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LAW AND CHOICE OF ENTITY ON THE SOCIAL ENTERPRISE FRONTIER

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I. Introduction

In 2007, David Gergen, the ubiquitous media pundit, described social entrepreneurship as "one of the hottest movements" among young people in the United States.[1] In 2008, the New York Times columnist, Nicholas Kristof, compared today's social entrepreneurs to the leaders of America's civil rights movement.[2] What is social entrepreneurship and why should lawyers take notice?

If their press is to be believed, social entrepreneurs are people who "envision widespread, systematic change," who attack society's ills at the roots, and who do so with an "entrepreneurial and innovative spirit."[3] History provides countless examples of innovators who have devised solutions to enduring social problems,[4] but the new social entrepreneurs that Gergen and Kristof celebrate distinguish themselves by rejecting the traditional boundaries between the nonprofit and for-profit sectors and carrying out their plans through so-called hybrid social enterprise organizations. They embrace market oriented solutions to social ills, and often structure their organizations with earned

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[1] David Gergen, *The New Engines of Reform,* U.S. NEWS & WORLD REPORT, February 20, 2006, at 48.
[2] Nicholas D. Kristof, *The Age of Ambition,* N. Y. TIMES, January 27, 2008, at 18. *See also* Andrew M. Wolk, *Advancing Social Entrepreneurship: Recommendations for Policy Makers and Government Agencies,* http://www.rootcause.org/sites/rootcause.org/files/files/Advancing_SE.pdf, at p. 2 (quoting a Kristof speech in which he described social entrepreneurship as "the most important movement since the civil rights movement").
[3] Gergen, *supra* note 1, at 48. *See also* J. Gregory Dees, *The Meaning of 'Social Entrepreneurship'* (2001), http://www.caseatduke.org/documents/dees_sedef.pdf, at 1-4.
[4] *See generally* Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law,* 73 FORDHAM L. REV. 2437, 2453-2457, 2462 (discussing Benjamin Franklin's Junto Society, Jane Addams and the settlement house movement, and Andrew Carnegie's scientific philanthropy).

income strategies so that they do not rely, at least not exclusively, on charitable donations. Although social entrepreneurs generally are driven by a desire to do good, they view themselves not as nonprofit executives who run commercial activities on the side in order to cross-subsidize their charitable operations, but as business people who are trying to achieve "double bottom-line" (financial and social) or "triple bottom-line" (financial, social, environmental) results.[5]

There is dissent over whether any of this is really new or valuable,[6] but there seems to be an increasing consensus among experts, devotees, and the surfeit of new social enterprise[7] organizations they have spawned[8] that these hybrid social enterprises

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[5] Transcript of the January 20, 2007, ABA Tax Section Exempt Organizations Committee Meeting [hereinafter ABA 2007 Exempt Organizations Transcript], *available at* http://meetings.abanet.org/webupload/commupload/TX319000/sitesofinterest_files/56EO0021.pdf, at 55. *See also* John M. Conley & Cynthia A. Williams, *Engage, Embed, and Embellish: Theory Versus Practice in the Corporate Social Responsibility Movement,* 31 IOWA J. CORP. L. 1, 24 (2005) (defining triple bottom line). Social entrepreneurs also employ a related term, "blended value," to describe and to advocate for measuring organizations' value and success in terms of the economic and social benefits that they produce. *See, e.g.,* Jed Emerson et al., *The Blended Value Map: Tracking the Interests and Opportunities of Economic, Social and Environmental Value Creation,* October, 2003, *available at* http://www.blendedvalue.org/media/pdf-bv-map.pdf. *See also* Jed Emerson, *The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and The Blended Value Proposition* 10 (Harvard Business School Social Enterprise Series, Working Paper No. 17, 2000).

[6] The gist of most critiques is that this new movement is merely a repackaging of ideas and methods that have been around for generations, and that social entrepreneurship consists mainly of new terminology mixed with savvy marketing. *See* James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches,* 76 FORDHAM L. REV. 567, 603-06 (2007) (arguing that social enterprise is "old wine in a new bottle"); Kelley, *supra* note 4, at 2462 (noting that innovative, entrepreneurial solutions to society's ills have a long history in the US). Recent commentators have made sport of the terminology employed by social entrepreneurs. *See e.g.,* David E Pozen, *We Are All Entrepreneurs Now,* 43 WAKE FOREST L. REV. 283 (2008). *See also* ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 53 (quoting a lawyer as saying that "everybody is 'incentivizing' everybody else, often toward a new paradigm").

[7] The nomenclature of this new area is variable and contested. In this article, I use the term social entrepreneur to refer to the individuals described in this introduction. I use the terms "social enterprise," "hybrid organization," and "hybrid social enterprise" interchangeably to refer to the entities through which social entrepreneurs carry on their affairs. The "fourth sector," sometimes preceded by adjective "emerging," refers to the social sector that is, at least arguably, giving definition and structure to the social entrepreneurs and their hybrid social enterprises.

[8] To name a few examples, The Social Enterprise Alliance is a national intermediary organization that promotes social enterprise (described at http://www.se-alliance.org/), while the The Center for the Advancement of Social Entrepreneurship (CASE) does the same but from an academic and research perspective (described at http://www.caseatduke.org/). The Echoing Green Foundation, (described at http://www.echoinggreen.org/), the Acumen Fund (described at http://www.acumenfund.org/) and Ashoka

and the entrepreneurs who launch and sustain them comprise an evolutionary step in the structuring of American society. According to them, we are in the process of moving beyond the traditional conception of society as divided neatly into three sectors – business, nonprofit, and government – and are witnessing the emergence of a new fourth sector that encompasses elements of both the business and nonprofit sectors.[9]

Why should the emergence of this new societal sector be of particular concern to lawyers? It is because the new entrepreneurs claim to inhabit a social frontier where outmoded law and inappropriate old-style legal entities hamstring their socially transformative plans. With increasing vehemence, they are demanding that the law – and lawyers – catch up.[10]

Some legal progress has been made. A few practitioners have learned to cobble together complex structures – some of which will be described in Part IV, below – that draw on a mix of for-profit and nonprofit forms and doctrines to create legal scaffolding for hybrid ventures.[11] But those complex structures, which involve corporations with multiple classes of stock and detailed shareholder agreements, or the creation of multiple interlocking entities, or the use of delicately drafted joint venture agreements, tend to be

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(described at http://www.ashoka.org/) provide funding and support for social entrepreneurs and their ventures.

[9] Thomas J. Billitteri, *Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach?* 2 (January 2007), http://www.nonprofitresearch.org/usr_doc/New_Legal_Forms_Report_FINAL.pdf. (Report of an Aspen Institute Round Table Discussion).

[10] *See id.* at 8-15 (describing the growth of hybrid organizations and the sense that new legal forms are needed). *See also* Nicole Wallace, *New Business-Charity Hybrid Sought,* THE CHRONICLE OF PHILANTHROPY, March 12, 2008, at X (reporting the increasing demand for new laws). *See generally* Robert A. Wexler, *Social Enterprise: A Legal Context,* THE EXEMPT ORGANIZATIONS TAX REVIEW 233, 239 (December 2006) (discussing the increasingly complex legal issues faced by hybrid social enterprises).

[11] ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 53. *See* Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective* 2-10 (2007) ("Discussion Draft" on file with the author) (summarizing various approaches to creating legal structures for hybrid ventures); Wexler, *supra* note 10, at 236-244 (same).

expensive to create, burdensome to maintain,[12] and, due to their novelty, legally insecure. A call has arisen from the emerging fourth sector for lawyers and law makers to develop new laws, in particular new legal entities, to provide structures better suited to double and triple bottom-line endeavors.[13]

The modest goal for this paper is to begin responding to social entrepreneurs' demands, first by attempting to summarize the legal challenges they face, then by evaluating the merits of various possible solutions. Part II will sketch the metes and bounds of the fourth sector frontier, and will conclude by narrowing the inquiry's focus to a very recent and legally challenging trend: hybrid organizations formed as for-profits even though their purpose is essentially charitable. Part III will describe some of the practical and legal complications faced by these hybrid social enterprise organizations. Part IV will briefly describe some of the cobbled-together solutions that social enterprise lawyers have employed up until now, and will analyze various proposals for new laws and legal entities that purport to resolve most if not all of the challenges described in Part III. The paper will conclude that one very recent legal innovation – the Low-Profit Limited Liability Company ("L3C") – holds particular promise for responding to the legal needs of the emerging fourth sector.

II. The Social Enterprise Terrain

A. Examples of Hybrid Organizations

[12] ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 57 (quoting a social enterprise lawyer as saying "there's usually not a lot of appetite for multiple entities and the cumbersome nature of how you deal with the relationship between the two when one of them is a nonprofit").
[13] Wallace, *supra* note 10, at X.

According to its boosters, social enterprise is taking root in the fertile space between the for-profit and nonprofit worlds.[14] Many of the early social enterprise organizations, founded in the 1980s and 1990s,[15] were formed as nonprofit organizations even though they engaged in significant levels of commercial activity.

1. Nonprofits Doing For-Profit Work

A celebrated example is Triangle Residential Options for Substance Abusers ("TROSA"), located in Durham, North Carolina. TROSA is a long-term residential drug rehabilitation program that houses, feeds, trains and provides counseling for several hundred recovering addicts at any given time.[16] In spite of its ambitious charitable mission and its status as a tax exempt nonprofit corporation, TROSA is largely financially self-sufficient, subsisting on revenues generated by various industries that it launches and sustains. For example, it has a highly successful moving business, a bricklaying business, a frame shop, and a used-furniture showroom.[17] TROSA's recovering drug addicts, or "residents" as they are referred to, supply all of the labor and most of the expertise necessary to sustain the ventures, and while they are on the job they learn employment and life skills that help them in their recovery process. All profits from the industries go back to TROSA to cover operating expenses such as salaries for

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[14] Billitteri, *supra* note 9, at 2.

[15] Some commentators identify the Grameen Bank, founded by Muhammad Yunus in 1976 in Bangladesh, as the original social enterprise, or at least the enterprise that brought world-wide attention to the potential for using market strategies to address enduring social ills. *See generally* Louise A. Howells, *The Dimensions of Microenterprise: A Critical Look at Microenterprise as a Tool to Alleviate Poverty,* 9 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 161, 163 (describing the Grameen Bank's founding). *See also* Laurie A Morin, *Legal Services Attorneys as Partners In Community Economic Development: Creating Wealth For Poor Communities Through Cooperative Economics,* 5 U.D.C. L. Rev 125, 133-34 (Fall 2000) (describing the Grameen Banks as the first microenterprise organization and describing how its approach was adapted by social entrepreneurs in the U.S.). Others claim that this concept has been around much longer. *See* Kelley, *supra* note 4, at 2462 (discussing social innovators throughout American history).

[16] *See generally* http://www.trosainc.org/program/index.htm (describing TROSA's mission and programs).

[17] *See* http://www.trosainc.org/businesses/index.htm (describing TROSA's various business enterprises).

professional staff and food, clothing, shelter, medicine and medical treatment for the residents.[18]

A few years ago, I wrote an article about entrepreneurial nonprofit organizations such as TROSA, particularly about the confusing, contradictory, and unpredictable legal regime that they must contend with as they pursue their entrepreneurial, market-oriented solutions to social issues.[19] Although those problems have yet to be resolved, this paper will leave that topic behind[20] and will focus primarily on the legal challenges faced by a different, increasingly common form of entrepreneurial hybrid: for-profit entities formed with the avowed dual purposes of turning a profit and achieving sustained social benefits.

2. For-Profits Doing Nonprofit Work

Google.org provides a recent, much discussed example of a for-profit organization formed for largely social benefit purposes.[21] In 2005, the extremely

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[18] My knowledge of TROSA's structure and its business operations is based partly on direct experience: I served on its board of directors from 1995-2000.

