the Model Act nor the Delaware Act changes the fiduciary duties owed by corporate directors. Again, benefit corporation statutes simply set benefit corporations apart as a certain type of for-profit corporation. As such, the standard fiduciary duty of care, duty of loyalty, and, in states where it is separated out from the duty of care, duty of obedience continue to apply. What makes the duties of directors unique with respect to benefit corporations is what interests they are to consider when exercising those fiduciary duties. For example, to the extent the duty of care requires a director to act in good faith with ordinary care and in a manner he or she reasonably believes to be in the best interests of the corporation, rather than merely considering profit maximization over the short term or long term, a benefit corporation director *must* consider other interests. Specifically, benefit corporation directors in states basing their legislation on the Model Act must consider the effects of any action or inaction on the shareholders; the employees and workforce of the benefit corporation (its subsidiaries and its suppliers); the interests of customers; the community in which the benefit corporation, its subsidiaries, or its suppliers are located; the local and global environment; the short-term and long-term interests of the benefit corporation; and the ability of the benefit corporation to accomplish its general public benefit purpose and any specific public benefit purpose.[189] This requirement can lead to significantly different decisions being made. In addition to the requirement to consider these issues in making a decision, benefit corporation directors may consider other factors or interests that they deem pertinent and appropriate.[190] The Model Act specifically provides that in taking into consideration those interests that must be considered and may be considered, the directors need not give priority to a particular interest or factor unless the governing documents so require.[191] Finally, it is important to recall that under the Model Act, the creation of general public benefit and specific public benefit are specifically stated as being in the best interest of the benefit corporation.[192]

The Delaware Act differs slightly in that, because there is no requirement to create a "general public benefit" but rather to produce a public benefit and operate in a "responsible and sustainable manner" and produce one or more "specific public benefits," benefit directors have a slightly different mandate.[193] In those situations, directors are to balance the "pecuniary" interests of the shareholders, the best interests of "those materially affected by the corporation's conduct," and the "specific public benefits" described in the organizing document.[194] Commentators have referred to this consideration as a "tripartite mandate" and raised the question (yet unanswered) of whether there is a meaningful difference between "considering" factors under the Model Act and "balancing" factors under the Delaware Act.[195] Under both the Model Act and the Delaware Act, the directors' duties run to the shareholders and not the stakeholders and directors

[186] *See* Del. Code Ann. Tit. 8 § 366(b).
[187] Some states following the Delaware Act (such as Colorado) nevertheless require a third-party assessment.
[188] *See id.*
[189] *See* Model Act § 301(a)(1).
[190] *See id.* § 301(a)(2).
[191] *See id.* § 301(a)(3).
[192] *See id.* § 201(c).
[193] *See* Del. Code Ann. Tit. 8 §§ 362(a), 365(a).
[194] *See* Del. Code Ann. Tit. 8 § 365(a).
[195] *See* Brewer, Minnigh & Wexler, 489 T.M. at IV.C.3.d.

are generally not liable for their decision-making process provided they exercise their business judgment and are not interested in the subject of the business judgment.[196]

Finally, one unique issue in the context of the Model Act is the ability to create a position on the board of directors for a "benefit director" who, in addition to having the powers and responsibilities of the remaining directors, serves a special role in overseeing the annual reporting and making an annual compliance statement specifying whether the benefit corporation acted in accordance with the general public benefit and specific public benefit purposes set forth in its organizing documents, and if it failed to do so, in what respects.[197] The Model Act contains a specific provision exonerating this "special" benefit director from personal liability for acts or omission in the capacity of serving in such role absent self-dealing, willful misconduct, or a knowing violation of the law.[198] The Delaware Act does not contemplate such a unique "benefit director" position.

d. Federal Tax Issues

A benefit corporation receives no tax benefits and will be taxed as a C corporation unless subchapter S status is elected.[199]

e. State Tax Issues

While Texas does not have benefit corporation legislation, to the extent a benefit corporation organized in one of the many states with benefit corporation legislation registers to do business as a foreign corporation under Texas law, the Margin Tax will apply.[200]

