

THE ROLE OF SOCIAL ENTERPRISE

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INTRODUCTION

A market economy predictably under-produces certain urgent public or collective goods, such as a clean environment. It also perpetuates gross inequalities in resources among people and across regions. Recently, there has been growing interest in privately-led approaches that use business methods and forms for the express purpose of repairing society¹ and which go under the labels of social enterprise and social entrepreneurship. One of these approaches, the social enterprise, can be defined as “an organization or venture that achieves its primary social or environmental mission using business methods,”² typically by operating a revenue-generating business.³ So defined, a social enterprise may be organized as either a nonprofit or for-profit entity.⁴ It can also be set up using an organizational form specifically designed for social enterprises—one that seeks to “hybridize” or blend components of both nonprofit and for-profit endeavors. Social enterprises are founded by “social entrepreneurs,” a broader term that denotes an ambitious person who seeks social change on a large scale, characteristically through earned income strategies.⁵

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1. Ben Cohen, *On Becoming an Ecopreneur*, in THE GREEN FESTIVAL READER: FRESH IDEAS FROM AGENTS OF CHANGE 50, 51 (Kevin Danaher & Alisa Gravitz eds., 2008).

2. *Social Enterprise: Defining the Movement*, SOCIAL ENTERPRISE ALLIANCE, http://www.se-alliance.org/about_movement.cfm (last visited Sept. 16, 2010). This definition is advanced by the Social Enterprise Alliance, which describes itself as “the only member organization in North America to bring together the diverse field of social enterprise. It serves as advocate for the field, hub of information and education, and builder of a vibrant and growing community of social enterprises.” *Id.*

3. PAUL C. LIGHT, THE SEARCH FOR SOCIAL ENTREPRENEURSHIP 5 (2008); see also Dennis R. Young, *Alternative Perspectives on Social Enterprise*, in NONPROFITS & BUSINESS 21, 23 (Joseph J. Cordes & C. Eugene Steuerle eds., 2009) (“Social enterprise is activity intended to address social goals through the operation of private organizations in the marketplace.”).

4. See SOCIAL ENTERPRISE ALLIANCE, *supra* note 2 (“The social enterprise movement includes both nonprofits that use business models to pursue their mission and for-profits whose primary purposes are social. Social mission is primary and fundamental; the organizational form depends on what will best advance the social mission.”).

5. Jo Barraket, *Recasting Our Thinking? Social Enterprise and Social Value Creation in a Network Era*, CPNS-QUT-Nonprofit Podcast, Program 32, 2 (Mar. 3, 2009), <http://www.bus.qut.edu.au/research/cpns/podcast/documents/podcast32transcript.pdf> (“The language of social entrepreneurship . . . has found resonance with those concerned with dynamic individuals who utilise [sic] entrepreneurial strategies to progress social objectives inside and outside organisational [sic] structures, and across sectoral divisions.”) (citation omitted); Jerr Boschee & Jim McClurg, *Toward a Better Understanding of Social Entrepreneurship: Some Important Distinctions* 3 (2003), http://www.se-alliance.org/better_understanding.pdf (“A social entrepreneur is any person, in any sector, who uses earned income strategies to pursue a social objective . . .”).

An increasing number of people and entities are coalescing under these banners. Their expanding influence is reflected in the 2006 Nobel Peace Prize awarded to Muhammad Yunus, a leading promoter of microfinance and the concept of “social business;”⁶ the growth of centers for social entrepreneurship at leading business schools such as Harvard and Stanford,⁷ and media attention such as Business Week’s annual list of “America’s 25 Most Promising Social Entrepreneurs.”⁸ The Obama Administration has also unveiled several initiatives to encourage the growth of social enterprise.⁹ Even Bill Gates (a proponent of “creative capitalism”)¹⁰ and Pope Benedict XVI (who calls for “a profoundly new way of understanding business enterprise”)¹¹ have promoted the notion of business organizations and executives making decisions that are not purely profit-driven.

For many years, social enterprise was associated mainly with nonprofit organizations, which have no owners in the conventional sense and whose controllers can earn no more than “reasonable” compensation. The first wave of contemporary social enterprises was based in nonprofit organizations and gained significant momentum during the 1980s.¹² Over time, a growing number of nonprofit organizations began to embrace and pursue earned income strategies, largely as a means to reduce their dependence on donations and grants.¹³ Earned income also expanded the

6. See Vikas Bajaj, *Out to Maximize Social Gains, Not Profit*, N.Y. TIMES, Dec. 9, 2006, <http://nytimes.com> (enter “Out to Maximize Social Gains, Not Profit” in Search; then follow “Out to Maximize Social Gains, Not Profit” hyperlink) (describing Mr. Yunus’s recent Nobel Peace Prize and his partnering with Groupe Danone to start a “social business”).

7. *America’s Best Colleges for Entrepreneurs, Best for Social Entrepreneurs*, CNNMONEY.COM, http://money.cnn.com/galleries/2007/fsb/0708/gallery.bestcolleges_social.fsb/index.html (last visited Oct. 10, 2010).

8. John Tozzi, *America’s Most Promising Social Entrepreneurs*, NEW ENTREPRENEUR BLOG (June 8, 2010), BUSINESSWEEK.COM, http://www.businessweek.com/smallbiz/running_small_business/archives/2010/06/americas_most_promising_social_entrepreneurs.html.

9. Anne Field, *Obama Gives Big Boost to Global Rating System for Social Enterprises*, TRUE/SLANT (Apr. 27, 2010, 3:42 PM), <http://trueslant.com> (noting that Obama supports a rating system for social enterprises to encourage investment by socially-concerned investors seeking more robust means for measuring their social and environment achievements). The Obama administration also encourages innovations in the nonprofit sector through its Office of Social Innovation. See, e.g., Press Release, The White House Office of the Press Sec’y, President Obama to Request \$50 Million to Identify and Expand Effective, Innovative Non-Profits (May 5, 2009), available at http://www.whitehouse.gov/the_press_office/President-Obama-to-Request-50-Million-to-Identify-and-Expand-Effective-Innovative-Non-Profits.

10. Bill Gates, *Making Capitalism More Creative*, TIME, July 31, 2008, www.time.com/time/business/article/0,8599,1828069,00.html.

11. Encyclical Letter *Caritas in Veritate* of the Supreme Pontiff Benedict XVI to the Bishops Priests and Deacons Men and Women Religious the Lay Faithful and All People of Good Will on Integral Human Development in Charity and Truth, ¶40 (Jun. 29, 2009), available at http://www.vatican.va/holy_father/benedict_xvi/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate_en.html (emphasis omitted).

12. See, e.g., Barraket, *supra* note 5, at 2 (“The idea of social enterprise was popularised [sic] in the early 1990s and has gained considerable traction in public policy frameworks and not for personal profit management practices in a number of regions around the world.”) (citation omitted).

13. *Id.*

controllers' power over their organization's resources because earned income—unlike donations—is generally unencumbered by donor-imposed restrictions on its use.¹⁴

Nonprofit organizations have of course been earning income for many years. In some nonprofits, a revenue-generating activity may be its “very reason for existence”¹⁵ and inextricably connected to the accomplishment of its mission. Examples include the tuition-funded nonprofit school that imparts knowledge to each paying student and the self-financing religious publisher that spreads The Word with each book sold.¹⁶ In other nonprofits, as with a church bake sale, the business activity is unrelated to the organization's mission and is conducted solely to raise funds to support mission functions.

Yet, there were several novel and noteworthy aspects about the growing interest among nonprofits for earned income that took off during the 1980s. First, some proponents of these projects saw themselves as vanguards whose members rejected the traditional ethos that denigrated nonprofit business activity as a commercialism of dubious ethicality.¹⁷ Also, some new wave nonprofit social entrepreneurs pursued ambitious strategies to raise revenues through business activities that directly advanced their organizations' missions.¹⁸

More recently, the term or concept of “social enterprise” has been applied to some for-profit business ventures with social missions.¹⁹ We refer to these entities as “for-profit social enterprises.”²⁰ Other terms for members of this genus include “hybrid social ventures,”²¹ “for-profit social

14. Burton A. Weisbrod, *The Nonprofit Mission and its Financing: Growing Links Between Nonprofits and the Rest of the Economy*, in *TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR* 1, 14–16 (Burton A. Weisbrod ed., 1998) (analyzing the trend for nonprofit organizations to rely more heavily on commercial sales activity compared to charitable donations).

15. JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 593 (3d ed. 2006).

16. *Id.*

17. Boschee & McClurg, *supra* note 5, at 1 (“Twenty years ago the idea of nonprofits acting in an entrepreneurial manner was anathema to most people in the sector: The idea of merging mission and money filled them with distaste.”).

18. See, e.g., *Evolution of the Social Enterprise Industry: A Chronology of Key Events*, THE INST. FOR SOC. ENTREPRENEURS 3 (Aug. 1, 2008), http://socialent.org/Free_Downloads.htm (follow “Evolution of the Social Enterprise Industry: A Chronology of Key Events” hyperlink) (last visited Sept. 2, 2010) (“Social enterprises *directly* confront social needs through their products and services rather than *indirectly* through . . . [inter alia] the unrelated business activities mounted by nonprofits.”) (emphasis in original).

19. Daniel J. Isenberg, *An Indian FOPSE: Innovations Case Discussion: Keggfarms*, INNOVATIONS: TECH., GOVERNANCE, GLOBALIZATION, Winter 2008, at 52, 55 n.1 (“[For-profit social enterprises] have explicitly stated goals of earning a profit while solving a major societal problem.”). Isenberg asserts that he coined the term “for-profit social enterprise” in April 2007. *Id.* at 54.

20. *Id.*

21. Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 337 (2009).

businesses,”²² “social purpose business ventures,”²³ blended value organizations, companies with a conscience, Fourth Sector organizations,²⁴ a “for profit with a nonprofit soul,”²⁵ and for-benefit organizations.²⁶ Like a nonprofit social enterprise, a for-profit social enterprise expressly seeks to use business means to address social problems. Yet unlike a nonprofit social enterprise, it is owned (in whole or in part) by equity investors, and one of its core goals (alongside its social purposes) is to generate returns for those investor-owners. These investor-owners include founders who are entitled to a portion of the proceeds from the organization’s sale or an initial public offering (IPO). Thus, an essential difference between nonprofit and for-profit social enterprises is the ability of the enterprise’s founders, controllers and investors to lawfully appropriate its surpluses for their private benefit.

According to one commentator, social entrepreneurs as a group are shifting their focus “away from the non-profit sector, traditionally in charity and philanthropic activities, towards entrepreneurial private-sector oriented business activities.”²⁷ As interest in for-profit social enterprise grows, so too does interest in legal and regulatory strategies to encourage the creation and flourishing of for-profit social enterprises. Many social entrepreneurs, reports Professor Thomas Kelley, believe that “outmoded law and inappropriate old-style legal entities hamstringing their socially transformative plans.”²⁸ At the same time, maintains Kelley, many social entrepreneurs crave “new laws, in particular new legal entities, to provide structures better suited” to ventures that seek social and environmental betterment, in addition to enriching their owners.²⁹

In response, legislators, practitioners, and scholars are devoting more resources to exploring organizational forms and public policies to promote for-profit social enterprise. In recent years, a number of jurisdictions have enacted (or are contemplating) a variety of legal forms intended to foster the creation of for-profit social enterprises and the activities of social

22. Barraket, *supra* note 5.

23. Boschee & McClurg, *supra* note 5, at 4.

24. Heerad Sabeti et al., *The Emerging Fourth Sector: A New Sector of Organizations at the Intersection of the Public, Private, and Social Sectors: Executive Summary*, 4 (2009) http://www.fourthsector.net/attachments/39/original/The_Emerging_Fourth_Sector_-_Exec_Summary.pdf.

25. *What is the L3C?*, AMS. FOR CMTY. DEV., <http://americansforcommunitydevelopment.org/downloads/WhatsTheL3C.pdf> (last visited Aug. 31, 2010) (“The L3C is the ‘for profit with the nonprofit soul.’”) (citing Robert Lang and crediting him with the creation of the L3C).

26. Sabeti, *supra* note 24.

27. Jürgen Nagler, *The Importance of Social Entrepreneurship for Economic Development Policies 2* (Apr. 3, 2007) (unpublished manuscript), available at <http://sites.google.com/site/jjnagler/Home/ReportJNaglerSocialEntrepreneurshipandDevelopment.pdf>.

28. Kelley, *supra* note 21, at 340–41.

29. *Id.* at 341.

entrepreneurs seeking equity investors. These include, most notably, the low-profit limited liability company (L3C) enacted in Vermont and several other states; the United Kingdom's Community Interest Company (CIC);³⁰ and the "benefit corporation" recently enacted in Maryland,³¹ Vermont,³² and under consideration in several states including New York.³³ The California legislature is currently considering another corporate form called the "flexible purpose corporation."³⁴ There is also growing interest in a private-sector accreditation scheme called "B Lab,"³⁵ which provides standards for "social enterprises" and that certifies businesses for compliances with its standards.

Part I of this Article examines nonprofit organizations. In this section, we are especially interested in the potential role of nonprofit organizations as sites for social entrepreneurship and as instruments of social change—namely, nonprofit social enterprises. This section identifies perhaps the core problem that nonprofit organizations seek to address, namely, the predictable failure of market economies to optimize social welfare and mitigate economic inequality. It explores the economic functions that nonprofit organizations can serve generally (i.e., they can mitigate the agency costs that can arise in situations where there is severe information asymmetry between a supplier of goods and services and its "patrons," and where these agency costs cannot be adequately addressed by ordinary contractual mechanisms). We focus on commercial nonprofits that undertake to help society by producing "mixed" public/private goods—that is, (a) private goods that are bought for the purchaser's private consumption, and (b) that nonetheless have significant positive externalities. Lastly, we consider the government's regulation of nonprofits and especially how it challenged commercial nonprofits to develop earned-

30. See generally, Community Interest Company Regulations, 2005, S.I. 2005/1788 (U.K.), available at <http://www.legislation.gov.uk/ukxi/2005/1788/contents/made> (creating regulations for community interest companies).

31. John Tozzi, *Maryland Passes 'BenefitCorp.'* *Law for Social Entrepreneurs*, NEW ENTREPRENEUR BLOG (Apr. 13, 2010), BUSINESSWEEK, http://www.businessweek.com/smallbiz/runnimg_small_business/archives/2010/04/benefit_corp_bi.html.

32. VT. STAT. ANN. tit. 11A, §§ 21.01–21.14 (2010) (establishing "benefit corporations" in the state of Vermont).

33. N.Y. S.B. 7855, Leg., Reg. Sess. (N.Y. 2010) (authorizing the incorporation of benefit corporations), available at open.nysenate.gov/legislation/api/html/bill/s7855.

