

NOTE

Designing a Legal Vehicle for Social Enterprises: An Issue Spotting Exercise

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Abstract

Social entrepreneurship is at the juncture of creative capitalism and social innovation. It aims at combining the best of two sectors, and thus is cramped in the traditional vehicles designed for either world in isolation. Although the social bottom line of these enterprises can usually meet the broad charitable purpose requirement of the Internal Revenue Code, tax-exempt vehicles have proven to be unable to hose the financial one. Conversely, the advantages of for-profits stem from their flexibility, but their failure to receive funding from tax-exempts and the lack of a social enterprise brand have made it necessary to design new vehicles.

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I INTRODUCTION: SOCIETAL INNOVATION AND THE DEFINITION OF SOCIAL ENTERPRISE

A. The Call for Creative Capitalism

In his closing comments at the Stanford commencement in 2005, Steve Jobs called on the graduates to “Stay Hungry. Stay Foolish.”¹ Turning negative adjectives into positive ones, his address was an encouragement to innovate, a wish that graduates be eager to make unconventional decisions. This vision fits what, by nature, entrepreneurs are expected to do: think outside of the box to create something new. About two years later, in his commencement speech at Harvard University, Bill Gates pushed for “a more creative capitalism” that would “stretch the reach of market forces so that more people can make a profit, or at least make a living, serving people who are suffering from the worst inequities.”²

Studies reveal that U.S. corporations allocate billions of dollars to social causes: the “Giving in Numbers: 2012 Edition” survey, based on data from 214 companies, including 62 of the top 100 companies in the Fortune 500, reveals that the sum of contributions across all its respondents in 2011 was \$19.9 billion (in cash and product giving).³ These contributions are expressions of the theory of corporate social responsibility, “a broad concept that describes a business's obligation to interact with society in a socially responsible way.”⁴ However, corporate social responsibility treats the contribution to public good as incidental to the profitmaking activity, whereas Bill Gates suggests that companies could primarily and profitably promote social causes.

Such a use of business strategies to promote public welfare purposes has increasingly been referred to as social entrepreneurship, and in many ways it has been responding to both of these exhortations long before they were formulated. As early as in 1963, Bill Drayton began to entertain the model of change that Bill Gates praised in 2007, a model that “combine[s] the pragmatic and results-oriented methods of a business entrepreneur with the goals of a social reformer.”⁵ In 1980, he structured this commitment through Ashoka, a nonprofit that “aims to find change-making leaders around the world, provide them with support and modest ‘social venture capital,’” thus creating a “community for people seeking to make change, encouraging them to inspire, mentor and challenge each other to come up with the best ideas in social innovation.”⁶ In 1974, Muhammad Yunus started giving out “micro-loans” to the poor in Bangladesh, helping them create “the spark of personal initiative and enterprise necessary to pull themselves

¹ Steve Jobs, CEO, Apple Computer, Commencement Address at Stanford University (June 12, 2005) (transcript available at <http://news.stanford.edu/news/2005/june15/jobs-061505.html>).

² Bill Gates, Chairman, Microsoft Inc., Commencement Address at Harvard University (June 7, 2007) (transcript available at <http://news.harvard.edu/gazette/story/2007/06/remarks-of-bill-gates-harvard-commencement-2007/>).

³ *Giving in numbers 2012 Edition* 4, COMM. ENCOURAGING CORPORATE PHILANTHROPY, http://cecp.co/pdfs/giving_in_numbers/GIN2012_finalweb.pdf (last visited Sep. 22, 2013).

However, when considered as a percentage of the profits of these companies, these contributions are a modest commitment to social welfare.

⁴ Z. Jill Barclift, *Corporate Social Responsibility and Financial Institutions: Beyond Dodd-Frank*, BANKING & FIN. SERVICES POL'Y REP., January 2012, at 13, 14 (2012).

⁵ Caroline Hsu, *Entrepreneur For Social Change*, U.S. NEWS & WORLD REPORT (Oct. 31, 2005), available at <http://www.usnews.com/usnews/news/articles/051031/31drayton.htm>.

⁶ Tom Dawkins, *Huffington Post Gamechangers Poll Recognizes Ashoka Community*, ASHOKA.ORG (Nov. 5, 2009), <https://www.ashoka.org/story/6142>.

out of poverty.”⁷ In 1983, he carried on, founding the Grameen Bank – literally “the Village Bank” – on principles of trust and solidarity.⁸

Since the 1980s, this phenomenon has dramatically expanded as the traditional division of the society into three sectors – for-profit, government and nonprofit – began to seem unable to adequately address the broad array of social challenges. Social entrepreneurship has led to the emergence of a fourth sector, somewhere in between the for-profit and the nonprofit sectors.⁹

B. A Lack of Uniform Definition

Social entrepreneurship has been thriving for four decades and is increasingly recognized as a game changer – the 2006 Nobel Peace Prize was awarded jointly to Muhammad Yunus and Grameen Bank “for their efforts to create economic and social development from below”.¹⁰ Yet so far it has no legal definition. Thus, it is the social entrepreneurship movement itself that elaborated its description. Consequently, it is commonly acknowledged that the topic lacks “a clear and concise definition” as “[c]onservative or exclusionary classifications of social entrepreneurship vary widely from publication to publication”¹¹ In 2008, Paul C. Light noted that recent scholarship had offered an inventory of more than 20 definitions for social enterprise.¹² Yet, the Social Enterprise Alliance’s contribution to the definition of social entrepreneurship is of particular interest, since it is a “membership organization for the diverse and rapidly growing social enterprise sector in North America.”¹³ It defines social enterprises as “businesses whose primary purpose is the common good” and that use “the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas.”¹⁴

Pursuant to this definition, social enterprises have three characteristics that distinguish them from other types of businesses, nonprofits and government agencies: they directly address social needs, the common good is their primary purpose, and their

⁷ *Biography of Dr. Muhammad Yunus*, GRAMEEN.COM, http://grameen.com/index.php?option=com_content&task=view&id=329&Itemid=363 (last visited Nov. 8, 2013).

⁸ *Id.* (“In Bangladesh today, Grameen has 2,564 branches, with 19,800 staff serving 8.29 million borrowers in 81,367 villages. On any working day Grameen collects an average of \$1.5 million in weekly installments. Of the borrowers, 97% are women and over 97% of the loans are paid back, a recovery rate higher than any other banking system. Grameen methods are applied in projects in 58 countries, including the US, Canada, France, The Netherlands and Norway.”).

⁹ See Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 340 (2009); see also Alissa Mickels, *Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe*, 32 HASTINGS INT’L & COMP. L. REV. 271, 279 (2009).

¹⁰ *The Nobel Peace Prize 2006*, NOBELPRIZE.ORG, http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/ (last visited Sep. 22, 2013). Other examples of this public recognition include Business Week’s annual publication of its list of America’s Most Promising Social Entrepreneurs since 2008. See John Tozzi, *America’s Most Promising Social Entrepreneurs 2011*, BLOOMBERG BUSINESSWEEK (Jul. 19, 2011), available at http://www.businessweek.com/sml/biz/content/jun2011/sb20110621_158462.htm.

¹¹ Ryan J. Gaffney, *Hype and Hostility for Hybrid Companies: A Fourth Sector Case Study*, 5 J. BUS. ENTREPRENEURSHIP & L. 329, 332 (2012) (quoting Matthew F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20

DUKE J. COMP. & INT’L L. 291, 292 (2010)).

¹² PAUL C. LIGHT, *THE SEARCH FOR SOCIAL ENTREPRENEURSHIP* 3 (2008).

¹³ *The Case for Social Enterprise Alliance*, SOCIAL ENTERPRISE ALLIANCE, <https://www.se-alliance.org/why#whatwereallabout> (last visited Sep. 22, 2013).

¹⁴ *Id.*

commercial activity is a strong revenue driver.¹⁵ Such a broad definition encompasses enterprises addressing needs “as diverse as human ingenuity.”¹⁶

Whereas this definition conveys a broad understanding of social entrepreneurship, it also emphasizes a characteristic that is essential to its legal analysis: “unlike traditional business models, any profit that flows to individuals is incidental to the social enterprise’s primary purpose.”¹⁷ Indeed, in the United States the definition of social entrepreneurship “focus[es] on generating income for organizations that provide services typically thought of as being provided by the nonprofit sector.”¹⁸ This focus reflects what has come to be called the double bottom-line of social enterprises: they further the dual and co-equal purposes of making profit and contributing to the public good.¹⁹ Neither of these co-objectives is incidental to the other,²⁰ hence the idea of a double bottom-line. Consequently, social entrepreneurs seek both an economic return on investment and a social one.

The very difficulty social entrepreneurs face relates to this double bottom-line return. Part II explains why tax-exempt nonprofits do not meet the needs of this peculiar business model. Part III then delineates the effect of the so-called shareholder primacy doctrine on social enterprises that adopt a corporate form. Part IV then develops the governance and funding challenges that stem from the capitalization of a for-profit social enterprise. Part V subsequently outlines the main attempts to adapt the traditional vehicles to these challenges. Part VI finally describes the main hybrid vehicles, which try to combine the two sectors in a single entity.

II THE CHARITABLE NONPROFIT: A VEHICLE UNSUITED FOR THE SOCIAL ENTERPRISE BUSINESS MODEL

This part first offers an overview of the business model that social enterprises usually pursue. Then it outlines why traditional tax-exempt nonprofits fail to address this business plan.

A. Characterizing Social Entrepreneurship from Its Business Model

The characteristics of social enterprise business models pertain to their double bottom line. First of all, they are organized for the primary purpose of addressing a social issue. This mission is not subsidiary to their business activity; it is its very motive. Hence, social outcomes are as important as economic objectives in the decision-making process. This first element is essential to determine whether a tax-exempt vehicle might be used, and it distinguishes social enterprises’ business models from those of traditional for-profit enterprises, in which an incidental part of the enterprise’s activity may be allocated to the public good.

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Keren G. Raz, *Toward an Improved Legal Form for Social Enterprise*, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 289 (2012).

¹⁸ Matthew F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT’L L. 291, 292 (2009-2010).

¹⁹ See Linda O. Smiddy, *Symposium Introduction: Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 5 (2010).

²⁰ See Briana Cummings, *Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest*, 112 COLUM. L. REV. 578, 581-82 (2012); see also Dana Brakman Reiser, *Symposium: Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship, Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 105 (“[A]chieving and governing truly blended enterprise means consistently serving two masters.”).

Secondly, the social enterprise activity in and of itself addresses a social issue: the business is part of the solution to the social problem, as opposed to a mere fundraising tool. For instance, Generation Water, a Los Angeles-based social enterprise, furthers three aims: restoring landscape and promoting water saving, preparing young adults with the skills necessary to lead the transition to a sustainable economy, and creating economic value through these social missions.²¹ The business itself is therefore favoring the development of a sustainable economy. This second element distinguishes social enterprises from tax-exempt enterprises that use business-like activities merely to provide funds for their charitable undertakings,²² although tax-exempts sometimes further charitable goals through such activities.²³

A third characteristic of social enterprises relates to the way they finance their activity. While traditional tax-exempts rely mostly on philanthropy, social enterprises aim at sustaining their activity through earned income.²⁴ This financial self-sufficiency guarantees a consistent cash flow, whereas grants and donations can vary greatly from one year to another. Nonetheless, even though the objective of social enterprises is to become self-sufficient with earned income, they have to explore other funding opportunities during start-up and expansion stages.

The question of where social entrepreneurs expect to find their capital for a given venture is a central one. If they contemplate charitable contributions and grants, a tax-exempt entity might be considered – alone or in combination with a for-profit. However, because they expect to create economic value through their activity, social entrepreneurs usually also want to access capital from market investors.²⁵ In such a situation, social entrepreneurs may need to form a for-profit – alone or in combination with a tax-exempt.

Incidental to this question is the determination of the economic return that founders or investors expect from the venture. A tax-exempt organization, in and of itself, does not allow founders a share in the profit, other than in form of a reasonable salary.²⁶ Therefore, since social enterprises' business plans usually include equity-based financing, implying at the very least equity distributions and liquidity, a for-profit must be part of the legal structure.