The type of earned income strategy pursued by TROSA, a nonprofit tax-exempt organization, has a long pedigree in the U.S. and has been endorsed by the Internal Revenue Service. *See* Aid to Artisans, Inc. v. Comm'r, 71 T.C. 202, 213 (1978) (concluding that profit-making activity is not a bar to exemption if the activity furthers or accomplishes an exempt purpose); Industrial Aid for the Blind v. Comm'r, 73 T.C. 96 (1979) (concluding that a charity's profits were permissible where the purpose of the profit generating activity was to provide employment and thus alleviate hardship for the blind) . Although this area of law vague and therefore treacherous, entrepreneurial nonprofits such as TROSA that engage in earned income strategies do not (or at least should not) endanger their tax exempt status, nor are they required to pay unrelated business income tax on their profits, so long as the fee-generating activities are directly related to and in furtherance of their charitable missions. *See* Kelley, *supra* note 4, at X. *See also* Aid to Artisans, 71 T.C. 202 (1978); Treas. Reg. § 1.501(c)(3)-1(c), §1.501(c)(3)-1(D)(2), (3). In TROSA's case, the recovering addicts receive therapeutic value from their work activities and, simultaneously, receive job training that leads to future employment.

[19] Kelley, *supra* note 4, at X (describing how entrepreneurial nonprofit organizations become ensnared by contradictions among nonprofit law's Operational Test, Commerciality Doctrine, Unrelated Business Income, and the Commensurate in Scope Doctrine).

[20] The two topics – legal problems faced by nonprofits that engage in entrepreneurial, profit-generating activity and the growing phenomenon of for-profit organizations forming to pursue essentially social benefit missions – are closely and even causally linked. The causal link arises because to an increasing degree social entrepreneurs are choosing to launch their hybrid ventures as for-profits precisely because they wish to avoid the legal quagmire faced by entrepreneurial nonprofits. *See infra* note 26 and accompanying text.

[21] I use the term "social benefit" in this paper as synonymous with "charitable." All organizations that qualify as "charitable" under federal law and that are designated as exempt from taxation under § 501(c)(3)

successful internet parent company Google, Inc., established a philanthropic entity, The Google Foundation, as a standard private grant-making foundation, endowing it with a comparatively modest $90 million.[22] Nothing about The Google Foundation heralded an aggressive move by the parent, Google, Inc., into fourth sector innovation. However, in 2006 Google, Inc. made a much larger philanthropic commitment, this time to a hybrid social venture called Google.org, established as a for-profit corporation and capitalized with an initial $1 billion worth of Google, Inc.'s stock plus a share of its future profits.[23] Google.org's mission is to improve the world by, among other things, investing[24] in planet saving technologies and lobbying Congress for policies to help stimulate emerging markets for these revolutionary innovations.[25]

According to Google, Inc.'s spokespeople, the parent corporation decided to carry out the bulk of its philanthropic activities through a for-profit organization because it wanted to maintain maximum operational flexibility and avoid the regulatory

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of the Treasury Code, must demonstrate, among many other things, that they provide a benefit to the public at large. The hybrid social ventures described in this paper generally would provide such benefits, but would not qualify as "charitable" for other reasons, such as the fact that they are not exclusively dedicated to charitable outcomes or that they intend to distribute part of their profits to their owners. *See* 26 C.F.R. 1.501(c)(3)-1(c)(1).

[22] Katie Hafner, *Philanthropy Google's Way: Not the Usual,* N.Y. TIMES, September 14, 2006, at A1**.** *See also* Google.org – About Us, http://www.google.org/about.html. In comparison, the endowment of the Ford Foundation is $11 billion, and of the Gates Foundation is $38.9 billion. Matthew S. L. Cate, *State's Top Givers Put on the Brakes: '07 Foundation Gifts See Little Rise*, ARKANSAS DEMOCRAT-GAZETTE, February 15, 2009, at 1. [better cite].

[23] Hafner, *supra* note 22(reporting Google, Inc.'s principals pledged one percent of Google Inc.'s profits over the next twenty years). *See also* Chris Gaither, *Google Sets Aside $1 Billion for Causes,* L.A. TIMES, Oct. 12, 2005, at 2; Google.org – About Us, *supra* note 22.

[24] Until recently, the word "invest" was largely taboo for nonprofit organizations because it sounded too commercial and because, particularly for private foundations, it raised the specter of "jeopardizing investments" regulations, which punished foundations that engaged in financially risky investments. I.R.C. § 4944. In the fourth sector world, however, no one – not even traditional grant making private foundations – merely provides grants; everyone "invests" in "socially beneficial outcomes," which ideally produce "social return on investment." *See generally supra* note 5.

[25] Hafner, *supra* note 22, at A1. *See also* Jessi Hempel, *Googling for Charity,* BUSINESS WEEK, October 20, 2005, at _ (*available at* http://www.businessweek.com/print/technology/content/oct2005/tc2051020_721687.htm). *See also* Fishman, *supra* note 6, at X. Google.org – About Us, *supra* note 22.

straightjacket imposed by the laws that govern nonprofit organizations;[26] after all, activities such as venture capital investing and lobbying Congress – two of Google.org's professed priorities – are difficult and legally risky to carry out from within a nonprofit organization.[27] As a for-profit, Google.org will be free to back social venture investment funds,[28] finance the work of individual entrepreneurs, and invest in for-profit ventures that show promise for addressing pressing social needs.[29] Consistent with the double bottom-line approach described above,[30] the Google, Inc. founders hope that some of Google.org's social ventures will turn a profit, but they are complacent about the possibility of losing money.[31] In their words, "We're not doing it for the profit. [T]he emphasis is on social . . . not economic returns."[32]

The emergence of Google.org helped focus the world's attention on the possibility that a new era of hybrid organizations had arrived, but, with its vast resources, its global vision, its essentially philanthropic nature, and its practically limitless budget for sophisticated legal counsel, it is hardly typical of the social enterprises that are migrating away from nonprofit and toward for-profit legal forms. A more typical example would be a proposed community economic development project in North Carolina that aims to

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[26] Hempel, *supra* note 25, at X. Larry Brilliant, the president of Google.org, likens traditional philanthropy carried on through nonprofit organizations to a musician confined to playing only on the high register on a piano and says that, as a for-profit, Google.org can "can play on the entire keyboard." Hafner, *supra* note 22, at A1. Google.org – About Us, *supra* note 22.

[27] The IRS proscribes and punishes with fines lobbying by private foundations. I.R.C. § 4945. Private foundations are permitted to invest in for-profit entities that serve a social purpose, but only in very narrow circumstances and constrained by onerous regulations. *See infra* Part III.A.1 (discussing program related investments by private foundations). Nonprofit organizations, including private foundations that engage in excessive commercial activity, risk losing their tax exemption under the Operational Test or the closely related Commerciality Doctrine. *See* Kelley, *supra* note 4, at X.

[28] *See infra* Part III.A.2 (describing socially responsible investment funds).

[29] Hempel, *supra* note 25, at X.

[30] *See supra* note 5 and accompanying text (defining double bottom-line).

[31] Hafner, *supra* note 22, at A1.

[32] *Id.* at A1 (quoting Larry Brilliant the director of Google.org)

save portions of the region's dying furniture industry.[33] Until recently, North Carolina was a national center of furniture manufacturing, an industry that provided relatively high-paying jobs and buoyed the economy of the central region of the state.[34] Lately, many of the furniture factories have shut down or moved overseas, leaving behind derelict plants and devastating levels of unemployment.[35]

From the perspective of a furniture corporation whose primary mission – indeed, arguably its legal responsibility – is to maximize profits for shareholders,[36] the abandonment of the North Carolina furniture factories makes perfect sense. A manufacturer might face the prospect of spending tens of millions of dollars to modernize a factory in North Carolina when for a smaller initial outlay it could transfer its manufacturing activity to China where it would enjoy significantly lower ongoing production costs and higher profit margins.[37] But although such a move would be rational from a purely economic perspective, it would have devastating social consequences on the North Carolina communities where the plants were located.

A hybrid social venture – one that desires to make a profit but that is equally committed to a social bottom line – could step in to the void created by the purely for-profit furniture businesses. The hybrid organization could purchase the abandoned

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[33] *See* Mannweiler Foundation, Inc., *No Jobs Here: Endangered Industry Equals Endangered Job* [hereinafter Manweiler Report], October 23, 2006 (a report accompanying a presentation to the Joint Study Committee on the North Carolina Center for Applied Furniture Technology of the North Carolina legislature) (copy on file with author).

[34] *See* Virginia Bryson, et. al., *The Furniture Industry (Case Goods): The Future of the Industry, United States versus China* (March 7, 2003) (a report by the UNC-Chapel Hill Kenan-Flagler Business School) *available at*: http://www.kenan-flagler.unc.edu/assets/documents/furn_paper.pdf (arguing that the North Carolina furniture industry is "losing ground quickly" to China and reporting that furniture manufacturing hourly wages in the US are approximately $15 compared to $ 0.75 in China).

[35] *See id.* (describing international competition and referring to a recent slew of domestic furniture industry bankruptcies). *See also* Jon Chavez, *Overseas Competition Challenges Furniture Industry,* TOLEDO BLADE, March 22, 2007, at p. X (saying US furniture manufacturers are shuttering domestic factories and moving their operations overseas).

[36] *See infra* note 57 and accompanying text (describing the enduring debate over "shareholder primacy").

[37] Mannweiler Report, *supra* note 33.

factories along with the unused equipment and run them as ongoing concerns that would provide state residents with jobs that come with reasonable wages and benefits.[38] The social enterprise would form as a for-profit because purchasing and renovating the factories would necessitate raising significant capital and, for reasons described in more detail in Part III, below, nonprofits are hobbled when it comes to capital formation. The fact that the economic returns on such a venture would be limited – say, five percent overall, rather than the twelve or fifteen percent that the owners of purely commercial ventures might expect – would be acceptable to the hybrid organization because at least some of its owners and all of its managers would be motivated by multiple bottom lines: a modest financial return on investment coupled with the maintenance of strong, healthy, sustainable communities that results from retaining high quality jobs.[39]

B. Distinguishing Hybrid Social Ventures From Corporate Philanthropy and Corporate Social Responsibility

Google.org and the hypothetical North Carolina furniture factory inhabit the liminal world of hybrid organizations where success is measured by both profits and social impact.[40] But these purportedly new hybrid social ventures are not the first organizations to hold themselves out as having mixed motives. Before proceeding to a discussion of the legal challenges faced by hybrid ventures in the new fourth sector, we examine the fourth sector antecedents, particularly corporate philanthropy and the

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[38] *Id*.

[39] Robert M. Lang, *The L3C: The New Way to Organize Socially Responsible Organizations* , TAX EXEMPT CHARITABLE ORGANIZATIONS, ALI-ABA Course of Study, Course Number SN036 251 (2007). *See also* Robert M. Lang Jr., *Saving Endangered Industries: The North Carolina Furniture Industry* (Report of the Mannweiler Foundation, Inc. 2005-2006) (copy on file with author). *See also* Victor Fleischer, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy,* 30 WESTERN NEW ENGLAND L. REV. 93 (2007) (arguing that for-profit entities are appropriate vehicles for community investment activity).

[40] *See supra* note 5 (defining multiple bottom lines and the concept of "blended value").

corporate social responsibility movement, and ask, at least implicitly, whether in fact there anything new in all of this.

