

Commission on Connecticut's Leadership in Corporation & Business Law

Social Enterprise Law Working Group

Policy Recommendations & Explanations

Introduction

The area of social enterprise law, non-existent just eight years ago, has exploded over the past four years. In that short period of time, over 30 states across the nation have adopted some form of new legal entity specifically for social entrepreneurs¹ - individuals who operate mission-driven businesses that work to create a positive social or environmental impact, in addition to generating profits. The trend of states adopting legal entities specifically for social entrepreneurs shows no sign of stopping, either. In 2015 alone, it is expected that at least fourteen states² will consider legislation establishing the benefit corporation as a new legal entity, which is currently the most popular form of social enterprise legal entity in the U.S.³

While many states have passed legislation enabling these new legal entities for social enterprises, there is no state that has taken up the mantle as the *go-to state* for attorneys and entrepreneurs incorporating their social enterprises⁴, in the way that Delaware has become a haven for Fortune 500 corporations⁵, and Nevada has become attractive for its LLC statute.⁶ This lack of leadership in the social enterprise law space presents a clear point of pain in a developing legal market, and an opportunity for Connecticut, which has one of, if not *the* most comprehensive benefit corporation statutes in the United States. This report outlines four policy proposals that, if implemented, could help Connecticut become the 'social enterprise state.'

¹ <http://benefitcorp.net/>

² Id.

³ http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304892

⁴ Phone conversation with Professor Haskell Murray, J.D. of Belmont University on Thursday, January 29th, 2015

⁵ http://corp.delaware.gov/whycorporations_web.pdf

⁶ See: <http://www.reviewjournal.com/business/nevada-s-business-climate-14th-us-according-poll-professionals>; and <http://www.nasdaq.com/personal-finance/selecting-state-corporation.stm>.

The Opportunity

Despite the fact that social enterprise legal entities have been passed into law in a majority of the states across the U.S., there is no state that has formally committed to developing an infrastructure - legally or otherwise - to encourage the organization or incorporation of these new entities, or to provide information and solutions for doing so. Some of the most forward-thinking states have provided helpful links to third party resources on their Secretary of the State's website⁷, have provided easy-to-use incorporation forms,⁸ or have provided easy access to public data about social enterprise legal entities.⁹ Connecticut, specifically, has developed policy innovations to address perceived issues with legislation in other states.¹⁰

