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Law's Facilitating Role in the Field of Social Enterprise.

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Book Review

A Review of Dana Brakman Reiser and Steven A. Dean. *Social Enterprise Law: Trust, Public Benefit, and Capital Markets*. New York: Oxford University Press, 2017, 216 pp., $44.95 (hardback) ISBN 978-0-19-024978-6

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To appreciate the contribution of Professors Dana Brakman Reiser and Steven A. Dean in their pathbreaking volume on social enterprise law, we must begin by recognizing what we are not discussing. As the authors declare: "social enterprises are not charities" (p. 165). By definition, social enterprises are businesses, and thus not subject to the nondistribution constraint so familiar to nonprofit scholars and practitioners. An impact investor seeks profit, perhaps limited because of the social mission or to redirect to a new social enterprise. But the dual motives open up the parties to the risk that their objectives will not align. Brakman Reiser and Dean examine how the law can perform a supporting function in developing trust between social enterprise entrepreneurs and potential investors (and among investors). Because investing for mission is a voluntary exchange in a situation of asymmetric information – sound familiar? – the law can enable vehicles that enhance the reliability of signals and back up precommitment devices.

As a threshold matter, nonprofit organizations and those who study and advise them could have an incomplete view of the role of law if they primarily deal with law as a source of regulation and government oversight. Nonprofit observers properly worry about the prescriptions and proscriptions of nonprofit corporate and trust law, and of the requirements for tax exemption and charitable-contribution deductions. Enforcement of these laws largely is the responsibility of the state attorneys general and courts and of the Internal Revenue Service, as befits a public-law portion of the legal landscape.

Often underappreciated by nonprofit scholars, though, is the positive role played by private law – and by transactional lawyers. Consider the tax lawyer who structures a real-estate joint venture between a nonprofit organization and a limited partnership of private investors, or an estate planner who fashions a restricted gift instrument or charitable bequest in a will for a wealthy client. While these types of private ordering must take place within the larger regulatory framework – such as avoiding unrelated business taxable income or ensuring that the transaction qualifies as a completed gift[1] – the generally laissez-faire legal regime allows for a wide range of activities.

From the perspective of the business sector, we find that business lawyers, legislators, and judges generally (although not exclusively) privilege a profit motive and ultimate control by the equity owners. Moreover, because the "business judgment rule" is a key feature of board governance, courts will not second-guess mere mistakes, untainted by fiduciary self-dealing or abdication of the duty of care. Needless to say, the state attorney general lacks standing to complain on shareholders' behalf.

Now we arrive at our topic: Given that the law is largely organized around organizational form, what happens when the participants seek both margin and mission? Accustomed to a sectoral analysis of nonprofit activity, many legal scholars and practitioners – as well as policy makers, regulators, and judges – are left discomfited by the rise of social enterprise, hybrid organizations, and double-bottom-line ventures.

Some state legislatures have enacted enabling statutes for specific types of organizations – such as for Benefit Corporations or Low-Profit Limited Liability Companies (L3Cs) – that allow social enterprise entrepreneurs to focus on both mission and profit in carrying out their fiduciary duties. Separately, some legal practitioners and academics have been formulating proposals to liberalize the legal – particularly tax – regime that compartmentalizes commercial activities. Besides the inability of a corporate taxpayer to zero out income through charitable contributions, specific barriers arise from the difficulty of raising patient capital due to: (1) the ability of a nonprofit to borrow (and pay interest) but not to issue stock (and pay dividends); (2) the ability of a charity but not other nonprofits and taxable enterprises to attract tax-deductible charitable contributions; (3) the uncertain ability of private foundations to make grants to businesses; and (4) limitations on designing appropriate governance, investment-return, and compensation structures.