1. Corporate Philanthropy

Corporate philanthropy generally involves a parent business corporation establishing a controlled charitable entity through which it engages in a sustained program of grant making.[41] The Google Foundation, Google, Inc.'s nonprofit philanthropic vehicle, provides a typical example.[42] Corporations offer various rationales for their philanthropic programs. Many justify them in purely financial terms, arguing that by enhancing the public's sense of good will and loyalty toward the corporation, the philanthropy ultimately serves the organization's long-term financial interests.[43] Others offer more philosophic justifications such as the desire to do good and act as responsible members of the communities in which they are situated.[44]

Corporate philanthropy has been criticized, at least since the early 20th century, as serving the interests of entrenched corporate managers who use in-house foundations to funnel corporate funds to pet projects such as museums and symphonies, projects that

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[41] David F. Freeman, The Handbook on Private Foundations, The Council of Private Foundations 1-9 (Rev. Ed. 1991).

[42] *See supra* note 22.

[43] *See* Adam Winkler, *Corporate Law or the Law of Business?: Stakeholders and Corporate Governance at the End of History,* LAW & CONTEMP. PROBS. 109, 117 (2004) (stating corporate charity remains formally tied to shareholder profit maximization). *See also* CHRISTINE ARENA, THE HIGH PURPOSE COMPANY: THE TRULY RESPONSIBLE – AND HIGHLY PROFITABLE – FIRMS THAT ARE CHANGING BUSINESS NOW 12 (2007) (discussing the controversy over whether corporate social responsibility is about doing the right thing or enhancing long-term profits). *But cf.* James R. Boatsman & Sanjay Gupta, *Taxes and Corporate Charity: Empirical Evidence from Microlevel Panel Data,* NAT'L TAX J. VOL 9 NO 2 193 (1996) (concluding that there is little empirical evidence to support the idea that corporate philanthropy and CSR enhance long-term financial performance). [William O. Brown, et. al, *Corporate Philanthropic Practices,* 12 J. CORP. FIN. 855, 856 (2006). Victor Brudney & Allen Farrell, *Management and Control of the Modern Business Corporation: Corporate Charitable Giving,* 69 U. CHI. L. REV. 1191, 1192-3 (2002); Jayne W. Barnard, *Corporate Philanthropy, Executives' Pet Charities and the Agency Problem,* 41 N.Y.L. SCH. L. REV. 1147, 1147-8.]

[44] *See* Brudney & Farrell, *supra* note 43, at 1194-5 (critiquing moral arguments in favor of corporate philanthropy).

enhance the managers' social profiles but accomplish little for people in need and expend shareholders' resources without their consent.[45] But in spite of periodic legal challenges, most court decisions have upheld the right of managers to engage in corporate philanthropy,[46] and in recent times all fifty states have adopted legislation specifically empowering them to do so.[47]

2. Corporate Social Responsibility

Corporate Social Responsibility, or CSR as it is often referred to, is a more recent and more sweeping trend in the corporate world,[48] one which has largely subsumed the older and narrower category of corporate philanthropy.[49] Proponents of CSR contend that modern corporations are responsible for more than merely maximizing financial returns for their investors[50] and instead should take into the consideration the needs and desires of other "stakeholders" such as the corporation's employees, the citizens of the communities in which the corporations operate, governments, and organizations advocating for various social and environmental interests.[51] Importantly, the CSR movement can be distinguished from most corporate philanthropy in that it generally

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[45] Barnard, *supra* note 43 at 1160-64. *See* Winkler, *supra* note 43, at 118 (arguing that expanding managerial discretion to engage in philanthropy often gives rise to opportunistic behavior).
[46] A.P. Smith Manufacturing Co. v. Barlow, 98 A.2d 581 (N.J. 1953).
[47] Brown, et al., *supra* note 43, at 859-60 (referring to the passage of philanthropy statutes across the U.S.).
[48] Conley & Williams, *supra* note 5, at 13-14. Not everyone is confident that CSR is anything more than trend "in corporate communication." Conley & Williams, supra note 5, at 5. However, if the significance of the movement can be judged by the number of publications it has spawned, CSR will be with us for a long time to come. *See, e.g.,* ARENA, *supra* note 43; JAN JONKER & MARCO DE WITTE, THE CHALLENGE OF ORGANIZATING AND IMPLEMENTING CORPORATE SOCIAL RESPONSIBILITY (2006); David Maurrasse, *A Future for Everyone: Innovative Social Responsibility and Community Partnerships, in* A FUTURE FOR EVERYONE: INNOVATIVE SOCIAL RESPONSIBILITY AND COMMUNITY PARTNERSHIPS (ed. David Maurrasse, 2004); MALCOLM MCINTOSH, ET AL., CORPORATE CITIZENSHIP: SUCCESSFUL STRATEGIES FOR SUCCESSFUL COMPANIES (1998); ALAN REDER, THE PURSUIT OF PRINCIPLE AND PROFIT: BUSINESS SUCCESS THROUGH SOCIAL RESPONSIBILITY (1994).
[49] *See* [Klaus Schwab, *Global Corporate Citizenship: Working with Governments and Society*, 87 FOREIGN AFFAIRS _, January 1, 2008 (discussing the relationship between corporate philanthropy and CSR).]
[50] Conley & Williams, *supra* note 5, at 2.
[51] *See id.*

holds that corporations should consider the interests of these varied constituencies even if it negatively affects the corporation's financial performance.[52] Proponents argue that corporations have become so pervasively powerful and comparatively unregulated, in many cases even displacing governments, that society will be well ordered only if those ultra-powerful corporations look beyond the interests of their owners and respond directly to society's needs.[53] As is true of corporate philanthropy, some make more generalized claims that CSR is simply the right thing to do.[54]

The CSR movement has for the most part stood up to legal challenge in the United States.[55] The main question has been whether managers are permitted to use corporate assets to serve constituents beyond their shareholders. Although there is still ample controversy over whether shareholder primacy ought to rule as the underlying principle of corporate decision making,[56] it is reasonably well settled in most jurisdictions

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[52] *See* Winkler, *supra* note 43, at 115-16. Corporations committed to the principles of CSR place great emphasis on reporting and evaluating the social impact that their activities have on their diverse constituents. *See generally* Conley and Williams, *supra* note 5, at 4-5 (comparing CSR reporting in the US and UK); ARENA, *supra* note 43, at 9 (claiming that in 2005 more than half of the world's 250 largest companies either had a separate CSR report or devoted much of their annual report to CSR issues); SIMON ZADEK, TOMORROW'S HISTORY: SELECTED WRITINGS OF SIMON ZADEK 1993-2003 10 (2004) (noting that these reports are sometimes referred to as "social audits," a term coined by The Body Shop in the early 1990s). *See cf. supra* note 43 (discussing whether CSR and corporate philanthropy enhance profits).

[53] Introduction, THE CHALLENGE OF ORGANIZING AND IMPLEMENTING CORPORATE SOCIAL RESPONSIBILITY 2 (Jan Jonker & Marco de Witte eds., 2006). MCINTOSH, ET AL., *supra* note 48, at 43.

[54] *See* MICHAEL SCHOEMAKER & JAN JONKER, IN GOOD COMPANY: REFLECTIONS ON THE CHANGING NATURE OF THE CONTEMPORARY BUSINESS ENTERPRISE AND ITS EMBEDDED VALUE SYSTEMS 51 (2006) (arguing that corporations should evolve from "first order values," which focus on serving customers and owners to "second order values," which focus on how to create sustainable communities); MCINTOSH, ET AL., *supra* note 48, at xx, 135 (arguing that companies, just like individuals, have social rights and responsibilities).

[55] Conley & Williams, *supra* note 5, at 2.

[56] *See* MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962). *See also* Milton Friedman, *A Friedman Doctrine – The Social Responsibility of Business Is to Increase Its Profits,* N.Y. TIMES, Sept. 13, 1970 (Magazine), at 33; Winkler, *supra* note 43, at 118 (arguing that constituency statutes create inefficiencies by giving corporate managers too much discretion to donate to pet charities); Brudney & Ferrell, *supra* note 43, at 1216-17(arguing that corporate owners, not managers, should decide on charitable contributions).

in the United States that corporations may take into consideration the interests of other, broader constituencies.[57]

3. Distinguishing Hybrid Social Enterprise from its Corporate Cousins

Corporate philanthropy and CSR are precursors of the newly emergent hybrid social enterprise movement and they share some important features. All three view for-profit corporations as proper vehicles for achieving socially beneficial outcomes. Although corporate philanthropy more often justifies itself as being in the long-term financial interests of shareholders, CSR and social enterprise generally consider it proper for corporate managers to consider the interests of a broad array of stakeholders, even if such decisions produce negative impacts on financial returns for shareholders. [58]

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[57] The shareholder primacy argument arose long before the CSR movement. The seminal case of Dodge v. Ford Motor Company, 170 N.W. 668 (Mich. 1919), squelched Henry Ford's plans to "benefit mankind" by lowering prices and making his cars available to the masses even though such steps would constrain shareholder profits. In deciding the case, the Michigan Supreme Court fell squarely into the shareholder primacy camp, ruling that a "business corporation is organized and carried on primarily for the profit of stockholders." *Id.* at 684. Since that time, however, many states have leaned hard in the opposite direction, initially in the Delaware case of Theodora Holding Corp. v. Henderson, 257 A.2d 398 (Del. 1969), which recognized managers' rights to contribute corporate resources to socially beneficial ends.

Since the 1980s, many states have passed so-called "constituency statutes," which explicitly permit – and in some cases require – corporate managers to look beyond shareholder interests. *See* Winkler, *supra* note 43, at 123 (describing different states' constituency statutes). Although such statutes are generally lauded by CSR proponents, many were actually intended to help domestic corporations fend off hostile takeovers. They permitted managers of corporate takeover targets to claim that, in spite of shareholders' desire to benefit from takeover premiums, the corporation should refrain because the transaction would harm the long-term interests of its employees, the environment, or the community in which it was located. *See* Winkler, *supra* note 43, at 124 (discussing the use and abuse of constituency statutes as defense against hostile takeovers). Predictably, these statutes are criticized as tending to entrench corporate management, permitting them to serve their own rather than their shareholders' interests. Winkler, *supra* note 43, at 124.

[58] Aside from their shared historical link, one important and growing contemporary connection between corporate philanthropy and CSR on one hand and social enterprise on the other, a link that this paper will not explore in any detail, is that increasing numbers of contemporary corporations are seeking to satisfy their CSR obligations by partnering with and funding social entrepreneurs. Examples abound. To name just two, the corporation Home Depot funds the social enterprise, KaBoom! and the Timberland Corporation and Bank of America fund the social enterprise, City Year. *See generally* Jane Nelson & Beth Jenkins, *Investing in Social Innovation: Harnessing the Potential of Partnership Between Corporations and Social Entrepreneurs,* Working Paper No. 20, Corporate Social Responsibility Initiative at the John F. Kennedy School of Government, Harvard University, March 2006.