34. See S.B. 1463, 2009–2010 Leg. Sess. (Cal. 2010); see also W. Derrick Britt, R. Todd Johnson & Susan H. MacCormac, *Frequently Asked Questions: The Flexible Purpose Corporation 1* (Jan. 5, 2010), available at www.primakers.net/files/FAQ%20re%20the%20Flexible%20Purpose%20Corp.doc (last visited Sept. 2, 2010) (explaining that the new organizational form was "designed to facilitate the organization of companies in California with greater flexibility for combining profitability with a broader social or environmental purpose").

35. CERTIFIED B CORPORATION, <http://www.bcorporation.net> (follow "About B Corp" hyperlink; then follow "Who Certifies?") (last visited Sept. 17, 2010).

income activities that are significantly related to their charitable missions. Commercial nonprofits thus pioneered the concept of social enterprise and some of these insights were carried over to the for-profit social enterprise context.

Part II considers what for-profit social enterprises might be, how they can address market shortcomings, and why they might sometimes do so more successfully than nonprofit social enterprises. In other words, we identify some of the obstacles faced by nonprofit social enterprises that for-profit social enterprises might be better able to overcome. One comparative advantage of for-profit social enterprises is their ability to provide social entrepreneurs, employees, and investors with more financial inducement to tackle social problems in effective ways. This Part considers some of the elements of nonprofit organizations, law and policy that allegedly necessitate the creation of new legal forms specifically tailored to for-profit social enterprises. In doing this, we ask: What is the comparative advantage of for-profit social enterprises compared to traditional forms in achieving this goal? We also look at an obvious challenge faced by for-profit social enterprise—the balance between social and financial mission.

Part III distinguishes between two approaches to the for-profit social enterprise's distinct value proposition, with each pushing the law of social enterprise in a different direction. The first approach is grounded in the organizational law of nonprofit and charitable organizations. This "nonprofit lite" approach seeks to address market failure by attracting resources into a legal form that is explicitly committed to generating social value in perpetuity. A key goal is for the organization to survive even after the social entrepreneur's exit or loss of enthusiasm. From the "nonprofit lite" perspective, the main challenge of social enterprise law is tweaking the asset lock (the prohibition on distributing residual income) and control mechanisms at the margins to ensure greater access to capital and talent.

The second approach is grounded in the broader ambitions of social entrepreneurship, which is to increase supply of public goods by transforming markets and preferences thereby creating a new more socially-optimal equilibrium. The social entrepreneur looks to more fundamental and sustainable changes in the way things are done that go well beyond the venture's earned income. Ideally, the new equilibrium will require of market participants no (or at least much less) explicit altruism. Because the social enterprise itself may be transitional and need not survive in order to be successful, asset locks and control mechanisms are less important. It is the overall social change which the social enterprise initiated that is most important, not the particular social enterprise itself.

This Article concludes that, though at the organizational level the for-profit social enterprise has some clear comparative advantages, we should be wary of regulation adapted from the nonprofit context that may dilute these advantages.

I. THE LAW AND ECONOMIC ROLE OF NONPROFIT ORGANIZATIONS AND SOCIAL ENTERPRISE

In liberal capitalist societies, we tend to look first to markets to allocate resources efficiently and in this way increase social welfare. We then look to other sectors and institutions—government and nongovernmental nonprofit organizations—to help counter any market shortcomings. For many reasons, nonprofit organizations serve as apt instruments for privately-led efforts to improve society.

This section examines nonprofit organizations, their key characteristics, and how they can serve to address market shortcomings. It then discusses how government helps nonprofit organizations perform these roles through its organizational laws and tax policies. Some of these entities may be usefully described as nonprofit social enterprises. This discussion lays the foundation for the subsequent examination of for-profit social enterprises.

A. Market Shortcomings

In developed countries, markets operate tolerably well to allocate consumer goods (such as television sets) to final purchasers for their personal consumption.³⁶ Yet markets have at least two serious flaws that reduce their efficacy as instruments for improving social welfare and human happiness. First, they predictably undersupply public or collective goods. Examples of such goods include national defense, basic infrastructure, environmental protection, listener-sponsored radio, improved race relations, and community development.³⁷ These market failures are more likely to occur when the parties engaged in an activity do not enjoy all the benefits it generates (i.e., there are positive externalities).³⁸ This result inheres in the

36. Rob Atkinson, *Theories of the Federal Income Tax Exemption for Charities: Thesis, Antithesis, and Syntheses*, 27 STETSON L. REV. 395, 415 (1997) (“Economic theory tells us that consumers usually know what goods and services they want to buy, that they are usually able to tell whether they got what they paid for, and that competition among for-profit suppliers usually ensures that they paid the lowest possible price.”).

37. R. H. Coase, *The Lighthouse in Economics*, 17 J.L. & ECON. 357, 358 (1974). Lighthouses used to be the textbook example of a public good, but later research has called this into question. *Id.* at 375.

38. See OXFORD DICTIONARY OF ECONOMICS 160 (John Black, et al. eds., 3d ed. 2009) (defining

nature of public goods, which generally cannot be limited to those who pay for them.

Consider the olfactory enjoyment that a store selling chocolate confers on those who live or work nearby. In economic terms, public goods such as chocolate aroma are non-rivalrous (i.e., one party's enjoyment of such goods does not preclude their enjoyment by others) and non-excludable (i.e., such goods cannot be provided to payors without also providing them to non-payors). Conversely, public "bads" tend to occur when the parties engaged in an activity do not incur all the harm and costs it imposes. These are negative externalities. Consider the effluents that a paper mill dumps into a river that affect those downstream. Where the externalities generated by a firm's activities do not affect its financial bottom line, the firm may be less motivated to consider these externalities. Such firms are thus less likely to produce public goods and public bads in socially optimal quantities—either too little or too much.

Second, unaided markets have difficulty in reducing the human misery that results from inequalities of wealth and other resources. According to neoclassical economists, the economic value of a good or service is a function of how much people are either willing to pay for it or be paid to part with it.³⁹ In this view, the market in equilibrium does not directly register the suffering of persons whose limited income puts life's necessities beyond their reach.⁴⁰ Judge Posner illustrates this point:

Suppose that pituitary extract is in very short supply relative to the demand and is therefore very expensive. A poor family has a child who will be a dwarf if he doesn't get some of the extract, but the family cannot afford the price A rich family has a child who will grow to normal height, but the extract will add a few inches more, and his parents decide to buy it for him. In the sense of value used in [Posner's economic analysis of law], the pituitary extract is more valuable to the rich family than to the poor one, because value is measured by willingness to pay; but the extract would confer greater happiness in the hands of the poor family than in the hands of the rich one.⁴¹

positive externalities as "effects of an activity which are pleasant or profitable for other people who cannot be charged for them").

39. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 1.2, 10 (7th ed. 2007).

40. RESTATEMENT (SECOND) OF TRUSTS § 369 cmt. d (stating that "a trust to assist persons who have an income which does not afford the necessities of life without such assistance is charitable," even though such persons "are not absolutely destitute").

41. POSNER, *supra* note 39, at 11.

Insofar as the market responds to raw human need, it does so indirectly and derivatively. A relatively well-to-do person donates money to a relief organization that assists indigents. This donor may experience some humanitarian satisfaction from improving the indigents' condition. This satisfaction, however, derives from the indigents' increased well-being (i.e., as a positive externality of the indigents' consumption of the assistance provided). Moreover, the donor's satisfaction—as reflected or registered in her willingness to “pay” or donate a certain sum—is probably only a fraction of the satisfaction that the indigents experience.

B. Defining Nonprofit, Charitable, and Tax-exempt Organizations

Ownership may be defined as “[t]he right to exclusive use of an asset”⁴²—most notably, in the case of an organization, the rights to control the asset, capture its net earnings or profits, and transfer it for consideration. A nonprofit organization lacks ownership in this sense.⁴³ Although it has controllers (e.g., managers, directors, and trustees), they are legally prohibited from appropriating the organization's net earnings for their personal benefit.⁴⁴ A nonprofit cannot offer controllers a share in equity, nor can it use salary as a device or pretext for distributing profits to them.⁴⁵ Economist and law professor Henry Hansmann identifies this prohibition—the “nondistribution constraint”—as the nonprofit's critical and defining characteristic.⁴⁶

A nonprofit may compensate controllers for the goods, services, and capital they render to the firm. Such compensation must, however, be reasonable.⁴⁷ This “fair compensation constraint”—as Professors Richard Steinberg and Bradford H. Gray call it—is a corollary of the nondistribution constraint.⁴⁸ In the case of employment, it discourages a nonprofit organization from paying bonuses to managers when its profits

42. OXFORD DICTIONARY OF ECONOMICS, *supra* note 38, at 331 (explaining that the owner's use of an asset may be limited by the state, which can tax it, regulate it, appropriate it in whole or in part for public use, and also by persons who have acquired contractual rights over the asset).

43. HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 228 (1996) [hereinafter HANSMANN, THE OWNERSHIP OF ENTERPRISE] (noting that shareholders in a corporation, although having full ownership of their shares, only have limited ownership rights regarding the corporation itself).

44. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) [hereinafter Hansmann, *The Role of Nonprofit Enterprise*].

45. *Id.* at 838, 900.

46. HANSMANN, THE OWNERSHIP OF ENTERPRISE, *supra* note 43; Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44.

47. Richard Steinberg & Bradford H. Gray, “*The Role of Nonprofit Enterprise*” in 1993: *Hansmann Revisited*, 22 NONPROFIT & VOLUNTARY SECTOR Q. 297, 302 (1993) (noting that salaries must “be ‘reasonable’ in relation to the going market rate for similar jobs in other organizations”).

48. *Id.*

are high.⁴⁹ These controllers will tend to earn less than their for-profit counterparts—especially in sectors where for-profit firms pay a significant part of compensation in equity shares, stock options, or otherwise based on stock performance. In those sectors, explains Hansmann, “it is likely to be only the salary portion of a for-profit manager/entrepreneur’s compensation that is taken as a norm in determining whether the salary received by the manager/entrepreneur of a nonprofit is excessive.”⁵⁰ This hurts a nonprofit controller’s earning potential because the benchmark for comparison—the salary portion of a for-profit controller’s compensation—is generally not as large without taking into account full compensation provided to for-profit managers based on equity shares.⁵¹

A nonprofit organization can generate profits at the institutional level (i.e., its revenues may exceed expenses).⁵² Yet a nonprofit’s controllers are obliged to do more than merely refrain from diverting the entity’s surplus to themselves. They have an affirmative duty to advance the organization’s mission, for example, by supplying more of whatever the entity was organized to supply.⁵³ A poverty-relief organization, for example, may distribute its profits to indigent people in cash or in-kind (e.g., food and shelter). A nonprofit’s controllers are thus fiduciaries who hold the organization’s assets in trust for its declared purposes and intended beneficiaries.⁵⁴ The flip-side of the non-distribution constraint is an injunction to actively pursue the organization’s social mission. This characteristic separates the typical nonprofit organization from the for-profit firm, which “generally has, as its chief business activity, the direct and indirect transfer of money or other property (essentially, its profits) to or for the benefit of its shareholders” or owners.⁵⁵

The most familiar type of nonprofit organization is the charity, which advances purposes deemed charitable under the law of trusts.⁵⁶ Legally charitable purposes include the relief of poverty, the advancement of religion, education, and health, as well as lessening the burdens of government.⁵⁷ Charities are typically set up as nonprofit corporations or

49. See, e.g., Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2024 (2007) (stating a nonprofit controller’s compensation “may not be a proxy for profits (for example, bonuses when profits are high)”).

50. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 900.

51. *Id.*

52. *Id.* at 880 (“All nonprofit organizations, just like profit-seeking organizations, ultimately must cover the full economic cost of all resources that they consume, including both the cost of labor and all other variable inputs and a reasonable return on any capital employed in their activities.”).

53. *Id.* at 838.

54. HANSMANN, *THE OWNERSHIP OF ENTERPRISE*, *supra* note 43, at 228.

55. 46 AM. JUR. 3D *Proof of Facts* § 3 (1998).

56. See 15 AM. JUR. 2D *Charities* § 4 (2000) (explaining that charities are regarded as trusts).

57. RESTATEMENT (SECOND) OF TRUSTS § 368 (1959).

charitable trusts under state organizational law. Each body of law imposes its own formulation of the non-distribution constraint. The Model Nonprofit Corporation Act (Third Edition) states that “a nonprofit corporation shall not pay dividends or make distributions of any part of its assets, income, or profits to its members, directors, members of a designated body, or officers.”⁵⁸ The Restatement (Second) of Trusts states that a charitable trust cannot be a “proprietary institution” (i.e., the “profits derived from its operation” cannot be paid to specified beneficiaries other than members of a charitable class and the trust’s intended and legally-permissible beneficiaries).⁵⁹ The Restatement also declares that any profits earned by a charity must “be applied only to charitable purposes.”⁶⁰

Charities typically benefit society by supplying public goods. These might be either pure public goods (e.g., a cleaner environment) or impure public goods (often referred to as “mixed” goods), which are private goods⁶¹ that confer substantial positive externalities. “Mixed public goods and services,” explains Professor Nina Crimm, “indirectly benefit the public, but provide direct benefits to special groups of people.”⁶² Consider an art museum, which can make a “community a more appealing and exciting place for all persons to live,” while at the same time can directly benefit those who visit it.⁶³ In the same vein, Professor George Bogert and his coauthors consider a charitable trust to relieve poverty in a particular city.⁶⁴ In common parlance, writes Bogert, the term “beneficiary” applies to the specific individuals who receive food, shelter, and clothing from the trust.⁶⁵ Yet the larger community can also benefit from the trust’s activities, which may, for example, reduce crime or create a more productive workforce.⁶⁶ In this sense, the trust’s direct beneficiaries are “conduits of the social benefits to the public,” and the “instrumentalities through which the community benefits flow.”⁶⁷

58. MODEL NONPROFIT CORPORATION ACT § 6.40 (a) (3d ed. 2008).

59. RESTATEMENT (SECOND) OF TRUSTS § 376 cmt. a (1959).

60. *Id.* at § 376 cmt. d.

61. OXFORD DICTIONARY OF ECONOMICS, *supra* note 38, at 357 (defining “private good”).

62. Nina J. Crimm, *An Explanation of the Federal Income Tax Exemption for Charitable Organizations: A Theory of Risk Compensation*, 50 FLA. L. REV. 419, 441 (1998) (citation omitted).

63. *Id.*

64. GEORGE GLEASON BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES § 363, at 27 (2d ed. 1991).

65. *Id.*

66. *Id.* at 27–28.

67. *Id.* Like Crimm, Bogert elaborates this point by invoking an art museum, whose “educational and cultural advantages . . . flow [both] to the neighboring community *and* its visitors.” *Id.* at 28 (emphasis added).