Consequently, social enterprises should be financially flexible in order to obtain grants and donations as well as traditional equity-based or bank funding. Further, this financial flexibility also allows social enterprises to access a peculiar source of capital known as “impact investments,” which are investments made “into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.”²⁷ As a result, social entrepreneurs

²¹ *Our Story*, GENERATION WATER, <http://www.generationwater.org/meet/story> (last visited Sep. 22, 2013).

²² *See, e.g.*, Raz, *supra* note 17, at 291 (“If the business exists solely to provide funding to the organization, then it is not a social enterprise. However, if the business is essential to solving the problem that the organization aims to tackle, then it could be considered a social enterprise.”).

²³ *See infra* Part II.C.

²⁴ *See, e.g.*, Raz, *supra* note 17, at 294 (“Once a social enterprise establishes itself, if it is successful as a business, the revenue it generates will cover its costs.”).

²⁵ *See, e.g.*, John Walker, *A Financing Gap*, ECHOING GREEN, <http://www.echoinggreen.org/blog/financing-gap> (last visited Nov. 8, 2013).

²⁶ This results from the inurement rule and private benefit doctrines. *See infra* Part II.C.

²⁷ *Global Impact Investing Network: Impact Investing*, GLOBAL IMPACT INVESTING NETWORK, <http://www.thegiin.org/cgi-bin/iowa/investing/index.html> (last visited Sep. 22, 2013).

must search for legal forms or combinations adaptable enough not to deprive them of any funding opportunity.

A fourth element of the business model pertains to the governance issues resulting from these various sources of funding. A social enterprise may bring together actors as different as entrepreneurs, traditional investors, impact investors and philanthropic contributors. Each of them has different expectations: one may ask for a higher rate of return, while another may be more focused on controlling the venture or assuring that it furthers its social mission. Thus, the double bottom line, which implies co-equal financial and social returns, also leads to a financial structure that presents governance and funding challenges.

This broad overview of social enterprises' business models reveals two constraints flowing from their double bottom line: social enterprises aims at being financially flexible while ensuring that their social mission prevails over mere profit-maximization. This double constraint renders traditional tax-exempt organizations hardly practicable for social enterprises.

B. The Tax-Exempt Entity: An Appealing but Rigid Framework to Host a Social Business

Under section 501 of the Internal Revenue Code, the tax-exempt sector can be divided into two categories. On the one hand there are the section 501(c)(3) entities, which are organized and operated exclusively for certain exempt purposes.²⁸ The term "charitable organizations" is used to identify them both because "charitable" is the residual exempt purpose they can further and because the U.S. Supreme Court ruled that all section 501(c)(3) organizations must meet "certain common law standards of charity."²⁹ The charitable world is itself divided between public charities and private foundations depending, essentially, on the width of the organization's financial support.³⁰ Indeed, while public charities are broad publicly-supported nonprofits, the funding sources of private foundations are more limited.³¹ On the other hand, there are the "noncharitable nonprofits," which are organized under sections 501(c)(4)-(25).³² These entities "may roughly be described as carrying forward the private interests of their members."³³ Even though the distinction is not absolutely accurate, it is often stated that the former provide "public benefit" while the latter provide "mutual benefit."³⁴

²⁸ These exempt purposes are charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. *See* 26 U.S.C. § 501 (2012)

²⁹ *Bob Jones Univ. v. United States*, 461 U.S. 574, 586 (1983). The legal meaning of charitable purpose is further broadly construed: *see* Treas. Reg. § 1.501(c)(3)-1(d) (2008).

³⁰ *See* Internal Revenue Serv., *Applying for 501(c)(3) Tax-Exempt Status 5*, available at <http://www.irs.gov/pub/irs-pdf/p4220.pdf> ("Every organization that qualifies for tax-exempt status under section 501(c)(3) of the IRC is further classified as either a public charity or a private foundation. Under section 508(b) of the IRC, every organization is automatically classified as a private foundation unless it meets one of the exceptions listed in sections 508(c) or 509(a).")

³¹ *See, e.g.*, JAMES J. FISHMAN & STEPHEN SHWARZ, *NONPROFIT ORGANIZATIONS* 722 (4th ed. 2010) (Stating that public charities "share the characteristic of 'publicness' in that they rely on public support or are accountable to a broad constituency.")

³² *Id.* at 41.

³³ *Id.*

³⁴ *Id.*

While charitable and non-charitable nonprofits are both tax-exempt, there are a number of advantages that only charitable organizations enjoy.³⁵ Most notably, 501(c)(3) status provides eligibility to receive tax-deductible charitable contributions.³⁶ Thus, charitable organizations are more likely to benefit from individual and corporate donors, as they will be entitled to deduct their donations.³⁷ Further, this status guarantees grant-making institutions, and particularly foundations,³⁸ that the organization is a permitted beneficiary under the Internal Revenue Code.³⁹ Overall, the 501(c)(3) status also operates as a brand by identifying the organization's activity as a proper social mission. Thus, charitable organizations, and particularly public charities, can attract resources that are appealing for social enterprises. Indeed, at least until charitable organizations reach the profitability stage, their social bottom line, which usually meets the broad definition of charitable activity, could incentivize them to structure the venture as a tax-exempt organization to attract charitable contributions and grants. However, the business model previously discussed seems incompatible with the requirements that an entity must meet to qualify as a public charity.

C. The Economic Bottom Line: A Financial Return Irreconcilable with the Constraints of the Third Sector

Nonprofit organizations are not automatically tax-exempt. A nonprofit is required to apply for the exemption, and it will be granted only if the entity meets a variety of criteria.⁴⁰ A comprehensive study of these requirements is beyond the scope of this paper. However, a brief overview of the tensions between some of them and the double bottom line is helpful to understand why a genuine social enterprise cannot qualify as a tax-exempt nonprofit.

To qualify for tax-exempt status pursuant to section 501(c)(3) of the Internal Revenue Code, a nonprofit must be organized and operated exclusively for exempt purposes as set forth in that section, and none of its earnings may inure to any private shareholder or individual.⁴¹ The Treasury Regulations provide a twofold test to determine whether a nonprofit meets these requirements.⁴²

On the one hand, the nonprofit must pass a formalistic "organizational test," which scrutinizes the language of its organic documents.⁴³ Under this test, the articles of

³⁵ For a broad overview of these advantages, see FISHMAN, *supra* note 32, at 42-43. *See also* Internal Revenue Serv., *supra* note 31, at 2 ("An IRS determination of 501(c)(3) status is recognized and accepted for other purposes. For example, state and local officials may grant exemption from income, sales or property taxes. In addition, the U.S. Postal Service offers reduced postal rates to certain organizations.").

³⁶ I.R.C. § 170(a) (2012).

³⁷ Under §170 of the Internal Revenue Code, deductibility of contributions to a public charity is higher than deductibility of contributions to a private foundation. However, the federal gift and estate tax treatment of gift and bequest to public charities and private foundation is the same, pursuant to I.R.C. §§ 2055, 2522.

³⁸ This point is developed *infra* regarding the difficulties that corporations face to attract foundation grants. *See infra* Part IV.B.

³⁹ *See* Internal Revenue Serv., *supra* note 31, at 2.

⁴⁰ *See* Internal Revenue Serv., *supra* note 31, at 5.

⁴¹ Treas. Reg. § 1.501(c)(3)-1(a) (2008).

⁴² *Id.*

⁴³ *See* FISHMAN, *supra* note 32, at 315.

organization must limit the purposes of such an organization⁴⁴ to one or more exempt purposes; and not expressly empower the organization to engage, in a substantial way, in activities which in themselves are not in furtherance of one or more exempt purposes.⁴⁵ This requirement is easy to meet, as the articles can be as broad as the purposes set forth in section 501(c)(3). For example, it is enough for the articles to state that the organization is formed for charitable purposes within the meaning of section 501(c)(3).⁴⁶ Thus, the organizational test, at this stage, does not bar public charities from hosting social enterprises.⁴⁷

Another part of the organizational test is nonetheless of more difficulty to them. Pursuant to Treasury Regulations, the articles must constrain the organization, upon dissolution, to distribute its assets to another 501(c)(3) or the Federal or State government for public purpose.⁴⁸ Thus, it is impossible for a 501(c)(3) to distribute its assets to its members or shareholders upon dissolution.

On the other hand, the treasury regulation establishes an operational test that essentially paraphrases the statute requirements.⁴⁹ Of most interest is the concession that “An organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes”⁵⁰ Thus, a public charity can further nonexempt purposes as long as they represent an insubstantial part of its activities. The Treasury Regulation further provides that:

An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513.⁵¹

As a result, when a public charity carries on a business-like activity, assessing whether the primary purpose requirement is met first necessitates asking if the business is in furtherance of the organization's exempt purpose. If it is, then even a substantial business activity will not jeopardize the exempt status. If it is not, a substantial business activity will jeopardize the exempt status, while an insubstantial one will only trigger an additional tax. In other terms, an organization “can engage in a trade or business so long

⁴⁴ THE ORGANIZATION MUST BE A CORPORATION, AN UNINCORPORATED ASSOCIATION, A TRUST, COMMUNITY CHEST, FUND, OR FOUNDATION. *ORGANIZATIONAL TEST - INTERNAL REVENUE CODE SECTION 501(C)(3)*, INTERNAL REVENUE SERV. (AUG. 7, 2013), [HTTP://WWW.IRS.GOV/CHARITIES-&-NON-PROFITS/CHARITABLE-ORGANIZATIONS/ORGANIZATIONAL-TEST-INTERNAL-REVENUE-CODE-SECTION-501\(C\)\(3\)](http://www.irs.gov/charities-&-non-profits/charitable-organizations/organizational-test-internal-revenue-code-section-501(c)(3)).

⁴⁵ Treas. Reg. § 1.501(c)(3)-1(b)(1)(i) (2008).

⁴⁶ Treas. Reg. § 1.501(c)(3)-1(b)(1)(ii) (2008).

⁴⁷ Even though Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) prohibits the articles from authorizing the nonprofit to engage in a manufacturing business otherwise than as an insubstantial part of its activities, it is more a drafting constraint at the stage of the organizational test than a substantive one.

⁴⁸ Treas. Reg. § 1.501(c)(3)-1(b)(4) (2008).

⁴⁹ See FISHMAN, *supra* note 32, at 317.

⁵⁰ Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008).

⁵¹ Treas. Reg. § 1.501(c)(3)-1(e) (2008).

as it furthers the organization's tax-exempt purpose and, if it does not, so long as it does not constitute the primary purpose of the organization."⁵²

This issue is critical for social enterprises. It stems from their business model that they aim at achieving social outcomes through their very business activity. The core of the notion of social entrepreneurship is that "social entrepreneurs use business acumen to do well and do good."⁵³ The Generation Water example⁵⁴ accurately illustrates this point: the business activity contributes to the development of a sustainable economy through the employment of young workers to restore landscapes and promote water saving. Consequently, a genuine social enterprise typically conducts a business-like activity as its primary purpose. Thus, social enterprises that want to adopt a public charity vehicle must ascertain that their business activity adequately furthers an exempt purpose.

To determine whether the business activity furthers an exempt purpose, the Treasury Regulation first refers to section 513 of the Internal Revenue Code that defines "unrelated trade or business" for the application of the unrelated business income tax. Section 513 defines "unrelated trade or business" as any trade or business the conduct of which is not substantially related to the tax exempt purpose, aside from the need of such organization for income or funds or the use it makes of the profits derived.⁵⁵ Treasury Regulation section 1.513-1 provides more guidance in the definition of unrelated trade or business. Pursuant to the regulation, a business is related to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income).⁵⁶ It is then substantially related only if the causal relationship is a substantial one, i.e. if the business activity contributes importantly to the accomplishment of those exempt purposes.⁵⁷ Whether a business-like activity importantly contributes to an exempt purpose thus requires a fact-intensive inquiry and highly depends on the circumstances.⁵⁸ To this end, the regulation indicates that when assessing this "important contribution" criterion, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve.⁵⁹ Indeed, the scale of the business activity must not exceed what is reasonably necessary for performance of the exempt purpose.⁶⁰ If the business is carried on at a larger scale than what the needs of the exempt function reasonably require, then this business is unrelated to the exempt purpose.⁶¹ As a consequence, if this activity is a primary one in the organization, then the tax-exempt status will be jeopardized.⁶² Although this understanding of the regulations "loosely links the exemption qualification question with the UBIT relatedness standard," it underscores the issues that double bottom

⁵² Cameron Holland, *Engaging in a Trade or Business as a 501(c)(3) Organization*, <http://cameronholland.com/engaging-in-a-trade-or-business-as-a-501c3-organization/> (last visited Nov. 8, 2013).