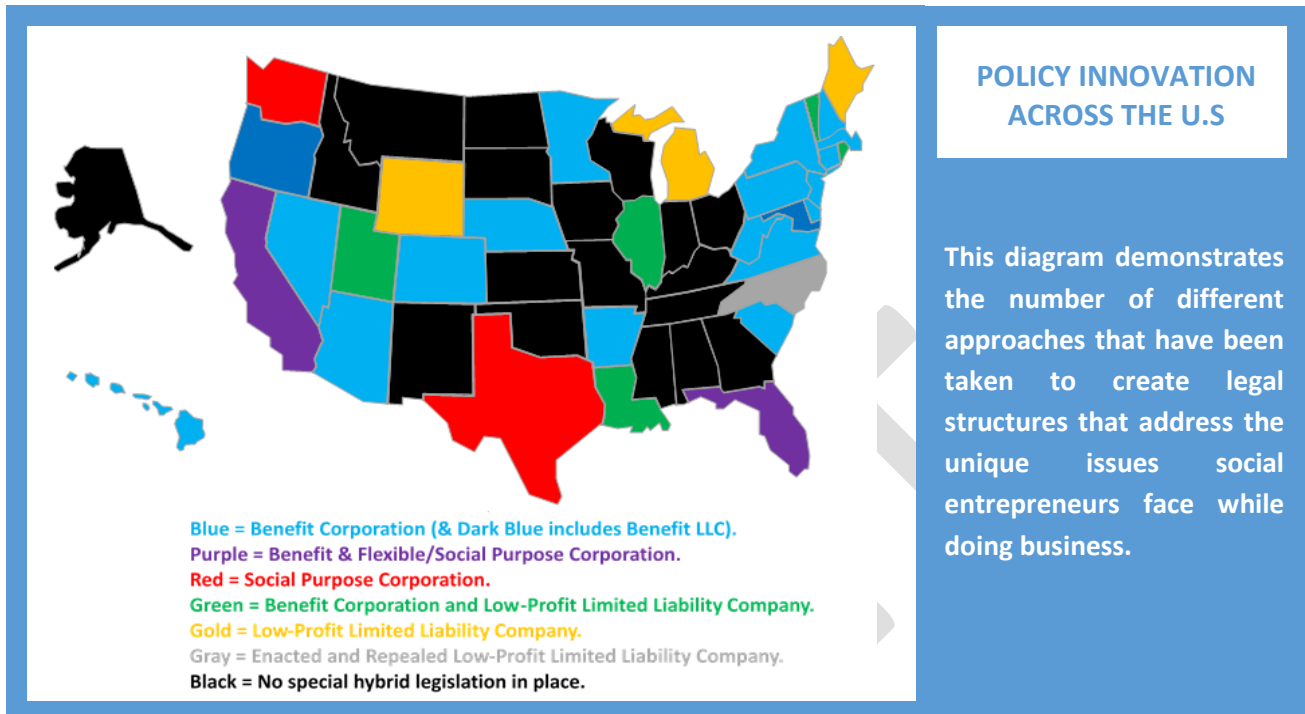
No state, however, has gone to lengths to establish itself as the "Delaware" of social enterprise law, which is to say that no state has specifically undertaken or executed on a mission to establish itself as a leading or highly desirable location to organize a social enterprise, and/or attract other business entities to organize using their social enterprise statutes. This lack of leadership is demonstrated by the differentiation from state to state in social enterprise statutes, the lack of transparency and understanding of the sector as a whole, and the difficulty in most states (due to a lack of foresight/planning) to track the formation of these new entities, and learn about the challenges they face as they launch and scale.

⁷ <http://sos.oregon.gov/business/Pages/benefit-company.aspx>

⁸ Connecticut and Nevada offer simple check boxes on their certificate of incorporation forms:
http://www.ct.gov/sots/lib/sots/commercialrecording/allforms/cert_of_inc_-_stock_corp.pdf;
<http://nvsos.gov/Modules/ShowDocument.aspx?documentid=669>.

⁹ <http://sos.oregon.gov/business/Pages/oregon-benefit-companies.aspx>;
http://www.sos.wa.gov/corps/search_advanced.aspx

¹⁰ <http://www.smithmoorelaw.com/b-legal-briefing-new-hampshire-and-connecticut-join-the-ranks>



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Making Connecticut the ‘Social Enterprise State’

Rather than attempt to compete with Delaware, a state that has clearly established a hegemony in the area of corporate law with the operation of its specialized Court of Chancery and Secretary of the State’s office, Connecticut is uniquely situated to capitalize on the opportunity to become *the* state for social entrepreneurship. Although there are a number of reasons which can be cited to support this idea, there are three specific reasons of note.

● *Positive Externalities*

There are considerable positive externalities associated with social entrepreneurship. Social enterprises are for-profit businesses¹² that in some way are dedicated to creating a positive social or environmental impact. While typical businesses provide positive externalities

¹¹ <http://socentlaw.com/2014/08/social-enterprise-law-update-and-map/>

¹² Every social enterprise entity across the U.S. is taxed as either a partnership, an S Corporation, or a C Corporation, and receives no special tax breaks or subsidies at the State or Federal level.

such as providing jobs, and bringing goods or services to market, social enterprises go the extra mile and operate with social or environmental mission. Social enterprises commonly carry out their mission by hiring individuals from underserved communities, by donating significant amounts of goods, services, or cash to charitable entities, or by offering goods or services that create an inherent social or environmental impact at affordable rates. Social enterprises create jobs, pay taxes, and make the communities that they operate in better places to live and work.