3. Social Purpose Corporation

a. States with Social Purpose Corporation Legislation

California, Texas, and Washington have each adopted legislation authorizing the creation of a social purpose corporation.[201] The legislation in each of these states differs, and there is no model act for the social purpose corporation.

b. Structure/Purpose

As with benefit corporations, social purpose corporations are merely a variant of the standard for-profit corporation in the three states where they exist. Thus, the structure will continue to be a corporate structure with one or more shareholders and a board of directors. The purpose of the special purpose corporation varies from state to state. The California social purpose statutes provide that an entity engaging in a lawful business purpose can additionally engage in one or more specific charitable or public purpose activities that could normally be carried out by a nonprofit public benefit corporation or any other purpose that promotes positive short-term or long-term effects or minimizes negative effects on employees, suppliers, customers, creditors, the community, or the environment.[202] These purposes are to be spelled out in the organizing document and an annual report is to be sent to the shareholders along with posting the report on the corporation's website.[203] Washington's statutory regime contains different available social

[196] *See* Model Act § 301(d); Del. Code Ann. Tit. 8 § 365(b).
[197] *See* Model Act § 302.
[198] *See id.* § 302(e).
[199] *See supra* note 135 and accompanying text.
[200] *See supra* note 67 and accompanying text.
[201] While Florida has legislation referencing a "social purpose corporation," the actual legislation is based on the Model Act and creates a benefit corporation rather than a unique form of social purpose corporation.
[202] *See* Cal. Corp. Code § 2602.
[203] *See id.* §§ 2602, 3500.

purposes and requires the annual report to be posted on the organization's website but not sent to the shareholders.[204] The Texas version of the social purpose corporation came about when the BOC was modified in 2013 to provide that a for-profit corporation could include one or more social purposes (a term specifically defined in the BOC) in addition to the purpose or purposes required to be stated in the corporation's certificate of formation.[205] Specifically, whereas Section 2.008 of the BOC sets out that certain activities can only be conducted by a corporation that is a nonprofit corporation, the BOC now makes an exception for corporations that include a social purpose statement.[206] However, Texas does not have any type of reporting requirement with respect to the social purpose.

Section 1.002 of the BOC provides that "'social purposes' means one or more purposes of a for-profit corporation that are specified in the corporation's certificate of formation and consist of promoting one or more positive impacts on society or the environment or minimizing one or more adverse impacts on the corporation's activities on society or the environment.[207] Those impacts may include:

1. Providing low-income or underserved individuals or communities with beneficial products or services;

2. Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;

3. Preserving the environment;

4. Improving human health;

5. Promoting the arts, sciences, or advancement of knowledge;

6. Increasing the flow of capital to entities with a social purpose; and

7. Conferring any particular benefit on society or the environment."[208]

This definition is taken from the definition of "specific public benefit" in the Model Act for benefit corporations.[209]

c. Control/Fiduciary Duties

As referenced above, social purpose corporations, as a variant of the standard for-profit corporation, are governed by a board of directors. Those directors owe the standard fiduciary duties of directors—care, loyalty, and obedience. In social purpose corporations (in all three states) directors *may*, but are not *required* to, consider the specific social purpose(s) unless the governing documents so require. Stated differently, while the statutory regime in each state allows the social purpose corporation to include social purposes and authorizes directors to properly consider those purposes, the statutes do not require the directors to consider those purposes. Rather, the purpose of these statutes is simply to overcome any requirement that directors consider only profit maximization and risk breaching fiduciary duties by considering social purposes. The legislation was not intended to create the mandatory consideration or balancing test required under benefit corporation legislation (Model Act and Delaware Act, respectively).[210] In California, a benefit corporation would be used for this purpose, though there is no

[204] Wash. Rev. Code §§ 23B.25.020, .030, .150.
[205] *See* Tex. Bus. Orgs. Code § 3.007(d).
[206] *See id.*
[207] *See id.* § 1.002 (82-a).
[208] *See id.*
[209] *Cf.* Model Act § 102 ("Specific public benefit").
[210] *See* Texas Bill Analysis, S.B. 849, 7/16/2013 (explaining that "officers and directors of for-profit corporations would violate the duty they owed to shareholders to maximize shareholder profit if they were to pursue business decisions based solely on a

benefit corporation analog in Washington or Texas. As referenced above, although Washington and California both require a social purpose report to be generated (though there is no requirement that a third-party assessment is used, as with benefit corporations), Texas has no reporting requirement.