⁵³ Raed Elaydi, *Do Well and Do Good: How Social Entrepreneurship is Changing the World*, ROOSEVELT REV., Fall 2012, at 18, 19, available at http://www.roosevelt.edu/~media/Files/pdfs/RooseveltReview/RRFall2012_pdf.ashx

⁵⁴ See GENERATION WATER, *supra* note 21.

⁵⁵ I.R.C. § 513(a) (2012).

⁵⁶ Treas. Reg. § 1.513-1(d)(2) (1983).

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ Treas. Reg. § 1.513-1(d)(3) (1983).

⁶⁰ *Id.*

⁶¹ *Id.*

⁶² Otherwise, the exempt status is not affected but the gross income from this unrelated activity, i.e. that portion of the activities in excess of the needs of exempt functions, will be subject to the unrelated business income tax. See 26 U.S.C. § 511 (2012); 26 U.S.C. § 512 (2012); 26 U.S.C. § 513 (2012).

line entities face if they adopt a 501(c)(3) vehicle. Notably, they often conduct their business activity at a larger scale than reasonably needed for their exempt purpose as they aim at creating economic wealth along with social benefits.⁶³

Further, this area of tax law is particularly blurry and fact-specific. As a result, even if there is a strong argument that the business activity importantly contributes to the exempt purpose, the Internal Revenue Service often applies “an amorphous ‘all the facts and circumstances’ smell test that never even mentions the UBIT.”⁶⁴ Under the so-called “commerciality doctrine,”⁶⁵ the focus is on the nature of the activity, i.e. whether the business has a “commercial hue.”⁶⁶ As a result, although there is no bright line in this area, the stronger the business logic is in the conduct of the organization’s activity, the weaker the tax-exempt status gets.⁶⁷ In any case, because double bottom line entities equally, or co-primarily, aim at making profit and achieving social outcomes, they are more likely to fall outside of courts’ tolerance for business-like activities.⁶⁸

Another part of the operational test presents even greater challenges to social enterprises’ business model. The Treasury Regulation forbids the inurement of the organization’s earnings to insiders, i.e. persons having a personal and private interest in the activities of the organization.⁶⁹ The related private benefit doctrine, which was articulated in a landmark U.S. Tax Court opinion,⁷⁰ expressly states that the prohibition is not limited to these insiders. Thus, the private benefit rule prevents 501(c)(3)s from providing any substantial benefit to outsiders, who are labelled “disinterested persons”⁷¹ by the court. As a result, the inurement and private benefit doctrines, along with the dissolution constraints, effectively prevent section 501(c)(3) organizations from substantially benefiting private interests at any time.⁷² This “non-distribution constraint”⁷³ underscores the fact that tax-exempts have no owners, and thus their benefits must be reinvested in their public endeavors. This constraint is particularly harmful to social enterprises as it limits their access to capital. Indeed, section 501(c)(3) organizations cannot generate a return to venture capitalists, neither during the activity nor at the dissolution of the entity, and their

⁶³ See FISHMAN, *supra* note 32, at 572.

⁶⁴ *Id.*

⁶⁵ See Holland, *supra* note 53.

⁶⁶ *Better Bus. Bureau v. United States*, 326 U.S. 279, 283 (1945).

⁶⁷ For a summary of the factors the Courts and the Internal Revenue Service have considered for the application of this doctrine, see Holland, *supra* note 53.

⁶⁸ *Id.* (noting that “the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly educational purposes,” and hence because “an important if not the primary pursuit of petitioner’s organization is to promote not only an ethical but also a profitable business community,” “the exemption is therefore unavailable to petitioner.”)

⁶⁹ Treas. Reg. § 1.501(c)(3)-1(c)(2) (2008).

⁷⁰ *Am. Campaign Acad. v. Comm’r*, 92 T.C. 1053 (1989).

⁷¹ *Id.* at 1069 (“We use ‘disinterested’ to distinguish persons who are not private shareholders or individuals having a personal and private interest in the activities of the organization within the meaning of section 1.501(a)-1(c), Income Tax Regs.”).

⁷² While beyond the scope of this paper, it must be noted that the Internal Revenue Service and the Courts view inurement and private benefit doctrines are distinct ones, notably as to the consequences of disregarding them. See, e.g., *Am. Campaign Acad.*, 92 T.C. at 1068; *Canada v. Commissioner*, 82 T.C. 973, 981 (1984); *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202, 215 (1978); *Church of Ethereal Joy v. Commissioner*, 83 T.C. 20, 21 (1984); *Goldsboro Art League, Inc. v. Commissioner*, 75 T.C. 337, 345 n.10 (1980).

⁷³ The term originated with Henry Hansmann. See Henry B. Hansmann, *The Role of Nonprofit Enterprises*, 89 YALE L. J. 835 (1980).

funding is thus limited to donations, grants and self-generated incomes, along with traditional loans.

As a result, even in cases where the tax-exempt social enterprise is permitted to further a business-like activity under the operational test, the non-distribution constraint would prevent the entity from generating a financial return to its founders and investors. Thus, a genuine social enterprise will not adopt a tax-exempt vehicle since the dual bottom line implies not only financial profitability but also financial returns to investors.⁷⁴ While a tax-exempt vehicle could attract substantial charitable funding, it fails to address the diversity of interests represented in a social enterprise.

III THE SHAREHOLDER PRIMACY MYTH, A BARRIER TO CORPORATE SOCIAL ACTIVISM?

It is commonly taught that a director's duty is to prioritize the creation of shareholder wealth over other considerations. Part A explains that this duty does not merely stem from statutory provisions. Part B then briefly clarifies how directors' fiduciary duties catch the shareholder primacy doctrine.

A. The Overall Absence of Statutory Provisions

In 1962, Milton Friedman wrote that, in a free economy, "there is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."⁷⁵ Along with Smith, Friedman considers that corporations are ill equipped to address social issues, and thus instead of diversifying the interests they further they should specialize in the efficient maximization of profit. This specialization – corporations make profit whereas the government addresses social interests – would in turn maximize the overall welfare.⁷⁶ The merits of this theory need not be discussed here. Of greater relevance is whether the economic apprehension of corporations has resulted in a legal framework limiting their ability to further social purposes.

States' corporate statutory laws are mostly silent on this issue. For instance, section 102(a)(3) of Delaware General Corporation Law only requires that the purpose of the corporation be to engage in "any lawful act or activity."⁷⁷ Section 3.01 of the Model Business Corporation Act provides that corporations shall have the purpose of "engaging in any lawful business unless a more limited purpose is set forth in the articles of incorporation."⁷⁸ Thus, the broadly defined statutory purposes of corporations do not prevent them from engaging incidentally, or even primarily, in social activities that do not seek the maximization of profit. Interestingly enough, the American Law Institute (ALI's) Principles of Corporate Governance depart from state laws: Section 2.01 provides that "a corporation should have as its objective the conduct of business activities with a view to

⁷⁴ Other constraints limit the use of a 501(c)(3) vehicle for social enterprises, such as the interdiction of self-dealing or the prohibition of political activity. Some of these can be circumvented notably through the adoption of a 501(c)(4) nonprofit. However, a comprehensive study of these limitations is not necessary since this development on tax-exempt nonprofits only aims at underscoring that they suffer from an inflexible business model hardly compatible with the financial bottom line of social enterprises.

⁷⁵ MILTON FRIEDMAN, CAPITALISM AND FREEDOM 133 (1962).

⁷⁶ THOMAS DONALDSON, CORPORATIONS AND MORALITY 68-69 (1982).

⁷⁷ DEL. CODE ANN. tit. 8, § 102 (West 2013).

⁷⁸ MODEL BUS. CORP. ACT § 3.01 (2008).

enhancing corporate profit and shareholder gain.”⁷⁹ ALI’s Principles nonetheless admit exceptions to this profit-based conduct when the corporation either takes into account ethical considerations reasonably related to the responsible conduct of its business, or allocates a reasonable amount of its resources to listed social purposes.⁸⁰ Thus the ALI’s Principles only authorize corporations to depart from their profit maximization purpose incidentally. This is scarcely compatible with the double bottom line that social entrepreneurs seek since it only enables corporations to develop a corporate social responsibility practice.

However, although they undeniably are of doctrinal interests, these principles have no binding force. Thus, statutory corporate law, in and of itself, is not a sufficient source to require corporations to further exclusively or primarily wealth maximization. Rather, this theory seems to stem from the “legal principles of agency, property rights,⁸¹ and contract,⁸² all of which are intertwined in the corporate form.”⁸³

B. The Fiduciary Duty to Prioritize Shareholders’ Value

Indeed, the agency relationship between board members and shareholders⁸⁴ has been widely construed as directing the formers (the agents) to maximize the wealth of the latter (the principals.)

The foundation of this shareholder primacy theory is traditionally traced back to *Dodge v. Ford Motor Co.*⁸⁵ in which the Michigan Supreme Court ruled that “it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others.”⁸⁶ This stems from the premise that “a business corporation is organized and carried on primarily for the profit of the stockholders,” and “the powers of the directors are to be employed for that end.”⁸⁷ Hence the idea of a shareholder primacy model of corporate governance, in which directors’ actions must primarily aim at increasing shareholders’ profits.⁸⁸ Even though it is sometimes argued that *Dodge* is a “doctrinal oddity,”⁸⁹ it is more widely understood as “an accurate statement of the form, if not the substance, of the current law that describes the fundamental purpose of the

⁷⁹ AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE, § 2.01 (1994).

⁸⁰ *Id.*

⁸¹ See Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631, 635-36 (2009) (“Under [the property] theory, the corporation is seen as the property of the shareholders and the corporate managers, as the agents of the shareholders, are obliged to act to advance the latter’s financial interests.”).

⁸² See *id.* at 637 (Stating that under the contractarian theory, “profit maximization is the goal of the corporation because this is the expectation, or ‘bargained for right,’ under which shareholders have implicitly contracted with the corporation.”)

⁸³ John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 129 (2010).

⁸⁴ See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) (“The existence and exercise of directors’ power carries with it certain fundamental fiduciary obligations to the corporation and its shareholders.”), *overruled by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

⁸⁵ 204 Mich. 459 (1919).

⁸⁶ *Id.* at 684.

⁸⁷ *Id.*

⁸⁸ See, e.g., Edward B. Rock, *Corporate Law Through an Antitrust Lens*, 92 COLUM. L. REV. 497, 546 (1992).

⁸⁹ Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 166 (2008).

corporation.”⁹⁰ Under this view, any profit reinvested in the social endeavor conflicts with shareholders’ interest in increasing the financial return on their equity investment.⁹¹

It is not necessary, for the purpose of this paper, to precisely define the content of directors’ fiduciary duties. Corporations being creatures of states, the fiduciary duties of their directors vary depending on the location of their incorporation. Yet, a broad overview of how Delaware has implemented the shareholder primacy model is appropriate since this state is legal home for more than 50% of all publicly-traded companies in the United States, including 63% of the Fortune 500,⁹² and its case law is influential nationwide. The specific substance of directors’ fiduciary duties needs not be stated here. Of more interest is the Delaware Supreme Court’s focus on whether directors are entitled to further non-profit-maximising considerations. In this matter, Delaware Courts’ deference to directors’ judgement depends on the context of their decision.