One example of a highly impactful social enterprise is Greyston Bakery. A benefit corporation, the company makes brownies for Ben & Jerry's Ice Cream products, and also produces items for Whole Foods.¹³ The company creates a positive social impact through its open door hiring policy, which allows individuals from Yonkers, New York with criminal backgrounds, a past history of drug use, or low to no education a chance to work in the brownie factory, no questions asked.¹⁴ They also donate 2% of their revenues through brownie sales to the Whole Planet Foundation, an organization that makes micro loans to small businesses in Yonkers.¹⁵

Another example of a social enterprise is the Walker Group. Located in Farmington, Connecticut, the company is one of the largest IT services firms in the greater Hartford area. The company creates a social impact through its profit distribution model. One third of its profits are distributed to shareholders, one third are distributed to employees in the form of bonuses, and one third are donated to charity.¹⁶ The company's CEO and primary shareholder, Kate Emery, has also instituted salary controls to ensure that the ratio of pay from the CEO to the lowest-paid individual is remains equitable and constant.¹⁷

These are just two examples of impactful social enterprises, but there are hundreds of others operating across the country. All social enterprises operate on a varying spectrum of size

¹³ http://benefitcorp.net/storage/documents/greyston_annual_2012_ks_05.pdf

¹⁴ Id.

¹⁵ Id.

¹⁶ <http://www.thewalkergroup.com/about-us/social-enterprise/>

¹⁷ Id.

and profitability, but share a common goal of creating a social or environmental impact. While Connecticut has a large number of social enterprises operating within the state, increasing the size of the sector would surely be desirable, as it would drive economic growth and generate a positive impact in Connecticut's cities and towns – the kinds of positive externalities that the State of Connecticut could surely benefit from.

● *Market Expansion*

Another factor supporting the assertion that Connecticut should become a state known for its social enterprise sector, is that the social enterprise movement is one that is rapidly expanding, not contracting. As mentioned above, while it took 30 years to see adoption of LLCs across all 50 states,¹⁸ in just over four years, 30 states have already adopted social enterprise statutes.¹⁹ Additionally, millennials, the fastest growing demographic group,²⁰ prefer to work for these types of impactful companies. In a recent study, 58% of soon-to-be college graduates stated that they would take a 15% pay cut to work for an organization that has values that reflected their own.²¹ There is support from consumers as well. A recent study out of NYU's Stern School of Business found that "60 percent of consumers are indeed willing to pay extra for socially responsible products and, on average, those consumers were willing to pay a 17.3 percent premium for them."²²

The social enterprise sector is clearly up-and-coming, and enjoys wide support from the millennial generation. Making Connecticut *the* state for social enterprise would be an investment in the future, as it would make the state attractive to a generation whose spending power and ability to start or invest in businesses is on the cusp of increasing. It would also likely lead to an increase in the number of businesses choosing to establish and maintain their

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https://www.americanbar.org/newsletter/publications/law_trends_news_practice_area_e_newsletter_home/llc.html

¹⁹ Supra at 11.

²⁰ <http://www.fastcompany.com/3033488/hit-the-ground-running/4-employee-engagement-secrets-from-millennials>

²¹ <https://netimpact.org/sites/default/files/documents/what-workers-want-2012-summary.pdf>

²² <http://www.nyu.edu/about/news-publications/news/2013/09/17/stern-study-shows-customers-are-willing-to-pay-more-for-socially-responsible-products-.html>

headquarters within the state, because there would be a culture of social entrepreneurship, and a critical mass of these types of businesses operating here.

● *Low Barriers to Making Connecticut a Leader*

Another reason to make Connecticut *the* social enterprise state is the low marginal costs associated with doing so. As stated previously in this report, no state has taken up the mantle as *the* state for social entrepreneurship, and Connecticut's Benefit Corporation Act is one of the most comprehensive in the country. Because of this fact, it will not take much policy innovation or heavy lifting on the part of Connecticut's legislature to position the state as a national leader in this area, as Connecticut would have a "first to market" advantage within the sector. In the next section, there is a list of four policy innovations that, if passed into law, would position Connecticut as a leading and highly desirable location to organize a social enterprise.