The categories of nonprofit and charitable organizations were created by state organizational law.⁶⁸ Federal tax law reinforces these categories and adds new dimensions to them. Most nonprofit organizations are eligible for tax-exempt status under § 501(c) of the Internal Revenue Code (IRC).⁶⁹ This means that an organization is exempt from paying corporate income taxes on its net income.⁷⁰ Federal tax law reiterates the nondistribution constraint by denying 501(c) tax-exempt status unless no part of an organization's net earnings inure to the benefit of "any private shareholder or individual."⁷¹ Lastly, federal tax law contains a category—section 501(c)(3)—whose criteria more or less overlap with those for charitable organizations under state law.⁷² When an organization is organized and operated for charitable or "exempt" purposes under § 501(c)(3), its donors can deduct their contributions from their income taxes.⁷³

C. *The Economic Role of Nonprofit Organizations*

Hansmann proposed a distinct economic role for nonprofit organizations in a market economy.⁷⁴ These entities can be useful when prospective purchasers (or donors) cannot readily monitor the supplier. Prospective purchasers may see a supplier's nonprofit form as a signal that it (or more precisely, its founders and controllers) will behave in a way more aligned with the purchasers' interests than the suppliers' for-profit counterparts.⁷⁵ In these situations, the nonprofit form can help assure prospective purchasers that suppliers will perform as promised.⁷⁶

It is essential to note that a social entrepreneur's interest in nonprofit organizations is narrower than Hansmann's. Hansmann explores how nonprofit organizations might address a wide range of situations that he

68. Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective* 4 (2007) (unpublished manuscript), available at <http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf>.

69. See I.R.C. § 501(c)(4)(A) (2006) (including "organizations not organized for profit" under exempt status).

70. An otherwise tax-exempt organization may be taxed on the income generated by business activities that are unrelated to their charitable missions. *Id.* § 511(a)(1)–(2).

71. *Id.* at § 501(c)(3). The term "shareholder or private individual" refers to an "insider," i.e., someone who by virtue of his position can control or influence an organization's action. Inurement occurs when an insider diverts a charity's proceeds for his or her private benefit. See *Variety Club Tent No. 6 Charities Inc. v. Comm'r*, 74 T.C.M. (CCH) 1485, 1492 (1997) (defining "insider").

72. See I.R.C. § 501(c)(3); *Bob Jones Univ. v. United States*, 461 U.S. 574, 589–92 (1983) (holding that all 501(c)(3) organizations must conform to certain fundamental common law charitable criteria).

73. I.R.C. § 170.

74. Hansmann, *The Role of Nonprofit Enterprises*, *supra* note 44, at 837.

75. *Id.* at 845.

76. *Id.* at 899–901.

calls “contract failure.”⁷⁷ By this he means situations in which agency costs are so severe that ordinary market mechanisms and contractual devices cannot be relied upon to ensure a supplier’s performance.⁷⁸ Contract failures can occur with respect to both public goods and private goods. These failures include situations where the market undersupplies some public good, due in part to the presence of positive externalities, or agency costs deter private parties from transacting for primarily private goods.⁷⁹

Unlike Hansmann, the social entrepreneur is primarily interested in organizational forms as a way to promote privately-led efforts to supply mixed goods (i.e., goods and services supplied to paying consumers for their private consumption but which also generate substantial positive externalities). One way to do this is by making it less costly for private parties to engage effective and faithful agents to execute their wishes.

1. Mitigating the Agency Problem

From an efficiency perspective, say leading nonprofit economists, “nonprofits are uniquely suited to supply particular types of goods and services”⁸⁰—most notably, those goods and services whose quality or quantity the purchaser cannot readily assess due to severe information asymmetries vis-à-vis the suppliers.⁸¹ For Hansmann, this purchaser can be *either* a donor who pays for a third party’s consumption or a customer who buys an item for her own consumption.⁸² Hansmann uses the same term, “patron,” to refer to both types of purchasers.⁸³ In either case, the situation creates an agency relationship between the patron and supplier. Agency problems arise when the supplier’s aims and interests diverge from the patron’s interest. When the information asymmetry is severe, the patron cannot readily or practically observe the supplier’s effort and performance.⁸⁴

77. Henry Hansmann, *Economic Theories of Nonprofit Organization*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 57–84 (Walter W. Powell & Richard Steinberg eds., 2d ed. 1987).

78. Hansmann, *The Role of Nonprofit Enterprises*, *supra* note 44, at 845, 860.

79. *See generally, id.* at 846–50 (providing examples of contract failure due to public inadequate agency accountability and oversupply of public goods).

80. Steven Rathgeb Smith & Kirsten A. Grønbjerg, *Scope and Theory of Government-Nonprofit Relations*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 221, 223 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

81. Information asymmetries are simply where one party knows something that another does not. George Akerlof famously explored the problem and means of mitigation. George Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 490 (1970).

82. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 841.

83. *Id.*

84. OXFORD DICTIONARY OF ECONOMICS, *supra* note 38, at 7 (defining “agency theory”).

When a patron cannot readily observe the supplier's performance, she might instead try to assess the supplier's motives. In such a situation, she might see the supplier's organizational form as a proxy or signal of those motives, and reasonably conclude that these are more closely aligned with her interests than a for-profit controller's. Why might that be? In any given sector, Hansmann posits, some entrepreneurs and controllers would prefer to start or run a high-quality institution⁸⁵ (i.e., one that may forgo some profits in order to maintain or raise quality). Hansmann refers to such persons as "craftsmanlike" and contrasts them to "greedy" people who are mainly interested in increasing their personal wealth.⁸⁶ Craftsmanlike persons are so committed to their craft that they may accept less compensation in order to maintain higher standards. In a nonprofit firm, for reasons explained, controllers and employees may feel less pressure to forgo quality for profit. As a result, craftsmanlike people might prefer to start or run a nonprofit firm in order to insulate themselves and their institutions from shareholder demands to sacrifice social mission for greater profitability. Additionally, business-savvy persons might see the nonprofit form as giving them a competitive advantage regarding quality with patrons who are more wary of for-profit competitors.

2. Donative Nonprofits

Donative nonprofits can reduce the agency costs that may accompany gratuitous transfers. This is most clear when firms solicit funds to help third persons whom the donors do not know, such as an organization that assists the victims of an overseas disaster.⁸⁷ The agency problem is serious in such cases, explains Hansmann, because relatively few donors "could ever be expected to travel to India or Africa to see if the food they paid for was in fact ever delivered"⁸⁸ Here again, the intermediary's legal form can affect the agency problem. If the intermediary is "organized for profit, it would have a strong incentive to skimp on the services it promises [donors

85. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 899.

86. *Id.*

87. *Id.* at 846–47.

88. *Id.* at 847. The notion of a donor monitoring the use of his donation is mocked in the satirical paper, *The Onion*. See *Area Man Visits Haiti to Check up on \$10 Donation*, *THE ONION*, May 28, 2010, www.theonion.com/articles/area-man-visits-haiti-to-check-up-on-10-donation,17503.

Three months after a 7.0 earthquake rocked the impoverished island nation of Haiti, 36-year-old Brad Halder visited its demolished capital to see firsthand how his \$10 donation to a relief fund was being spent. "It's been a little while, so I just wanted to check in and make sure my money was being put to good use," Halder told reporters while surveying the still largely devastated region.

Id.

to deliver to third parties], or even to neglect to perform them entirely, and, instead, to divert most or all of its revenues directly to its owners.”⁸⁹

The prospective donor engages the relief organization to deliver assistance to the intended beneficiaries. This organization is a “leaky bucket” insofar as it wastes its donors’ gifts through inefficient behavior or siphons off some of the gifts for its controllers’ enrichment (i.e., payments in excess of reasonable compensation).⁹⁰ As a result, the patron must either tolerate a certain amount of leakage or spend more resources on monitoring. Or she may conclude that, given the ratio between relief versus waste and pilfering, she will derive more satisfaction by spending the proposed sum on something else, such as a flat-screen television for her exclusive personal enjoyment. Thus, agency costs can reduce the amount of private giving for public goods (thereby making agency costs a problem for both patron and supplier) in addition to reducing the effectiveness of the private giving.

Hansmann’s analysis best explains donative nonprofits that supply nearly pure public goods, such as listener-supported radio stations. Information asymmetry arises because the patron “cannot observe the marginal increment to the service” that her donation ostensibly finances (e.g., radio broadcasts).⁹¹ In other words, “she cannot know from direct observation whether the same quantity and quality of service would have been provided even without her contribution.”⁹² The prospective patron might refuse to contribute to a for-profit station on the grounds that its owners presumably have incentive “to solicit payments far in excess of the total needed to pay for its broadcasts, and simply to distribute the difference to the owners as profits.”⁹³ In this situation, a prospective patron may see the nonprofit form as a rational means of mitigating the principal-agent problem vis-à-vis the station’s controllers.

The nonprofit form may reassure prospective donors that their preferences will prevail against those of the controllers, but also even when these diverge somewhat from the preferences of their intended beneficiaries. A nonprofit’s beneficiaries benefit from its activities because the donors want them to. Yet the donors and beneficiaries may disagree as to the benefit that the former should confer upon the latter. For example,

89. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 847.

90. The metaphor of the “leaky bucket” was introduced by Arthur M. Okun. ARTHUR M. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF 91 (1975) “[T]he money [raised for wealth transfers through taxation] must be carried from the rich to the poor in a leaky bucket. Some of it will simply disappear in transit, so the poor will not receive all the money that is taken from the rich.” *Id.* These losses, he claimed, were due to the administrative costs of taxing and transferring, and also to incentive effects. *Id.* at 92.

91. HANSMANN, THE OWNERSHIP OF ENTERPRISE, *supra* note 43, at 230.

92. *Id.* at 230–31.

93. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, 850.

donors may wish to distribute in-kind benefits (e.g., food, clothing, and job training), while the beneficiaries may prefer to receive cash gifts.⁹⁴ One might even use the agency framework to elucidate important aspects of the relationship between donor and beneficiaries.⁹⁵ The donor (qua principal) benefits when the beneficiary (qua agent) performs some task with care or effort (i.e., the beneficiary uses the donation to either improve her welfare or increase her consumption of the donor's preferred good or service). In this sense, the nonprofit form mitigates two sets of agency costs in donative nonprofits: (a) those imposed by a nonprofit's controllers through shirking; and (b) those imposed by a nonprofit's beneficiaries who would depart from a donor's wishes in order to improve their welfare by their own rights. By mitigating both sets of agency costs, the donative nonprofit facilitates privately-led efforts to provide public goods.

Two other factors aggravate a donor's agency costs vis-à-vis the firm's controllers. First, the donor of a completed gift has no pecuniary incentive to monitor the controller's performance—her financial payout from the gift (i.e., zero dollars) does not vary. Second, when individual donors pass on (notably a requirement for testamentary donations), they are altogether absent, and the information asymmetry that results is chronic.

We have seen how nonprofit law helps ensure that the resources conveyed to or generated by charitable organizations remain dedicated to benefiting society for the long term. "Asset locks"⁹⁶ ensure that assets remain dedicated to: (a) their charitable purposes in general, and (b) the founder's and donor's preferred charitable purposes in particular (insofar as this is not impossible, illegal, or impracticable to do—the *cy pres* criteria).⁹⁷ This is because a charitable organization's profits cannot be distributed to its controllers and upon dissolution its assets must be transferred to another charitable organization or to the state.⁹⁸ Nonprofit law also helps the

94. Eric A. Posner, *Altruism, Status, and Trust in the Law of Gifts and Gratuitous Promises*, 1997 WIS. L. REV. 567, 586.

95. See generally Robert A. Katz, *Can Principal-Agent Models Help Explain Charitable Gifts and Organizations?*, 2000 WIS. L. REV. 1, 4 (evaluating the utility of the "donor-as-principal approach to charity").

96. The term "asset lock" was coined to describe the more modest constraints that apply to the assets of "Community Interest Companies" (CICs) under U.K. law. CICs are subject to a community interest test and an "asset lock" to ensure that the entity remains dedicated to its community purposes. Community Interest Company Regulations, 2005, S.I. 2005/1788 art. 1, 2 (U.K.), available at <http://www.legislation.gov.uk/ukSI/2005/1788/contents/made>.

97. Under the doctrine of *cy pres*, a charitable trust's assets may be used to fulfill a charitable purpose other than the donor's original purpose where it becomes impossible, impractical, or illegal to advance the original purpose, and the donor "manifested a more general intention to devote the property to charitable purposes." RESTATEMENT (SECOND) OF TRUSTS § 399 (1959). This substitute purpose must "fall[] within the general charitable intention" of the donor. *Id.*

98. See generally Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 838–41 (discussing features and implications of the "nondistribution constraint" that assets cannot be distributed

founder enshrine and entrench her vision of the entity's mission from tampering by future managers. The founder selects the initial board of directors or trustees and can screen them carefully for commitment to her vision. Those directors in turn select their own successors, and so on.⁹⁹ (Although an asset lock mitigates some problems, it aggravates others. An asset lock may prevent the firm from redeploying its resources to more socially efficient uses in light of changing circumstances that fall short of the relatively strict *cy pres* criteria and thus can thwart a donor's larger goal of long-term social change.)

Even if the law permits a nonprofit to efficiently redeploy resources—say the assets available for sale were purchased with retained earnings rather than donor gifts, and the assets can be sold for at least their fair market value—nonprofit managers have less personal incentive than for-profit counterparts to pursue or approve such a redeployment. When a scrappy start-up commercial nonprofit firm becomes sufficiently attractive, outside investors may attempt to purchase the firm; founders and insiders with equity interests may have great incentive to sell. But a nonprofit's controllers cannot lawfully appropriate sale proceeds (beyond reasonable compensation) and thus may have little to gain and much to lose—namely, their jobs. They may, therefore, have less incentive to approve such sales, notwithstanding society's potential gain.¹⁰⁰ Moreover, because they are unowned, underperforming nonprofit firms are not subject to hostile takeovers.¹⁰¹ They are thus shielded from the market for corporate control, which helps increase managerial and corporate efficiency in for-profit firms.¹⁰²

3. Commercial Nonprofits

A commercial nonprofit earns the bulk of its revenue by selling private goods to paying customers for their own consumption, as opposed to

to controllers).

99. *Id.* at 876.

100. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986) (holding that a board negotiating a change of control, sale, or break-up of a for-profit corporation must conduct a market check and accept the bidder offering the highest value); Ovide M. Lamontagne & Ryan M. Williams, *Case Study: Sale Of A Nonprofit—The Sale of Daniel Webster College to ITT Educational Services, Inc.*, 50 N.H. BAR J. 80, 82 (2009) (“[I]t does not appear that any court has yet had the opportunity to consider whether the so-called Revlon duties would apply to the sale of a non-profit corporation.”); Colin T. Moran, *Why Revlon Applies to Nonprofit Corporations*, 53 BUS. LAW. 373, 375 (1998) (“[N]o court has yet reached the question of whether *Revlon* duties apply to nonprofit boards.”).