There are, however, important distinctions between hybrid social enterprise and its corporate forbearers. Most fundamentally, proponents of corporate philanthropy and CSR generally accept that a corporation's core function is to produce profits to benefit its shareholders,[59] even if they sometimes believe that wealth maximization does not have to be the corporation's only animating value.[60] Proponents of social enterprise, on the other hand, do not concede that financial maximization must necessarily be the for-profit corporation's preeminent motivation. They envision a world in which some corporations pursue multiple bottom-line, or "blended value" results,[61] seeking to create value for shareholders but giving equal, and in some cases paramount consideration to social and environmental outcomes.[62] Stated otherwise, corporate philanthropy and CSR are willing to engage in socially beneficial activity even if it has some effect on the bottom line, while the hybrid social enterprise movement maintains that the socially beneficial activity is ineluctably part of the bottom line.[63] Social entrepreneurs insist that their organizations' multi bottom-line goals be written into their entities' DNA, and that the commitment to social and/or environmental goals be permanent, not variable according to the vagaries of the market or the wishes of owners.[64]

Social enterprise and the emerging fourth sector are sometimes denigrated as the flavor of the month, a mere passing fad that is more marketing and verbiage than

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[59] *See* Conley and Williams, *supra* note 5, at 24-25 (analyzing Shell Oil Corporation's approach to CSR and concluding that Shell, in spite of its outward commitment to CSR, takes for granted that shareholder value is its fundamental concern).
[60] *See supra* note 5 and accompanying text.
[61] *Id*.
[62] *See* Dana Brakman Reiser, *For-Profit Philanthropy,* 77 FORDHAM L. REV. 4 (2009) (claiming hybrid ventures such as Google.org go well beyond CSR's aims of "mere awareness and consideration" of non-financial outcomes).
[63] *See id.* at 4 (arguing that Google.org integrates its "philanthropic vision within its corporate operations" and therefore is different from corporate philanthropy or CSR, and that social enterprises "place philanthropic and profit making goals on a par from the outset and at the very core of their business models").
[64] *See infra* Part III.B (discussing social entrepreneurs desire to create effective "asset locks").

substance.[65] I have been hearing such critiques for more than a decade, and in the meantime the world of hybrid social enterprise has grown rapidly and has expanded from non-profits engaging in market-oriented work to for-profits doing essentially charitable work. Although it may be true that the social enterprise movement is sometimes diminished by its breathless, overblown, easy-to-ridicule rhetoric,[66] I see no indication that it is a mere flash in the pan or that it will do anything but expand in scope and importance in the coming years. Lawyers – and law professors – should face this fact and grapple with the emerging sector's particular legal challenges.

III. Challenges Faced By Hybrid Social Enterprises

Hybrid social entrepreneurs' say that their plans for social transformation are hindered by existing laws, which were written to regulate and give order to the old three-sector world. This paper's focus will remain on the legal challenges faced by for-profit social enterprises, but the discussion necessarily will include some inquiry into the legal difficulties the social entrepreneurs would face if they attempted to avoid the legal challenges of operating as for-profits by turning back to the nonprofit sector.

A. The Challenge of Capitalizing Social Enterprise

In a recent study of the emerging fourth sector, social entrepreneurs reported that their most pressing challenge was gaining access to investment capital.[67] Hybrid social enterprises such as the furniture factory describe in Part II.A.2, above, require significant

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[65] *See supra* note 6.
[66] *See id.*
[67] ALLIANZE, DUPONT, THE SKOLL FOUNDATION & SUSTAINABILITY, GROWING OPPORTUNITY: ENTREPRENEURIAL SOLUTIONS TO INSOLUBLE PROBLEMS [hereinafter *Allianze Report*] 4, 15 (2007), *available at*: http://www.sustainability.com/researchandadvocacy/reports_article.asp?id=937. *See also* Billitteri, *supra* note 9, at 10 (referring to an Aspen Institute Roundtable where social enterprise experts bemoaned the difficulty under existing laws of attracting investment capital, whether from bank loans, venture capital, or other sources).

amounts of capital investment, but have struggled because organizations with multi bottom-line goals do not fit the settled categories and the expectations of existing sources of capital. If social enterprises are to survive and "go to scale,"[68] they have to find ways of gaining access to traditional sources of capital.

Not so long ago, when most socially beneficial programs were formed as nonprofits, a hybrid organization's best hope for obtaining start-up capital was to approach a private foundation for seed funding and then, having proven its worth during a two or three-year pilot phase, approach local, state, or federal governments for financial support to take the program to scale.[69] Some social ventures included earned-income strategies that helped ensure long-term sustainability, but many were able to function from a combination of private foundation and government largess.[70] This model for capitalizing nonprofit social ventures worked reasonably well, at least into the 1980s, but became untenable when the Reagan Revolution drastically reduced government funds going to the nonprofit sector.[71]

Beginning in the 1980s, nonprofit social ventures were forced to become more entrepreneurial and diversify their capitalization strategies, but many social entrepreneurs found that the nonprofit form was not well suited to this task. One obvious problem was that tax-exempt nonprofits, according to federal and state law, exist to benefit the public, which means that all profits must be ploughed back into serving the organizations'

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[68] Among social entrepreneurs, "going to scale" is a fundamental precept. Because their stated goal is widespread social change or social "transformation," many have national and international ambitions. *See generally* Gregory Dees, Beth Battle Anderson, and Jane Wei-Skillern, *Scaling Social Impact,* STAN. SOCIAL INNOVATION REV. 24 (Spring 2004) (discussing the challenges of "scaling" social enterprise). Social entrepreneurs often rue that fact that their plans for "scaling up" are inhibited by the difficulty of raising capital. *See* ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 56.

[69] Jed Emerson, *The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and The Blended Value Proposition, supra* note 5, at 10.

[70] *Id.*

[71] *Id.*at 10. Kelley, *supra* note 4, at 2461-62, 2467.

charitable missions.[72] Because nonprofits generally cannot issue stock or otherwise distribute their profits to owners,[73] there is no straightforward way for a venture capitalist or other for-profit investor to take an equity stake in a nonprofit social venture.[74] Nonprofits may, like other organizations, rely on traditional debt, but debt instruments tend to be more expensive and less flexible than equity.[75] Furthermore, even traditional lenders such as banks are reluctant to make loans to nonprofits on competitive terms because they know the nonprofits' ability to repay is constrained by the lack of access to other sources of capital.[76]

Social entrepreneurs' difficulty raising start-up or expansion capital has driven many away from the nonprofit sector, but their capitalization problems are not entirely solved by choosing to launch as for-profit ventures. As an initial matter, for-profit social entrepreneurs generally cut themselves off from the sources that traditionally have funded socially beneficial activities – private foundations and governments.[77] Although those sources are shrinking,[78] they still represent a significant and necessary source of support for social ventures.[79]

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[72] *See* Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (as amended in 2008) (prohibiting tax exempt public charities from distributing profits to equity investors); REVISED MODEL NONPROFIT CORP. ACT §§ 1.40, 13.01 (prohibiting payments under model state law from nonprofit corporations to their "members, directors, or officers").

[73] *Id. See* Bromberger, *supra* note 11, at 2-3 (arguing that the absence of corporate shares in nonprofit organizations means that there is no convenient vehicle for equity investors to withdraw their stakes or sell them to third parties).

[74] Bromberger, *supra* note 11, at 2.

[75] Allianze Report, *supra* note 67, at 16.

[76] *Id.*

[77] *See supra* notes 69-70 and accompanying text.

[78] *See supra* notes 71-72 and accompanying text.

[79] There are means by which both foundations and government can provide funding to socially beneficial, for-profit activities. For example, private foundations may under certain circumstances invest in socially beneficial activities carried on by for-profit organizations through program related investments, discussed at more length in Part III.A.1, *infra*. Government entities rarely provide grants or investment capital to for-profit ventures but can support them by engaging in fee-for-service arrangements or, particularly at the local level, by granting special tax exemptions for their socially beneficial activities. However, both

Another reason that choosing to form as a for-profit entity does not solve hybrid social ventures' capitalization woes is that the practices and the expectations of the normal sources of for-profit capital – venture capitalist and institutional investors such as pension funds – do not line up neatly with the needs of hybrid social enterprises. Those investors typically expect market rates of return,[80] which hybrid, multi bottom-line organizations are rarely in a position to offer.[81] Most social venture start-ups, such as the North Carolina furniture factory described in Part II.A.2, above, are looking for financial success on a smaller scale, aiming for slow but steady growth in an under-resourced community.[82] To achieve their social and environmental bottom lines, they require "patient capital," which is not easy to find.[83] There are at least two existing possible sources for patient capital, but for reasons discussed below, neither has solved for-profit social entrepreneurs' capitalization problems.

1. Program Related Investments

Since passage of the Tax Reform Act of 1968, federal law has authorized private grant making foundations to engage in program related investments, or "PRIs," which are investments in the form of debt or equity that support socially beneficial activities.[84] Of great potential significance to hybrid social enterprises, the law permits foundations to

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private foundations and government generally choose not to avail themselves of these options. Allianze Report, *supra* note 67, at X.

[80] Venture capitalists typically seek to invest in high risk ventures that will disrupt existing product markets and give rise to enormous returns. Fleischer, *supra* note 39, at 95.

[81] Allianze Report, *supra* note 67, at 18.

[82] Fleischer, *supra* note 39, at 96.

[83] Allianze Report, *supra* note 67, at 17.

[84] I.R.C. § 4944. The Code's program related investment provisions are, in essence, an exception to its strictures on jeopardy investments by private foundations. The Code imposes onerous excise taxes on imprudent investments by private foundations that jeopardize their ability to carry out their exempt functions. I.R.C §§ 4944(a)-(b). Section 4944(c) makes an exception for investments that qualify as "program related." IRC §4944, Treas Reg. § 53.4944-1(a)(2). *See* Anita L. Horn, *Venture Capital Philanthropy: The IRS and Treasury Hold the No-Cost Key to the Growth of Self-Sufficient Nonprofits,* FEDERAL BAR ASSOCIATION SECTION OF TAXATION REPORT 7 (Winter 2003).

engage in PRIs regardless of whether the socially beneficial activities are conducted by a nonprofit or for-profit organization.[85] PRIs could, therefore, be a significant source of investment capital for social enterprise, but thus far few PRI dollars have flowed in that direction.[86] The paucity of PRIs stems from several problems, some that pre-existed the rise of hybrid social enterprise and some that are due specifically to foundations' discomfort with this new form.

To qualify as a PRI, a private foundation's investment or loan must meet three criteria. First, the foundation must be motivated solely by a desire to accomplish its exempt purpose.[87] Second, the production of income or the appreciation of property may not be a significant factor motivating the foundation's investment.[88] In combination, the first two criteria compel the foundation to demonstrate that the investment or loan would not have been made but for its relationship to the foundation's exempt activities.[89] Third, absolutely no electioneering and only limited lobbying purposes may be served by the investments.[90] If the private foundation satisfies these three criteria, it may invest its capital in the socially beneficial venture and expect that capital to be returned at a reasonable rate of interest.[91] Best of all from the perspective of the private foundation, the IRS considers all moneys paid out as PRIs to be "qualifying distributions," which means they count toward the IRS's requirement that private foundations spend five percent of their net worth in any given year.[92]

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[85] Treas. Reg. § 53.4944-3(a)(2)(i);Rev. Rul. 74-587, 1974-2 C.B. 162.
[86] *See* Wexler, *supra* note 10, at 238-9 (referring to complications with PRIs); Horn, *supra* note 84, at 7.
[87] Treas. Reg. § 53.4944-3(a)(1)(i).
[88] Treas. Reg. § 53.4944-3(a)(1)(ii).
[89] Wexler, *supra* note 10, at 239.
[90] Treas. Reg. § 53.4944-3(a)(1)(iii).
[91] Wexler, *supra* note 10, at 239.
[92] I.R.C. §4942(g).