Policy Proposals

The following proposals were developed as a result of a comprehensive nation-wide study of social enterprise statutes and scholarly articles, as well as significant numbers of discussions with attorneys, social entrepreneurs, and experts in social enterprise law. They are designed to work together to make it as simple as possible for entrepreneurs to organize and operate as a social enterprise in Connecticut, for consumers to differentiate them from standard businesses, and to incentivize potential investors to drive capital to social enterprises. While each of the four proposals would have a positive effect on Connecticut's social enterprise sector if they were implemented separately, together, they will be much more powerful. The policy proposals combine to create a comprehensive approach to making Connecticut a leader in social enterprise law by driving greater information and capital flows, while at the same time making it easier for startup social enterprises to do business within the state.

- Naming

For social entrepreneurs, the ability to clearly differentiate a social enterprise from a regular for-profit business is a key signaling function for attracting customers and investors. Likewise, from a legal standpoint, it is generally seen as important to differentiate between entity types such as corporations and limited liability companies by placing a signifier such as “LLC” or “Inc.” after the name of the business. While some states have created unique signifiers for benefit corporations (Delaware benefit corporations must put “PBC”²³ where typical corporations place “Inc.”, and Minnesota Benefit Corporations must put “GBC” or “SBC”),²⁴ every other state that has passed benefit corporation legislation (including Connecticut) treats them like regular corporations, simply requires the use of “Inc.,” “Corp.,” or “Incorporated” after the business’s name.²⁵ This trend, somewhat strangely enough, is unique to benefit corporations. Other social enterprise entities use their own unique indicators. For example, ‘low-profit limited liability companies are required by law to use “L3C” as a signifier²⁶, ‘social purpose corporations’ must use “SPC,”²⁷ etc.

To ensure that the distinction between benefit corporations and other corporations is clear, the signifier “BC” or “Ben. Corp.” should be required after the names of all benefit corporations operating or incorporating in Connecticut.²⁸ This would leave little doubt in the minds of consumers whether or not the company was organized as a benefit corporation. It would also be an added advantage in the fight against greenwashing, a practice whereby businesses without a demonstrable social or environmental mission position themselves as

²³ http://benefitcorp.net/storage/documents/How_to_Become_a_DE_Public_Benefit_Corporation_Charter_Amendment.pdf

²⁴ <http://socentlaw.com/2014/08/social-enterprise-law-update-and-map/>

²⁵ Brewer, Cass, Social Enterprise Entity Comparison Chart (August 1, 2014). Available at SSRN: <http://ssrn.com/abstract=2304892>

²⁶ <http://www.cga.ct.gov/2011/rpt/2011-R-0344.htm>

²⁷ <http://apps.leg.wa.gov/rcw/default.aspx?cite=23B.25&full=true#23B.25.040>

²⁸ Some people use the term “B Corp” to refer to a benefit corporation. A “b corp,” however, is a certification offered by B Lab, the non-profit organization that developed the first benefit corporation act. Any for-profit organization, regardless of its legal structure, can become a “certified b corp.” Requiring Connecticut benefit corporations to call themselves “b corps” would likely breed even more confusion than what currently exists when it comes to the difference between the “b corp” certification, and the “benefit corporation” legal entity. To learn more, visit <http://ctinnovations.com/resource/70/BCorpsvsBenefitCorps>

social enterprises as a marketing ploy. Additionally, because it will not include the “G” or “P” before the “BC” of the signifier, as in Delaware and Minnesota, it will be as simple as possible for those not familiar with benefit corporations to ascertain what exactly the signifier is referring to. Ideally, it would also set a precedent favoring simplicity and uniformity (since the signifier is not state-specific), leading to adoption in other states.