101. Henry Hansmann, Daniel Kessler & Mark McClellan, *Ownership Form and Trapped Capital in the Hospital Industry 5* (Yale Law Sch. Ctr. for Law, Econ., & Pub. Policy, Research Paper No. 266, 2002), available at <http://ssrn.com/abstract=313827>.

102. See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112–13 (1965) (arguing that the market for corporate control and the risk of takeover promotes managerial efficiency in for-profit corporations).

soliciting donations to finance the supply of goods and services to the donor's (or nonprofit's) preferred third-party beneficiaries. Notwithstanding these differences, Hansmann contends that commercial nonprofits serve a similar economic role as donative nonprofits, namely, to promote efficiency by reducing agency costs.¹⁰³

Commercial nonprofits can promote efficiency, explains Hansmann, by reducing the agency costs that can arise when suppliers sell “complex personal services.”¹⁰⁴ This category of private goods includes nursing homes, day care, schools, and hospitals that provide certain “subtle” and “nonstandardized” services whose quality some customers may find difficult to assess.¹⁰⁵ In such situations, customers may rationally prefer to patronize a nonprofit firm for all the reasons previously discussed—namely, its organizational form signals that its controllers are more craftsmanlike and less greedy than for-profit competitors, and so are less likely to exploit information asymmetries to enrich themselves at their payors' expense.

The problem of “contract failure,” Hansmann observes, is generally less serious in commercial nonprofits than donative ones.¹⁰⁶ A payor is typically better able to evaluate goods and services that she purchases for herself, as compared to those she pays an intermediary to supply to third parties—potentially distant and unknown to her—who belong to her preferred charitable class.

What, if any, is the connection between social entrepreneurship and Hansmann's “contract failure” analysis of commercial nonprofits? Paying customers of private goods may not know or care whether an enterprise is organized as a nonprofit or also produces public goods. Yet consider the matter from the social entrepreneur's perspective. The social entrepreneur, like the craftsmanlike person, has a higher calling than mere pecuniary gain. In a nonprofit, the controllers have no investor-owners to demand that they trade off mission for greater profits. If the entity sells superior or merit goods—health, education, high culture, etc.—then its consumers cannot help but produce positive externalities. If the entity sells ordinary products to customers who are indifferent to its mission, it can use the sale proceeds to finance its mission-related activities. The classic example is New York University School of Law, which once owned and operated C.F. Mueller Company, a leading pasta manufacturer, and used the net profits to support legal education.¹⁰⁷

103. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 862.

104. *Id.* at 862–63.

105. *Id.* at 863–66.

106. *Id.* at 863.

107. John Brooks, *The Marts of Trade: The Law School and the Noodle Factory*, *NEW YORKER*, Dec. 26, 1977, at 48; Alexander R. Hammer, *Foremost-McKesson to Purchase Mueller Stock*, *N.Y.*

Of course, some of a nonprofit's customers may embrace its social mission and partly for this reason prefer its products over those of a for-profit competitor. For example, some parents who pay full tuition at a private school know that they are subsidizing scholarships for deserving children with less financial means and are pleased because it exposes their own children to more diversity. These purchasers are partly consumers *and* donors. In such cases, as Hansmann observes, "there is a substantial donative element to many commercial nonprofits."¹⁰⁸ He posits that:

[C]ommercial nonprofits commonly serve in industries where it is difficult to specify with any precision just what services the organization is to provide to a patron; rather, the patron generally must yield some discretion to the organization in this regard. Thus, payments made to commercial nonprofits are, to an extent, contributions to the organization to be used as the organization chooses—constrained, again, by the purposes set forth in its charter.¹⁰⁹

Where information asymmetry is severe, it may be reasonable for a nonprofit's consumer/donors to expect its controllers, who are bound by the non-distribution constraint and mission mandate, to better serve both them and their intended third-party beneficiaries.

D. Government Policy Toward Nonprofits

Through various means, government promotes the creation and flourishing of nonprofit organizations that address social problems. Governments do so in part in order to shift the burden of addressing these social problems to private entities. State organizational law supplies an off-the-rack legal form—the nonprofit corporation—that is available to most nonprofit organizations, and another form—the charitable trust—exclusively for charitable nonprofit organizations. These forms and their related bodies of law reduce the transaction costs involved in setting up and governing a nonprofit organization. These forms also enable parties to achieve certain goals that cannot be practicably achieved through ordinary rules of contract, property, or agency.¹¹⁰ For example, if a nonprofit

TIMES, Sept. 29, 1976, at 71.

108. Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 873.

109. *Id.*

110. See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law* 1–2 n.2 (Yale Int'l. Ctr. For Fin., Working Paper No. 00-11, 2000), available at http://papers.ssrn.com/paper.taf?abstract_id=229956 (focusing on the enabling aspects of organizational law and the otherwise unattainable possibilities it creates). "Arguably the tools of the common law are inadequate to permit imposition of

corporation or charitable trust goes bankrupt, the entity's tort creditors have no claim to its restricted assets, which must remain committed to charitable purposes.¹¹¹

Federal tax law and state organizational law help charities raise revenue from donations. Federal tax law permits donors to charities to deduct their pecuniary contributions from their income taxes.¹¹² It also exempts charities from the corporate income tax¹¹³ and does not tax them on profits from donations. State trust law encourages donations to charities by providing assurances to donors that the donee entity will honor their charitable wishes.¹¹⁴ Charitable trustees have a fiduciary duty to advance a donor's specified charitable purpose, absent extenuating circumstances.¹¹⁵ This duty also applies to the directors of a charitable corporation insofar as it receives restricted gifts.¹¹⁶ This duty is not obviated by the termination or dissolution of a charitable organization.¹¹⁷ If that occurs, the charitable assets will be transferred to another charity and thus remain within charitable channels.¹¹⁸

Government also promotes nonprofit activity by permitting charities to generate some revenue from business activities. State organizational law permits charities to engage in business activities, so long as the profits are used for charitable purposes and not distributed to insiders as dividends.¹¹⁹

perpetual obligations on self-appointing managers who cannot—because of the absence of control over them—be considered agents of any party in interest. In this respect, then, the law of charitable trusts and nonprofit corporations adds something to the law, beyond asset partitioning, that is 'essential' in the sense we use here: it could not feasibly be replicated in the absence of organizational law." *Id.* at 41.

111. *Id.* at 5.

112. I.R.C. § 170(c) (2006).

113. *Id.* § 501(c)(3).

114. See Paul Ingram & Karen Clay, *The Choice-Within-Constraints New Institutionalism and Implications for Sociology*, 26 ANN. REV. SOC. 525, 531 (2000). "[T]he state may smooth exchange between its subjects by providing institutions that allow them to make credible commitments. This can be achieved if the state provides a legal system to protect property rights, decrease transaction costs, and enforce contracts." *Id.*

115. See RESTATEMENT (SECOND) OF TRUSTS § 399 (1959).

116. *Id.* § 399 cmt. a.

117. *Id.* § 399.

118. *Id.* at cmt. a.

119. See, e.g., *People ex. rel. Groman v. Sinai Temple*, 99 Cal. Rptr. 603, 606 (1971). California nonprofit corporations code does not prohibit such entities from earning or accumulating profits. "Instead, the statute requires that the purposes 'do not contemplate the distribution of gains, profits, or dividends to the members.' The use of the word 'distribution' indicates that the accrual of gains is not thereby prohibited." *Id.* RESTATEMENT (SECOND) OF TRUSTS § 376 cmt. c (1959) ("A trust to establish or maintain an educational institution or hospital or home for poor persons is charitable although it is provided that the pupils or patients or inmates shall pay fees or otherwise contribute to the expense of maintaining the institution if the income so derived is to be used only to maintain the institution or for some other charitable purpose.").

This law focuses on how an entity uses its net earnings, not how it earns them.¹²⁰

Through selective taxation, federal tax law encourages charities to engage in certain types of business activity more than others. It does not tax a charity's net earnings from a business activity that is deemed "related" to its charitable or exempt purposes—apart from generating revenue to finance its charitable activities.¹²¹ This may be where the "conduct of the business activities has [a substantial] causal relationship to the achievement of" an entity's charitable or exempt purpose.¹²² At the same time, federal tax law discourages unrelated business activity by imposing the aptly-named Unrelated Business Income Tax (UBIT), which requires an otherwise exempt organization to pay corporate income tax on the profits earned from an unrelated trade or business that is regularly carried on.¹²³ Moreover, if the entity engages in an "excessive" amount of unrelated business activity, it can lose its exemption altogether.¹²⁴

A sufficient relationship or relatedness may be found "[w]here the production or distribution of the goods or the performance of the services [from which the gross income is derived] . . . contribute importantly to the accomplishment [of those] purpose[s]."¹²⁵ The exempt business activity may involve selling a product whose use and consumption substantially advances the mission. Consider an organization that aims to improve healthcare for children by encouraging children to wash their hands as a means of preventing infection.¹²⁶ This entity sells a distinctive certificate form to hospitals, day care centers, etc., on which to print the name of a child who has agreed to wash his or her hands and which the child will ideally honor and cherish (or at least post on the family refrigerator). The net revenues are not taxed because the underlying business activity substantially advances the organization's purpose. Each fill-in-the-name certificate sold has the potential to kill millions of illness-inflicting germs.

120. This focus was the rule under federal tax law until 1950, when Congress enacted the Unrelated Business Income Tax (UBIT). *See, e.g.,* *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924) (finding that income tax exemption for charitable nonprofit corporations "says nothing about the source of the income, but makes the destination the ultimate test of exemption").

121. I.R.C. § 513(a) (2006) ("The term 'unrelated trade or business' means . . . any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by [an exempt] organization" of its exempt or charitable purpose or function).

122. *Treas. Reg.* § 1.513-1(d)(2) (2009).

123. *Id.* § 1.501(c)(2)-1(b).

124. *Id.* § 1.501(c)(3)-1(c) to (e) (providing that substantial unrelated business activity will disqualify an organization from tax exemption).

125. *Id.* § 1.513-1(d)(2).

126. I.R.S. Priv. Ltr. Rul. 86-33-034 (May 20, 1986).

Alternatively, the exempt business activity may involve a distribution process that advances the mission, even though the product itself and its mode of production are incidental. Members of the Girl Scouts do not make or package the cookies they sell, and the cookies' consumption by their buyers produces no manifest public benefit. Even so, Girl Scouts who sell cookies do more than simply finance other Girl Scouting activities.¹²⁷ "The activity of selling cookies," the organization asserts, "is directly related to our purpose of helping all girls realize their full potential" because it helps Girl Scouts practice life skills like goal-setting, money management, and teamwork.¹²⁸

A related business activity can involve a production process that advances a charitable mission. Consider an organization that manufactures toys and distributes them through regular commercial channels, in order to provide vocational training for the under-skilled or under-employed persons.¹²⁹ This business activity is sufficiently mission-related so that its net earnings are not taxed.¹³⁰

Federal tax law also aims to discourage commercial nonprofits from acting too much like their for-profit counterparts, that is, from conducting their activities in the same manner as conventional for-profit businesses in the same sector.¹³¹ This is known as the "commerciality doctrine."¹³² If a nonprofit's business behavior is found to essentially mimic that of its for-profit competitors, its tax exempt status may either be denied or the resultant profits subjected to income tax.¹³³

E. Rationales for Government Policies Towards Nonprofits

The advantages that government confers upon charitable organizations are not without a cost. The tax advantages—tax exemption and the

127. *Girl Scouts Cookie Program*, GIRL SCOUTS, http://www.girlscouts.org/program/gsc_cookies (last visited Sept. 18, 2010) (explaining that proceeds of cookie sales "support Girl Scouting in the local community").

128. *Id.* (emphasis added).

129. Rev. Rul. 73-128, 1973-1 C.B. 222.

130. *Id.*

131. BRUCE R. HOPKINS, *THE TAX LAW OF UNRELATED BUSINESS FOR NONPROFIT ORGANIZATIONS* § 7.1 (2005).

132. *Id.*

133. *See, e.g.*, *Airlie Foundation v. IRS*, 283 F. Supp. 2d 58, 66 (D.D.C. 2003) (denying tax exemption to a foundation that operates a conference center "in a manner consistent with that of a commercial business"); Priv. Ltr. Rul. 00-21-056 (Feb. 8, 2000) (finding that entity's income from tea room is subject to UBIT where, *inter alia*, "(a) its operations are presumptively commercial, (b) it competes directly with other restaurants, (c) it uses profit-making pricing formulas common in the retail businesses, (d) its hours of operation are competitive with other commercial enterprises, and (e) [the entity] lacks plans to solicit donations from the general public").

charitable contribution deduction—are especially costly.¹³⁴ The general view is that these tax advantages are subsidies whereby the government encourages nonprofits and donors to engage or support charitable activity.¹³⁵ Hansmann’s defense of these tax advantages is (naturally) more economic. The inability of nonprofits to sell equity shares, he argues, reduces social welfare in those sectors where nonprofit organizations are more efficient than for-profit firms.¹³⁶ Without access to equity capital, nonprofits must seek alternative sources to finance their expansion (e.g., retained earnings, donations, and debt). These alternative sources, Hansmann posits, may nonetheless be insufficient to permit nonprofits to expand to their socially optimal capacity.¹³⁷ Tax exemption enables a nonprofit to retain more of its earnings than comparable for-profit firms in the same sector. In this way, tax exemption “serves to compensate for difficulties that nonprofits have in raising capital”¹³⁸

Under Hansmann’s “capital subsidy” theory, there is a relatively weak connection between social entrepreneurship and government advantages for charitable nonprofits. Hansmann’s analysis of tax exemption is generic in that it can apply to most commercial nonprofits in situations of “contract failure,” including those entities that sell purely private goods.¹³⁹ Contrast this with Professor Crimm’s approach, which focuses on commercial nonprofits that seek to supply mixed public/private goods (i.e., private goods with significant positive externalities).¹⁴⁰ These nonprofits may find it difficult to bundle in substantially more positive externalities per unit of private good than conventional for-profit firms selling the same private

134. *Nonprofits*, SUBSIDYSCOPE, <http://subsidyscope.org/nonprofits/summary> (last visited Sept. 18, 2010) (“[T]he federal government lost approximately \$50 billion in forgone tax revenue in fiscal year 2008 due to tax expenditures that specifically target activities involving nonprofits”) (citation omitted).