Given these obviously beneficial features, one would expect private foundations to engage in PRIs liberally and hybrid social ventures to pursue them ardently. However, private foundations have made scant use of the provision, and social entrepreneurs have thus far made little headway in overcoming the foundations' reluctance.[93]

The reason that PRIs have never become a powerful force in the world of social enterprise is that foundations generally perceive them as burdensome and risky. A foundation considering investing through the PRI provisions historically has faced two equally unappealing choices. First, it could go through an exhaustive process of program development and negotiation with a potential PRI recipient in an attempt to ensure that the recipient's activities would comply with the federal strictures summarized above. This process could place a significant burden on the foundation's administrators and be costly if lawyers were involved.[94] Having performed its due diligence, the foundation could invest its money, but would have to hold its breath hoping that the IRS would not intervene and retroactively declare that the investment failed to qualify. Such a retrospective negative determination by the IRS could put a foundation in jeopardy of losing its tax exemption or, at the very least, disrupting its long term fiscal plans.[95]

Alternatively, a foundation considering a PRI could reduce its risk by seeking a private letter ruling from the IRS, which in effect would act as pre-approval. Private letter rulings, however, can cost tens of thousands of dollars in filing and legal fees, and can take up to eighteen months to be processed with no guarantee of a positive

[93] Billitteri, *supra* note 9, at 5.
[94] *Id.*
[95] *Id.*

outcome.[96] Given the risks and transaction costs of these alternatives, most private foundations decide to forgo PRIs and stick largely to making straight-forward grants.[97]

This explains private foundations' historical reluctance to engage in PRIs. There are additional factors particular to the emerging fourth sector that have further constrained PRI investments in social enterprises. PRIs were conceived at a time when the concept of a "social investment" was much more limited than it is today. For the most part, people in the private foundation world, and the IRS, envisaged socially beneficial investing as entities making capital investment in job-creating ventures in inner-cities to stimulate urban economies and combat blight.[98] The IRS regulations on PRIs, which were drafted during that era, require foundation investors to withdraw their capital as soon as the urban ventures become commercially viable and capable of attracting market capital.[99]

In contrast, today's social enterprises often envision a long-term or even perpetual existence for multi bottom-line organizations that will always provide social benefit and always produce modest profits, but that will never be financially dynamic enough to attract large amounts of private capital and operate in the market economy without subsidy.[100] These are different visions of social investing and, at present, neither

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[96] Lang, *The L3C: The New Way to Organize Socially Responsible Organizations* , *supra* note 39.
[97] PRIs pose additional administrative burdens on private foundations. Once a foundation has begun making PRI investments, the regulations make it difficult to stop. If the PRI investments or loans that go out the foundation's door work as they are supposed to, the money bounces back to the foundation, often with interest, at some time in the future. If the foundation does not want that returning money to throw off its annual mandatory five percent payout, it must push the money back out the door by making additional PRI investments or loans in the same fiscal year. I.R.S. Code § 4942(f)(2)(C)(i); Wexler, *supra* note 10, at 239. For this reason, private foundations find that it works best either to create a revolving PRI fund to manage incoming and outgoing investments, or not engage in PRIs at all. Until now, many have chosen the latter. *Id*.
[98] *See* Treas. Reg. § 53.4944-3(b) (providing illustrative examples of acceptable investments).
[99] Treas. Reg. § 953.4944-3(b); ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 57 (noting that the PRI regulations compel private foundations to withdraw when the investment "turns around").
[100] *See supra* notes 82-83 and accompanying text.

foundations nor social enterprises are certain that the PRI regulations will stretch to accommodate the low-profit social venture model.[101]

In sum, PRIs should be attractive to private foundations because they permit them to have a social impact while preserving their capital, and because they satisfy the IRS's requirement of disbursing five percent of their assets each year. They should be attractive sources of capital for hybrid social ventures because foundations – which are after all charities – tend to be patient investors, and because such investments are permitted whether the recipient is organized as a nonprofit or for-profit.

2. Socially Responsible Investment Funds

Social entrepreneurs view Socially Responsible Investing, or SRI, as a potential source of growth capital for the emerging fourth sector.[102] Although the definition and practices of SRI vary, it generally refers to institutional funds that make investment decisions based at least partly on non-financial, social benefit considerations.[103] Mutual funds are the most common form of SRI, and the most common method of achieving social benefit is "social and/or environmental screening," whereby the fund managers either avoid investments in companies that engage in socially or environmentally harmful behaviors or focus their investments in companies that engage in positive behaviors.[104] The targeted behaviors can vary from fund to fund – environmental records, human

[101] *See* Wexler, *supra* note 10, at 239 (arguing that the PRI regulations' examples are out of step with modern social investing).
[102] Cite (Jay Gilbert said so at the Aspen Roundtable. Find a source.]
[103] Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law,* 59 ALABAMA L. R. 1385, 1435 (2008).
[104] *See* SOCIAL INVESTMENT FORUM, 2007 REPORT ON SOCIALLY RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES ii, *available at* http://www.socialinvest.org/resources/pubs [hereinafter 2007 SRI REPORT].

rights, labor, reproductive rights, animal welfare,[105] – or can be targeted generally toward investing in companies that commit to sufficiently enlightened environmental, social and governance principles.[106] SRI has grown steadily in recent decades[107] and, according to the industry's leading professional association, the Social Investment Forum, in 2007 accounted for approximately eleven percent of all assets under professional management in the United States.[108]

Given that SRI funds seek to achieve "blended value"[109] with their investments, social entrepreneurs are hopeful that the funds will be willing to provide at least some of the patient capital required by hybrid social enterprise. There are, however, complications. First, although SRI appears to be on a steady growth trend, it remains a small slice of U.S. capital markets.[110] More important, SRI proponents often advertise it as a way of "doing well by doing good,"[111] and emphasize that with proper screening techniques they can match or even outperform non-socially responsible investors.[112] Thus, although some SRI funds may be willing to accept marginally lower financial

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[105] *See* Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investing,* BUSINESS LAWYER 681, 684-87 (2002) (noting that SRI began as a way for religiously motivated investors to avoid investing in companies that dealt in tobacco, alcohol or gambling and gained significant momentum when its principles were used to choke off investment in apartheid South Africa).

[106] *See* Andrew Coen, *New Approach to Social Investing Finds Favor,* INVESTMENT NEWS, February 1, 2009, *available at* http://www.investmentnews.com/apps/pbcs.dll/article?AID=2009302019971 (reporting an increase in so-called ESG social investing in spite of the present financial downturn).

[107] Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency,* 112 HARV. L. R. 1197, 1287-8 (1999) (noting the growth of SRI from the 1970s to 1990s).

[108] 2007 SRI REPORT, *supra* note 104, at ii (reporting recent rapid growth of SRI and $2.71 trillion investment assets, including $2.08 billion in socially and environmentally screened funds).

[109] *See supra* note 5.

[110] Bruner, *supra* note 103, at 1437.

[111] Knoll, *supra* note 105, at 683.

[112] *Id.* at 682; Bruner, *supra* note 103, at 1437; *see* Coen, *supra* note 106, at X (quoting an SRI fund manager as saying "socially conscious investing does not mean putting up with lower returns").

returns in exchange for a demonstrated social benefit,[113] many will not accept the lower returns and higher risk involved in providing patient social venture capital.

Social entrepreneurs respond optimistically that more and more SRI-type investment funds are coming on line with the express purpose of investing in modest-return, hybrid social enterprise. They claim that such sources of patient SRI capital will expand further when social enterprise devises a distinctive brand for itself and when social entrepreneurs find a way to ensure such investors that their capital will remain the social enterprise stream and not be converted into private wealth, issues discussed directly below.[114]

B. The Challenge of Locking Assets into the Social Enterprise Stream

If raising capital is social entrepreneurs' primary challenge, locking that capital into the social enterprise stream and preventing it from being converted to private wealth is close behind. Dedicated social entrepreneurs fear that if hybrid, multiple bottom-line organizations become financially successful, their managers may disavow their social or environmental missions, or might be purchased by new owners who are dedicated exclusively to generating profits.[115] If this happens, and if consumers and investors, particularly private foundations and socially responsible investors, feel that they have been duped, the hybrid fourth sector as a whole – not just the individual social enterprise – will lose credibility and fail to achieve its transformational potential. The most

[113] *See* Knoll, *supra* note 105, at 689 (indicating that some firms accept investments for ethical reasons that they would reject on purely financial grounds).
[114] Cite.
[115] See Bromberger, *supra* note 11, at 7 (arguing that the lack of an "asset lock" harms the credibility of social enterprise).

celebrated recent example of such conversation comes from the Ben and Jerry's ice cream corporation.[116]

Ben and Jerry's Corporation claimed throughout most of its existence to serve the interests of society and the environment along with its shareholders.[117] Although their corporate good works were sometimes criticized as fatuous and ineffective,[118] the corporation had a good run as a darling of the CSR and social enterprise movements, even though financial analysts and some shareholders viewed it as a financially underperforming business concern.[119] In the year 2000, Ben and Jerry's was purchased by Unilever, a conglomerate not known as particularly socially or environmentally conscious. This cast doubt on the ice cream maker's purported social mission and multiple bottom-line philosophy and raised the possibility that the corporate goodwill that Ben and Jerry's built up as a socially responsible entity would be converted entirely to private profit by Unilever.[120] Although Unilever assured the public that it would continue Ben and Jerry's tradition of CSR, outraged CSR and social enterprise proponents pointed out that no law would prevent the new corporate parent from chucking those principles if they found them too expensive or inconvenient.[121]

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[116] Commentators debate whether Ben and Jerry's was a true social enterprise or merely a company dedicated to CSR. *See supra* Part II.B.3. Either way, the Ben and Jerry's example illustrates the credibility problems that social enterprises and the fourth sector generally will face if they fail to develop effective mechanisms for locking equity into the social enterprise sector.

[117] *See* Hanna Rosin, *The Evil Empire: The Scoop on Ben and Jerry's Crunchy Capitalism,* THE NEW REPUBLIC, September, 1995, at p. 22.

[118] *See id.*

[119] Andrew Marshall, *Double Trouble: Why Ben Has Gone Totally Nuts with his Partner in Cream Jerry*, THE INDEPENDENT, March 30, 2000, available at: http://www.independent.co.uk/news/people/profiles/double-trouble-why-ben-has-gone-totally-nuts-with-his-partner-in-cream-jerry-723503.html ; Suzanne Smalley, *Ben and Jerry's Bitter Crunch*, NEWSWEEK, December 3, 2007, at p. _, available at: http://www.newsweek.com/id/72016.

[120] *See generally* Rob Walker, *The Scoop on Ben & Jerry's Sellout,* SLATE.COM, April 12, 2000, *available at* www.slate.com/id/1005081.

[121] *See* Peter Foster, *Chunky Monkey and Hippie Hypocrisy*, THE FINANCIAL TIMES LIMITED, April 14, 2000, at p. 19. *See also,* .Allianze Report, *supra* note 67, at 15 (describing a similar instance in which

Similar concerns have been raised about Google Inc.'s plans to run its philanthropic activities through the for-profit Google.org.[122] Although Google, Inc. has publically declared that profits generated by Google.org's social benefit activities will be returned to Google.org and perpetually ploughed back into other socially beneficial projects[123] skeptics point out that if the financial picture for Google, Inc. were to deteriorate, the corporate parent's board could force Google.org to disgorge its profits and abandon its philanthropic mission.[124] Additionally, if Google.org were to dissolve, its assets would automatically revert to its parent corporation, unlike the nonprofit Google Foundation, which would be required by federal law to distribute its assets upon dissolution to other charitable organizations.[125]

C. The Challenge of "Branding" Social Enterprises

Social entrepreneurs believe that to succeed in gaining support from the general public, and, more important, from the various sources of capital they need access to – charitable, governmental, and private – they must create a recognizable brand for hybrid organizations,[126] "a coherent and marketable image of what it means to be a social enterprise organization."[127] They must convince consumers and individual investors that they are different from mere corporate philanthropy and CSR, both of which social

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Burt's Bees sold itself to the Clorox Company, the makers of plastic bags, bathroom cleaners, and laundry bleach).

[122] Hafner, *supra* note 22, at A1. *See supra* Part II.A.2 (describing Google.org).

[123] Amanda Little, *Branson With the Stars*, GRIST MUCKRAKER (2006), http://www.grist.org/cgi-bin/printthis.pl?uri=/news/muck/2006/09/28/branson/index.html (quoting a Google.org spokesperson as saying, "any profits that come from Google.org go back to Google.org").

[124] Hafner, *supra* note 22, at A1.

[125] Fishman, *supra* note 6, at 14; Treas. Reg. § 1.501(c)(3)-1(b)(4)(as amended 1990); I.R.C. 501(c)(3) (2000) (stating no part of the net earnings of an exempt organization may inure to the benefit of a private individual).