Section 141(a) of Delaware General Corporation Law provides that “the business of every corporation organized under this chapter shall be managed by or under the supervision of a board of directors.”⁹³ Accordingly, in the day-to-day management of the business directors are entitled to the business judgement rule, pursuant to which Courts defer to their determination that the action taken was in the best interest of the company.⁹⁴ Thus, the rule is both a substantive standard of review and a procedural burden of proof. Under the former, “where the business judgment presumptions are applicable, the board’s decision will be upheld unless it cannot be attributed to any rational business purpose.”⁹⁵ Under the latter, the rule “places the burden on the party challenging the board’s decision to establish facts rebutting the presumption.”⁹⁶ Hence, in the day-to-day decision-making, the business judgement rule grants director great latitude to undertake social actions as courts defer to their determination that it furthers the overall interest of the corporation.⁹⁷ In some specific circumstances however, courts apply a higher standard of review requiring directors to establish a closer relationship between shareholders’ benefit and other constituencies’ interests.

First, when defensive measures are adopted in a takeover context, Delaware Courts have scrutinized directors’ decisions under the so-called heightened or reasonableness

⁹⁰ Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 VA. L. & BUS. REV. 177, 178 (2008).

⁹¹ See, e.g., *Doeringer*, *supra* note 18, at 304.

⁹² *About Agency*, DELAWARE.GOV, <http://corp.delaware.gov/aboutagency.shtml> (last visited Nov. 8, 2013).

⁹³ DEL. CODE ANN. tit. 8, § 141(a) (West 2013).

⁹⁴ See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (stating that the business judgment rule creates “a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”).

⁹⁵ *In re Walt Disney Co. Derivative Litig. v. Eisner*, 906 A.2d 27, 74 (Del. 2006) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); see also *Orman v. Cullman*, 794 A.2d 5, 20 (Del. Ch. 2002) (“The judgment of a properly functioning board will not be second-guessed and absent an abuse of discretion, that judgment will be respected by the courts.”).

⁹⁶ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995).

⁹⁷ See, e.g., Steven J. Haymore, *Public(ly Oriented) Companies: B Corporations and the Delaware Stakeholder Provision Dilemma*, 64 VAND. L. REV. 1311, 1327-28 (2011) (“In fact, directors can connect virtually every business decision to a rationally related benefit to the company, absent waste of corporate proceeds.”); Robert A. Ragazzo, *Unifying the Law of Hostile Takeovers: Bridging the Unocal/Revlon Gap*, 35 ARIZ. L. REV. 989, 1030 (1993) (“Modern law allows directors to consider the interests of nonshareholder constituencies as long as the impact on shareholders is not excessive.”).

scrutiny. Indeed, under Unocal⁹⁸ and its progeny,⁹⁹ to benefit from the business judgement rule directors must first prove that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed; and then that the defensive measures are reasonable in relation to the threat posed. On various occasions, courts ruled that directors might consider the interests of constituencies distinct from the shareholders when addressing a takeover threat, provided nonetheless that there was “some rationally related benefit accruing to stockholders”¹⁰⁰ or that so doing bore “some reasonable relation to general shareholder interest.”¹⁰¹ Therefore, despite a reduced leeway there is still room for social considerations under the heightened scrutiny.

It is in another context, namely the sale of the corporation, that the shareholder primacy theory truly applies. Under Revlon¹⁰² and its progeny, when a company is at auction¹⁰³ the directors’ only duty becomes to maximise shareholders’ value. In such a context, Revlon explicitly directed that “concern for non-stockholder interests is inappropriate.”¹⁰⁴ That is why in 2000 Ben & Jerry’s directors felt they had to accept Unilever’s bid, although it would undoubtedly jeopardize the corporation’s double bottom line.¹⁰⁵ Indeed, they accepted its offer while lesser bidders would have better continued Ben & Jerry’s social endeavours.¹⁰⁶

As a result, the duty to prioritize shareholders’ value over non-shareholders’ considerations is absolute only in the narrow situations in which Revlon is triggered. Thus, the acquisition setting aside, directors enjoy some leeway to undertake social actions, in Delaware¹⁰⁷ and elsewhere.¹⁰⁸ Further, the corporation entity is traditionally construed as

⁹⁸ Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

⁹⁹ See, e.g., Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003); Moran v. Household International, Inc., 500 A.2d 1346 (1985); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990).

¹⁰⁰ Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182-83 (Del. 1986).

¹⁰¹ Mills Acquisition Co v. MacMillan, Inc., 559 A.2d 1261, 1982 (Del. 1989).

¹⁰² Revlon, 506 A.2d at 173.

¹⁰³ The Court of Chancery recently summarized the triggering circumstances of Revlon: “[U]nder binding authority of our Supreme Court as set forth in QVC and its progeny, Revlon duties only apply when a corporation undertakes a transaction that results in the sale or change of control . . . A change of control ‘does not occur for purposes of Revlon where control of the corporation remains, post-merger, in a large, fluid market.’” *In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1048-49 (Del. Ch. 2012) (quoting *In re NYMEX S’holder Litig.*, No. 3621-VCN, 2009 Del. Ch. LEXIS 176, at *5 (Del. Ch. Sept. 30, 2009)).

¹⁰⁴ Revlon, 506 A.2d at 182.

¹⁰⁵ Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 VT. L. REV. 211, 212 (2010); see also Jill Bamburg, GETTING TO SCALE: GROWING YOUR BUSINESS WITHOUT SELLING OUT 57 (2006) (“Virtually every mission-driven entrepreneur knows the sad ending to the tale of Ben & Jerry’s: the forced sale of one of the country’s premier socially responsible businesses to a giant multinational clearly focused on the financial bottom line.”).

¹⁰⁶ Katherine R. Lofft et al., *Are Hybrids Really More Efficient?*, BUS. L. TODAY, Sept. 21, 2012, at 1.

¹⁰⁷ See, e.g., Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board’s Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 668 (2007) (“However, the existing framework of corporate governance law allows for social impact considerations. Under the laws of corporate governance, specifically the duty of care as protected by the business judgment rule, board decisions are protected.”).

¹⁰⁸ See, e.g., A. P. Smith Mfg. Co. v. Barlow, 97 A.2d 186, 190 (N.J. 1953) (“Corporate contributions to Princeton and institutions rendering the like public service are, if held within reasonable limitations, a matter of direct benefit to the giving corporations, and this without regard to the

a “contract-based form of business organization” in which the shareholder-primacy model is merely a default rule.¹⁰⁹ Consequently, shareholders could contract around directors’ duty to maximize profits through adequate charter provisions. However, they have shown little tendency to do so,¹¹⁰ certainly due to practical and tax barriers that add to the legal framework uncertainties.

IV BEING TRAPPED BETWEEN TWO WORLDS: THE CHALLENGE OF CAPITALIZING SOCIAL ENTERPRISES

Part A delineates the challenges that social enterprises encounter to raise funding on the market place. Part B subsequently describes the tax provisions that prevent for-profit social enterprises from receiving charitable contributions and grants. Part C finally underscores the issues they confront to attract the one foundation investment that is available to them, namely the program-related investment.

A. Raising Capital from the For-Profit Sector: Identifying the Practical Barriers

In the traditional binary legal framework, it is difficult for double bottom line for-profits to efficiently brand their social commitment. While each social enterprise can individually signal itself as such, there is a lack of, and hence a need for, a unified and identifiable marketable brand.¹¹¹ Indeed, branding and positioning social enterprises on the market place has long been identified as the key to raising capital and building customer loyalty.¹¹² Social enterprises are frequently confused with corporate philanthropy or corporate social responsibility models, in which social endeavors are merely incidental to the financial bottom line, and often serve marketing purposes as well.¹¹³ Thus, by telling the difference between “a good company and just good marketing,”¹¹⁴ a recognizable brand could attract consumers and investors equally interested in social and financial returns.

Screening double bottom line for-profits is the key to attracting Sustainable and Responsible Investments. Sustainable and Responsible Investing (SRI)¹¹⁵ considers both the investor’s financial needs and an investment’s impact on society so as to build wealth in underserved communities or a more sustainable world while earning competitive

extent or sweep of the donors’ business. The benefits derived from such contributions are nationwide and promote the welfare of everyone anywhere in the land.”)

¹⁰⁹ See Macey, *supra* note 92, at 179.

¹¹⁰ *Id.*

¹¹¹ See, e.g., Michael D. Gottesman, *From Cobblestones to Pavement: the Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL’Y REV. 345, 351 (2007).

¹¹² See, e.g., Jason Mogus, *It’s All About Them: Branding and Positioning your Social Enterprise to Build Customer Loyalty*, Presentation at the 2007 Canadian Social Enterprise Conference (Jan. 29, 2007), available at <http://www.socialenterprisecanada.ca/en/learn/nav/resourcelibrary.html?page=resourceDetail.tpt&iddoc=321058>.

¹¹³ See Kelley, *supra* note 9, at 362.

¹¹⁴ *Frequently Asked Questions*, B CORPS FOR NON-PROFITS, <http://www.bcorpsfornonprofits.com/faq> (last visited Nov. 8, 2013).

¹¹⁵ SRI is also referred to as mission investing, responsible investing, double or triple bottom line investing, ethical investing, sustainable investing, or green investing. See, e.g., *Sustainable and Socially Responsible Investing*, BLUE SUMMIT WEALTH MANAGEMENT, <http://www.bluesummitwealth.com/investing/> (last visited Nov. 8, 2013).

returns.¹¹⁶ SRI mutual funds have significantly grown over 20 years¹¹⁷ and they now use a wide spectrum of investment products, “from stocks and bonds, to savings, checking and other banking accounts, to venture capital.”¹¹⁸ As a result, although social entrepreneurs are confident in the development of this source of funding, they emphasize the need for a distinctive brand for the fourth sector to be adequately screened by SRI funds.¹¹⁹ Attracting alternative capital is further desirable as social enterprises face practical difficulties to attract funds commonly available to for-profits at their start-up and expansion stages. Traditional investors have returns on investment objectives to meet regardless of whether the business achieves – incidentally or primarily – social welfare missions;¹²⁰ whereas social enterprises need what is sometimes called “patient capital,” which aims at “slow but steady growth.”¹²¹ Hence, their difficulties to commit to market-rate returns undermines their access to traditional investors.

A second practical barrier, once the capital is raised, pertains to the “challenge of locking assets into the social enterprise stream.”¹²² Social entrepreneurs aim at ensuring that the capital they raised remains dedicated to the social endeavours. However, the pressure of the market could incentivize managers to focus more on financial returns than on the social accomplishments in the actual running of the business. Further, the Ben & Jerry case is an accurate example of the threat that a change in ownership poses to the social bottom line. No law prevents the new controlling entity from allocating the corporation’s capital primarily or exclusively to profit maximization.¹²³ Thus, as a matter of credibility as well as to incentivise SRI investments, social entrepreneurship would benefit from the development of asset lock mechanisms.

B. Benefitting from Charitable Contributions and Grants: The Tax Barriers

Federal tax law also operates as a barrier to social accomplishments by for-profits as it denies them access to financial resources available to tax-exempt nonprofits. First, individual and corporate donations and gifts are only deductible when made to 501(c)(3) nonprofits.¹²⁴ As a result, for-profits do not receive charitable contributions, although their social bottom line triggers some sympathy in the general public. Further, for-profits hardly obtain funding from private foundations.

Broadly defined, a foundation is “a fund of private wealth established for charitable purposes, often in perpetuity.”¹²⁵ Foundations are usually construed as grant-making institutions, as opposed to public charities that actually operate a charitable program.¹²⁶ In

¹¹⁶ *SRI Basics*, US SIF, <http://www.ussif.org/sribasics> (last visited Nov. 8, 2013).

¹¹⁷ *Id.* (“As of 2012, there were 333 mutual fund products in the US that consider environmental, social, or corporate governance (ESG) criteria, with assets of \$640.5 billion. By contrast, there were just 55 SRI funds in 1995 with \$12 billion in assets.”)

¹¹⁸ *Performance and SRI Investments*, US SIF, <http://ussif.org/resources/performance.cfm> (last visited Nov. 8, 2013).

¹¹⁹ See Kelley, *supra* note 9, at 359.

¹²⁰ Victor Fleischer, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 94 (2007) (“The greater challenge facing urban entrepreneurs is convincing investors that they will receive a sufficient return on their investment.”).