● Benefit LLC

The ‘benefit LLC’ is an elegant solution to an issue that many attorneys have identified with the benefit corporation - the issue of double taxation. Benefit corporations can be taxed under either subchapter C, or subchapter S of the federal tax code, which in turn affects state tax status.²⁹ The earnings of subchapter C corporations are taxed once at the corporate level, and then again when dividends are paid out, hence the term “double taxation.”³⁰ Subchapter S corporations receive pass-through tax treatment, meaning that any earnings or losses are passed through to the personal income statements of the owners of the corporation.³¹ This is known as “single” taxation.

It is quite obvious why a startup social entrepreneur would not prefer subchapter C tax status, and would choose to elect subchapter S tax status. Unfortunately, there are significant downsides to electing subchapter S tax status. To do so, all shareholders of the business must be U.S. Citizens, and must be natural persons (no investment companies allowed).³² Additionally, S corporations may only issue one class of stock, and there may be no more than one hundred shareholders of the corporation.³³ With the myriad issues that subchapter S taxation causes, many Connecticut practitioners working with social entrepreneurs have been reticent to recommend the benefit corporation as a legal structure to their start-up clients, and

²⁹ <http://benefitcorp.net/what-makes-benefit-corp-different/benefit-corp-and-nonprofits>

³⁰ <http://www.inc.com/guides/starting-a-c-corp.html>

³¹ <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporations>

³² Id.

³³ Id.

have called for adoption of legislation establishing “benefit LLCs,” which are available now in two states, Oregon and Maryland.³⁴

Benefit LLCs are treated identically to LLCs for tax purposes. They receive all of the benefits S Corporations do with pass-through taxation, but without the onerous obstacles. Much like its statutory sister the benefit corporation, the benefit LLC is required to provide both a general (“a material, positive, impact on society and the environment”)³⁵ and (if desired) a specific public benefit.³⁶ In addition, like benefit corporations, benefit LLCs are required to submit an annual benefit report which includes an assessment of the business’s social and environmental impact by an independent third party, and include a narrative discussing the extent to which a specific and/or general public benefit has been created, along with any circumstances which hindered the creation of a specific and/or public benefit by the benefit LLC.³⁷ All other elements of the benefit LLC are identical to and subject to the same laws as a traditional LLC.

Because the LLC is a hybrid legal entity that is extremely flexible (it has a partnership’s tax structure and the limited liability of a corporation), it is possible for critics to question the utility associated with creating a new, separate legal entity based on the LLC that accomplishes nothing a regular LLC cannot (technically) already do. Proponents would answer by citing the lower transaction costs and branding advantages of the benefit LLC. In a law review article by J. Haskell Murray, a frequent scholarly contributor to the area of social enterprise law, he states that “[s]ocial investors want transparency, accountability, and measurability, but each of those increases transaction costs for the social entrepreneur. Social entrepreneurs with their often very small companies, need easy points of entry.”³⁸

³⁴ <http://socentlaw.com/2014/08/social-enterprise-law-update-and-map/>

³⁵ S.B. 595, 2011 Gen. Assemb, Reg. Sess. (Md. 2011).

³⁶ *Id.*

³⁷ *Id.*

³⁸ Murray, *supra* note 2 (manuscript at 42).

Murray later suggests that benefit LLCs, along with “increased automation of organizational documents”³⁹ will help provide budding social entrepreneurs with a ready-made framework for organizing their social enterprise, through the use of the benefit LLC framework and model organization documents. Ultimately, the benefit LLC can offer startup social entrepreneurs an alternative to creating benefit corporations, providing the easy point of entry discussed by Professor Murray, and minimizing transaction costs.

With regards to branding, the use of the ‘benefit LLC’ signifier can help signal to businesspeople and consumers alike that it operates with a fundamentally different purpose than the typical LLC, and that it is attempting to solve social problems with market-based solutions. As noted in the previous section, rather than forcing the greater public to examine mission statements, corporate reports, etc. consumers can look to the signifier following the business’s name and receive “some assurance that the company is attempting to improve society and the environment,”⁴⁰ thus providing a substantial boost to the marketing efforts of nascent social enterprises, which would normally not have sufficient funds to differentiate themselves from typical for-profit ventures.