d. Federal Tax Issues

A social purpose corporation receives no tax benefits and will be taxed as a C corporation unless subchapter S status is elected.[211]

e. State Tax Issues

Social purpose corporations (whether formed in Texas or in Washington or California) receive no special tax benefit under Texas law and will be subject to the Margin Tax.[212]

E. SELECTING THE STRUCTURE—A FLOWCHART OVERVIEW

Selection of an appropriate structure for a social enterprise requires consideration of the key characteristics and distinctions discussed above. In addition, questions such as the source of capitalization, compelling reasons to operate in the nonprofit or for-profit form, and other related questions are all critical. These factors and the decision making process can be helpfully viewed through the lens of a decision tree or flowchart. For a flowchart overview of the decision making process, please see Appendix A.

III. REGULATION OF THE WILD WEST

Although the IRS has, over the past decade, developed an increasing interest in governance based on the proposition that a well-governed organization is more likely to be a tax-compliant organization, governance is, at its core, a state law issue. In Texas, that means governance is within the purview of the Office of the Attorney General ("OAG") and, where a derivative suit is brought, within the purview of the courts.

The OAG has broad standing and powers with respect to charitable organizations. The OAG's standing arises from that office's role as the representative of the public interest in charity.[213] The OAG is charged to ensure charitable assets are used for appropriate charitable purposes and has broad authority to carry out that duty emanating from the Texas Constitution, common law, and various statutes. Where the OAG brings suit alleging breach of one of the fiduciary duties outlined above, venue is in Travis County.[214] In the event the OAG is successful in its claims of breach of fiduciary duty, the OAG is entitled to recover from the fiduciary actual costs incurred in bringing the suit and may recover reasonable attorney's fees.[215] While the public is the beneficiary of the work of charitable organizations and funds held by charitable organizations are said to be held in trust for the benefit of the public, a member of the public lacks standing on such basis to bring a claim against a decision maker. No duty is owed directly to stakeholders, but rather the duty is owed to the public.[216] The OAG is the proper party to protect the public's interest.[217]

Unlike with respect to charitable organizations, the OAG has no special standing to bring a breach of fiduciary duty claim with respect to for-profit organizations. Rather, such claims may be brought by the

---

social purpose" and noting that the BOC amendment "shields directors and officers from liability from shareholder suits when making a decision based on the stated social purpose").

[211] *See supra* note 135 and accompanying text.

[212] *See supra* note 67 and accompanying text.

[213] *See* Tex. Prop. Code § 123.001, et. seq.

[214] *See id.* § 123.005(a).

[215] *See id.* § 123.005(b).

[216] *See Nacol v. State*, 792 S.W.2d 810, 812 (Tex. App.—Houston [14th Dist.] 1990, writ denied).

[217] *See id.*

shareholders through a derivative suit, as a director's fiduciary duties are owed to the corporation and not to individual shareholders.[218] Within the context of limited liability companies, the right to make a claim can be modified in the company agreement.[219] In both for-profit corporations and limited liability companies, the BOC allows for the elimination of liability of the decision maker in certain circumstances, though the duty of loyalty cannot be eliminated.[220]

Despite lacking the same type of oversight and enforcement authority with respect to for-profit directors as it has under Chapter 123 of the Property Code in relation to directors of charitable organizations, the OAG nevertheless has broad regulatory powers and investigative authority over all domestic entities in Texas. Many powers are implied from the provisions of the BOC, which require corporate compliance (e.g. keeping accurate books and records).[221] The BOC provides the OAG the authority to present a written request to examine the operations of a filing entity (without notice), the authority to apply for involuntary dissolution (and liquidation), and the authority to apply for the appointment of a receiver in proper cases.[222] The OAG additionally has certain special authority under the Texas Deceptive Trade Practices Act ("DTPA").[223] False, misleading, or deceptive acts or practices that occur in the conduct of any trade or commerce are generally governed by the DTPA.[224] Even if a nonprofit corporation does not charge for services or products, the DTPA applies.[225] This is because the DTPA applies to charitable organizations with respect to fraudulent solicitation regardless of whether goods or services are offered as a part of the solicitation. The DTPA provides authority to the OAG to issue requests for production of documents under a civil investigative demand, conduct pre-suit investigations, file lawsuits for enforcement, and impose penalties for noncompliance.[226] In addition, the DTPA allows for an enhanced penalty in the event the OAG determines that the fraudulent act or practice was seeking to acquire or deprive money from a consumer age 65 or older.[227]