¹²¹ See Kelley, *supra* note 9, at 354.

¹²² *Id.* at 359.

¹²³ See, e.g., Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective*, <http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf> (last visited Oct. 27, 2013) (underscoring that “[a] change in ownership or control – or a drop in earnings – can bring everything down.”).

¹²⁴ See *supra* Part II.B.

¹²⁵ See FISHMAN, *supra* note 32, at 703.

¹²⁶ *Id.*

many ways, due to Congressional defiance over foundations,¹²⁷ their federal tax treatment is less favorable than the federal tax treatment of public charities. Indeed, a variety of excise taxes and penalties limits their ability to engage in activities such as self-dealing,¹²⁸ excess ownership in a business enterprise,¹²⁹ jeopardy investments¹³⁰ or expenditures for non-charitable purposes.¹³¹

The minimum distribution requirement is here of particular interest. Pursuant to section 4942 of the Internal Revenue Code, private foundations must make a certain amount of qualifying distributions each year, and failure to do so triggers a burdensome excise tax. These qualifying distributions are essentially charitable contributions, as defined in section 170(c)(2)(B) of the Internal Revenue Code; hence contribution to for-profit social enterprises would not be included in the foundation-qualified distributions. Further, section 4945 lists a number of expenditures that are subject to heavy tax penalties due to their inconsistency with the foundation public interest purpose. Prohibited expenditures notably include grants to any organization that is not a public charity or an operating private foundation unless the private foundation exercises expenditures responsibility to ensure that the grant is used only for charitable purposes.¹³² Therefore, for-profits are virtually excluded from foundations' grant-making programs.

Hence foundations, under the federal tax framework, are more likely to contribute to for-profits through traditional investment from their endowment funds. Their leeway is however limited by a burdensome tax on investments that jeopardize their exempt purpose.¹³³ According to the treasury regulation, the jeopardy rule is triggered when the "foundation managers . . . have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."¹³⁴ The regulation further indicates how the standard of care and prudence must be construed¹³⁵ and how to determine whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes.¹³⁶ As a result, risk-averse foundations will not invest in social enterprises at their early or expansion stages, as the risk of such investment might trigger the jeopardy rule. They would rather invest in traditional widely

¹²⁷ *Id.*

¹²⁸ I.R.C. § 4941 (2012).

¹²⁹ I.R.C. § 4943 (2012).

¹³⁰ I.R.C. § 4944 (2012).

¹³¹ I.R.C. § 4945 (2012).

¹³² I.R.C. § 4945(d)(4) (2012).

¹³³ I.R.C. § 4944 (2012). This tax is equal to 10 percent of the amount so invested for each year in the taxable period, and a penalty is also imposed on any foundation manager that knowingly participated in the jeopardy investment. Additional taxes can be triggered as well if the foundation does not take remedial measures. *Id.*

¹³⁴ Treas. Reg. § 53.4944-1(a)(2) (1973).

¹³⁵ *Id.* ("In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return).")

¹³⁶ *Id.* ("The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole. No category of investments shall be treated as a per se violation of section 4944.")

held corporations, which although not particularly committed to public welfare offer a secure return on investment.

The treasury regulation clearly illustrates this point in the example (1), which provides:

A is a foundation manager of B, a private foundation with assets of \$100,000. A approves the following three investments by B after taking into account with respect to each of them B's portfolio as a whole: (1) An investment of \$5,000 in the common stock of corporation X; (2) an investment of \$10,000 in the common stock of corporation Y; and (3) an investment of \$8,000 in the common stock of corporation Z. Corporation X has been in business a considerable time, its record of earnings is good and there is no reason to anticipate a diminution of its earnings. Corporation Y has a promising product, has had earnings in some years and substantial losses in others, has never paid a dividend, and is widely reported in investment advisory services as seriously undercapitalized. Corporation Z has been in business a short period of time and manufactures a product that is new, is not sold by others, and must compete with a well-established alternative product that serves the same purpose. Z's stock is classified as a high-risk investment by most investment advisory services with the possibility of substantial long-term appreciation but with little prospect of a current return. A has studied the records of the three corporations and knows the foregoing facts. In each case the price per share of common stock purchased by B is favorable to B. Under the standards of paragraph (a)(2)(i) of this section, the investment of \$10,000 in the common stock of Y and the investment of \$8,000 in the common stock of Z may be classified as jeopardizing investments, while the investment of \$5,000 in the common stock of X will not be so classified. B would then be liable for an initial tax of \$500 (i.e., 5 percent of \$10,000) for each year (or part thereof) in the taxable period for the investment in Y, and an initial tax of \$400 (i.e., 5 percent of \$8,000) for each year (or part thereof) in the taxable period for the investment in Z. Further, since A had actual knowledge that the investments in the common stock of Y and Z were jeopardizing investments, A would then be liable for the same amount of initial taxes as B.¹³⁷

In this example, Z's case is particularly relevant as many social enterprises at their early stage offer promising but risky investments. Even though Example (2)¹³⁸ provides some guidance for such investments to be ruled out of the jeopardy rule, the guarantees¹³⁹ it requires to this end are often difficult to meet for start-ups. The federal tax rules hence "support a bizarre paradox for private foundations: a foundation can give its money away to an organization supporting the foundation's mission, but if it makes a risky but 'promising' investment in support of its mission, the foundation faces the threat of penalty

¹³⁷ Treas. Reg. § 53.4944-1(c) (1973).

¹³⁸ *Id.*

¹³⁹ *Id.*, indicating that Z's management must have demonstrated capacity for getting new businesses started successfully and Z must have received substantial orders for its new product.

taxes.”¹⁴⁰ This is because the jeopardy rule is generally indifferent to the purpose of the entities in which the foundation invests. Thus, only social enterprises that have reached, if not profitability, at least a high level of certainty that they will be profitable, can access funding from foundation.

C. Attracting Foundation Dollars: The Program-Related Investment Experiment

The jeopardy rule contains an interesting exception for program-related investments (PRIs),¹⁴¹ which are somewhere in-between foundation grants and traditional investments. The regulation provides three criteria for an investment to qualify as a PRI.¹⁴² The primary purpose of the investment must be to accomplish a charitable purpose,¹⁴³ the production of income or the appreciation of property must not be a significant purpose,¹⁴⁴ and the investment cannot further any political or lobbying purpose at all.¹⁴⁵

The regulation then provides that the investment is made primarily to accomplish a charitable purpose if it significantly furthers the accomplishment of the private foundation's exempt activities and it would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.¹⁴⁶ In addition, it is specified that whether the organization is a 501(c)(3) entity is irrelevant; thus a for-profit social enterprise carrying out a charitable purpose could be the recipient of a PRI.¹⁴⁷ Besides, the regulation indicates that although “whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation”¹⁴⁸ is relevant to determine if a significant purpose of the investment is the production of income or the appreciation of property, a substantial return on investment shall not be conclusive evidence of such significant purpose absent other factors.¹⁴⁹ As a result, private foundations can escape the jeopardy rule through risky program-related investments in the charitable bottom line of social enterprises. Indeed, the regulation examples (1) to (6)¹⁵⁰ describe some of the various means granted private foundations under the PRI exception to invest in business entities, from making a loan to purchasing stock.

An investment only needs to comply with the above-mentioned requirement to qualify under the PRI exception. Then, once it has been determined that an investment is “program-related,” it shall not cease to qualify as such as long as changes in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property.¹⁵¹ Notably, changes made to protect the foundation’s investment do not ordinarily affect the PRI

¹⁴⁰ Cass Brewer, *Repeal IR § 4944 to Encourage Investment in Social Enterprise*, SOCENT LAW (Feb. 25, 2013), <http://socentlaw.com/2013/02/repeal-irc-%C2%A7-4944-to-encourage-investment-in-social-enterprise/>.

¹⁴¹ I.R.C. § 4944(c) (2012).

¹⁴² Treas. Reg. § 53.4944-3(a)(1) (1972).

¹⁴³ Treas. Reg. § 53.4944-3(a)(1)(i) (1972).

¹⁴⁴ Treas. Reg. § 53.4944-3(a)(1)(ii) (1972).

¹⁴⁵ Treas. Reg. § 53.4944-3(a)(1)(iii) (1972).

¹⁴⁶ Treas. Reg. § 53.4944-3(a)(2)(i) (1972).

¹⁴⁷ *Id.*

¹⁴⁸ Treas. Reg. § 53.4944-3(a)(2)(iii) (1972).

¹⁴⁹ *Id.*

¹⁵⁰ Treas. Reg. § 53.4944-3(b) (1972).

¹⁵¹ Treas. Reg. § 53.4944-3(a)(3)(i) (1972).

qualification.¹⁵² However, despite the illusive simplicity of this test, private foundations tend to seek a preliminary determination from an Internal Revenue Service private letter ruling that a given investment qualifies as a PRI.¹⁵³ Indeed, an investment that does not qualify as such would trigger the heavy tax of the jeopardy rule, and because previous private letter rulings have no precedential value, risk-averse foundations usually seek a discrete Service's approval, although it is not required, before initiating a program-related investment.¹⁵⁴

The use of PRIs further triggers the foundation's duty to exercise expenditures' responsibility with respect to the investment¹⁵⁵ in order for it not to be considered as taxable expenditure. The expenditures' responsibility implies that the foundation must exert all reasonable efforts and establish adequate procedures to see that the grant is spent solely for the purpose for which it was made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary.¹⁵⁶ The regulations first provide that "a private foundation is not an insurer of the activity of the organization to which it makes a grant"¹⁵⁷ and will thus be considered as exercising "expenditure responsibility" under section 4945(h) as long as it exerts all reasonable efforts and establishes adequate procedures to comply with its requirements. However, the regulation then goes on with a number of requirements and specifies various duties that apply to foundations with regard to the making of PRIs.¹⁵⁸ They can be clearly outlined in 3 steps:

The first step is the preinvestment inquiry into the organization that will potentially receive the PRI. If after following the regulation guidelines the foundation believes the reasonableness standard for the inquiry has been met, the foundation must establish and follow a procedure with the recipient organization to ensure that the PRI is used for the proper purposes. Finally, the foundation must submit complete and accurate reports to the IRS about the status of the PRI in accordance with the Regulations.¹⁵⁹

The making of a PRI thus represents a heavy administrative burden for private foundations. They have to design a two-tier reporting system, between the recipient organization and the foundation, and between the foundation and the Internal Revenue Service. Besides, as was said above, foundations usually seek a private letter ruling before making a PRI. Thus, PRIs generate significant transactional, legal, administrative and

¹⁵² *Id.*

¹⁵³ James P. Joseph & Andras Kosaras, *New Strategies for Leveraging Foundation Assets*, TAX'N OF EXEMPTS, July/Aug. 2008, at 24 (emphasizing that "If an investment meets the requirements, it can qualify as a PRI. IRS approval is not required but foundations considering more complex PRIs may find it prudent—despite the time and costs involved—to seek approval from the IRS, given the lack of precedential guidance on PRIs.").

¹⁵⁴ *Id.* at 24, n.16 (underscoring that "Much of the 'law' on PRIs comes from private letter rulings that offer some insights into how the Service may treat a particular investment. However, letter rulings can be relied on only by the taxpayer requesting the ruling and have no precedential authority.")

¹⁵⁵ I.R.C. § 4945(d)(4) (2012).

¹⁵⁶ I.R.C. § 4945(h) (2012).

¹⁵⁷ Treas. Reg. § 53.4945-5(b)(1) (1973).

¹⁵⁸ Treas. Reg. § 53.4945-5(b)(4) (1973).

¹⁵⁹ Christopher C. Archer, *Private Benefit for the Public Good: Promoting Foundation Investment in the "Fourth Sector" to Provide More Efficient and Effective Social Missions*, 84 TEMP. L. REV. 159, 168 (2011).

monitoring costs, and therefore are not widely used,¹⁶⁰ with the result that most for-profit social enterprises hardly benefit from private foundation funding.