When it comes to making Connecticut *the* state for social enterprise law, making benefit LLCs available is absolutely crucial. Oregon, whose Benefit Corporation Act went into effect on January 1st, 2014, has 62 benefit corporations that have incorporated to date.⁴¹ In stark contrast, Oregon’s benefit LLC, which also became available on January 1st, 2014 has 362 users of the entity.⁴² While it is difficult to ascertain for certain why this is the case, it can almost certainly be attributed to the fact that the LLC form is preferred by attorneys when establishing start-up businesses, due to the flexibility and tax advantages that the form provides.

Connecticut, where the benefit corporation entity has been available for just five months, had 32 companies that incorporated as a benefit corporation as of January 29th, 2015,

³⁹ Id. at 43.

⁴⁰ Id.

⁴¹ [Sos.oregon.gov/business/Pages/Oregon-benefit-companies.aspx](http://sos.oregon.gov/business/Pages/Oregon-benefit-companies.aspx) (Last accessed March 23rd, 2015)

⁴² Id.

a number which is growing.⁴³ Both Oregon and Connecticut have similar populations (CT - 3.5 million, OR - 3.9 million),⁴⁴ and while there is no way to tell whether Connecticut would have a similar adoption rate of benefit LLCs as Oregon has had, judging from initial feedback by social entrepreneurs and attorneys who have weighed the pros and cons of becoming a benefit corporation, the issues associated with electing subchapter S tax status has proven to be insurmountable for many interested in formally organizing their business as a social enterprise under Connecticut law.

● Access to Entity-Specific Data from Secretary of the State's Office

In a recent article on the intersection between open data and business, the author states "innovation is a function of access to information and knowledge of how government works."⁴⁵ This is particularly true in the emerging sector of social enterprise law. States that provide easy access to open data regarding the number of social enterprises incorporated or organized within the state have started to drive innovation within their states, as well as beyond them.

The state of Oregon provides access to real-time data regarding the incorporation or organization of benefit corporations and benefit LLC's within the state, and the state of Washington provides similar data for the social enterprise entity available in that state as well.⁴⁶ This provides opportunities for consumers and investors to easily access information about benefit corporations and LLCs, it allows social entrepreneurs to identify each other and build communities of like-minded businesses, and it allows scholars to accurately and efficiently study the state's benefit corporation and LLC sector without having to resort to Freedom of Information Act requests.

⁴³ E-mail correspondence with Attorney Seth Klaskin, Director, Business Services Division, Office of the Secretary of the State, Connecticut. January 30, 2014.

⁴⁴ <http://www.census.gov/popest/data/state/totals/2014/index.html>

⁴⁵ <http://www.govtech.com/data/Can-Open-Data-Find-Business-Model.html>

⁴⁶ http://www.sos.wa.gov/corps/search_advanced.aspx

An example of the positive effect of opening up entity-specific data to the public is Washington State's "SPCWA" website.⁴⁷ The site's founder and administrator, Andrea Gates Sanford, put it together to provide free information about how the social purpose corporation (hereafter "SPC," a social enterprise legal structure available only in Washington, Texas, and California) works, why people would use it, and a list and interactive map showing the names and locations of all of the SPCs operating across the state. In an interview with Ms. Sanford, she mentioned that due to the ease of use of the Washington Secretary of State's website, she only needs to dedicate a few hours each month to updating the list of social purpose corporations in existence in the state, and adding them to the interactive map. Open data allows people like Ms. Sanford to quickly and easily create web applications and other materials that consumers, researchers, and other businesses can use to locate and patronize active social purpose corporations in the state.⁴⁸

Providing open data regarding the adoption of benefit corporations and benefit LLCs can also assist policy-makers as they work to develop Connecticut's social enterprise sector. Without the ability to track the growth of the benefit company sector in Oregon, it would have been extremely difficult to conduct an analysis of the adoption of benefit corporations and LLCs for this report. Maryland, the other state that offers benefit LLCs, does not provide open data regarding the adoption of benefit corps and benefit LLCs, and as a result, it was not possible to access that state's information for this analysis.