While the regulatory authority of charitable organizations and other filing entities is well-established under Texas law, how those provisions apply in the context of social enterprises, particularly social enterprises that are formed as dual-purpose entities, is less clear. At first blush, it would seem that the OAG's authority under Chapter 123 of the Property Code over charitable entities would not be applicable. However, Section 123.001(1) defines "charitable entity" as "a corporation … or other entity organized for scientific, educational, philanthropic, or environmental purposes, social welfare, the arts and humanities, or another civic or public purpose described by Section 501(c)(3) … ."[228] Because L3Cs must be organized and operated in a way that demonstrates the company significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Code, it is worth considering whether an L3C would fit the definition of "charitable entity" under Chapter 123 of the Property Code. Note that nothing in the definition of charitable entity as set out above requires that the entity actually be exempt under Section 501(c)(3) of the Code. Likewise, if a benefit corporation or social purpose corporation specifies that they have been organized for public or social purposes that fit within the definition of charitable entity, could the OAG's enforcement authority under Chapter 123 apply? These are, as yet, unanswered questions.

---

[218] *See Ritchie*, 443 S.W.3d at 868.
[219] *See* Tex. Bus. Orgs. Code §§ 101.401, 101.052.
[220] *See id.* § 7.001.
[221] *See id.* § 3.151.
[222] *See id.* §§ 12.151; 11.303; 11.402-11.405.
[223] *See* Tex. Bus. & Com. Code § 17.46.
[224] *See id.*
[225] *See Mother and Unborn Baby Care of North Texas, Inc. v. State*, 749 S.W.2d 533, 538 (Tex. App.—Fort Worth 1988, writ denied).
[226] *See* Tex. Bus. & Com. Code §§ 17.61; §§ 17.47.
[227] *See id.* § 17.47(c)(2).
[228] *See* TEX. PROP. CODE § 123.001(1).

Certainly, the OAG's regulatory authority under the BOC would apply to dual-purpose entities. Likewise, the OAG's authority under the DTPA would apply. The author believes that the most likely causes of action to be brought by the OAG with respect to dual-purpose entities would be under the DTPA based on an argument that the organization was holding itself out as an L3C, benefit corporation, or social purpose corporation and not fulfilling its responsibilities. This would seem to fit within several of the prohibited acts under the DTPA in the laundry list of prohibited acts in Section 17.46 of the Texas Business and Commerce Code.[229] Specifically, an argument could be made that this type of conduct would fall under the prohibition on "causing confusion or misunderstanding as to the source, sponsorship, approval, or certification of goods or services" or under the prohibited act of "causing confusion or misunderstanding as to affiliation, connection, or association with, or certification by, another."[230] The author is aware of no Texas cases, OAG opinions, or OAG investigations in this area.

If this dual-purpose space is not to be specially regulated under Chapter 123 of the Property Code or the DTPA, consumers will need to be watchful when relying upon the dual-purpose nature of an organization. This may well cause organizations to see the benefit of seeking out special certification. One such certification is provided by B Lab, a nonprofit corporation who certifies entities as certified B Corps.[231] Certification as a B Corp is distinct from being formed as a benefit corporation.[232] The third-party assessment is verified by B Lab and verification must be recertified every two years.[233] B Corp certification is available to any private business and does not require an organization to be formed as a benefit corporation.[234] Reviewing the webpage on B Lab's website "Why Become a B Corp?," it is easy to identify consumer and investor assurance as a primary driver for B Corp certification.[235] While this type of certification continues to be a relatively recent phenomenon, it will be interesting to watch and see if B Corp certification (or another similar certification) will result in self-regulation of the dual-purpose marketplace to prevent abuse and protect consumers.