V NEW DESIGNS FOR OLD TOOLS: WHY THE EARLY LEGAL AND STRUCTURAL INNOVATIONS WERE NOT ENOUGH

This part first develops the early adaptation of the legal framework in an attempt to account for stakeholder interests. It then goes on with a description of tandem entities, which amount to a practical combination of the tax-exempt and the for-profit worlds.

A. Constituency Statutes: an Inconclusive Effort to Protect Stakeholder Interests

In the flourishing takeover context of the 1980s,¹⁶¹ and with the development of the Unocal and Revlon doctrines in the nationally influential Delaware case law, public corporations started lobbying for statutory authorisation to consider stakeholder interests.¹⁶² In the wake of a 1983 Pennsylvania Statute, a number of states adopted statutes elucidating the application of the business judgement rule when stakeholder considerations conflicted with shareholder interests. These statutes are usually referred to as “corporate constituency statutes,” “nonshareholder constituency statutes,” or “stakeholder statutes,” and a majority of the states have adopted them as of today.¹⁶³ These statutes all have in common that the consideration of stakeholder interests is permissible but not mandatory,¹⁶⁴ although an earlier version of the Connecticut statute provided for the compulsory consideration of various stakeholder interests.¹⁶⁵ The Connecticut unique provision was repealed, and the new version now provides that directors may consider, in determining what they reasonably believe to be in the best interests of the corporation, the interests of the corporation's employees, customers, creditors and suppliers, as well as community and societal considerations.¹⁶⁶

The Pennsylvania Statute is another great example of this permissive aspect. It provides:

[I]n discharging the duties of their respective positions, the board of directors, committees of the board and individual directors of a domestic corporation may, in assessing the best interests of the corporation, consider the effects of any action upon employees, upon suppliers and customers of the corporation and upon communities in which offices or other establishments of the corporation are located, and all other pertinent factors. The consideration of those factors shall not constitute a violation of section 512 (relating to standard of care and justifiable reliance).¹⁶⁷

As a result, whether nonshareholder interests ought to be considered and to what extent remains in directors' discretion. Although it gives them enough flexibility to engage in corporate social responsibility actions, and it is useful to this end, it fails to answer the

¹⁶⁰ See, e.g., Gottesman, *supra* note 113, at 350; Heather Sertial, *Hybrid Entities: Distributing Profits with a Purpose*, 17 *FORDHAM J. CORP. & FIN. L.* 261, 267 (2012).

¹⁶¹ Anthony Bisconti, *The Double Bottom Line: Can Constituency Statutes Protect Socially Responsible Corporations Stuck in Revlon Land?*, 42 *LOY. L.A. L. REV.* 765, 780-81 (2009).

¹⁶² Douglas M. Branson, *Corporate Governance "Reform" and the New Corporate Social Responsibility*, 62 *U. PITT. L. REV.* 605, 636 (2001).

¹⁶³ Bisconti, *supra* note 163, at 768.

¹⁶⁴ Branson, *supra* note 164, at 636.

¹⁶⁵ See *CONN. GEN. STAT. ANN.* § 33-313(e) (1994) (repealed 1997).

¹⁶⁶ *CONN. GEN. STAT. ANN.* § 33-756 (1997).

¹⁶⁷ 15 *PA. CONS. STAT. ANN.* § 516 (2013).

branding, capitalizing and lock asset concerns previously identified. Indeed, these statutes are better construed as tools protecting directors when they consider stakeholder interests: they merely allow such considerations, in contexts that vary greatly from state to state depending on the scope of each statute. Accordingly, these provisions do not vest any additional rights in shareholders or stakeholders, and their impact has been somewhat innocuous in the case law.¹⁶⁸ Most notably, the New York constituency provision expressly provides that it does not create any additional duties for directors.¹⁶⁹ Indeed, constituency statutes neither require directors to prioritize stakeholder interests over those of shareholders, nor provide for enforcement or standing devices to compel directors to consider such interests.¹⁷⁰ Consequently, they are insufficient to preserve the social bottom line of the fourth sector: a compulsory requirement that directors consider stakeholder interests must be sought elsewhere.

B. Tandem Entities, An Attempt to Combine the Two Worlds

Social entrepreneurs have long tried to combine the flexibility of for-profits with the funding opportunities of tax-exempt nonprofits. Indeed, some entrepreneurs – or more accurately their lawyers – have questioned the soundness of having to choose between these two worlds.¹⁷¹ Instead, they argue, social entrepreneurs could form both a charitable nonprofit and a for-profit: the former would host the social bottom line while the latter would carry out the business.¹⁷² These dual entities, often referred to as “tandem structures”¹⁷³ or “cross-sector partnerships,”¹⁷⁴ would allow the social business to enjoy the branding feature and charitable contributions and grants available to the 501(c)(3)s while conducting the business in a flexible entity.

Two main models of tandems have been identified: the “nonprofit parent model,” in which the for-profit is owned and managed by the nonprofit,¹⁷⁵ and the “social business mutual benefit model,” in which the for-profit manages the tax-exempt.¹⁷⁶ However, both of these structures are cumbersome and require comprehensive legal and tax expertise, as well as extensive administrative monitoring, to ensure that the tax-exempt status is not jeopardized.¹⁷⁷ Further, it must be noted at the outset that the situation here contemplated is different from a mere joint venture between a tax-exempt and a for-profit, in which the tax-exempt usually pre-exists the joint venture and serves a broader charitable purpose. In these ordinary joint ventures, the very concern of the Internal Revenue Service and of courts is that the business shall not become the primary activity of the nonprofit.¹⁷⁸

¹⁶⁸ See Bisconti, *supra* note 163, at 790 (“Courts seem to be interpreting constituency statutes to essentially add nothing to the existing law.”).

¹⁶⁹ N.Y. BUS. CORP. LAW § 717(b) (McKinney 2013).

¹⁷⁰ See Tyler, *supra* note 84, at 135.

¹⁷¹ Ingrid Mittermaier et al., *Operating In Two Worlds: Tandem Structures in Social Enterprise*, 26 No. 1 PRAC. TAX LAW. 5, 6 (2011).

¹⁷² *Id.*

¹⁷³ See, e.g., *id.*

¹⁷⁴ See, e.g., Ashley Schoenjahn, *New Faces of Corporate Responsibility: Will New Entity Forms Allow Businesses to Do Good?*, 37 J. CORP. L. 453, 459 (2012).

¹⁷⁵ Gautam Jagannath, *Using Nonprofits to Serve Charitable Goals of Social Businesses in the United States: Circumventing the Lack of Recognition of the Social Business Model in the Federal Tax Code*, 32 PACE L. REV. 239, 256 (2012).

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at 257.

¹⁷⁸ *Id.* at 253.

In the case of a tandem social enterprise, there is a strong relation between the business and the charitable purpose. The business is not merely ancillary to the charitable mission, as a pharmacy would be to a hospital. Further, founders and investors aim at retaining control over the venture as well as at getting some financial return while achieving social goals.¹⁷⁹ Although these two aspects are profoundly intertwined in a social enterprise, a tandem structure requires maintaining distinct entities.¹⁸⁰ From a governance standpoint, the two entities must conduct their affairs separately, hold distinct board meetings, and maintain legal walls between each other to protect their respective liabilities.¹⁸¹ In addition, it is necessary to avoid a total overlap on boards' composition of the two entities.¹⁸² It is required that the tax-exempt be turned primarily on charitable purposes, therefore disinterested directors are arguably needed to approve the conflicting interests transactions between the two entities.¹⁸³

In a significant private letter ruling,¹⁸⁴ the Internal Revenue Service required that the tax-exempt parent demonstrate that the subsidiary had a substantial business purpose and a separate corporate existence from its parent, and gave some guidelines to this end. As a result, the IRS and the courts have particularly scrutinized tax-exempts that provide a market for a corporate business controlled by their officers.¹⁸⁵ The Service notably requires that the for-profit subsidiary have an independent board from the tax-exempt parent and that the key officers of both companies be different.¹⁸⁶ These constraints stem from the private benefit and inurement doctrines,¹⁸⁷ which prohibit the tax-exempt entity from being dedicated to benefiting the for-profit and its investors. Tandem entities therefore do not offer social entrepreneurs a governance structure flexible enough to accommodate their peculiar needs. The burden of creating two organizations, and of losing control over one of them or otherwise risking substantial tax liability, usually greatly exceeds the advantages that the combination of the two entities represents.¹⁸⁸ The tandem structure further fails to address the branding problem that social enterprises face: the two types of investments – traditional capital on the one hand, and charitable contributions and grants on the other hand – are kept into separate entities that “present different faces to different sectors of society.”¹⁸⁹ Thus, the two entities loosely appear as an innovative social enterprise as a whole and are hardly marketable as such.

Eventually, the for-profit enterprise has an existence of its own, and this can lead to difficulties when it is intended to subsidize the tax-exempt nonprofit entity. First, a donation exceeding ten percent of the corporation's taxable income is taxed at the corporate income tax rate.¹⁹⁰ Thus, independent directors are less likely to donate amounts that would not be deductible and that, further, might engage their fiduciary duties for waste of corporate assets. The Delaware General Corporation Law expressly authorizes directors

¹⁷⁹ See, e.g., Schoejahn, *supra* note 176.

¹⁸⁰ See Mittermaier et al., *supra* note 173.

¹⁸¹ See *id.* at 8–10.

¹⁸² *Id.*

¹⁸³ See *id.* at 8.

¹⁸⁴ I.R.S. Priv. Ltr. Rul. 9542045 (July 28, 1995).

¹⁸⁵ See, e.g., *Church by Mail, Inc. v. Commissioner*, 765 F.2d 1387 (9th Cir. 1985); I.R.S. Priv. Ltr. Rul. 201044016 (2010).

¹⁸⁶ See, e.g., I.R.S. Priv. Ltr. Rul. 9542045 (July 28, 1995).

¹⁸⁷ See *supra* –Part II.C.

¹⁸⁸ See Kelley, *supra* note 9, at 365.

¹⁸⁹ See Kelley, *supra* note 9, at 366.

¹⁹⁰ I.R.C. § 170 (2012).

to engage in charitable donations.¹⁹¹ Yet, even though there is no formal requirement that the donation be limited in size, courts have only upheld “reasonable” donations.¹⁹² Further the Delaware Supreme Court ruled that in examining the merits of a claim alleging corporate waste, “the provisions of the Internal Revenue Code pertaining to charitable gifts by corporations furnish a helpful guide” to assess the reasonableness of the donation.¹⁹³ As a result, “it appears that in most situations, for-profit public corporations donating more than 10% of their profits to a nonprofit would be opening up themselves to liability from a derivative suit, essentially foreclosing this scheme as a viable option for social enterprises.”¹⁹⁴

Although only some of the constraints weighing on tandem entities are outlined in this part, they underscore that this structure is contrary to the convergence of business and charitable missions that social entrepreneurship embodies. This is so notably because the extensive non-distribution constraint and the related private benefit doctrine limit the possibility for a social entrepreneur to be the leader of both the business entity and its charitable counterpart. Further, the uncertainty is great in this area as the Internal Revenue Service proceeds with a case-by-case analysis instead of establishing a bright line rule, usually basing its decision loosely on “all the facts and circumstances.”¹⁹⁵ Hence, circumventing these constraints demands expertise and formalism that are scarcely consistent with the business-like flexibility that social entrepreneurs seek to introduce in the charitable world.

VI COMBINING THE TWO SECTORS IN HYBRID VEHICLES

The previous parts have outlined why the tension between for-profits and nonprofits to host social enterprises has turned in favor of the for-profits. Central in this conflict was the flexibility that social entrepreneurs need to conduct their business. However, some issues remain at least partially unaddressed by for-profit vehicles, namely the branding, funding and governance challenges. Various legislators thus attempted to answer the expectations of responsible entrepreneurs who, especially in the wake of the 2008 financial crisis, were seeking to “re-buff the notion of ‘corporate greed’ by diversifying their revenue streams and/or balancing their profitmaking with socially responsible motives.”¹⁹⁶ Accordingly, a number of States enacted legislation that incentivized for-profits to consider social interests, without the heavy constraints of the tax-exempt sector, through hybrid vehicles. Two main vehicles have been created thus far: the Benefit Corporation (Part A), and the L3C (Part B).