[126] *See* Allianze Report *supra* note 67, at 15 (referring to a study that concludes that branding social enterprise is one of social entrepreneurs' greatest challenges and concerns).

[127] Billitteri, *supra* note 9, at 9-10. *See* Introductory Page, B Corporation Website (*available at:* www.bcorporation.net) (proclaiming the importance of, and offering to ease the task of telling "the difference between a 'good company' and just 'good marketing'").

entrepreneurs and socially conscious consumers view as too closely tied to corporate marketing and too often designed primarily to serve corporations' financial bottom lines.[128] Proponents argue that creating this recognized and respected brand for social enterprise would also give comfort to the varied array of potential sources of capital that presently shy away largely they have never dealt with such an entity and do not know how to approach it.[129]

D. The Challenge of Satisfying For-Profit Fiduciary Duties

Social entrepreneurs who launch their multi bottom-line hybrid ventures as for-profit organizations express concern that they will be sued by shareholders for failing to maximize financial returns.[130] Indeed, for-profit organizations do have owners – typically corporate shareholders or limited liability company members – and the directors of those corporations unquestionably owe a duty to serve their interests.[131] As discussed in Part II.B.2, above, in some jurisdictions those directors have been subject to suit for directing corporate assets toward socially beneficial activities unless they can demonstrate that those activities serve an ostensible business purpose such as producing good will among consumers or government regulators.[132] Even when for-profit directors succeed in minimizing this risk through careful drafting of corporate documents and by choosing to form in states with strong constituency statutes that grant broad discretion to corporate directors,[133] those protective measures can be vitiated, social entrepreneurs

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[128] *See supra* notes 60-63 and accompanying text.
[129] *See* Michael D. Gottesman, Comment, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, YALE L. & POLICY REV. 345, 351 (2007).
[130] *Id. at* 350-51. Bromberger, *supra* note 11, at 3.
[131] Bromberger, *supra* note 11, at 3. *See supra* notes 56-57and accompanying text.
[132] Bromberger, *supra* note 11, at 3.
[133] *See infra* notes 188-89 and accompanying text [discussing asset locks in the context of limited liability companies).

claim, if the organization experiences either a rapid change in financial circumstances or a change in ownership.[134]

E. Uncertainty Over How to Tax Hybrid Entities

Although social entrepreneurs rarely mention the topic of tax relief for their socially beneficial activities, some lawmakers and commentators have raised the question on their behalf. In Hawaii, for example, law makers who promoted a new hybrid corporate form to accommodate social enterprise, discussed in more detail in Part IV.B.1, below, included language that would have exempted those ventures from state income taxation.[135] Although not directed squarely at social enterprise, a much discussed recent law review article by Anup Malani and Eric Posner argued that it is economically unjustifiable and inefficient to grant tax exemptions based solely on the form that an enterprise chooses, and that tax exemption ought to be available for socially beneficial activities regardless of whether the entity creating those benefits is organized as a for-profit or nonprofit.[136] It is beyond the scope of this article to sort out the conflicting arguments regarding the proper tax treatment of hybrid social enterprises, but it is significant to note that the debate looms over the emerging fourth sector.

F. Summary

The various challenges cited by social entrepreneurs arise largely from their organizations' liminal status. Hybrid organizations inhabit a social frontier where their development is impeded because they do not fit into any of the boxes that American law has created for enterprises. They belong to neither the for-profit, nor the nonprofit sector, and the laws and regulations that govern those sectors are ill-suited to their multiple

[134] Bromberger, *supra* note 11, at 3.
[135] *See infra* note 165 and accompanying text.
[136] *See* Anup Malani & Eric A. Posner, *The Case for For-Profit Charities,* 93 VA. L. REV. 2017 (2007).

bottom-line aspirations. With increasing vehemence, leaders in the social enterprise sector are claiming it is time to survey the metes and bounds of a new fourth sector, and that this sector should be populated by new legally sanctioned hybrid entities and governed by new laws that will help them address the challenges described above.[137] The following section will critically examine some proposals for the creation of new legal entities and new laws to govern the fourth sector.

IV. Taming the Legal Frontier: Responses to the Challenges Faced by Social Enterprise Organizations

Social entrepreneurs claim that the growth of their hybrid social enterprises and of the social enterprise sector as a whole is being retarded by a lack of appropriate legal scaffolding, leading to, or at least exacerbating, the problems discussed in Part III, above. Some, guided by their lawyers, have employed existing laws and legal entities to give structure to their ventures, often with limited success. The paper will briefly examine and critique their strategies, and then turn to various proposals for reform.

A. Making Do With Existing Laws and Legal Entities

In recent years, lawyers working with social entrepreneurs have employed existing laws and legal entities in novel ways to address some of the problems that arise from hybrid social enterprise organizations' liminal status. Although these cobbled-together strategies have permitted the growth of the emerging fourth sector, social entrepreneurs critique them as too complex and expensive.[138] The entrepreneurs also complain that the cobbling together of existing laws and legal entities leaves third parties

[137] *See* Bromberger, *supra* note 11, at 1 (referring to a recent study conducted by the Social Enterprise Alliance revealing that seventy-one percent of social entrepreneurs said that their single greatest challenge was choosing the best legal structure for their ventures); Billitteri, *supra* note 9, at X (discussing the call for new entities).
[138] *See supra* note 5.

– most importantly, sources of investment capital – scratching their head wondering whether and if so how to engage with them.[139]

1. Not-For-Loss Social Enterprises

Certain social enterprises, particularly those that intend to operate as relatively low-profit, fee-for-service operations, or those such as Google.org that have a consistent source of funding and do not have to search for outside investment, have opted to operate as "not-for-loss" organizations.[140] The social entrepreneur who pursues this strategy forms either a for-profit or nonprofit corporation to house the enterprise. If the entity is formed as a nonprofit under state law, the entrepreneur may forgo applying for federal tax exemption under § 501(c)(3). That way, the enterprise can enjoy the "halo effect" of nonprofit status without having to suffer under the onerous and inconsistent laws that govern entrepreneurial organizations that are federally tax exempt.[141] Once formed, the organization pursues its multiple bottom-line mission and, for corporate income-tax purposes, simply treats its money-losing social-benefit activities as business losses. If the model works well, the losses will limit profits generated by the organization's commercial activity and thereby keep corporate income tax liability to a minimum. This strategy works for some organizations, but relatively few hybrid social enterprises are based on a business model that permits them to forgo outside sources of investment and

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[139] *See generally* Declan Jones & William Keogh, *Social Enterprise: A Case of Terminological Ambiguity and Complexity*, SOCIAL ENTERPRISE JOURNAL, Vol. 2, Issue 1, *available at* http://www.socialenterprisebalance.org/docs/Social_Enterprise_Journal_(2006).pdf#page=21 (arguing generally that the terminology surrounding social enterprise is confusing); Chris Low, *A Framework for the Governance of Social Enterprise*, 33 INT'L J. OF SOCIAL EC. 376 (2006), *available at:* http://www.emeraldinsight.com/Insight/ViewContentServlet?Filename=Published/EmeraldFullTextArticle/Articles/0060330502.html (arguing that social enterprise needs a cohesive governance model so that investors can more easily understand how to approach).

[140] ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 55 (employing the term).

[141] Bromberger, *supra* note 11, at 4. *See* ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 58 (discussing the not-for-loss strategy and recommending pursuing it a taxable nonprofit to take advantage of the "halo effect"); Kelley, *supra* note 4, at X (describing the confusing, inconsistent, and vague federal laws governing entrepreneurial nonprofit organizations).

support.[142] Those that require capitalization from private foundations, charitable donors, or market investors must rely on other approaches.[143]

2. Multiple Entity Social Enterprises

Some social enterprises have relied on dual or multiple-entity solutions to the problems caused by their hybrid status. With this approach, the social entrepreneur and her lawyers establish a for-profit entity to carry out the revenue-generating aspects of the mission and a related nonprofit tax-exempt organization to house the social benefit activities. With sophisticated legal and accounting advice, the nonprofit entity can preserve its exempt status and attract support from private foundations, governments, and charitable donors, while simultaneously receiving tax-advantaged cross-subsidization from the related for-profit.[144] At the same time, the for-profit entity can seek access to venture capital, bank financing, and other investors accustomed to operating in the open market.

The main disadvantages to such multiple entity strategies is that they are expensive to create and administratively burdensome to maintain.[145] Also, because they

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[142] *See* ABA 2007 Exempt Organizations Transcript, *supra* note 5, at 60.

[143] Most philanthropic and government funds go to organizations that are federally tax exempt. There are exceptions, such as PRIs by private foundations, but for reasons discussed earlier in this paper,they are rare. *See supra* notes 93-96 and accompanying text. Typically, market investors will not put their money into an organization that is not designed for rapid growth and significant returns. *See supra* note 80. Socially responsible investors are a possible source, but even they require a financial return on their investment. *See supra* notes 111-12 and accompanying text.

[144] Bromberger, *supra* note 11, at 2. Taking advantage of specific exceptions in the IRS Code, nonprofit organizations can receive money from related for-profits without adverse tax consequences for either entity by, for example, licensing intellectual property to the for-profit, and renting office space owned by the nonprofit to the for-profit. Also, the nonprofit can be established as a shareholder of the for-profit, and the latter can issue dividends that are counted as exempt income to the nonprofit organization. I.R.C. §

[145] ABA 2007 Exempt Organizations Transcript 2007, *supra* note 5, at 57 (quoting a social enterprise attorney as saying "there's usually not a lot of appetite for multiple entities" due to the cumbersome relationship between them when one is nonprofit). Gottesman, *supra* note 129, at 345.

present different faces to different sectors of society, they fail to address the branding problem that social entrepreneurs articulate.[146]

3. LLC Social Enterprises

Increasingly, social entrepreneurs are choosing to form their organizations as limited liability companies, or LLCs. This relatively new and – compared to corporations, flexible – form of business entity resolves at least some of social entrepreneurs' practical and legal challenges. Part IV.B.2, below, will describe at some length a new type of LLC that holds particular promise for resolving challenges faced by social enterprise. To avoid repetition, we postpone the discussion of LLCs until then.

B. Proposed Legal Forms to Accommodate Hybrid Social Enterprises

As the social enterprise movement has gained momentum and legitimacy, some innovators have turned their energies away from adapting existing legal doctrines and have begun proposing new laws and new legal entities to accommodate the fourth sector. One approach has been to devise new kinds of corporations to accommodate hybrid social ventures. These proposed entities go by the names For-Benefit Corporations, B Corporations, and Socially Responsible Business Corporations. Each of these proposed new forms has its particular features, but they are sufficiently similar that they can be considered as a group.