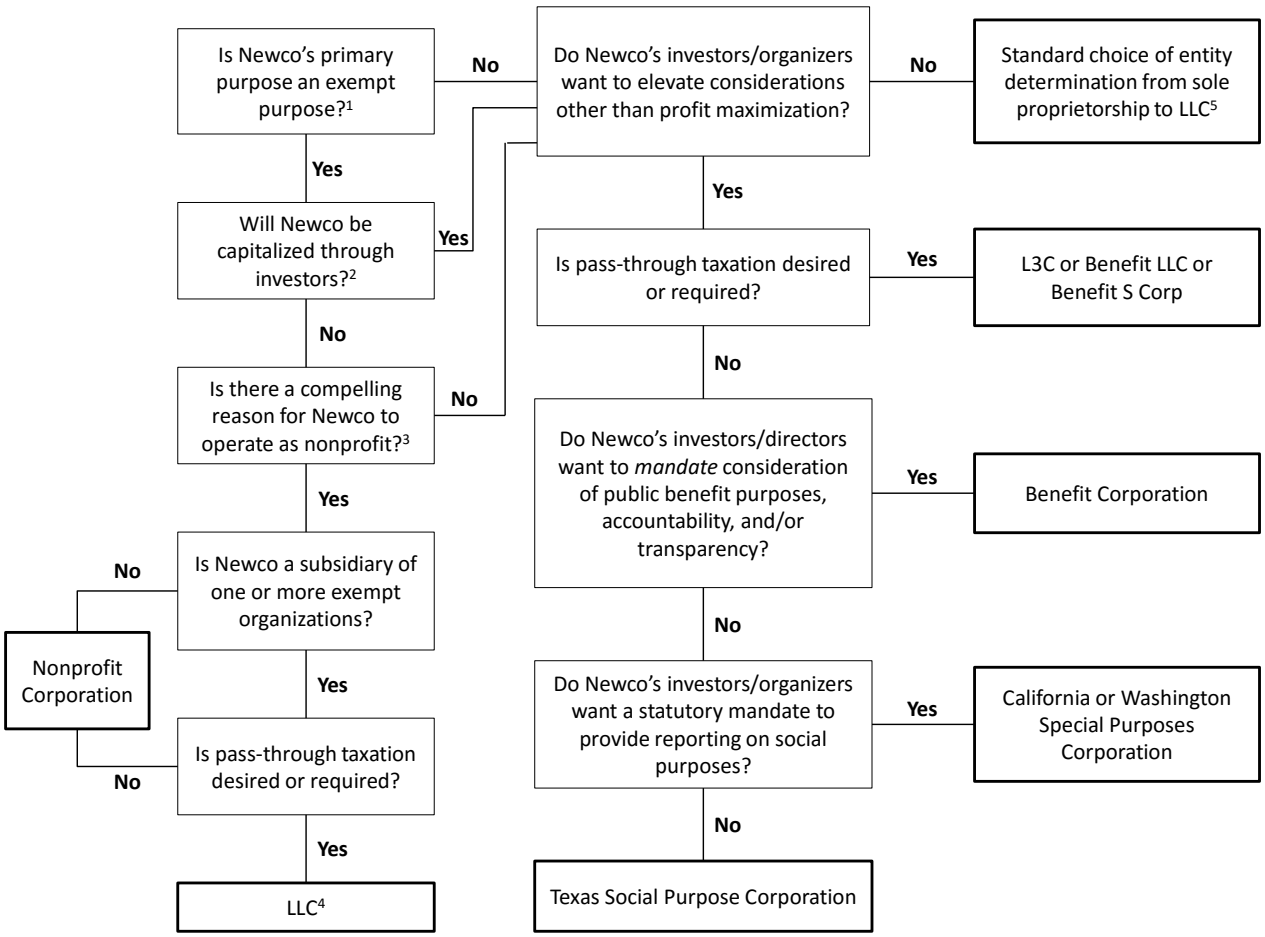
IV. CONCLUSION

While there have been examples of businesses seeking to do well by doing good throughout American history, the idea of a social enterprise sector is relatively new and developing. Legislation is being passed across the country providing for different corporate forms. There is discussion as to whether these forms are necessary or beneficial, and the question of the need for new corporate structures or certification is being debated. Nevertheless, social entrepreneurs are not waiting, they are innovating. Social entrepreneurs have a goal for what it is they seek to accomplish, and it is up to advisors to understand the available forms, the unique characteristics of those forms, and be in a position to advise clients on these structural decisions. The ocean of social enterprise is far from static, and all who seek to swim in it must keep their eyes open for opportunities and hazards.