A. The Benefit Corporation, An Initiative Toward Responsible Businesses

1. *The General Public Benefit: A Purpose Broadly Construed*

At the outset of this subpart, the Benefit Corporation must be distinguished from the Certified B Corporation – also called B Corp. While the former is a legal form, the latter is a label granted by B Lab, a 501(c)(3) nonprofit devoted to serving “a global movement of entrepreneurs using the power of business to solve social and environmental

¹⁹¹ DEL. CODE ANN. tit. 8, § 122(9) (2013).

¹⁹² *E.g.*, *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969).

¹⁹³ *Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991).

¹⁹⁴ *See Doeringer*, *supra* note 18, at 304–05.

¹⁹⁵ *See Archer*, *supra* note 161, at 185.

¹⁹⁶ *See Lofft et al.*, *supra* note 108.

problems.”¹⁹⁷ The B Corp label guarantees that the certified entity meets a high standard of overall social and environmental performance, along with transparency and accountability constraints.¹⁹⁸ Once they are labelled as B Corps, these entities gain access to a portfolio of services and support from B Lab.¹⁹⁹ Thus, Benefit Corporations are not necessarily certified as B Corp, and entities need not be organized as Benefit Corporations to get certified. Consequently, whereas B Lab’s initiative provides a solution to the branding issue and an easier access to funding, the certification does not in and of itself vest any rights or standing in shareholders or stakeholders whose social expectations are deceived.

Maryland was the first state to pass a Benefit Corporation Statute in April 2010.²⁰⁰ Since then, eleven other states have enacted similar statutes, and fifteen more have introduced such legislation.²⁰¹ Because Maryland’s initiative inspired its sister states, its statute is particularly relevant to understand how legislators tried to deal with the social enterprise innovation and why they fell short of adequately addressing its challenges.

Maryland’s Benefit Corporation statute, as well as its counterparts, broadly aims at ensuring that Benefit Corporations are socially valuable through three means.

First, it requires that the Benefit Corporation further “the purpose of creating a general public benefit”²⁰² and specifies this general purpose in its charter,²⁰³ possibly along with one or more specific benefits.²⁰⁴ However, the notion of “general public benefit” is defined loosely as “a material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote a combination of specific public benefits.”²⁰⁵ These specific benefits are then largely construed²⁰⁶ and could be as broad as “providing individuals or communities with beneficial products or services” or “increasing the flow of capital to entities with a public benefit purpose.” As a result, a food company that would engage in a significant donation program to charities along with providing food packages to the poor could qualify as a Benefit Corporation under this first criterion although its primary activity would be focused on profit maximization. Hence, while the Benefit Corporation can be an appropriate vehicle for a social enterprise, its wide definition is better construed as aimed to host all kinds of responsible businesses. Indeed, the Benefit Corporation allows the creation of double bottom line enterprises but does not require it: while a general public benefit purpose must exist, it does not have to be equal to the profitmaking purpose.²⁰⁷ Therefore, a Benefit Corporation can be turned primarily, although not exclusively, to profit maximization. Further, a general public purpose, such as donating to charities, is distinct from a social mission accomplished through a business

¹⁹⁷ The Non-Profit Behind B Corps., <http://www.bcorporation.net/what-are-b-corps/the-non-profit-behind-b-corps> (last visited Nov. 8, 2013).

¹⁹⁸ *Id.*

¹⁹⁹ *Id.*

²⁰⁰ Anne Field, *First-Ever Study of Maryland Benefit Corps Released*, FORBES.COM (Jan. 25, 2013, 12:25 PM), <http://www.forbes.com/sites/annefield/2013/01/25/first-ever-study-of-maryland-benefit-corps-released/>.

²⁰¹ BENEFIT CORP INFORMATION CENTER, *State by State Legislative Status*, <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Nov. 8, 2013).

²⁰² MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-06(a)(1) (West 2013).

²⁰³ *Id.*

²⁰⁴ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-06(a)(2) (West 2013).

²⁰⁵ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-01(c) (West 2013)

²⁰⁶ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-01(d) (West 2013)

²⁰⁷ BENEFIT CORP INFORMATION CENTER, *What are the Requirements?*, <http://benefitcorp.net/for-business/what-are-the-requirements> (last visited Nov. 8, 2013).

activity. While a social mission would undoubtedly be a general public purpose, the latter is a broader notion than the former. In other terms, the Benefit Corporation fails to “distinguish between a business that chooses to be generally responsible and a business that binds itself to a specific social mission.”²⁰⁸ The second and third means then aim at ensuring that the Benefit Corporation is actually meeting the public benefit requirement.

2. *Enforcing the Public Purpose, An Uncertain Balance Between Adverse Considerations*

As a second means to ensure the beneficial externalities of the corporation, the statute creates an affirmative duty for directors to consider stakeholder interests in their decision-making. Community, societal and environmental considerations are expressly included in this constraint.²⁰⁹ Thus, the statute expands the traditional fiduciary duties to command that directors in their decision-making, in any context,²¹⁰ consider non-financial interests.²¹¹ Directors are hence shielded from liability when they further such interests²¹² even though their decisions are contrary to mere profit maximization objectives. Conversely, directors’ failure to comply with these extended fiduciary duties could trigger their liability. The main question is thus: who is to enforce these provisions? The statute does not go so far as to create a third party right of action. To the contrary, it expressly denies it.²¹³ Hence, only shareholders and directors have a right of action, either for “violation of or failure to pursue or create general or specific public benefit”; or for violation of the director’s extended standard of conduct.²¹⁴

However, courts have yet to decide to what extent directors can privilege general or specific public benefits over profitmaking. Indeed, the statute indicates that directors must consider such benefits in determining what they “reasonably believe[] to be in the best interests of the benefit corporation.”²¹⁵ Thus, the board’s main duty remains to act in the overall best interest of the corporation; hence the question of whether their liability is triggered by a decision that, despite furthering a general or public benefit, greatly undermines the profitability of the corporation. However, whatever the answer is, directors are statutorily immune from liability when they reasonably perform these extended duties.²¹⁶ As this “reasonable performance” standard also remains to be interpreted by the courts, the threshold of public benefit or shareholder profit underperformance that would trigger directors’ liability is unclear. Nonetheless, a total leeway for directors to sacrifice benefits to social endeavors would deter traditional investors from capitalizing a Benefit Corporation.

Therefore, whether the courts will construe the Benefit Corporation as a device for shielding directors from liability or as a tool for allowing shareholders to enforce public benefit purposes is yet to be determined. The latter case still supposes that at least some shareholders will be socially driven enough to sue for enforcement of the benefit purpose,

²⁰⁸ See Raz, *supra* note 17, at 303.

²⁰⁹ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-07(a)(1) (West 2013).

²¹⁰ BENEFIT CORP INFORMATION CENTER, *supra* note 210. Hence, even in the takeover context non-financial interests shall be considered.

²¹¹ BENEFIT CORP INFORMATION CENTER, *Benefit Corporation White Paper*, <http://www.benefitcorp.net/for-attorneys/benefit-corp-white-paper> (last visited Nov. 8, 2013).

²¹² MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-07(c) (West 2013).

²¹³ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-07(d) (West 2013).

²¹⁴ BENEFIT CORP INFORMATION CENTER, *supra* note 210.

²¹⁵ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-07(a)(1) (West 2013).

²¹⁶ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-07(c) (West 2013).

as the intended beneficiaries of the Benefit Corporation will not have any right of action.²¹⁷ Hence a concern that “[w]hile helpful in encouraging socially-conscious business decisions by protecting directors, the statute provides little protection for the mission itself. The broad, unchecked discretion vested in management can result in over-reaching and opportunism at the expense of the social benefit.”²¹⁸

However, the Benefit Corporation’s actions are not entirely unchecked. The third way that the Maryland statute ensures that some public benefits are achieved is a transparency check on the board’s decisions. Indeed, the corporation must deliver to each stockholder an annual benefit report describing its public benefit achievements and assessing its overall corporate social and environmental performance against a third-party standard.²¹⁹ Further, the report must be made available on the corporation’s website or, if it does not have a website, the report must be provided to any person that requests it without charge.²²⁰ However, while the independence of the third party and the transparency of its standard are statutorily guaranteed,²²¹ the assessment of the corporation’s performance is made by the board itself.²²² Thus, this reporting mechanism might not be sufficient to ensure that Benefit Corporations act in compliance with their alleged public benefit purpose.

On its face, the concept of the Benefit Corporation addresses the social enterprise’s branding challenge through a legal form that is inherently tilted toward public benefit and a reporting system that publicly assesses the accomplishment of such benefit. Consequently, the branded enterprise should attract more diverse sources of capital, notably responsible investments.²²³ However, because the statute does not strike a decisive balance between the conflicting interests at stake, whether this scheme will actually work in practice now depends notably on the courts’ answer to the enforceability issue.²²⁴

B. The L3C, a Vehicle Specially Tailored for Social Enterprises

I. An Attempt to Attract Foundation Dollars

In 2008, Vermont enacted the first Low-profit Limited Liability Company (L3C) statute.²²⁵ Rather than creating a new form, the L3C legislation was enacted as an amendment to the LLC act, so as to take advantage of the LLC flexibility and of the existing body of law regarding its governance.²²⁶ The L3C was publicly construed as “a cross between a nonprofit organization and a for-profit corporation”²²⁷ and designated as a

²¹⁷ See, e.g., Raz, *supra* note 17, at 306. More importantly, the statute neither solves nor gives any guidance for the case where shareholders themselves disagree upon the furtherance of, or the extent to which directors should further, the benefit purpose. *Id.*

²¹⁸ *Id.* at 305.

²¹⁹ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-08(a) (West 2013).

²²⁰ MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-08(c) (West 2013).

²²¹ See MD. CODE ANN., CORPS. & ASS’NS § 5-6C-01 (West 2013).

²²² MD. CODE ANN., CORPS. & ASS’NS, § 5-6C-08(a) (West 2013).

²²³ For PRIs, however, Benefit Corporations face the same difficulty as L3Cs.

²²⁴ See, e.g., Schoenjahn, *supra* note 176, at 472 (“To make this entity more effective, courts would have to strike a delicate balance between protection for boards of directors and protection for shareholders.”).

²²⁵ VERMONT SECRETARY OF STATE, *Low-Profit Limited Liability Company*, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Nov. 6, 2013).

²²⁶ See, e.g., Robert Lang & Elizabeth Carrott Minnigh, *The L3C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 20 (2010)

²²⁷ *Low-Profit Limited Liability Company*, VERMONT SECRETARY OF STATE, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Nov. 6, 2013).

double-bottom-line entity seeking a low profit along with charitable or educational goals.²²⁸ Since 2008, a number of States have adopted L3C statutes,²²⁹ but the Vermont L3C remains the most popular one.²³⁰ While there are currently over 903 L3Cs nationwide,²³¹ the effectiveness of this model is questionable

The main purpose of the L3C is “to signal to foundations and donor directed funds that entities formed under this provision intend to conduct their activities in a way that would qualify as program related investments.”²³² This approach is obvious in the relevant part of the Vermont statute, which provides:

(27) “L3C” or “low-profit limited liability company” means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:

(A) The company:

(i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and

(ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D).

(D) If a company that met the definition of this subdivision (27) at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit limited liability company, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company. The name of the company must be changed to be in conformance with subsection 3005(a)

²²⁸ *Id.*

²²⁹ Robert Lang, AMERICANS FOR COMMUNITY DEVELOPMENT, *THE L3C – BACKGROUND AND LEGISLATIVE ISSUES 5*, (2009), available at <http://www.americansforcommunitydevelopment.org> (“Because it is a variant form of LLC, the L3C is now legal in all 50 states as a result of legislation signed into law in Vermont in April 2008, Michigan in January 2009, the Crow Indian Nation in January 2009, Wyoming in February 2009, Utah in March 2009, the Oglala Sioux in July 2009, Illinois in August 2009, Maine in April 2010, Louisiana in June 2010, North Carolina in August 2010 and Rhode Island in June 2011. An L3C from any of these states, like a Delaware corporation, can be used anywhere. The L3C bill is now active in the legislatures of many states.”).