Brakman Resier and Dean's book provides both a lucid description of the history and current legal landscape for social enterprise and offers carefully designed proposals for reform. Those who hold a negative view of the law – that it means only the three "R"s of regulation, red tape, and roadblocks – will find eye-opening the authors' view of law as a positive force in facilitating the trust

1 See Simon, Dale, and Chisolm (2006), discussing federal tax law's four-pronged role: The support function (subsidy), the equity function (notably redistribution), the regulatory function (constraints on managerial behavior), and the border-patrol function (that is, between charities and both the business and public sectors). Of course, dense financial ties among the sectors exist. See generally, Brody (2009).

between social enterprise entrepreneurs and impact investors that will induce them to pool their resources. The authors' delightfully memorable names for their innovative new vehicles – MPH, FLY paper, and SE(c)(3) – aptly suggest the variety of ways in which the law can be helpful in promoting and backing up this trust.

Chapter 1, "The Social Enterprise Trust Deficit," starts from the extreme of the business corporation. In terms of raising capital, Brakman Reiser and Dean view the corporate form as "mak[ing] trust all but irrelevant" (p. 14) due to the law's power of declaring the rights of shareholders and the obligations of management. Corporate law, however, cannot adequately remedy the betrayal of a particular unhappy investor when management and the other shareholders sell a social enterprise to an acquirer who will not continue the mission: "That truly committed impact investor might take her windfall and plow it into another double-bottom-line venture, but can never recapture what was lost" (p. 16). Indeed, the typical legal remedy for breach is measured by quantifying the harm in dollars, but "privileging profit over social good will often increase profits and stock prices" (p. 21). The need to aggregate capital raises the fundamental challenge of heterogeneity: Shareholders might have different views about how much to preserve a social enterprise's mission.

Chapter 2, "Prioritizing Mission with a Mission-Protected Hybrid," begins with the statutory development of novel organizational forms. Brakman Reiser and Dean characterize these efforts – which saw the rise of variously named "benefit" corporations and L3Cs – as the "first-generation" legal response. Chapter 3, "Evaluating the Current Menu of Legal Forms for Social Enterprise," describes these vehicles in detail, but concludes by reporting disappointing numbers of such entities.

After all, chapter 2 explains: "If the [organizational] form offers no guidance as to how to break a tie [between margin and mission], it will be impossible to police these entities or their leaders" (p. 28). Thus Brakman Reiser and Dean propose a second-generation vehicle, the Mission-Protected Hybrid (MPH), which must, in the aggregate, prioritize social good over profit. The authors urge that MPH legislation include disclosure requirements both to an oversight agency and to shareholders, resulting in ongoing external and internal enforcement mechanisms to test compliance. However, Brakman Reiser and Dean acknowledge the limitations of disclosure, due not only to optimistic self-reporting, but also to the challenges of designing reliable metrics (see Chapter 6, "The Promise of Metrics").

In a nod to the struggles of state charity regulators, chapter 2 suggests that the designated agency might leverage enforcement resources by delegating the review of compliance to private certifying bodies. Turning to the question of remedy, the authors recount the cautionary tale that led to the development of intermediate sanctions short of the “death penalty” of loss of federal tax exemption for charities. These weaknesses of public oversight prompt Brakman Reiser and Dean’s MPH legislative proposal to include ways to “empower stakeholders to police each other” (p. 43) and for shareholders to challenge fiduciaries. At the same time, the authors explain why resort to court will unlikely be a reliable or even desirable route to resolving these types of disputes. Accordingly, they turn to the “crucial third leg to the enforcement stool” (p. 47): ensuring some degree of fidelity to mission on exit (discussed further in chapter 7). They describe a process requiring supermajority shareholder approval for dissolution, and a procedure, akin to cy pres, to transfer a specified percentage of the remaining assets to a charity to use for the social mission of the dissolving MPH.