135. See, e.g., *Bob Jones Univ. v. United States*, 461 U.S. 574, 591 (1983) (finding that tax-exempt charities confer a benefit that “the society or the community may not itself choose or be able to provide, or which supplements and advances the work of public institutions already supported by tax revenues”); *Overview of the Tax-Exempt Sector: Hearing Before the H. Comm. on Ways & Means*, 109th Cong. (2005) (Testimony of John Colombo, Professor), available at <http://waysandmeans.house.gov/hearings/testimony.aspx?TID=937> (“Although we academics carry on a lively debate about the rationale for charitable tax exemption, all of us would agree, I think, that at some level exemption for charities is tied to a concept that they are improving general public welfare in some way.”); John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 682 (2001) (stating that the public benefit theory is the “most widely accepted rationale”).

136. Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from the Corporate Income Tax*, 91 YALE L.J. 54, 72 (1981).

137. *Id.*

138. *Id.*

139. The analysis is applicable insofar as under-capitalized nonprofits provide these private goods more efficiently than for-profit competitors or could provide them more efficiently if they were able to scale up. *Id.* at 74–75.

140. Crimm, *supra* note 62, at 441, 450–51.

good. This is because self-interested consumers who want the private component of these mixed goods may be unwilling to pay higher prices in order to subsidize the positive externalities a nonprofit seeks to generate. In Crimm's view, tax exemption helps level the playing field between nonprofits and for-profit firms that compete for buyers of the same good.¹⁴¹ With the additional retained earnings, nonprofit firms can increase the public good/positive externalities that accompany each private good they sell without having to raise their prices.

The foregoing analyses help explain the role of government subsidies for commercial nonprofits. What explains the differential treatment of nonprofit commercial activities? Why does federal tax law channel commercial nonprofits into mission-related business activity and encourage these organizations to conduct this activity in a manner that qualitatively differs from its for-profit competitors? Why do nonprofits pay the same tax on unrelated business income as for-profit firms engaged in the same business activity? The received explanation is that UBIT helps protect for-profit firms from unfair competition from charitable tax-exempt suppliers of the same goods.¹⁴² Government, it seems, should not skew the regulatory playing field too heavily in the nonprofits' favor.

If we accept a subsidy explanation of tax advantages for charities, then UBIT and the commerciality doctrine serve no obvious purpose. Exempting the income that a nonprofit organization earns from *any* type or manner of nonprofit business activity can subsidize its provision of public goods. Professor Ethan Stone provides a more satisfying explanation of the origins of UBIT, which Congress enacted in 1950.¹⁴³ In his view, UBIT's enactment is best understood as "political symbolism": it reflects the policymakers' perceptions as to which business activities were more consistent with their conception of "charitable" and which were less so. Stone argues that "UBIT was largely designed to keep charities from wandering too far from traditional good works that defined the charitable sector."¹⁴⁴ The most egregious example of this is the previously mentioned story of New York University School of Law's acquisition of a pasta company in 1947.

141. *Id.* at 462.

142. Treas. Reg. § 1.513-1(b) (2009) ("The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.").

143. Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1479 (2005).

144. John D. Colombo, *Reforming Internal Revenue Code Provisions on Commercial Activity by Charities*, 76 FORDHAM L. REV. 667, 670 n.16 (2007) (discussing Stone's analysis).

So what has UBIT accomplished? The tax itself yields only modest tax revenues. For example, in 2008, the country's 91 largest charities reported \$419.1 million in income, but paid only \$3 million in UBIT.¹⁴⁵ Several factors can explain this low figure. UBIT has likely pressured many nonprofit organizations to avoid or abandon business activity subject to UBIT. Those nonprofits that do engage in unrelated business activities may underreport it due to sloth, ignorance, or cleverness (i.e., they offer push-the-envelope explanations as to how seemingly unrelated business activities directly advance their missions).

At the same time, federal tax law's treatment of nonprofit enterprise has encouraged more profound changes. This treatment challenged nonprofit organizations to develop creative models of profitable earned-income activities that integrally and inextricably relate to their public benefit missions and that also increase efficiency by taking advantage of economies of scale. These endeavors have genuinely advanced the concepts and causes of social enterprise and social entrepreneurship.

Consider Ten Thousand Villages, a 501(c)(3) nonprofit organization that helped initiate the movement for global "fair trade."¹⁴⁶ It was among the first to articulate and implement "the idea that poverty can be alleviated if tiny businesses in poor countries are able to sell their goods in rich ones for a decent price."¹⁴⁷ Ten Thousand Villages traces its origins to 1946, when a Mennonite missionary and relief worker in Puerto Rico undertook to help impoverished communities by stimulating the market for handicrafts of local artisans.¹⁴⁸ In fiscal year 2010, the organization purchased items

145. Peter Panepento & Grant Williams, *A Question of Calculation*, CHRON. OF PHILANTHROPY, Feb. 7, 2008, at 33.

146. *FAQs*, TEN THOUSAND VILLAGES, http://www.tenthousandvillages.com/php/about.us/about_faqs.php (last visited Sept. 6, 2010) [hereinafter *FAQs*, TEN THOUSAND VILLAGES] ("Ten Thousand Villages is a founding member of World Fair Trade Organization (WFTO) and a longstanding member of the Fair Trade Federation (FTF), two groups committed to the ideal that every worker should receive a fair wage for their work."); see also, *Ten Thousand Villages Report*, GUIDESTAR, <http://www2.guidestar.org/organizations/31-1690588/ten-thousand-villages.aspx> (last visited Sept. 25, 2010) ("As a nonprofit, we achieve this mission by building long term buying relationships in places where skilled artisan partners lack opportunities for stable income. Product sales help pay for food, education, healthcare and housing for artisans who would otherwise be unemployed or underemployed."); Ten Thousand Villages' Tax Form 990 (2007), available at <http://nccsdataweb.urban.org/PubApps/showVals.php?ein=311690588> (follow "2007" hyperlink) ("Ten Thousand Villages' primary purpose is to care for those in need in the name of Christ, primarily by providing vital, fair compensation to people of low income in developing countries, selling their handicrafts and other products, and telling their stories in North America.") (formatting altered).

147. Ashlea Ebeling, *Ten Thousand Villages Grows with Fair Trade*, FORBES, Sept. 7, 2009, at 66, available at <http://www.forbes.com/forbes/2009/0907/creative-giving-ten-thousand-villages-grows-with-fair-trade.html>.

148. *FAQs*, TEN THOUSAND VILLAGES, *supra* note 146. Until 2000, Ten Thousand Villages was run directly by the Mennonite Central Committee (MCC), *id.*, a missionary, relief, and antiwar agency run by Mennonite and Brethren in Christ congregations in the U.S. and Canada. *FAQs*, MENNONITE CENT. COMM., <http://mcc.org/about/faq> (last visited Sept. 25, 2010). In that year, it was set up as a separate, tax-exempt nonprofit corporation and a wholly-owned subsidiary of the MCC. *FAQs*, TEN

from 127 artisan groups in 37 countries, mostly in the Third World, and generated \$23.4 million in sales, mostly in North America.¹⁴⁹ The organization advances charitable goals through a range of commercial activities and practices. In addition to providing steady work for artisans, it also provides loans to artisans who are too poor to qualify for traditional bank loans. In many other ways, it assumes the economic risk that would otherwise be borne by the artisans.¹⁵⁰

Some of the people who buy Ten Thousand Villages' imported products are undoubtedly influenced by the organization's mission. The company's typical consumer, reports Forbes, is "an educated, *socially conscious* woman, aged 25 to 54, with a household income of \$70,000 to \$100,000."¹⁵¹ These consumers may be willing to pay a premium for these products in order to feel "virtuous about buying."¹⁵²

The Internal Revenue Service (IRS) has recognized some "fair trade" business activity as mission-related and thus not subject to UBIT. This was true for Aid for Artisans, founded in 1976, which sought to provide economic assistance to disadvantaged handicraft artisans overseas, which in turn would benefit the disadvantaged communities in which the artisans lived.¹⁵³ It also sought "to educate the American public in the artistry, history and cultural significance of such handicrafts."¹⁵⁴ In 1978, the U.S. Tax Court found that these purposes were exempt or charitable, and that the organization advanced its charitable purposes through its commercial activities—purchasing and importing handicrafts made by the artisans and distributing and selling the handicrafts in a manner designed to educate the buyers.¹⁵⁵

THOUSAND VILLAGES, *supra* note 146.

149. *Ten Thousand Villages Annual Report 2009–2010*, TEN THOUSAND VILLAGES 3 (2010), available at http://www.tenthousandvillages.com/pdf/Annual_Report_2010.pdf.

150. *Ten Thousand Villages Annual Report 2007–2008*, TEN THOUSAND VILLAGES 3 (2008), available at http://www.tenthousandvillages.com/pdf/Annual%20Report%2007_08_v6.pdf. "Artisans receive **up to 50 percent** in cash advances when an order is placed and payment in full when an order is shipped. Many artisans are too poor to qualify for traditional bank loans, and advance payments provide the necessary funds to let them cover the costs of materials and equipment without going into debt. By making prompt final payments when the order is shipped, Ten Thousand Villages takes on the business risk associated with getting the product to market." *Id.* (emphasis in original). Ebeling, *supra* note 147, at 66 ("Ten Thousand Villages does not take items on consignment; it, not the craft workers, absorbs the loss if a product doesn't sell.").

151. Ebeling, *supra* note 147, at 66 (emphasis added).

152. *See, e.g., id.* Among other factors, Ten Thousand Villages' "charitable hook seems to have sheltered it from the worst of the recession. Sales were down 6% in the last fiscal year, compared with a 13% drop at for-profit Pier 1 Imports." *Id.*

153. *About ATD: Mission & History*, AID TO ARTISANS, http://www.aidtoartisans.org/about_ata/mission_and_history/ (last visited Oct. 7, 2010).

154. *Aid to Artisans, Inc. v. Comm'r*, 71 T.C. 202, 204 (1978).

155. *Id.*

The term “social enterprise” has no legal significance under the law of tax-exempt or charitable organizations. Even so, the term connotes the distinctive nature and spirit of mission-driven nonprofit commercial endeavors like Ten Thousand Villages and Aid to Artisans. Such entities embody the conception of nonprofit social enterprise implicit in tax-exempt law.

II. THE FOR-PROFIT SOCIAL ENTERPRISE

A threshold challenge for aspiring social entrepreneurs is selecting and crafting the best legal structure for their social enterprise.¹⁵⁶ A recent survey showed that 71% of social entrepreneurs believed that the choice of legal structure was the single greatest challenge for their ventures.¹⁵⁷

Legal practitioners and academics in increasing numbers have begun struggling with the issue.¹⁵⁸ Although the nonprofit form is inherently conducive to socially-beneficial undertakings, it nonetheless also has drawbacks. Additionally, some social entrepreneurs and proponents perceive problems with conventional for-profit forms, such as legal and structural limits on their ability to pursue social aims at shareholders’ expenses¹⁵⁹ or to entrench the entity’s long-term pursuit of social ends.¹⁶⁰

For-profit social enterprises can address some of the real or perceived shortcomings associated with commercial and donative nonprofits. With the right organizational form, a social enterprise can have both greater access to equity capital and a deeply embedded, sustainable commitment to social purposes

This Part proceeds as follows. First, we identify the key features of for-profit social enterprise. These features might be contested (or relaxed); if they are, then other organizational forms already exist to accommodate their characteristics. Second, we identify certain problems with nonprofit organizations and show how for-profit social enterprise may address these

156. We assume here, as Hansmann and Kraakman have noted, that the purpose of organizational law is “presumably to serve the interests of society as a whole.” Henry Hansmann & Reinier Kraakman, *What is Corporate Law?*, in *THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH* 1, 18 (Reinier R. Kraakman et al. eds., 2004).

157. Bromberger, *supra* note 68, at 2 (referring to a recent study by the Social Enterprise Alliance).

158. *See, e.g., id.* (describing the lack of an appropriate legal form for social enterprises).

159. *See, e.g.,* Antony Page, *Has Corporate Law Failed? Addressing Proposals for Reform*, 107 MICH. L. REV. 979, 987–93 (2009) (discussing the perception that corporations must pursue shareholder wealth maximization).

160. Some are even alleged to have “form envy,” focusing on the advantages of other legal business forms. *See* JILL BAMBURG, *GETTING TO SCALE: GROWING YOUR BUSINESS WITHOUT SELLING OUT* 113 (2006).

problems.¹⁶¹ Third, we look at new problems that for-profit social enterprise might create.

A. What Is For-Profit Social Enterprise?

For-profit firms seek to produce and sell goods and services for personal consumption. A for-profit social enterprise seeks to do so in a manner that generates more public benefit or positive externalities than would a conventional for-profit firm.¹⁶² In contrast to an ordinary commercial business, it expressly measures its success both in terms of its financial performance (e.g., pecuniary profits, shareholder value, return on investment, etc.) and its success in advancing a social mission or addressing social concerns.¹⁶³ It is thus said to have a “double bottom line.”¹⁶⁴ This is another way of saying that it seeks to “do well” for its owners while “doing good” for society.

Profits are not a for-profit social enterprise’s sole objective. Although it shares the profit-making goal of a business corporation, it embraces the duty to sometimes make decisions that will not maximize profit. A for-profit social enterprise also shares some of the social aims of a public benefit nonprofit organization. It must have at least one express purpose to confer social benefits (i.e., supply public goods or mixed goods/private goods with significant positive externalities) above and beyond those conferred by the typical business.¹⁶⁵ Alternatively, it could seek to impose less social harm on third parties and the environment (i.e., negative externalities) than the typical business.

To formally distinguish a for-profit social enterprise from an ordinary business, its controllers must have lawful discretion to transparently reduce shareholder wealth in order to make presumably larger improvements in social welfare. This means that the firm may sometimes make trade-offs

161. Many proponents of for-profit social enterprises (including/especially those who advocate new organizational forms for them) usually accompany and/or base their advocacy in critiques of nonprofit social enterprise. *See, e.g.*, Bromberger, *supra* note 68, at 2 (describing the difficulty nonprofits have in accessing equity and distributing profits).

162. A successful traditional for-profit may also create significant social value or positive externalities, such as those that result from the consumer surplus the business creates for purchasers of its goods and services; the taxes it pays; the jobs it creates for its employees and those of its suppliers; etc.

163. BREWSTER BOYD ET AL., HYBRID ORGANIZATIONS: NEW BUSINESS MODELS FOR ENVIRONMENTAL LEADERSHIP 18–19 (2009) (stating that social enterprises are characterized by “non-financial performance valuation”).

164. Some commentators advocate a “triple bottom line” whereby firms measure their success along three dimensions—economic, social, and environmental (a.k.a., “people, planet, profit”). *See, e.g.*, ANDREW W. SAVITZ & KARL WEBER, THE TRIPLE BOTTOM LINE: HOW TODAY’S BEST-RUN COMPANIES ARE ACHIEVING ECONOMIC, SOCIAL, AND ENVIRONMENTAL SUCCESS—AND HOW YOU CAN TOO xii–xiii (2006).