²³⁰ INTERSECTOR PARTNERS, L3C, *L3C Tally*, http://www.intersectorl3c.com/l3c_tally.html (last visited Nov. 6, 2013).

²³¹ *Id.*

²³² VERMONT SECRETARY OF STATE, *Low-Profit Limited Liability Company*, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Nov. 6, 2013).

of this title.²³³

Thus, L3Cs can be characterized as twofold hybrid entities. First, they inherently further a double bottom line: they must be organized for a business purpose that significantly leads to the accomplishment of a charitable or educational outcome. Second, the entity aims at combining traditional investments with donation funds.

2. *The Statutory Balance Between Conflicting Bottom Lines, An Answer to the Governance Challenge*

The hybrid L3C aims at reconciling paradigms that are inherently conflicting: the for-profit value maximization quest and the tax-exempt charitable mission. Fiduciary duties of directors operating in these two worlds are wildly different, notably because nonprofit directors are focused principally on the success of the charitable mission and do not seek mere profit maximization.²³⁴ To avoid this conflict, where either the board is paralyzed or is granted so much deference as to allow departure from the charitable purpose – which is exactly the concern with the Benefit Corporation – the statute itself strikes the balance in favor of the charitable purposes.²³⁵ Indeed, the L3C must significantly further a charitable purpose,²³⁶ and no significant purpose must be the production of income.²³⁷ Hence, although the L3C can distribute profits, its primary objective must be to accomplish its social purpose through the conduct of its business. This statutory prioritization of the social mission thus goes beyond mere contractual arrangements by transforming directors' fiduciary duties.²³⁸ Further, in comparison with for-profit corporations, directors are not only required to consider public benefit purposes, but to prioritize social outcomes over profit making.²³⁹

This is consistent with the notion that social enterprises' profits result from their social endeavors— profit making is authorized, even if substantial earnings stem from the business activity, but they must be subordinate to the social mission. Hence the L3C adequately apprehends the social enterprise double bottom line, and addresses its branding and governance challenges. Accordingly, the L3C allows various kinds of investors to join

²³³ VT. STAT. ANN. 11, § 3001(27) (West 2013).

²³⁴ Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 641 (1998) (“The obligation of nonprofit directors and officers with respect to the corporation's mission creates a more difficult and complex decision-making process for them than for their for-profit peers. For-profit directors and officers are principally concerned about long-term profit maximization. While nonprofit directors and officers keep economic matters in mind, they are principally concerned about the effective performance of the nonprofit's mission. It would be entirely in accordance with their duty of care and business judgment responsibilities, for example, for the directors of a nonprofit hospital to accept a low bid from one of several suitors because the chosen bidder would provide a far higher level of public benefit or service to the community. In most instances, a for-profit board would not have—and should not have—such freedom.”).

²³⁵ See Tyler, *supra* note 84, at 141.

²³⁶ VT. STAT. ANN. 11, § 3001(27)(A) (West 2013).

²³⁷ VT. STAT. ANN. 11, § 3001(27)(B) (West 2013).

²³⁸ See Tyler, *supra* note 84, at 161.

²³⁹ VT. STAT. ANN. 11, § 3001(27)(D) (West 2013). If it turns out that they do not, the statute provides that the L3C will continue to exist as an LLC - for instance if the economic interest becomes a primary purpose or once the charitable purpose is accomplished. This provision strikes a balance between the need for the L3C to be a social enterprise brand – i.e. to guarantee that the entity primarily furthers social outcomes and thus attracts responsible investors – and the practical concern that the loss of the L3C status could jeopardize a profitable business if it led to its automatic dissolution, which would deter traditional investors. *Id.*

in the venture. Indeed, the vehicle offers “a degree of clarity and consistency that should provide reasonable confidence to investors, managers, creditors, policy-makers, and regulators that the form is legally viable for the appropriate circumstances.”²⁴⁰

3. *A Federal Barrier to the State Scheme: The PRI Problem*

The main purpose of the L3C legislation is to accommodate social enterprises’ particular need for diversified sources of funding.²⁴¹ More specifically, the L3C aims at attracting private foundations, which would accept below market returns through PRIs, along with investors seeking market-rate returns.²⁴² PRIs and grants would indeed permit L3Cs to pay market-rate returns to their market investors.²⁴³ This scheme is based on an uneven allocation of risks: foundations could accept the highest risk with the lowest return under the PRI, thus making the other investments more secure and attractive.²⁴⁴ Hence, the idea behind the L3C is to enable social enterprises to benefit from the “tranching of investments.”²⁴⁵ Foundations are at the bottom level, or “tranch,” of the investment scheme by making early high-risk low-return investments. Then, at the middle tranche, responsible investors agree to below-market returns. Eventually, these investments subsidize the upper tranche of the schemes, in which traditional investors are paid market-rate returns. This tranching scheme, however, presupposes that the L3C statute incentivizes foundations to invest through PRIs.

Therefore the whole idea behind the L3C statute is to signal to foundations and to the Internal Revenue Service that this vehicle qualifies as a PRI recipient, and thus to reduce their transactional costs.²⁴⁶ Indeed, the statutory language reproduces the Internal Revenue Code requirement: both the L3C²⁴⁷ and the PRI²⁴⁸ must further purposes described in section 170 (c)(2)(B), and no significant purpose of the company or of the program can be the production of income or the appreciation of property. Nonetheless, although the Vermont statute replicates the language of the Internal Revenue Code and of the Treasury Regulation,²⁴⁹ it has not made it easier for foundations to invest in L3C social enterprises. This is because the L3C is a state vehicle, whereas the PRI is a creature of federal tax law. Thus, the Internal Revenue Service continues to rule on a case-by-case basis whether a particular investment qualifies as PRI, either in advance through a private letter ruling or after it has been made and reported. Hence, although the L3C is a good fit for PRIs, the Service has no preference as to the entity that receives the investment.²⁵⁰ In other words, the Service is “structure agnostic,”²⁵¹ as it only wants “to insure [sic] that the recipient organization uses the money for an acceptable exempt purpose and holds the

²⁴⁰ See Tyler, *supra* note 84, at 161.

²⁴¹ See, e.g., Raz, *supra* note 17, at 298.

²⁴² See, e.g., *id.*

²⁴³ See *id.*

²⁴⁴ See Daniel S. Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 883-84 (2010).

²⁴⁵ *Id.* at 895.

²⁴⁶ *Id.* at 885.

²⁴⁷ VT. STAT. ANN. 11, § 3001(27) (West 2013).

²⁴⁸ I.R.C. § 4944 (2012).

²⁴⁹ TREAS. REG. § 53.4944-3(a) (2013).

²⁵⁰ For instance, the L3C scheme can be reached through a regular LLC by drafting the operating agreement so that it reproduces Treas. Reg. § 53.4944-3.

²⁵¹ Karen Woods, AMERICANS FOR COMMUNITY DEVELOPMENT, *L3Cs and the IRS*, available at <http://www.americansforcommunitydevelopment.org> (last visited Nov. 6, 2013).

investing foundation responsible for monitoring compliance.”²⁵² As a result, the reduction on transactional and monitoring costs has not happened.

Despite the charitable purpose and the transparency of the L3C, state legislation on its own cannot create new opportunities for PRIs. Consequently, the main interest of the L3C for social entrepreneurs rests in its branding aspect and the fiduciary responsibility of the company to further its charitable mission. In short, L3Cs provide a legal branding without the burdensome structure of tax-exempt organizations.

VII CONCLUSION: CREATIVE CAPITALISM CALLS FOR INNOVATIVE LEGISLATORS

Social entrepreneurship is at the juncture of creative capitalism and social innovation. It aims at combining the best of two sectors, and thus is cramped in the traditional vehicles designed for either world in isolation. Although the social bottom line of these enterprises can usually meet the broad charitable purpose requirement of the Internal Revenue Code, tax-exempt vehicles have proven to be unable to host the financial one. Indeed, tax-exempt nonprofits cannot distribute profits to investors if they suffer a burdensome federal oversight as well as substantial limitations on their activities. Conversely, the advantages of for-profit vehicles stem from their flexibility. They can raise capital on the market and organize their ownership structure as they see fit. They are free to engage in a number of activities that are either prohibited or highly regulated when carried out by tax-exempt nonprofits. However, the uncertainty as to the extent to which social purposes can be furthered by corporations, as well as the failure of the for-profit world to receive funding from tax-exempts and the lack of a social enterprise brand have made it necessary to design new vehicles.

Hence, the development of the social enterprise movement has caused an increasing number of states to “revisit a binary or 'either/or approach' to organizational structures.”²⁵³ Hybrid vehicles thus aim at enabling mission-driven for-profits to access a broad array of funding sources and to commit their capital to social endeavors. By adopting hybrid vehicles, social entrepreneurs brand their enterprises as committed to public interest purposes, even though the degree of this commitment varies depending on the legal form chosen. They further escape the significant non-distribution and disclosure constraints that weigh heavily on tax-exempt organizations. Consequently, their business-like flexibility along with their public identification as mission-driven creatures should favor investors’ confidence and consumers’ loyalty.

Nonetheless, various obstacles stand in the way of this speculative scheme. First, these new forms remain widely untested by the courts. How the balance between the two bottom lines will be struck is still an open question, particularly regarding the Benefit Corporation. Further, there is a lack of uniformity in the forms that are authorized nationwide. Different states have different answers to the social enterprise challenges: while some states have refused to create any hybrid form, others have adopted several mission-driven vehicles in their own legislation. California, for instance, created the Flexible Purpose Corporation²⁵⁴ in addition to its Benefit Corporation²⁵⁵: the former offers greater flexibility than the latter in the furtherance of public benefits through lighter

²⁵² *Id.*

²⁵³ See Lofft et al., *supra* note 108.

²⁵⁴ CAL. CORP. CODE § 2600 (West 2013).

²⁵⁵ CAL. CORP. CODE § 14610 (West 2013).

qualifying and reporting constraints.²⁵⁶ The state of Washington followed the same trend with the adoption of a new type of for-profit corporation, the Social Purpose Corporation, as of June 7, 2012.²⁵⁷ In many ways, the Social Purpose Corporation looks like a lighter version of the Benefit Corporation as well.²⁵⁸ This lack of uniform approach nationwide results in a lessened readability of the hybrid model and make it harder for social entrepreneurs and their investors to navigate between the forms it encompasses.

Consequently, the availability of nonprofit, for-profit and hybrid vehicles must be viewed as a menu from which social entrepreneurs can choose the form that is better suited for their own business model. Because social entrepreneurship rests on an innovative combination of the for-profit and charitable worlds, there is hardly one legal form that adequately fits the whole multiplicity of its variants. The preliminary issue that states should resolve is to better define social entrepreneurship, particularly regarding its mission, capitalizing and governance components. Understanding these challenges is the key to designing an appropriate legal form. Then, as for the state of Delaware regarding public corporations, the practice of these hybrid vehicles will direct social entrepreneurs and investors toward legislation that better reflects their expectations. It will then be up to the relevant market to make its determination. After all, social entrepreneurship is just another creature of capitalism.

²⁵⁶ See, e.g., HANSONBRIDGETT, *Flexible Purpose Corporation vs. Benefit Corporation*, <http://www.hansonbridgett.com/Publications/articles/2012-09-flexible-purpose.aspx> (last visited Nov. 6, 2013).

²⁵⁷ WASH. REV. CODE ANN. § 23B.25.005 (2013).

²⁵⁸ See, e.g., NETWORK FOR BUSINESS INNOVATION & SUSTAINABILITY, *B Corporations, Benefit Corporations and Social Purpose Corporations: Launching a New Era of Impact-Driven Companies* 4 (Oct. 2012), available at http://ecozome.com/wp-content/uploads/2012/10/bcorp_wp_distribution.pdf (“The Social Purpose

Corporation enables companies to pursue social and environmental goals alongside their efforts to provide financial returns. However, Washington’s SPC bill imposes a lighter set of verification and reporting requirements on companies than is required in a typical Benefit Corporation bill.”).