Initially, while it might not be possible to update the search capabilities of the Connecticut Secretary of the State's CONCORD system given the state's current fiscal situation, the Secretary of the State's office could publish monthly or quarterly reports outlining the incorporation of new benefit corporations (and eventually benefit LLCs) within the state, and host them on the CONCORD website. Although the information would not be available in real time, providing monthly or quarterly snapshots would still likely have the positive effect that offering real-time data has had in other states, as it would be made available to the public in

⁴⁷ <http://www.spcwa.com/>

⁴⁸ Conversation with Andrea Gates Sanford, June 5th, 2014.

regular and predictable intervals. At a later date, however, the state would be well-served by making an investment into infrastructure that would allow for real-time access to data regarding social enterprise entities.

- Impact Investor Tax Credits

There are a number of tax credits available to various types of businesses within Connecticut. Perhaps the most relevant to social entrepreneurs is the Angel Investor Tax Credit. Social entrepreneurs, not unlike typical entrepreneurs, are on a constant quest for access to investment capital. Because the majority of the social enterprises currently operating in Connecticut are at the startup phase, incentivizing investment in this stage of company is crucial if the state is to become a leader in the development of the social enterprise law sector.

Currently, the Angel Investor Tax Credit is structured in such a way that investors can receive a 25% tax credit (up to a total of \$250,000 in credits) on investments of \$25,000 or more.⁴⁹ The businesses must be Connecticut-based, and engaged in the fields of bioscience, advanced materials, photonics, information technology, or clean technology.⁵⁰ Since changes to the credit were put into place in 2012 to lower the amount of investment capital need to qualify for the credit (from \$100,000 to \$25,000), there has been increased use of the credit.⁵¹ According to an article published shortly after the changes to the credit were made, “the number grew with 84 angel investors pledging \$8.6 million in 23 companies as compared to 13 angel investors pledging \$2.4 million to 9 companies in the six month prior to revision.”⁵²

To promote investment in Connecticut social enterprises, the Angel Investor Tax Credit should be modified to include “social enterprise” as a sixth business category eligible for the tax credit. To do so would likely require the development of a statutory definition of what constitutes a “social enterprise” for purposes of the tax credit. There is no precedent for

⁴⁹ <http://ctinnovations.com/angels>

⁵⁰ <http://ctinnovations.com/pdf/Angel%20Legislation.pdf>

⁵¹ http://articles.courant.com/2012-06-08/business/hc-angel-investor-credits-20120608_1_angel-investors-tax-credit-start-up-firms

⁵² Understanding the Angel Investor Tax Credit, by Diego Mas Gonzales

developing such a definition in the U.S., but definitions for similar cutting edge sectors have been defined by statute for the purposes of tax credits. In Connecticut, the state's "New Reinsurance Reinvestment Fund Tax Credit" legislation, which was passed in 2010, defines a "green technology business" for example.⁵³ While the statutory term "social enterprise" should be defined as a benefit corporation, or benefit LLC to encourage the use of the entities, it may be necessary to add additional language to ensure that companies recognized as "social enterprises" are in compliance with the reporting requirements of the benefit corporation or benefit LLC statutes.

Conclusion

It is clear that there is a tremendous opportunity for Connecticut to become the national leader in social enterprise law. To become a national leader, however, the legislature must seize the opportunity at hand, and introduce legislation enabling the policies discussed above. The policies in this report have been crafted in such a way as to drive increases in the number of companies that use social enterprise entities within the state, to make it easier for consumers to gain access to information about these businesses, and to encourage investment in them, all with minimum fiscal impacts from a state budgeting perspective.

⁵³ <http://www.cga.ct.gov/2010/ACT/PA/2010PA-00075-R00HB-05435-PA.htm>