1. Hybrid Corporations

Perhaps the highest profile domestic solution proffered to meet the challenges faced by hybrid social enterprise is the B Corporation, a new entity proposed and

[146] *See supra* Part III.C.

promoted with near evangelical zeal[147] by Jay Coen Gilbert, the co-founder and former CEO of the And 1 basketball footwear and apparel company.[148] Although no states have adopted the B Corporation concept,[149] a nonprofit organization called B Lab, of which Gilbert is a principal, has established an independent certification system to allow businesses to brand themselves with the "B" label.[150]

The "B" in B Corporation stands for social "benefit." To earn the B designation from B Lab the social enterprise must draft or amend its articles of incorporation and other corporate documents to commit the organization to serving in the interests of its employees, the broader community, and the environment throughout its existence.[151] The prospective B Corporation also must earn a passing grade on a survey devised by the B Lab that tests its commitment to socially responsible behavior such as democratic decision making, having good employee benefits, donating profits to charity, and being energy efficient.[152] Once a corporation has earned its "B" designation, it must prepare an annual public interest report that tracks and evaluates its progress in meeting its public interest goals. In theory, if its progress is insufficient, it can forfeit its status.[153]

According to its proponents, the primary benefit of the B designation will be to create a brand for corporations that are truly and fundamentally committed to socially beneficial outcomes. Through this brand, and the rigorous standards that organizations

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[147] I base this characterization on my witnessing his presentation of the B Corporation concept at the Aspen Institute Nonprofit Sector and Philanthropy Program, "Exploring New Legal Forms and Tax Structures for Social Enterprise Organizations," which took place on September 29, 2006, in Washington, DC.
[148] Hannah Clark, *A New Kind of Company: B Corporations Worry About Stakeholders, Not Just Shareholders,* INC. MAGAZINE, July 2007, at p. 23
[149] Billitteri *supra* note 9, at 12.
[150] Clark, *supra* note 148, at 23.
[151] *Id.* at 23; B Corporation, *available at:* http://www.bcorporation.net/become (describing the steps to becoming a B corporation).
[152] Clark, *supra* note 148; B Corporation, *supra* note 151.
[153] B Corporation, *supra* note 151.

must meet to earn it, socially conscious consumers and investors will have confidence that a corporation's expressed commitment to non-financial bottom lines is more than mere marketing.

A similar notion, twice introduced but never adopted by the Minnesota legislature, would create a new corporate entity called the Socially Responsible Business Corporation. Corporations so designated would place the letters "SRC" after their names, indicating to the public that they were committed to multiple bottom-line outcomes.[154] In addition to the branding advantages offered by B Corporations, the SRC proposal would explicitly shield corporate board members and managers from liability under state law for failing to maximize economic returns, permitting them to focus on serving the long-term health of the company, its customers, and its broader universe of stakeholders.[155] Also, to ensure SRCs' long-term commitment to their socially beneficial missions, the law would require them to be governed by boards that included substantial community and employee representation.[156] Finally, like he B Corporation, SRCs would be required to compile and publish annual public interest reports describing the ways in which they had served their various stakeholders.[157]

In Hawaii, a bill to create Socially Responsible Business Corporations was passed in a watered down version by both houses of the legislature[158] but vetoed by the

[154] S.F. 1153, 85th Leg. Sess. § 4(d) (Minn. 2007).
[155] *Id.* at § 5.5.
[156] *Id.* at § 6. Employees would have the power to nominate and elect twenty percent of board members. An additional twenty percent of seats would be reserved for community representatives, who would be chosen in consultation with civil society groups. Shareholders would select the remaining sixty percent of seats.
[157] *Id.* at § 9.2.
[158] H.B. 3118, 23rd Leg. Sess. (Haw. 2006). During the committee process the bill was watered down by a provision designating the year 2020 as its effective date.

Governor.[159] Hawaii's law was similar in most respects to Minnesota's but included a provision for relief from state corporate income taxes for corporations formed under the law.[160]

Although each of these proposed corporate forms has unique features, they are similar in their structure and share several beneficial characteristics. Each would create a new brand for the fourth sector, thereby reducing confusion among consumers and investors and possibly opening new sources of socially responsible capital such as Socially Responsible Investment funds.[161] If given the force of state law, each would ease or eliminate the risk of suit by shareholders for failure to maximize financial returns.[162]

However, none of these proposed entities is perfectly adapted to the transformational, evolutionary step those entrepreneurs are planning. Most fundamentally, the corporate proposals share a structural weakness in that they do too little to resolve social entrepreneurs' primary problem: capital formation. The brand created by the B Corp. or the SRC labels might act as a palliative for those sectors of society concerned about corporate social responsibility, and might encourage individual and institutional socially responsible investors to provide capital, but, as mentioned

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[159] H.B. 3118 Measure History (generated on 8/25/2006), *available at:* http://www.capitol.Hawaii.gov/session2006/status/HB3118.asp.

[160] H.B. 3118, *supra* note 156, at § 10. In 2005, the United Kingdom passed legislation creating Community Investment Corporations, or "CICs," pronounced *kicks*. Fishman, *supra* note 6, at X. Although relevant to a discussion of hybrid organizations in the US, we do not dwell on CICs because the U.K.'s legal boundary between nonprofit and for-profit organizations is different than our own. In brief, corporations in the U.K. can earn the CIC designation if "a reasonable person might consider that its activities are being carried on for the benefit of the community." *Id.* (citing the Companies Act, 2004 c. 27, s. 35(2) (Eng.)). The scheme includes branding mechanism, a firm asset lock, and protection from shareholder lawsuits provided by B Corporations and SRCs. The U.K. legislation also adds a partial non-distribution constraint that permits CICs to pay dividends to investors but places strict limits on the percentage of profits that can be distributed. Fishman, *supra* note 6, at 14 (citing Community Interest Company Regulations, 2005, S.I. 2005/1788, arts. 17-22 (U.K.)).

[161] *See supra* Part III.A.2.

[162] *See supra* Part III.D.

previously, those are relatively shallow investment pools from which to draw.[163] If the fourth sector is to grow to scale and be truly transformative, as its proponents claim it can and should, its hybrid entities must have the capacity to attract investment capital from all sources including government and private foundations and market-oriented venture capitalists and financial institutions.

Corporations, even those with the salutary features of B Corps and SRCs, are simply too inflexible to accommodate that diversity of financial actors. From the point of view of the universe of potential investors, they include the unattractive features of both the for-profit and nonprofit forms. As long as their goals include producing financial returns for their investors the usual sources of nonprofit capital – government and private foundations – will be reluctant to participate. At the same time, as long as their financial engines are governed by their social and environmental goals, conventional market rate sources of capital will shy away.

In addition to the capital formation problem, none of the corporate proposals includes an effective asset lock, leaving open the possibility that the Ben & Jerry's problem might arise and damage the credibility of the new sector. Further, only the Hawaii proposal addresses the fiscally and politically delicate question whether to tax these entities.

In short, organizations that aspire to combine profit seeking and social benefits seamlessly within a single entity may not be served by housing themselves in retrofitted corporations because the corporate proposals fail to resolve hybrid organization's capital formation problems, do not provide an effective asset lock, and they leave unresolved the knotty question of how such entities should be taxed. The solution to these shorcomings

[163] *See supra* Part III.A.2.

may come in the form of a newer, more flexible form of business entity, the Limited Liability Company.

2. Hybrid LLCs, Including the Newly Proposed L3C

a. The Use of Generic LLCs

Limited Liability Companies, or LLCs, are hybrids of corporations and partnerships, melding into one entity the advantages of both legal forms. They are like corporations in that they offer limited liability for their owners, who are designated as "members" rather than "shareholders."[164] They are like partnerships in that they offer practically unlimited organizational flexibility. This flexibility means that members of an LLC are free to draft a membership agreement[165] that allocates management powers, profits and losses among themselves as they see fit.[166] If they wish, for example, they can provide a large share of profits to a member/investor that has a relatively small ownership interest and that has no role in managing the venture.[167]

Social entrepreneurs have begun to take advantage of this extreme organizational flexibility. Where a social enterprise is dedicated to social outcomes but requires participation by for-profit capital investment, the two can easily be brought together under the roof of a single LLC because the membership agreement can reward the for-profit investors with a large share of any profits, while the social benefit nonprofit actors can retain ultimate decision-making power and thereby ensure that the firm remains committed to its social and/or environmental purpose.[168]

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[164] Bromberger, *supra* note 11, at 6-7.
[165] The membership agreement fills the multiple functions of corporate charter, bylaws, and shareholder agreement. Cite.
[166] Bromberger, *supra* note 11, at 6-7.
[167] *Id.*
[168] *Id.* at 7.

LLCs are also like partnerships in that they feature pass-through taxation. This means that the income and expenses of the enterprise are reported and taxed as though the members had incurred them directly, with no tax consequences at the entity level.[169] The potentially knotty questions about how to tax hybrid social ventures[170] are therefore mitigated because the various co-venturers simply pay tax, or don't, according to their individual status.[171]

These features have induced social entrepreneurs to begin using LLCs for their social enterprises, but generic LLCs do not address all of social entrepreneurs' practical and legal challenges. First, because LLCs are generic throughout the country, they do nothing to solve social entrepreneurs' "branding" problems.[172] As discussed in Part III.C, above, the lack of a clear social enterprise brand means that social entrepreneurs' capital formation problems persist as traditional sources of charitable capital such as governments and private foundations reject them as unfamiliar and legally complicated, while for-profit sources of capital reject them as too dedicated to social outcomes to be worthy of market rate investment.[173]

b. The L3C: An LLC Tailored to Meet the Needs of Hybrid Social Enterprise

Not long ago a man named Robert Lang appeared on the social enterprise scene promoting the Low Profit Limited Liability Company, or "L3C," as a new type of LLC

[169] *Id.* at 6-7.
[170] *See supra* Part III.E.
[171] Assuming the LLC's activities serve the nonprofit co-venturer's tax exempt purpose, that nonprofit would be exempt from taxation on profits it received from the venture. The for-profit participant, on the other, hand, would pay corporate income taxes on its share of the LLC profits. Bromberger, *supra* note 11, at 6-7. I.R.C. §.
[172] *See supra* Part III.E.
[173] *See supra* Part III.C.

specifically designed to accommodate the needs of hybrid social ventures.[174] Although Lange's proposal was at first overshadowed by social entrepreneurs' enthusiasm for B Corporations and SRCs,[175] growing numbers of social entrepreneurs have begun to recognize it as an improvement upon corporate entity solutions and the use of generic LLCs. [176]

The L3C envisaged by Lang and his collaborators featured relatively minor but important changes to existing LLC forms. The first and most obvious was simply branding the new entity by including the term "low profit" in its name and in its statutory statement of purpose.

As discussed in Part III.C, above, secondary and tertiary benefits flow from creating a clear social benefit brand. Most obviously, the name and the statutory imprimatur put the world on notice that the organization's central purpose is not maximizing profits for the organization's owners.[177] This in turn should relieve social entrepreneurs' concern about being sued by owners for failing to maximize the organization's profits. Furthermore, the creation of a clear L3C hybrid social enterprise brand should help mitigate social entrepreneurs' capital formation problems by signaling to sources of charitable and social benefit capital – private foundations, governments, and

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[174] Lang is a former CEO of a cosmetics company and the president of the Mary Elizabeth & Gordon B. Mannweiler Foundation in Cross River New York. *See* Billitteri, *supra* note 9, at 13. I first encountered him at an Aspen Institute Roundtable, see *supra* note 147, where he presented his idea to a skeptical audience of social enterprise leaders.

[175] *See* Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 255 (stating Lang attended many meetings with social entrepreneurs but that the idea did not immediately catch on).

[176] Bromberger, *supra* note 11, at 6 (noting that LLCs are privately owned legal entities that can be formed for the purpose of realizing profits, pursuing a social mission, or both).

[177] Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 256. He has described L3Cs as "the for-profit with the nonprofit soul." *See* Americans for Community Development Website, http://americansforcommunitydevelopment.org/.

socially responsible investors – that the entity would be dedicated, at least in part, to producing social benefit returns.

The second distinctive feature of L3Cs was squarely intended to ameliorate social entrepreneurs' capital formation concerns by making the entities attractive vehicles for program related investments by private foundations. As discussed in Part III.A.1, above, program related investments, or PRIs, hold great potential as a source of capital for hybrid social ventures but have been under-utilized because their risks and transaction costs make them unappealing to most private foundations.[178]

Marcus Owens, who has collaborated with Robert Lang on designing the L3C and who earlier in his career was the head of the Exempt Organization Division at the IRS, came up with a simple but elegant way of making the L3C an attractive PRI vehicle. His idea was to draft model legislation – which he hoped would be adopted in at least one[179] state[180] -- that closely tracked the language of the PRI requirements laid out in Section

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[178] *See supra* notes 94-101and accompanying text.