165. Sabeti, *supra* note 24, at 5.

between social and financial performance that preference social performance over profit.¹⁶⁶ This commitment, although difficult to legally enforce,¹⁶⁷ goes beyond the promise of corporate social responsibility to make decisions that, all things being equal (i.e., where wealth-maximizing shareholders ought to be indifferent), will confer more benefits on society rather than less.¹⁶⁸

Typically, a social enterprise attempts to address some market failure but it could also seek to address distributional inequality. For example, a for-profit social enterprise may attempt to increase the suboptimal supply of a public good, which might then improve the welfare of a population or community that constitute a “charitable class” under charity law (e.g., an economically disadvantaged population). It might also seek to generate goods or outcomes that are deemed environmentally or morally superior, such as reducing wealth disparity, even without increasing net social wealth.¹⁶⁹

The social purpose may be legally charitable,¹⁷⁰ but it could be broader.¹⁷¹ “Social purpose” is not a legal term of art like “charitable purpose,” whose meaning has been elaborated by the common law over the course of centuries and by tax law for a century.¹⁷² The purposes and activities that can qualify as legally “charitable” are more predictable than those that a social entrepreneur might deem pro-social.¹⁷³ For example, paying a higher than market salary to a small class of employees (or

166. See, BOYD ET AL., *supra* note 163, at 12–13 (citing Oliver Salzmann, Aileen Ionescu-Somers & Ulrich Steger, *The Business Case for Corporate Sustainability: Literature Review and Research Options*, 23 EUR. MGMT. J. 27, 27–36 (2005)).

167. See generally, *infra* notes 207–18 and accompanying text for a discussion of why a lack of external legal enforcement in for-profit social enterprises may be less troubling than it initially appears.

168. See, e.g., *Aspirations for Corporate Social Responsibility (CSR)*, HONEST TEA, <http://www.honesttea.com/mission/about/overview> (last visited Sept. 2, 2010) (“When presented with a purchasing decision between two financially comparable alternatives, we will attempt to choose the option that better addresses the needs of economically disadvantaged communities.”).

169. This latter approach is really an attempt to internalize and ultimately reduce the negative externalities from some activity or industry that other participants in the industry (including their competitors) ignore. For example, Sun Ovens sells solar-powered ovens in part to replace the use of wood and charcoal for cooking, and thereby reduce health hazards from this activity. *Benefits*, SUNOVENS.COM, <http://www.sunoven.com/international/benefits.php> (last visited Sept. 6, 2010).

170. See *supra* notes 56–69 and accompanying text.

171. See *infra* notes 176–77 and accompanying text.

172. We do not intend to overstate the coherence of the legal definition of “charitable.” For example, “charitable” may be defined differently for charitable trust law, state and local property tax exemption, 501(c)(3) tax exemption, and charitable deduction. See John G. Simon, *Is There a Law of Charity?*, Paper Presented at the Nat’l Ctr. on Philanthropy & L. Ann. Conf. 2–4 (Oct. 2002), available at http://www1.law.nyu.edu/ncpl/pdfs/2002/Conf2002_Simon_Final.pdf.

173. See, e.g., Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 460–61 (1897) (“The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law.”).

subcontractors, like Guatemalan tea growers) may not qualify as charitable but would be a legitimate social purpose.¹⁷⁴

Social purpose undoubtedly includes non-pecuniary factors.¹⁷⁵ For example, people may well prefer a society that has a more equal distribution of wealth. Consider a business that pays its poorest employees higher than market wages—it distributes to one set of economically disadvantaged stakeholders a greater share of its profits than they could obtain through market transactions.¹⁷⁶ Thus, the promotion of greater equity or fairness, also referred to as distributive justice, in the distribution of a corporation's profits fits within the rubric of a social purpose. The United Kingdom recognized the potential breadth of a for-profit social enterprise's purpose in its enactment of a legal form tailored to them: a Community Interest Company (CIC).¹⁷⁷ A Community Interest Company must pursue a social purpose ("community interest"), which is defined as an activity that a reasonable person might consider as being "carried on for the benefit of the community."¹⁷⁸

There are, however, some limits on what qualifies as a social purpose. Most notably, personal pecuniary enrichment by itself does not qualify— notwithstanding the potential social value that can result from a self-interested person's pursuit of enrichment. Similarly, a firm's pursuit of higher profits for its owners and controllers is not by itself a social purpose. Thus, companies that follow weaker forms of corporate social responsibility (i.e., they follow pro-social practices because, or insofar as, they maximize profits) are not for-profit social enterprises.¹⁷⁹ These practices are uncontroversial, and there is nothing about a company following such practices that would distinguish them from the traditional for-profit

174. Under some circumstances, paying above-market wages to a disadvantaged population may be a tax-exempt or charitable purpose under § 501(c)(3). See I.R.C. § 501(c)(3) (2006) (exempting any organization operating exclusively for the promotion of "social welfare").

175. See Hansmann & Kraakman, *supra* note 156, at 18 n.32; see also LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 409–36 (2002).

176. See, e.g., Kent Greenfield, *New Principles for Corporate Law*, 1 HASTINGS BUS. L.J. 87, 110 (2005) ("[T]he fairness of the allocation of society's wealth is an important principle for the United States As a society, we look not only at the total social wealth, but also at the equality of its distribution.") (citation omitted).

177. See generally, *Community Interest Companies: Guidance Pages*, REGULATOR COMMUNITY INTEREST COMPANIES, <http://www.cicregulator.gov.uk/guidanceindex.shtml> (last visited Sept. 19, 2010).

178. *Id.* at § 4.

179. Organizations following stronger forms of corporate social responsibility, such as the draft ISO 26000 standard, may well qualify as social enterprises. *Guidance on Social Responsibility, ISO/WD 26000* § 3.9 (Int'l Standards Org., Working Draft 2, Oct. 6, 2006), available at <http://isotc.iso.org/livelink/livelink?func=ll&objId=3974907&objAction=browse> (follow "N080, Second Working Draft ISO 26000" hyperlink) (last modified June 19, 2008) (defining "social responsibility" as "actions of an organization to take responsibility for the impacts of its activities on society and the environment, where these actions: . . . are consistent with the interests of society and sustainable development; are based on ethical behaviour compliance with applicable law and intergovernmental instruments; and are integrated into the ongoing activities of an organization").

business.¹⁸⁰ Moreover, founders or institutions that wish to generate higher profits already have various incorporated forms that suit this purpose. Individuals who wish to maximize their personal wealth can simply stay investors in such incorporated forms.

Guayakí, a small California-based beverage company, approaches the ideal of a for-profit social enterprise.¹⁸¹ The company, in order to help preserve rain forests, sells yerba maté, a South American caffeinated plant whose dried leaves, steeped in hot water, create a drink with a strong, distinctive, and slightly bitter flavor.¹⁸² Guayakí buys yerba maté from indigenous and underprivileged farmers, pays above-market prices,¹⁸³ and enlists the farmers in reforestation projects.¹⁸⁴ Simultaneously, it intends to generate profits for its owners.

In order to sharpen focus,¹⁸⁵ we use the term for-profit social enterprise to denote an organization that unlike a nonprofit, does not have a complete asset lock (or non-distribution constraint), and unlike a for-profit corporation, is not bound by a norm or legal requirement to maximize shareholder wealth.¹⁸⁶ Such an organization is: (a) a business (b) housed in a single legal entity¹⁸⁷ (c) that is at least partly owned by equity investors,

180. As Robert C. Clark observed, “many types of corporate activities that appear to be profit-reducing voluntary expenditures for the public good are really conducive to profit maximization in the long run.” ROBERT C. CLARK, *CORPORATE LAW* § 16.2.2 (1986) (labeling this “the monist viewpoint”).

181. Guayakí, as a closely held company, does not face the same constraints as a publicly traded company. A closely held corporation is more readily operated like a social enterprise, because it generally does not face the pressures of (a) short-term financial reporting, (b) the market for corporate control, or (c) the separation of ownership and control. If the owners and controllers of a closely held corporation want to pursue social aims, their organizational form will not prevent it. RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. f(2) (2006). Note that it is only shareholders who would have standing to object to a board’s decision not to maximize profits. *Id.*

182. *What is Yerba Maté?*, GUAYAKI YERBA MATE, <http://guayaki.com/mate/130/what-is-yerba-mate%3F.html> (last visited Sept. 19, 2010).

183. Guayakí pays indigenous farmers who grow maté in eco-friendly ways two to three times the market price. “*Kue Tuvy*” – *The Aché Guayaki Preserve*, Guayakí Yerba Mate, <http://guayaki.com> (scroll to the bottom of the page; follow “Reforestation” hyperlink; then follow “*Kue Tuvy*” – *The Aché Guayaki Preserve*” hyperlink) (last visited Sept. 3, 2010).

184. *About Guayakí*, CERTIFIED B CORPORATION, <http://bcorporation.net/guayaki> (last visited Sept. 3, 2010) (“Each person that drinks two servings per day of Guayakí Yerba Mate [sic] helps protect approximately one acre of rainforest every year.”).

185. This definition serves our purposes in this Article. We do not claim that this is the only definition of for-profit social enterprise or necessarily even the best one. The terms “social enterprise” and close relative “social entrepreneurship,” observes Dennis Young are, “ill defined and can be interpreted in several ways” DENNIS YOUNG, *Alternative Perspectives on Social Enterprise*, in *NONPROFITS & BUSINESS* 21, 21 (Joseph J. Cordes & C. Eugene Steuerle eds., 2009). This hinders analysis, writes Young, as “[d]iscussion and debate are enhanced when participants share common definitions of terms.” *Id.* at 23.

186. This definition thus builds on that of Dana Brakman Reiser, who distinguishes social enterprises from “companies that make corporate contributions or practice CSR.” Dana Brakman Reiser, *For-Profit Philanthropy*, 77 *FORDHAM L. REV.* 2437, 2450 (2009).

187. We thus exclude contractual joint ventures between an exempt/nonprofit and for-profit organization. A broader definition of social enterprise would likely include some joint ventures, such as a “whole hospital” joint venture. Such an entity can simultaneously serve the interests of each partner.

and that simultaneously seeks (d) to advance a social mission while also (e) generating acceptable returns for investors.¹⁸⁸

Broadly speaking, doing well and doing good can be combined in various organizational forms,¹⁸⁹ but as suggested some combinations are already accommodated by existing organizational forms. The archetypal for-profit social enterprise, however, is legally organized as something other than a conventional nonprofit organization because of the non-distribution constraint. Absent a special form for social enterprise, it will be organized as a business corporation or limited liability company. Even so, the for-profit social enterprise tries to emulate many characteristics of nonprofit organizations and partly fill the same niche.

But the question remains: How could or should an enterprise's core commitment to a social mission be "embedded in its organizational structure"?¹⁹⁰ This also is sometimes referred to as "baking in" the social mission or "embedding" it into the organization's DNA.¹⁹¹ Would the model or archetypal for-profit social enterprise have distinctive legal characteristics that meaningfully differentiate it from conventional for-profit organizational forms? Can we formulate some legal characteristic that distinguishes for-profit social enterprises, similar to the way the non-distribution constraint marks out nonprofit organizations? That constraint, as Steinberg writes, "provides a clear distinction [between nonprofit and for-profits firms] that affects how the [nonprofit] organization obtains resources, how it is controlled, how it behaves in the marketplace, how it is perceived by donors and clients, and how its employees are motivated."¹⁹²

The jointly-owned hospital is run so as to preserve the nonprofit partner's tax-exempt status (e.g., it operates an emergency room open to all comers, regardless of ability to pay; it treats patients covered by Medicare and Medicaid; or it provides some free or below-cost care to uninsured and underinsured patients). If the joint venture is sufficiently profitable, it may also satisfy the financial goals of the for-profit partner.

188. An acceptable rate of return will depend on the investor. It could be at the market rate or even below the market rate if the investor is willing to subsidize the enterprise with below-market capital because he supports its social goals. See, e.g., John Tozzi, *Social Entrepreneurship: Resources for 'Patient' Capital*, NEW ENTREPRENEUR BLOG (Apr. 3, 2009, 3:00 PM) BUSINESSWEEK.COM, http://www.businessweek.com/smallbiz/content/mar2009/sb20090330_647056.htm (noting that some angel investors, venture capitalists, and foundations "look for mission-driven businesses that don't sacrifice financial returns at all, while others provide capital for ventures that may trade some profit for nonfinancial returns"). The L3C is premised in part on foundations receiving below market returns on their program-related investments, thereby subsidizing the contributions of market rate investors.

189. See, e.g., BAMBURG, *supra* note 160, at 113 ("Mission-driven ventures comes in all different flavors: for-profit, nonprofit, hybrid, public, private, co-op, employee stock ownership plans (ESOP), community development corporations (CDCs), and forms that have yet to be invented.").

190. Sabeti, *supra* note 24, at 5. Proponents of the "emerging Fourth Sector" assert that the archetypal Fourth Sector organization "has a core commitment to social purpose embedded in its organizational structure." *Id.*

191. See, e.g., Bromberger, *supra* note 68, at 6.

192. Richard Steinberg, *Economic Theories of Nonprofit Organizations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 117, 118 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006).

The archetypal social enterprise “makes” the additional social value instead of “buying” it. “Make” refers to generating this additional social value as a consequence of operating its revenue-generating activity itself,¹⁹³ as opposed to using some portion of its profits to make charitable donations.¹⁹⁴ (This is partly functional: A corporation that simply wants to donate money to charity is, generally speaking, statutorily permitted to do so.)¹⁹⁵ The commercial activities directly advance the mission instead of simply providing a source of revenue to subsidize the mission (e.g., Starbucks pays fair wages to coffee growers;¹⁹⁶ Ben & Jerry’s primarily uses hormone-free milk bought from family farms;¹⁹⁷ and Seventh Generation produces environmentally friendly cleaning products¹⁹⁸).

The distinction is analogous to the assertion, made by Judge Frank Easterbrook and Professor Daniel Fischel, that a corporation can be “characterized by a statement of capital contributions as formal claims against the firm’s income that are distinct from participation in the firm’s productive activities.”¹⁹⁹ In a for-profit social enterprise, participation in the firm’s productive activities is more basic or integral to the firm’s identity than donations from the corporate treasury. The more successful the business is as a business, the more social good it generates. It embodies the social entrepreneur’s way of addressing the world’s problems, which is to ask, “what can I do, that the more I do the more good it does?”²⁰⁰ This distinguishes the

193. For-profit social enterprises thus closely resemble commercial nonprofits, in that they derive the bulk of their revenue from fees from the sale of goods and services. They closely resemble corporations in that they have profit-seeking shareholders.