Chapter 4, “From Form to Finance,” considers a different tack: Instead of relying on organizational form or indeed a new state or federal regime, a tailored financial instrument could match impact investors with social entrepreneurs. As Brakman Reiser and Dean describe, corporate finance law already allows for a full spectrum of negotiated arrangements, ranging from plain vanilla common stock to plain vanilla debt. Mission-focused investors and entrepreneurs could come to terms over a variety of parameters, such as agreeing on deferred interest payments or a conversion feature in which the debt becomes equity upon sale of the enterprise. The authors propose such an instrument that they dub FLY (flexible low-yield) paper: “Providing capital for a specified period at concessionary rates coupled with terms designed to secure a social enterprise’s mission for that fixed period of time could fully satisfy many investors’ aims. Social entrepreneurs needing patient capital to bring their dual-mission visions to life could also be satisfied with this kind of stable, though not perpetual, investor commitment” (p. 82). That is, rather than red tape, use a sticky loan. Appropriately, the authors compare FLY paper to program- and mission-related investments made by some private foundations (pp. 88–89).

Of course, not every impact investor has the wherewithal and desire to negotiate over the investment, just like not every donor wants to hammer out a restricted gift instrument with a charity. Accordingly, chapter 5, “The Holy Grail of Retail Investment,” proposes that a new federal tax regime (and IRS policing) would allow electing small social enterprises to signal to small investors their social-mission commitment. Combining the acronym for the federal securities regulator (the Securities and Exchange Commission) and the federal tax classification for exempt charities (Internal Revenue Code section 501(c)(3)), Brakman Reiser and Dean dub this type of social enterprise “SE(c)(3).” The authors’ proposal embraces both a carrot and a stick: income-tax exclusion for the first $250,000 of income that furthers a charitable purpose (and certain other benefits) (p. 115), but ordinary tax rates rather than capital gains rates for investors who sell their stock (as well as on any dividends received) (p. 116). Overall, they suggest, this classification might even be revenue-neutral to the fisc: "Those increased taxes on SE(c)(3)s that de-emphasize mission in favor of the financial gains of their owners cross-subsidize the lighter burden enjoyed by more mission-focused enterprises" (p. 121).

For nonprofit organizations, an important corollary to the lack of owners is the absence of a "market for corporate control." (See Brody 1996.) As emphasized at the beginning of this book review, social enterprises are not nonprofits – but the analogy between social mission and charitable purpose offers helpful guidance for how the law should approach the keystone issue of what chapter 7 calls "Social Enterprise Exits." Brakman Reiser and Dean explain that the techniques covered in earlier chapters "harness the power of exit. An MPH can draw down; FLY paper has a term; certifying entities and exchanges can decertify and delist. Even SE(c)(3) status typically terminates at a claimant's dissolution" (p. 144).

The authors emphasize that the law can ensure that "[s]elling does not have to be selling out" (p. 155). Ideally, as Brakman Reiser and Dean urge, social entrepreneurs and investors would plan for exit at the outset of the enterprise or investment in order to ensure that their desired mission continues in legally enforceable ways upon dissolution or transfer to an acquirer. Either up-front or in the terms of sale, provision could be made to retain certain employees or apply specified terms of employment, to continue charitable activities, or to make contributions – at a cost, it might be expected, in sale price, whose proceeds the investors could redeploy to another social mission if they desire. Of course, bankruptcy is another matter; when assets are insufficient to cover liabilities, only restricted charitable assets are protected for their donated purpose (pp. 162–165; see Brody (2005)).

Brakman Reiser and Dean's conclusion to the volume aptly sums up their view that "the law poses no threat to social enterprise, but instead offers private and public actors an array of tools to nurture its growth." The thoughtful and creative techniques and instruments they propose – along with ample case studies – bring the possibilities of the law alive, in a way useful to legal experts and accessible to those grounded in other disciplines. Not only does social enterprise now have a cutting-edge legal guide, but also Brakman Reiser and Dean have helpfully mapped out the intriguing legal interstices between nonprofits and business for those scholars and practitioners who remain focused on a single sector but need to understand the evolving pressures on it.

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