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Legal Aspects of Starting a Social Enterprise

By

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- **Choosing a form for your enterprise**
- **Basic equity issues**
- **Basic intellectual property issues**
- **Basic employment issues**
- **Key contracts**
- **Questions**

- Limited Liability
- Establishes clear ownership rights
 - To equity
 - To assets
- Perpetual existence
- Employment considerations
- Easier to raise outside capital

■ Making the Choice: Questions

- Mission and message
- Funding
- Tax
- Sustainability
- Employment incentives
- Exit

Choosing a Form for the Enterprise

	For-Profit	Charitable Nonprofit
Mission	<ul style="list-style-type: none"> ■ Profit ■ Benefit corporation—profit & public benefit 	<ul style="list-style-type: none"> ■ Religious, charitable, scientific, testing for public safety, literary, educational, or other purposes
Funding	<ul style="list-style-type: none"> ■ Equity investments ■ Loans ■ Earned income 	<ul style="list-style-type: none"> ■ Donations and grants <i>(charitable deduction for donations to 501(c)(3) organizations)</i> ■ Loans ■ Earned income
Ownership	<ul style="list-style-type: none"> ■ Individuals and entities 	<ul style="list-style-type: none"> ■ None ■ Note: AG and IRS
Taxes	<ul style="list-style-type: none"> ■ Pay income tax and capital gains tax 	<ul style="list-style-type: none"> ■ Exempt from income tax and capital gains tax (but still must file an information return) ■ But: UBIT, employment tax, etc.

■ For-profit enterprise

- Sole proprietorship
- Corporation (traditional or benefit corporation)
- Limited liability company
- Partnership

■ Nonprofit enterprise

- Nonstock corporation
- Trust

Exemption from federal income tax requires a separate process

■ What is it?

- For start-ups, most commonly a “C corporation” (though can be “S corporation”) or an LLC.
- Key considerations:
 - Liability
 - Tax
 - Employment incentives
 - Expected sources of funding
- Profit motive: maximize financial return for shareholders
 - Benefit corporations explicitly combine maximizing financial return with supporting a stated public benefit

■ Formation

- Where?
 - Massachusetts (or state where company is located)
 - Delaware
- What?
 - For corporation, Certificate of Incorporation and by-laws
 - For LLC, Certificate of Formation and operating agreement
- Ongoing maintenance (meetings, file reports, etc.)

■ Funding sources

- Investors
- Earned income
- Loans

■ Certification

- B Corp status

■ Management

- Board of directors / Board of managers
 - Elected by stockholders / members
- Officers
 - Named by board
- Both are fiduciaries: duties of care and loyalty; business judgment rule

■ Equity ownership

- Stockholders are owners
 - “Internal” – founders, directors, officers, and other employees
 - “External” – investors
 - Public market

■ Equity ownership; internal (common stock)

- “Founders” shares
 - Issue shares as early as possible
 - Use “reverse vesting” – even for yourself
 - Critical tax consequences (e.g. 83(b) election)
- Shares to employees, new hires
 - Restricted stock vs. stock options
 - Avoid “percentages” – focus on number of shares

- **Equity ownership; “external” (usually preferred stock)**
 - Choosing investors wisely
 - Best angel and venture investors offer more than just money
 - Keep it simple, especially early on
 - Be mindful of securities laws issues
 - Understand what “preferences” really mean
 - Liquidation preference
 - Anti-dilution protection
 - Board representation
 - “Protective” provisions

Benefit Corporation – What is it?

- A unique, hybrid corporate form that combines characteristics of both for-profit and non-profit corporations
- In addition to maximizing profits, directors of a benefit corporation are empowered to consider societal impact when making corporate decisions,
 - Considerations may include a wide array of interests such as employees, the community, societal and environmental impact
- LLCs and LPs can replicate this broadened decision making through including provisions that provide for it in their organizing documents

- Examples include:



Similarities & Differences Between Delaware Public Benefit Corporations and Massachusetts Benefit Corporations	DE DGCL Sec. 361-368	MA MGL Ch. 156E
Similarities		
Charter must identify corporation as a benefit corporation	X	X
Empowers directors with fiduciary duty to consider public benefit purpose when making decisions	X	X
Must issue a periodic benefit report to stockholders	X	X
Conversion to (or conversion out of) benefit corporation status requires 2/3 vote of each class of shareholders	X	X
Shareholders may take derivative action to enforce public benefit purpose (but no personal liability attaches to directors in connection with any such action)	X	X