[179] Once one state adopted Owens' draft legislation, hybrid social enterprises around the country could take advantage of the law by simply forming in that state and registering to do business in their principal place(s) of business.

[180] Although the L3C was Lang's idea, Owen helped him develop it and came up with the idea of drafting the model law in such a way that it tracked federal PRI regulations. From the start, Lang intended to use L3Cs to attract PRIs from private foundations, but apparently it did not occur to him or the lawyers he was working with to draft such model legislation.

In fact, at first Lang did not believe that any new laws would be necessary. Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 255. He assumed that hybrid social ventures could be formed under existing LLC laws in whatever state was convenient for the social entrepreneurs. In their LLC membership agreement, they would describe themselves as L3Cs and, using the types of membership structures described in Part IV.B.2,, above, would commit irrevocably to their multi-bottom line outcomes. According to Lang's plan, the L3C would act much like the B Corporation, described in Part IV.B.1, above: its primary purpose would be to create a reliable brand for hybrid social ventures, one that would be even more flexible than a B Corporation because of the malleability of the LLC form.

Lang's plan was to convince a handful of private foundations to act as lead investors in the first L3Cs, and to seek advance private letter rulings from the IRS determining that the ventures would qualify under the PRI regulations. Once two or three of these ventures had been launched and vetted by the IRS, both the Service and private foundations would become comfortable the new L3C brand. Henceforth, L3Cs would be approved as a matter of course, and PRIs would take off. *See* Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 256.

4944(c) of the Internal Revenue Code.[181] In other words, if Owens' model legislation were adopted, any social enterprise that qualified for L3C status under state law would *ipso facto* qualify for program related investments under the IRS Code. Assuming the IRS supported the idea, private foundation PRI investors could invest with confidence in any organization that was designated as an L3C without needing to perform an exhaustive investigation or obtain a private letter ruling. Owen and Lang envisaged a master list – perhaps one maintained by the IRS – that would track the organizations around the country that had qualified under state law as L3Cs. If a private foundation were interested in investing in or loaning to a hybrid social enterprise in the form of a PRI, it could simply check the list to be sure the organization had qualified, and then proceed with its investment.[182]

The L3C's extreme organizational flexibility, which it shares with generic LLCs, would also contribute to resolving the capital formation problems faced by hybrid social enterprise. L3C membership agreements can create different classes of membership representing different tiers of capital investment. For example, having assured private foundations that their PRI investments would pass muster with the IRS, an L3C could contain the PRI investments within a class of membership – an investment tier – that would be compensated primarily by the venture's social outcomes (for example, the jobs created by the venture) and would not receive significant financial return on its

[181] *See supra* Part III.A.1.

[182] *See* Wallace, *supra* note 10, at X. Owens' and Lang's long-term plan for developing L3Cs also includes a solution to the difficulty of transferability of LLC ownership interests, although Owens' proposed legislation says nothing about how L3C membership interests would be bought and sold. One of the few drawbacks of using the LLC form instead of a standard corporation is that while corporate shares are generally easily valued and transferred, membership positions in LLCs are not. According to Lang and Owens, the long-term solution would be to create and market L3C securities. Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 258.

investment.[183] The venture could also create an intermediate ownership tier geared toward socially responsible investors who might be willing to accept lower than market rates of return so long as the organization were achieving significant socially beneficial outcomes.[184] Finally, the L3C could create a market-rate tier to attract capital from private sector investors such as venture capitalists and financial institutions such as banks. [185] As a result of this tiered capital structure, the overall rate of returns would be below market, say four of five percent, but the existence of the low-interest social benefit tier would permit the entity to offer higher returns to a limited number of market rate investors.

The same organizational flexibility that would allow for multi-tiered investment tranches would make it easy to lock the organization's assets into the hybrid social enterprise stream.[186] Social entrepreneurs could draft L3C membership agreements to create different classes of members, each with different rights and duties, and a particular member's powers and duties would not have to correspond in any way with his or her ownership stake in the venture.[187] It would be a straightforward drafting exercise to create a special class of members empowered to enforce the organization's social mission.[188] This member or members could be a public charity or private foundation with only a minor financial stake in the venture – or none at all – but with the power to

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[183] *See generally supra* Part III.A.1 (describing program related investments).
[184] *See supra* Part III.A.2 (describing socially responsible investing).
[185] The L3C, like generic LLCs, also avoids potentially knotty taxation issues due to pass-through taxation. *See supra* note 171 and accompanying text. No federal tax would be assessed at the entity level and each member would be taxed individually according to his, her or its own circumstances. *Id.* This is assuming the L3C's activity served the private foundation or other nonprofit investor's charitable purpose. *See* Bromberger*, supra* note 11, at 6-7. If the L3C's activities did not serve the charitable organization's purpose, income would be taxed at normal corporate rates as unrelated business income. *Id.*
[186] *See supra* Part III.B.
[187] *See* Bromberger, *supra* note 11, at 7. S*ee also* Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 256.
[188] Bromberger, *supra* note 11, at 14.

block other members from making changes to the organizational documents that would dilute its social mission.[189]

In sum, Robert Lang and David Owens' L3C addresses most of the major challenges that social entrepreneurs articulate. It addresses entrepreneurs' capital formation problems by parroting the IRS's program related investment language in its enabling legislation, thereby encouraging private foundations to furnish capital through PRIs. It also encourages diverse capital investment by its extreme organizational flexibility and its ability to house numerous investment tranches within a single entity.

That same organizational flexibility means that social entrepreneurs' desire for an effective asset lock is a simple matter of drafting the membership agreement in such a way that it gives a charity ultimate control of the venture's mission. As a secondary benefit, the existence of this asset lock will, at least in theory, loop back to the capital formation challenges because socially conscious investors and consumers will have confidence that the assets will remain dedicated to socially beneficial outcomes.

The L3C also has the potential to create a clear and recognizable social enterprise brand on a national scale. Not only will this permit the general growth and development of the emerging fourth sector, but, as is true of the asset lock, it may have a positive effect on capital formation as SRI investors become more aware of socially responsible investment opportunities.

Finally, the L3C does away with a concern that social entrepreneurs tend not to dwell upon but that might impede the development of the emerging fourth sector: the question of whether and if so how to tax it. Due to the pass through taxation associated

[189] *Id.*

with all LLCs, each participant in the hybrid entity will be taxed according to its own status.[190]

c. The Future of L3Cs

In 2006 and 2007, several state legislatures considered Lange's and Owens' plan for creating L3Cs,[191] but it was not until May 1, 2008 that Vermont became the first to adopt an L3C statute,[192] followed by Michigan in 2009.[193] It therefore is possible that in the near future there will be L3C social ventures, such as the hypothetical furniture factory described in Part II.A.2, above, striving for multiple bottom lines and capitalized

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[190] Although the L3C addresses most of social entrepreneurs' needs, it is not perfect. First, unlike the proposed Minnesota and Hawaii socially responsible corporations, the L3C laws contain no explicit ban on shareholder/member lawsuits for failing to maximize financial returns. By its very design, however, the L3C seems unlikely to engender investor lawsuits. The words "low profit" in the organization's name should clue investors into the fact that profit maximization will not be the enterprise's primary goal. Furthermore, with its organizational flexibility and its multiple investment tranches, the L3C social venture is well designed to meet the reasonable expectations of its various investors. *See supra* notes 183-85 and accompanying text.

Another drawback to LLCs generally and L3Cs in particular is that they are not as well suited as corporations to large ventures where shares are to be offered to the public and/or where frequent investor turnover is possible. Bromberger, *supra* note 11, at 7. Lang and Owens have suggested overcoming this weakness by positing the eventual securitization of L3C membership shares, where those L3C securities would provide the necessary liquidity. Lang, *The L3C: The New Way to Organize Socially Responsible Organizations, supra* note 39, at 258. According to Lang, if substantial brokerage houses of solid reputation could be convinced to package and market L3C securities, it is possible that primary and secondary markets would evolve and that those wishing to invest in hybrid social ventures – particularly private foundations looking to engage in PRIs – could work through those brokers to pick and choose appropriate investments. Those securities could be bonds, membership units, convertibles, options, loans, or whatever could be sold alone or as part of a package. An added benefit would arise from the due diligence these brokers would perform, which would provide added assurance to investors that the L3C investments were reasonably likely to achieve their multiple bottom line goals. *Id.* However, the viability of the securitization scheme is uncertain and in any case would not come on line until the fourth sector had grown beyond its present nascent form.

Finally, as mentioned in the text, the success of the L3C proposal will depend, at least in part, on the cooperation of the Internal Revenue Service. The Service will have to be willing to cooperate in a scheme to permit L3C status to create a presumption that the L3C qualifies for PRI investment. *See supra* note 182 and accompanying text.

[191] *See* Americans for Community Development -- FAQ About L3Cs, http://americansforcommunitydevelopment.org/FAQ.asp (reporting that law makers in North Carolina, Michigan, Georgia and Montana all had considered L3C legislation). *See also* Wallace, *supra* note 10, at X.

[192] H.B. 775 (Vt. 2008), *available at:* http://www.leg.state.vt.us/docs.cfm?URL=/docs/2008/acts/ACT106.HTM.

[193] S.B. 1445, 9th Leg. Sess. (Mi. 2008) (effective date January 12, 2009), *available at:* http://www.legislature.mi.gov/documents/2007-2008/publicact/pdf/2008-PA-0566.pdf.

by the full spectrum of investors.[194] Fully capitalized, the L3C venture would be able to purchase or lease the necessary manufacturing equipment and factory space. Although the factory – without the advantages of low cost Asian labor – would produce only modest financial returns, it would satisfy its social investors by producing quality manufacturing jobs and bolstering the local economy and its market rate investors by creating a limited, market rate investment tier.

V. Conclusion

In late 2008 and 2009, when this article was already in draft form, popular discourse about social enterprise and the emerging fourth sector quieted as the United States began to wrestle with the most severe financial downturn since the Great Depression. Understandably, Americans became less concerned about innovative social frontiers and more concerned about fundamental questions such as whether they would be able to retain their jobs and retire before their dotage.

However, the emerging fourth sector shows no signs of disappearing,[195] and it is at least arguable that the turmoil in our financial system will give rise to an open moment when Americans and their lawmakers may be willing to reconsider the theoretically rigid boundaries between the for-profit and nonprofit sectors. The predominant, traditional view of the business sector as guided exclusively by the goal of producing financial returns for investors,[196] a view that generally permitted scant consideration of social

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[194] *See* Americans for Community Development – FAQ, *supra* note 191.

[195] *See, e.g.,* Nathaniel Whitlemore, *Top Trends 2009 #3: Blended Value Investing* (blog maintained at the site of Change.org, posted December 30, 2008), http://socialentrepreneurship.change.org/blog?category_id=24330 (last visited January 27, 2009). *See also* Christopher Flavelle, *Responsibility is Still Good for Business*, THE WASHINGTON POST, February 15, 200, at F01 (reporting that CSR appears to be weathering the economic crisis).

[196] *See Bruner, supra* note 103, at 1397-98 (stating the contract theory of corporations predominates in the United States). *See also* Ian B. Lee, *Corporate Law, Profit Maximization, and the "Responsible" Shareholder,* STANFORD J. INT'L L., BUS. & FINANCE 31 (2005) (stating that the "nexus of contract"

benefit or third party interests,[197] may be open to reconsideration if Americans conclude that such unidirectional, unmonitored entities marched lockstep in the wrong direction and led our financial system off a steep cliff. If this open moment arrives, and if the fourth sector continues to flourish, the low profit limited liability company, or L3C, proposed by Robert Lang and his collaborators appears to be the tool best adapted to give legal standing and structure to its hybrid social enterprises.

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theory is usually tied to the view that the corporation's sole duty is to maximize shareholder profits). *See generally* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991).

[197] Lee, *supra* note 196, at 31.