194. Of course, contributions to charity may also have a beneficial impact on the corporation itself, and may even be judged (or discontinued) based on this evaluation. *See, e.g.,* Nell Minnow, *Corporate Charity: An Oxymoron?*, 54 *BUS. LAW.* 997, 999–1000 (1999).

195. Corporate law in some states expressly permits such donations, in some cases without regard to any potential benefit to the corporation. *See, e.g.,* CAL. CORP. CODE § 207(e) (West 1990) (permitting corporations to “[m]ake donations, regardless of specific corporate benefit”). Admittedly, in Delaware there is some limit on the amount of donations a corporation can make, although as *Kahn v. Sullivan*, 594 A.2d 48 (Del. 1991) suggests the limits are large. *Id.* at 61 (upholding the Chancery Court’s decision that Occidental’s charitable contribution to the Armand Hammer Museum, although well above the IRS limits for the deductibility of corporate charitable donations, would be protected by the business judgment rule). A messier example might be a corporation committed to corporate social responsibility. Such a corporation might run into difficulties, depending on how the social responsibility was practiced or justified.

196. *Responsibly Grown Coffee*, STARBUCKS COFFEE COMPANY, <http://www.starbucks.com/responsibility/sourcing/coffee> (last visited Sept. 19, 2010).

197. *Inside the Pint: Dairy*, BEN & JERRY’S ICE CREAM, <http://www.benjerry.com/activism/inside-the-pint/dairy> (last visited Sept. 19, 2010). For a detailed discussion of Ben & Jerry’s mission-related activities, see Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 *VT. L. REV.* 211, 221 (2010).

198. *About Our Products*, SEVENTH GENERATION, <http://www.seventhgeneration.com/about-our-products> (last visited Sept. 19, 2010).

199. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 10 (1991).

200. *Andrew Greenblatt: Doing Good in the World*, BATTERY PARK CITY BROADSHEET, Jan.

for-profit social enterprise from an entity that uses profits to cross-subsidize its mission-related activity, such as a law school that operates a pasta factory and uses the resultant revenue towards its social mission.²⁰¹

This distinction is admittedly not air-tight. When Guayakí pays South American farmers double or triple the market price for their yerba maté, it is engaged in a kind of in-house philanthropy towards those farmers, one that can be partly measured as the difference between market wages and above market wages. It subsidizes this in-house philanthropy with profits from its revenue-generating activities and with the savings it gains by paying below market wages to its employees in Northern California.²⁰²

Absent one or more of the above characteristics, the organization is more likely to be either unsustainable as a social enterprise in the long term or readily served by traditional corporate or non-profit forms. Put more succinctly, a for-profit social enterprise is organized and operated for some purpose *other* than to maximize the wealth of investors. It adopts organizational forms, structural devices, and contractual arrangements that reflect its rejection of profit as the sole maximand and that formally commit the organization to (sometimes) making improvements to social welfare at its shareholders' expense. One might say that insofar as a social enterprise is a purposive institution, it is bound by a shareholder non-primacy norm.

What would the for-profit social enterprise ideal organization form look like? At a minimum, the structure would enhance the entity's ability and prospects for identifying, fostering, and expanding a sustainable, embedded social technology to achieve a desirable social mission.²⁰³ In order to achieve this goal, the form should have several attributes. To facilitate the entity's expansion, or "scaling up," the form should ease access to capital investors without simultaneously jeopardizing or compromising the mission. This includes both short-term operational risk and longevity to address the social problem or market failure. There should,

22, 2008, at 2 (quoting Greenblatt's definition of "social entrepreneur"). Greenblatt is a serial social entrepreneur. He teaches a course on social entrepreneurship at New York University's Wagner Graduate School of Public Service. See <http://wagner.nyu.edu/greenblatt>.

201. See *supra* note 107 and accompanying text.

202. BOYD ET AL., *supra* note 163, at 69–70, 87.

203. This assumes, of course, that the creation of more and better for-profit social enterprises will in fact contribute to aggregate social welfare. This is typically assumed, but nowhere proved. We proceed tentatively under this assumption, but will not attempt to prove it. Rather we advance the more modest claims: (a) for-profit social enterprise law could help aspiring social entrepreneurs and their fellow travelers (mission-influenced investors) accomplish their goals (of triple bottom line, etc.) more effectively than existing forms; and (b) in certain situations, an individual for-profit social enterprise could do more for social welfare than alternative forms.

however, be enough flexibility so that resources can be deployed away from social missions that are ineffective or no longer necessary.²⁰⁴

Ideally, the form itself would communicate something valuable to mission-sympathetic parties who are also potential donors such that they and any other stakeholders are more willing to contribute.²⁰⁵ This includes, of course, mission-sympathetic investors who might accept below-market returns in order to promote the social good, but it could also help attract employees willing to accept below-market compensation. It could also cultivate demand among consumers (or consumer-donors²⁰⁶) and increase their willingness to pay a premium for, say, sustainable goods and services. It should encourage director performance beyond the mere absence of venality, which suggests at a minimum there should be active monitoring and accountability. Finally, the social enterprise form itself should be enticing to prospective entrepreneurs, increasing their desire to engage in *social* entrepreneurship and to express and entrench this desire by selecting the social enterprise form for their business. Although there is already some demand for an effective for-profit social enterprise form, preferably the creation of such an organizational form would augment the demand itself.

The enactment in several states (and the United Kingdom) of new off-the-rack organizational forms tailored to for-profit social enterprises illustrates the perceived need. These forms include those mentioned earlier—the L3C, the Benefit Corporation, the Community Interest Corporation, etc.—as well as the private sector “B Lab” accreditation.

B. What Problems Might For-Profit Social Enterprise Solve?

Nonprofit enterprises suffer from several problems. These problems include limits on a nonprofit’s ability to do many things—obtain capital, compensate founders and controllers, and mitigate agency costs between founders and donors on the one hand and controllers on the other. These

204. Not all social enterprises will be successful, and similarly not all social enterprises will be as successful as hoped. For example, a social enterprise that pays above market rates for tea may need to lower those rates in order to stay competitive. Neither tea growers nor investors are served by driving a social enterprise into bankruptcy.

205. Cf. Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1223 (2010) (noting that for employees there may not only be the warm fuzzy glow to be enjoyed from working on social goals, but also a warm fuzzy glow from working at a particular organization).

206. Consumer-donors are those who knowingly pay more for a product or service because of the good it can do. In Indianapolis, for example, garbage collection is a fixed cost for householders, but those who want to can pay extra for recycling collection. See REPUBLIC WASTE SERVICES OF INDIANA, <http://www.indywaste.com/Pages/RecyclingForTheEnvironment.aspx> (last visited Sept. 19, 2010). Consumer-donors may not be necessary to the success of a social enterprise—Guayakí reports that only 10% of its customers buy its maté because of its sustainable business practices. BOYD, *supra* note 163, at 71.

features limit a nonprofit firm's ability to achieve its goals and more broadly to redeploy its resources to more socially efficient uses.²⁰⁷ The for-profit social enterprise has the potential to mitigate each of these problems.

As we have seen, nonprofit law restricts the ability of a nonprofit organization's controllers to control its resources. These restrictions are designed to ensure that all the resources conveyed to or generated by charitable organizations remain dedicated to benefiting society in perpetuity. These restrictions are imposed in the first instance by the nondistribution constraint²⁰⁸—the über asset lock. If the organization is sold, the fair market value of its resources must remain in charitable channels.²⁰⁹ Donors, founders, and controllers can impose additional restrictions on the organization and its resources.²¹⁰ The founder also selects the initial board of directors or trustees and can screen them carefully for commitment to her vision.²¹¹

These restrictions, though designed to increase social welfare, impose social costs of their own. A social enterprise's ability to issue equity or ownership shares has important consequences for the entity's ability to expand or scale up in response to increased demand or to contract in response to shrinking demand.²¹² Because it can sell shares to investors, a for-profit social enterprise has access to an important source of capital unavailable to nonprofits. Nonprofits, by contrast, are generally restricted to retained earnings, debt, and donations.

A social enterprise's ability to issue equity also has important consequences for the compensation of social entrepreneurs, which in turn affects their financial incentives to increase social welfare. A nonprofit cannot issue stock options or other forms of equity compensation.²¹³ As a result, if a commercial nonprofit is successful and poised for greatness (or at least bigness), its founder and controllers cannot readily cash out their sweat equity or appropriate some of the social value the entity is expected to generate post-sale. Rather, nonprofit compensation is calculated

207. HANSMANN, *THE OWNERSHIP OF ENTERPRISE*, *supra* note 43, at 295–96.

208. *See* Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 838 and accompanying text.

209. *See* HANSMANN, *THE OWNERSHIP OF ENTERPRISE*, *supra* note 43 and accompanying text.

210. *See* Hansmann, *The Role of Nonprofit Enterprise*, *supra* note 44, at 853 n.55 and accompanying text.

211. *Id.* at 876.

212. *See* Darius Lakdawalla & Tomas Philipson, *Nonprofit Production and Competition* 2–4 (Nat'l Bureau of Econ. Research, Working Paper No. 6377, 1998), available at <http://www.nber.org/papers/w6377> (explaining that nonprofit's inability to utilize equity financing limits their ability to expand); Hansmann, Kessler, & McClellan, *supra* note 101, at 18–19 (noting that as demand for acute care hospital services declined more rapidly than hospital capacity, for-profit hospitals were most responsive to reductions in demand for acute care hospital services, while secular nonprofits were the least responsive).

213. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* § 20.5(d) (9th ed. 2007).

retrospectively and not prospectively. As a result, founder and controllers may decline to sell (or “convert”) a nonprofit organization to a for-profit entity—even if such sale would increase social welfare—where the sale will not substantially improve their personal well-being. In a for-profit social enterprise, by contrast, investor-owners are entitled to a proportional share of the venture’s net earnings—including the proceeds from selling the venture or from an initial public offering.

Even where nonprofit law does not prohibit profit-responsive compensation,²¹⁴ concerns over seemliness may have a similar impact.²¹⁵ Commentators have discussed (and criticized) the prevalence of a “nonprofit ideology” whereby many think it is evil for people who seek to do good in the world to get rich in the process.²¹⁶

Not only may there be a problem of incentives in a nonprofit organization, there may also be inadequate monitoring. There are neither shareholders who will monitor behavior nor a stock price for measurement. Nor is there a market for corporate control,²¹⁷ and thus no possibility of would-be acquirers monitoring the enterprise.²¹⁸ In theory, state attorneys general are to serve as monitors, but in practice they lack the resources to properly pursue managerial weaknesses. As a practical matter, many nonprofit directors can essentially satisfy their fiduciary duties by not stealing and are generally free from effective scrutiny. By contrast, for-profit social enterprises have owners with personal pecuniary incentives to monitor.

C. Managing Tradeoffs Between Mission and Profit

The archetypal for-profit social enterprise seeks to generate both extraordinary returns for society and acceptable returns for its owners and investors. The tension between these two aims gives rise to a distinct set of agency costs.

The risk that the for-profit social enterprise may subordinate social mission to profits is most likely to occur following a change in ownership.

214. *See id.* at § 20.5(f) (discussing cases where the compensation of a nonprofit’s manager may be tied to an entity’s profitability).

215. *See, e.g.,* Stephanie Strom, *Lawmakers, Tightening Belts, Question Nonprofit Salaries*, N.Y. TIMES, July 27, 2010 at A12.

216. *See generally* DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL (2009).

217. Nonprofits are subject to various non-legal constraints such as competition for charitable donations, which is especially potent for managers of nonprofits that rely mainly on a continuous stream of donations.

218. *See* Hansmann, Kessler & McClellan, *supra* note 101, at 4–5 (explaining that nonprofits are not susceptible to hostile takeovers).

Attorney and author Susan Mac Cormac refers to this risk as “the legacy problem.”²¹⁹ “Many socially oriented for-profits,” she writes, “find that their social mission is dependent on founders’ fervor, and when founders retire or sell, their social legacy is often lost as more traditional owners and managers take over.”²²⁰ Similarly, entrepreneur and journalist Marjorie Kelly worries that a social enterprise’s social mission may be squeezed out when the founders leave, sell, or go public.²²¹ The sale of Ben & Jerry’s is perhaps the most prominent example of this.²²²

The legacy problem arises in part from the risk that a founder’s commitment to creating social value will lessen over time. This can be seen as an inter-temporal agency problem between an idealist founder (principal) and his older and perhaps more acquisitive self (agent).²²³ In response, the founder of a new for-profit social enterprise may seek devices—a.k.a., pre-commitment strategies—to protect the social mission from his own self-regarding attempts to dilute it down the road. Donating company shares to a charitable foundation, for example, will prevent the donor from later benefiting from any price increase. The founder can also enlist a third party to monitor the controllers.²²⁴ The leading example of this is B Labs, the private organization which verifies a B Corporation’s compliance with social enterprise norms.²²⁵

This formulation of the legacy problem in for-profit social enterprises likens it to the agency problem faced by the founding donor (settlor) of a charitable trust—namely, that successive controllers (agents) will stray from the specific charitable mission selected by the settlor (principal). In truth, a for-profit social enterprise is more likely to stray from the founder’s original social mission than a charitable trust. The controllers of a charitable trust, the trustees, have some lawful leeway to redeploy trust assets away from the settlor’s specific charitable purposes, but any alternative purposes must be legally charitable. A for-profit social enterprise, by contrast, will have at least some owners who are entitled to appropriate some portion of

219. Susan H. Mac Cormac et al., *The Emergence of New Corporate Forms: The Need for Alternative Corporate Designs Integrating Financial and Social Missions*, SUMMIT ON THE FUTURE OF THE CORPORATION: PAPER SERIES ON CORPORATE DESIGN 88, 97 (Allen White & Marjorie Kelley eds., 2007), available at <http://www.corporation20/20.org/SummitPaperSeries.pdf>.

220. *Id.*

221. Marjorie Kelly, Pub., Bus. Ethics, Presentation at the Bus. Ethics Symp., System Design: New Frontier for Ethical Leadership (Oct. 2003), available at <http://www.e-businessethics.com/symposium/PPTs/M%20Kelly.pdf>.

222. Page & Katz, *supra* note 197, at 2–3 (describing the sale of Ben & Jerry’s to multinational Unilever).

223. See generally, George Loewenstein & Richard H. Thaler, *Anomalies: Intertemporal Choice*, 3 J. Econ. Perspectives 181, 191–92 (1989).

224. See generally, Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227.

225. CERTIFIED B CORPORATION, *supra* note 35.

the firm's assets for their private benefit.²²⁶ For them, this is part of the for-profit social enterprise's allure.