Similarities & Differences Between Delaware Public Benefit Corporations and Massachusetts Benefit Corporations	DE DGCL Sec. 361-368	MA MGL Ch. 156E
Differences		
Charter must state a general public benefit purpose <u>or</u> a specific public benefit purpose		X
Benefit report must be issued annually		X
Benefit report must use 3 rd party standard		X
Benefit report must be submitted to MA Secretary of the Commonwealth and requires additional filing fee (with sensitive information redacted)		X
Benefit report must be made public (with sensitive information redacted)		X
Directors and officers must consider the effects of their corporate decision-making on each the following: <ul style="list-style-type: none"> ○ The shareholders of the benefit corporation; ○ The employees and workforce of the benefit corporation; ○ The interest of clients; ○ Community and societal factors, including those of each community in which offices or facilities of the benefit corporation are located; ○ The local, regional 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 and specific public benefit purposes. The statute provides that <u>each decision</u> must consider <u>each</u> of these stakeholders and factors.		X
Benefit director required		X

Similarities & Differences Between Delaware Public Benefit Corporations and Massachusetts Benefit Corporations	DE DGCL Sec. 361-368	MA MGL Ch. 156E
Differences		
Charter must state a specific public benefit purpose	X	
Benefit report must be issued at least once every 2 years (but charter may provide for it to be more frequent)	X	
Benefit report does not require use of 3 rd party standard		
Benefit report does not need to be filed with the DE Secretary of State	X	
Benefit report does not need to be made public	X	
Directors must manage public benefit corporations in a way that balances: <ul style="list-style-type: none"> ○ The stockholders' pecuniary interests; ○ The interests of those materially affected by the corporation's conduct; and ○ The public benefit or public benefits identified in the corporation's certificate of incorporation. <i>(Tripartite balancing requirement)</i>	X	
Benefit director is not required	X	

- Certified B-Corps (which need not initially be benefit corporations) have been certified by B Lab as having met a high standard of overall social and environmental performance as determined by a third-party standard
- B-Corps must elect benefit corporation status within four years of the first effective date of benefit corporation legislation in their state of incorporation or two years of initial certification, whichever is later
- Although there are other third-party standards for certifying social benefit/environmental stewardship, the non-profit B-Lab currently leads the market
 - Pro: B-Lab clients join a growing network of collaborative businesses that often provide cost-saving services to one another
 - Con: Unclear criteria for certification, annual fees and lack of competition in the third-party certification marketplace

- **What is it?**
 - Almost always a corporation
- **Formation and maintenance**
 - Similar requirements as a for-profit corporation
- **Management**
 - Similar to a for-profit corporation
 - One difference: statutory members vs. stockholders
- **Equity ownership**
 - None. Major difference from for-profit enterprise
 - Assets held “in trust” for public

■ Funding sources

- Grants and donations (eligible for charitable contribution deduction)
- Earned income
- Membership fees
- Loans
- Passive income (investments, royalties, etc.)

■ Tax exemption

- Must apply to IRS to be recognized as tax-exempt and described in section 501(c)(3)
- Not taxable on income
 - Exceptions: taxable on unrelated business taxable income (“UBTI”), employment taxes, etc.
- Prohibited from conferring private benefit or private inurement
- If publicly supported, must meet a public support test
- If a private foundation, must adhere to certain strict rules

■ Use of funds

- Religious, charitable, scientific, testing for public safety, literary, educational purposes, or other purposes
- Oversight by Attorney General and IRS
 - Choice of venue may matter (e.g., MA versus DE)
- Articles of organization: dissolution clause
- No “exit”
- Arrangements with for-profit entities must be carefully structured
- Annual IRS filings (Form 990) requires financial transparency; are publicly available

■ Patents

- New and useful invention or process

■ Copyrights

- Original work of authorship (any medium)

■ Trade secrets

- Valuable information, maintained in secret

■ Trademarks

- Distinctive, associated with service or product

- Founders, employees, and consultants
 - Assignment of inventions agreements
- Confidentiality agreements
- Agreements with manufacturers, vendors, customers
- Have the right to use the intellectual property of others
- License to others the use of your intellectual property
- Protect intellectual property
 - Use
 - Registration

- Restrictive agreements with prior employers
- Student status
- Immigration status
- Terms of employment
 - At will
 - Term of employment (inadvertent or explicit)
- Employee or independent contractor
- Payroll taxes and withholding obligations
 - Potential personal liability for officers and directors

- Employment agreements/offer letters
- Agreements among founders
- Non-disclosure agreements
- Development and non-competition agreements
- Financial agreements
 - Stock purchase agreements (for-profit enterprises)
 - Loan agreements
 - Private foundation grants and PRIs
 - Private donations (nonprofit enterprises)
- Intellectual property licenses
- Insurance



Questions?

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