334990

[229] *See* Tex. Bus. & Com. Code § 17.46.
[230] *See id.* § 17.46(b)(2), (3).
[231] *See* B Lab, "*About B Lab*," available at www.bcorporation.net/what-are-b-corps/about-b-lab (last visited July 15, 2016).
[232] *See supra* note 175 and accompanying text.
[233] *See* B Lab, "*Performance Requirements*," available at www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/performance-requirements (last visited July 15, 2016).
[234] *See* B Lab, "*Corporation Legal Roadmap*," available at www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/legal-roadmap/corporation-legal-roadmap (last visited July 15, 2016).
[235] *See id.*, "*Why Become a B Corp?*," available at www.bcorporation.net/become-a-b-corp/why-become-a-b-corp (last visited July 15, 2016).

APPENDIX A—SELECTING THE STRUCTURE: A FLOWCHART OVERVIEW



[1] For purposes of Section 501(c)(3) of the Code, purposes that qualify for exemption include "religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals … ." Each of these purposes is a term of art with regulations and rulings setting forth and clarifying what it takes to qualify.

[2] If the entity is to be capitalized by invested capital from private investors, it will need to be structured as a for-profit entity (traditional for profit or dual purpose) whereas if it is to be capitalized by donated capital, it should be structured as a nonprofit entity (typically a tax-exempt nonprofit corporation). To the extent the organization will seek private investors, it should be mindful of securities laws, which are beyond the scope of this article. Likewise, if the organization is seeking loans or guarantees from the Small Business Administration, it will need to be structured as a for-profit entity pursuant to 13 CRF 1.120.1000(b) (2012).

[3] Compelling reasons may include exemption from federal income tax, ability to participate in government programs requiring nonprofit status, certification or licensure requiring nonprofit status, margin tax exemption availability under Texas law, certain liability protection under Texas law, and, with respect to subsidiaries, potential avoidance of unrelated business taxable income and tax due on dissolution of the entity. For more information on these issues, *see* Darren B. Moore, "Commercial Activities of Tax-Exempt Organizations: Issues and Structural Considerations in the Use of Subsidiary or Related Organizations," Journal of Exempt Organizations (upcoming).

[4] If the organization is a subsidiary of a single exempt organization, it will be a disregarded entity as a single member LLC. If the organization is a subsidiary of multiple exempt organizations, it can apply for and receive tax-exempt status as referenced at ___ above. The LLC can be formed as a standard limited liability company; however, if there is a desire for a "nonprofit LLC," the LLC will need to be formed in Kentucky, Minnesota, North Dakota, or Tennessee. Because Texas law does not require a limited liability company to be formed for a "business purpose," the author sees little benefit in forming a nonprofit LLC in one of these states.

[5] Standard choice of for-profit entity decisions are beyond the scope of this article, but factors will generally include federal taxation, state taxation, liability protection, and capitalization issues.

APPENDIX B—RESOURCES

Books

MARK J. LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS, ABA Publishing (2011).

RYAN HONEYMAN, THE B CORP HANDBOOK: HOW TO USE BUSINESS AS A FORCE FOR GOOD, Berrett-Koehler Publishers, Inc. (2014).

Articles and Charts

Brewer, Cassady v. Social Enterprise Entity Comparison Chart (May 17, 2015). Available at SSRN: http://ssrn.com/abstract=2304892.

Brewer, Minnigh & Wexler, 489 T.M., *Social Enterprise by Non-Profits in Hybrid Organizations*, (Bloomberg BNA Tax Management Portfolio 489-1).

Robert A. Wexler, *Effective Social Enterprises—A Menu of Legal Structures*, The Exempt Org. Tax Rev., June 2009.

Websites

B Lab: https://www.bcorporation.net.

www.benefitcorp.net