What makes the so-called "legacy problem" problematic, and for whom? A for-profit social enterprise, after all, has private owners, and some of them may be outside investors whose aims and interests diverge from the founder's original vision. They may prefer greater short-term profitability and less aggressive pursuit of that vision. In this respect, the enterprise's controllers (typically a board of directors) are agents of multiple principals—the founder and outside investors, among others—whose interests may diverge.

When a for-profit social enterprise shifts away from mission and towards greater profitability, some stakeholders may experience a windfall. At the time of purchase, an outside investor's expectations of profits are tempered by her awareness of the enterprise's simultaneous pursuit of a social mission. This does not imply that the investors are expecting or agreeing to a below market return—it may simply mean that the original owners subsidized the social mission by selling equity at a lower price. If the enterprise later abandons or reduces the social mission, these investors would receive a greater than expected return.

Attempts to address the "legacy problem" in for-profit social enterprises can harm the interests of investors who seek robust financial returns. Their investments may generate a lower return if the organization's controllers too zealously pursue the founder's social mission. The magnitude of these investors' losses is a function of their reasonable expectations. These investors' agency costs vis-à-vis the controllers can be mitigated with approaches that resemble those used in conventional for-profit organizations.²²⁷ The founder and outside investors can share control over the enterprise (e.g., both sit on the board of directors), which dramatically reduces the information asymmetries that aggravate agency costs. These control rights can be increased if, for example, the enterprise does not meet certain financial targets. The outside investors can also negotiate for the right to bring lawsuits against the controllers. They also have the right to exit the enterprise altogether by selling their equity shares, and can negotiate for other rights, such as the ability to put their shares back to the company.

226. See *supra* note 188 and accompanying text.

227. These approaches are not identical to those used in conventional for-profit corporations whose investors may also be protected by the directors' theoretical duty to maximize shareholder welfare. See Page & Katz, *supra* note 197.

III. MICRO VERSUS MACRO PERSPECTIVES ON FOR-PROFIT SOCIAL ENTERPRISE

Those who found, support, and study social enterprise have pondered how to design sustainable organizations to address enduring social and environmental problems. There is much concern about for-profit social enterprises selling control to conventional businesses—an act that some refer to pejoratively as “selling out.” The fear is that resources that were in part generating social value will now be dedicated solely to profit maximization. Will the virtuous mouse (described as “relatively small companies that have iconic status as socially progressive brands”) be co-opted by the “wealthy elephant”?²²⁸

Yet these micro questions of design and technique—how to make a for-profit social enterprise’s social mission more durable—should not distract from the critical macro questions: How durable should a for-profit social enterprise’s social mission be made? Under what circumstances should the demise or acquisition of a for-profit social enterprise be welcomed rather than opposed? A broader perspective on social enterprise focuses more on the continued creation and increase of social value and less on perpetuating any particular entity engaged in this activity.

One economic function that social enterprise can serve is to demonstrate the economic viability of a business activity that generates social benefits. In other words, a social enterprise can succeed by demonstrating that it is no longer necessary and that the market failure the nonprofit undertook to address no longer exists. One way this can occur is when a conventional for-profit firm acquires a for-profit social enterprise and continues the acquired entity’s social enterprise-like qualities and activities on a larger scale. Ideally, the acquiring entity will incorporate some of these qualities and activities into its overall operations.

A for-profit social enterprise can promote the longevity of its pro-social innovations by embedding its social mission into its business activities. It can do this by devising methods of producing, marketing, and distributing its products that are assured to produce the desired social value. Professors James Austin and Herman “Dutch” Leonard referred to this know-how as “social technology.”²²⁹ This “social technology” is relatively hardy because it “embeds social values into their missions, production processes, product

228. James E. Austin & Herman B. “Dutch” Leonard, *Can the Virtuous Mouse and the Wealthy Elephant Live Happily Ever After?*, 51 CAL. MGMT. REV. 77, 77 (2008). This idea is discussed in depth in Page & Katz, *supra* note 197.

229. Austin & Leonard, *supra* note 228, at 79.

characteristics, organizational cultures, and relationships with their employees, their suppliers, and their consumers.”²³⁰ So embedded, this social technology is more likely to persist, even when the social enterprise itself is acquired, because the acquiring company will be more likely to perpetuate the social enterprise-like aspects of the business activity of the acquired company.

The second way a for-profit social enterprise can increase social value is to increase consumer demand for products that embody their social technology. Firms that introduce new products and manufacturing methods often stress distinctive features, even if there was no clear prior demand for products with these features beforehand. When a product’s consumers come to value these qualities, any firm that acquires the product will feel market pressure to preserve these qualities. Indeed, the acquiring company is likely “betting on products with high social content becoming a salient component of the future marketplace.”²³¹

Consider the market for natural or “eco-friendly” cleaning products. For many years, the market was dominated by two relatively small producers: Seventh Generation and Simple Green. In December 2007, Clorox Company launched its Greenworks line of natural cleaning products.²³² To bolster its eco-friendly credibility, Clorox sought and obtained the Sierra Club’s endorsement for these products.²³³ Within a year of its launch, Greenworks was the top seller in the natural cleaners market—gaining 42%—and total sales of all natural cleaners doubled.²³⁴

Clorox’s size enabled it to grab a large slice of a growing pie. Economies of scope helped Clorox sell its Greenworks products for substantially less than competitors.²³⁵ Clorox also used its large distribution network to make Greenworks products more available. “Before, you had to go to a specialty [store to buy natural cleaners],” reported an industry analyst, while “[n]ow you can get it at Wal-Mart and Kroger’s just about anywhere.”²³⁶ This availability reduced consumers’ search costs for natural

230. *Id.*

231. *Id.*

232. Vinnee Tong, *Clorox Takes Top Share of Natural Cleaners Market*, ASSOCIATED PRESS FIN. WIRE, Jan. 11, 2009 (explaining that Greenworks products are made mostly with coconut oil, corn, and lemon and without bleach).

233. Felicity Barringer, *Clorox Courts Sierra Club, and a Product Is Endorsed*, N.Y. TIMES, Mar. 26, 2008, at SPG2. Around the same time the Sierra Club announced its endorsement of Greenworks products, Clorox announced that it would donate \$470,000 to the Sierra Club. Tong, *supra* note 232. There may be a connection between these two events.

234. Tong, *supra* note 232 (noting prior to Clorox’s entry the natural cleaners market was growing 20% a year).

235. *Id.* (“Other brands [of natural cleaners] charge between 50 percent to 60 percent more than regular cleaners while Greenworks products cost 10 percent to 20 percent more.”).

236. *Id.* (quoting Jefferies & Co. analyst Douglas Lane).

cleaners, which effectively lowered their prices further. Assuming that consumers' demand for natural cleaners remained constant, the lower prices would naturally increase sales.

Additionally, Greenworks' visibility and association with the Clorox brand likely stimulated demand for natural cleaners in general. By conspicuously marketing Greenworks as a Clorox product, Clorox effectively endorsed the efficacy of natural cleaners generally.²³⁷ If one of Seventh Generation and Simple Green's goals was to move "green cleaning" into the mainstream, they succeeded. They showed that the niche could be profitable. One key reason the Sierra Club endorsed Greenworks, according to the nonprofit's executive director, was indeed "to try to create this marketplace."²³⁸

In other cases, the virtuous mouse could arguably achieve greater social impact by selling an ownership stake to the wealthy elephant, rather than by staying independent. Consider Honest Tea, the bottled iced tea company and socially progressive start-up.²³⁹ In 2008, Coca-Cola acquired a 40% share in Honest Tea, which had been operating as a closely-held corporation.²⁴⁰ The rationale for the sale was that "Coca-Cola's distribution system would enable Honest Tea to go national and achieve profitability."²⁴¹ Some observers of the sale asked whether Seth Goldman, who co-founded the company and served as its CEO,²⁴² had made a "deal with the devil."²⁴³ Goldman responded that:

I believe that every time we sell a bottle of Honest Tea we are doing a positive thing for the people picking/processing the leaves, the ecosystem and the consumer. If you accept this first assumption, as I do, then I believe it is my responsibility to make Honest Tea as powerful as I can. The more we sell—provided it is the same product we have been selling for the past ten years—the more good we do. And the more we convince the larger

237. Jennifer Lance, *Clorox Greenworks: Greenwashing or Green Cleaning?*, REALLY NATURAL BLOG (Jan. 23, 2008, 8:56 AM) http://www.reallynatural.com/archives/home/clorox_greenworks_greenwashin_g.php. "We spent a lot of time talking with consumers who wanted to keep their homes clean and healthy but wanted more natural alternatives . . . [T]hey confessed in most cases they were disappointed with having to pay more for products that didn't work. So we concluded that we would initially bring it out with the Clorox brand name endorsing it because it gave people a belief in its efficacy." *Id.* (quoting Beth Springer, Vice President for Strategy and Growth at Clorox).

238. Barringer, *supra* note 233.

239. *Aspirations for Corporate Social Responsibility*, HONEST TEA, *supra* note 168.

240. Andrew Park, *Did Seth Go to the Dark Side?*, INC. MAGAZINE, May 2008, at 21.

241. Austin & Leonard, *supra* note 228, at 86.

242. Goldman is also described as the company's "TeaEO." *Our Mission*, HONEST TEA, <http://www.honesttea.com/mission/about/seth> (last visited Oct. 11, 2010).

243. Park, *supra* note 240, at 21–22.

beverage companies that there is a market for a product like ours.²⁴⁴

Recall that for-profit social enterprise exists to create more value than would be generated by either a nonprofit organization engaged in a similar undertaking (hampered as it is by reduced access to capital) or a conventional for-profit corporation engaged in a comparable activity. So it may be that “[t]here may be opportunities to leverage resources outside the organization’s boundaries”—including an erstwhile competitor’s resources—“than could be generated by the organization alone.”²⁴⁵

From society’s point of view, it is secondary which company is creating the social value.²⁴⁶ By entering the natural cleaners market with its own product, Clorox created more social value, in part by enlarging the market and inducing some consumers to stop buying *eco-unfriendly* products in favor of natural products. Those who are most concerned about perpetuating a particular social enterprise as a separate and distinct organization may have lost sight of the bigger picture. Which organization creates the social value is less important than the amount of social value created. Of course, if we believe that, all things being equal, for-profit social enterprise should hold out rather than sell out, we may conclude that the law should make it harder rather than easier for a for-profit corporation to discard the social type aspects of its operations.

CONCLUSIONS

The archetypal social enterprise serves a discrete set of economic functions—addressing market failures and distributive inequalities. It does so, moreover, through distinctive and alluring means—operating a business selling mixed public-private goods to paying consumers for their own

244. Seth Goldman, *An Honest Dialogue with a Disappointed Consumer*, HONEST TEA BLOG (Feb. 25, 2008), <http://www.honesttea.com/blog/2008/02/> (emphasis omitted).

245. James Austin et al., *Social and Commercial Entrepreneurship: Same, Different, or Both?*, 30 ENTREPRENEURSHIP THEORY & PRAC. 1, 18 (2006).

246. The identity of the producer is relevant. See, e.g., Jennifer Chait, *Alternatives to Toxic Cleaners*, BLISSTREE BLOG (Aug. 22, 2009, 9:50 PM) <http://blisstree.com/live/alternatives-to-toxic-cleaners>.

If you’re going to buy green cleaners . . . don’t be swayed by greenwashing companies if your goal is a better green lifestyle. For example, **Clorox Greenworks** is in truth, a safe non-toxic cleaner, BUT there is WAY more to being a green company than simply making one product, dying it green, and calling it a day. Clorox also makes mostly not eco-friendly products, many are super toxic, and there are plenty of other actual green companies who make green cleaners day in and day out, making them a more ethical choice.

Id. (emphasis in original).

consumption, in a manner that generates significantly greater positive externalities than conventional businesses in the same sector.

Nonprofit law supplies aspiring social entrepreneurs with an organizational form and a regulatory framework in which to pursue the social enterprise ideal. The for-profit social enterprise, where organized in a form other than the conventional corporation, has some of the advantages of nonprofit social enterprise, such as the ability to signal worthiness to potential investors, customers, employees, etc. sympathetic to its social mission. It also has the potential to address certain weaknesses of the nonprofit form, notably the lack of access to capital caused in part by the non-distribution constraint (and perhaps an excessive cost to society through their preferential tax treatment). The possibility of rich rewards for founders and early investors—if the for-profit social enterprise succeeds—may enable the enterprise to elicit more capital, enthusiasm, and other resources than if it were a nonprofit.²⁴⁷ The introduction of equity, and thus equity owners, may serve to reduce agency costs between donors, consumers, employees, and investors, on the one hand, and founders or controllers on the other.

Not only might an organizational form designed specifically for for-profit social enterprise have advantages in comparison to nonprofit social enterprise, but there may also be additional advantages to society. The mere existence of the form, complete with an implicit state endorsement, could attract founders who might otherwise form a conventional for-profit business. Granted, it might also attract founders who would otherwise form conventional nonprofits, however, this risk is mitigated to the degree that the for-profit social enterprise may create more social value than the nonprofit. Seth Goldman of Honest Tea went to business school “with the mindset of being an activist” and leading a nonprofit, but instead founded and ran a successful business with a public agenda, one seen as “a vehicle for change.”²⁴⁸ It is entirely plausible that Goldman has created more social value through Honest Tea than he would have in a nonprofit.

At the same time, owners create issues of sustainability, as the power to sell is a key indicium of ownership. Owners’ preferences may change: today’s social entrepreneur may tomorrow be concerned about paying for her children’s college education. The social good created by for-profit social enterprise is likely most sustainable when the value created both is

247. Honest Tea provides an example. Without the incentive of profitability Coke would never have invested in the business, and Honest Tea would not have been able to grow as quickly without access to Coke’s distribution network. Michelle Wu, *Brewing Honest Tea*, WALL STREET J., July 27, 2010, <http://online.wsj.com/article/SB10001424052748703700904575391140459661842.html?KEYWORDS=brewing+honest+tea>.

248. *Id.*

integral to the business activity itself and is perceived as such by consumers and key suppliers of capital, labor, and other inputs. The social good is likely least sustainable when it is dependent on the founders' or controllers' wish to use the business activity to cross subsidize the provision of public benefits. For the first type of for-profit social enterprise, as long as the focus remains on results, issues of sustainability are minimized. In contrast, the second type of for-profit social enterprise appears more vulnerable.²⁴⁹

Ideally, policy makers will consider the nonprofit experience with social enterprise to better enable and facilitate aspiring for-profit social entrepreneurs to realize their goals. They should, however, be wary of analogs to the nondistribution constraint, as such analogs may reduce the advantages of new organizational forms with no corresponding benefit.

249. Interestingly, this distinction between types of business activity is reflected in nonprofit law's UBIT. I.R.C. § 513(a) (2006).