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# SOCIAL ENTERPRISE LAW: A THEORETICAL AND COMPARATIVE PERSPECTIVE

RADO BOHINC\* & JEFF SCHWARTZ\*

The traditional US conception of business entities is that they exist to earn profits for their equity owners.<sup>1</sup> Well-developed legal doctrines support this corporate purpose.<sup>2</sup> But emergent companies seek to earn profits while pursuing a social mission. One of the many examples is 4ocean, which sells bracelets made from recycled materials and uses a portion of the profits to remove one pound of ocean plastic pollution for every bracelet sold.<sup>3</sup> The combination of profits with a social purpose is exciting because it represents a new way to fund projects for the social good. Unlike charities or nonprofits, which look primarily to donations,<sup>4</sup> these firms raise money from investors willing to sacrifice some returns to back a worthy cause. Lawmakers in the US and abroad are struggling to adopt existing legal structures, which are based on the for-profit or non-profit paradigm, to best support these so-called social enterprises.

This Article combines a theoretical and comparative analysis to show how current efforts to support social enterprise in the United States and Europe could be improved. Though scholars and regulators on both continents confront the same issues, the dialogues rarely intersect.<sup>5</sup> This Article fills this gap in the literature. It defines social enterprises, provides a framework for social enterprise law, and assesses the extent to which US and EU laws match this framework. This analysis crystalizes the purposes and mechanisms of social enterprise law and uncovers potential reforms to regulations and related legal technologies on both continents.

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<sup>1</sup> See Leo E. Strine, Jr., *The Dangers of Denial: The Need for a Clear-Eyed Understanding of the Power and Accountability Structure Established by the Delaware General Corporation Law*, 50 WAKE FOREST L. REV. 761, 790 (2015).

<sup>2</sup> See *id.*

<sup>3</sup> 4OCEAN, <https://4ocean.com/> (last visited Sept. 3, 2020) [<https://perma.cc/VAC6-CKWN>].

<sup>4</sup> Curtis Child, *Whither the Turn? The Ambiguous Nature of Nonprofits'* *Commercial Revenue*, 89 SOC. FORCES 145, 145–46 (2010).

<sup>5</sup> An exception is Jacques Defourny & Marthe Nyssens, *Conceptions of Social Enterprise and Social Entrepreneurship in Europe and the United States: Convergences and Divergences*, 1 J. SOC. ENTREPRENEURSHIP 32 (2010).

Social enterprises seek to earn profits, but their primary goal is to serve a public mission. Traditional legal regimes put firms into the for-profit or non-profit category, and thus fail to fit these hybrid entities. This is a concern because appropriate regulations are necessary for social enterprises to develop and thrive.<sup>6</sup> Social enterprise laws should make clear that these firms are unique from others, including for-profit firms that have a social conscious or contribute to charity.

The key legal principle is that social enterprises put their mission first—above profits, employees, and other stakeholders.<sup>7</sup> Social enterprise laws should require this. They should also put in place a legal structure that enables, supports, and polices this purpose. There are several primary regulatory tools for doing so: rules could require that social enterprises expand participation in corporate governance to include the views of those most impacted by their mission; impose restrictions on firm expenditures that do not go towards their mission; and require companies to assess and publicly disclose their impact on their chosen cause. Companies that follow these requirements would earn the “social enterprise” moniker, which would provide an important signal to investors and consumers, and thereby help these firms raise capital and sell their products and services.

US law has yet to fully embrace social enterprises. There are legal forms, like the benefit corporation, and certifications, like the B Corp certificate, which are available to help these firms distinguish themselves from typical for-profit corporations.<sup>8</sup> But these legal and nonlegal mechanisms suffer from several key flaws. First, they blur the distinction between socially responsible firms and true social enterprises. Socially responsible firms seek to earn profits in an ethical manner but are not necessarily driven by a social mission—the *sine qua non* of social enterprise. This distinction, while often lost, is an important one because it separates firms with very different goals. Benefit corporation rules and B Corp certification requirements also fail to mandate governance structures that align operations with stated ambitions and do not include transparency measures keyed to assessing the degree of a firm’s positive impact.

The concept of a social enterprise is much more well developed in Europe. Many EU countries have statutory provisions targeting these firms. But problems remain. Countries often define social enterprises too narrowly, fail to mandate appropriate governance structures, and lack transparency mandates. The divergence among countries creates an additional issue. The differing legal definitions of social enterprise create difficulties for potential consumers and investors in the EU region because the entity label alone is insufficiently descriptive.

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<sup>6</sup> Regulation is often criticized as stifling markets, but it is often necessary for them to effectively function. See Jeff Schwartz, *Reconceptualizing Investment Management Regulation*, 16 GEO. MASON L. REV. 521, 525–27 (2009) (summarizing market failure analysis of regulatory intervention).

<sup>7</sup> See *infra* pp. 5–8.

<sup>8</sup> See *infra* pp. 27–32.

The EU is seeking to address the disparities with a new proposal. The rule, if adopted by the European Parliament, would provide entities with a “European Social Economy” label if they meet certain social-enterprise criteria.<sup>9</sup> As drafted, the proposal mitigates, but does not eliminate, the risk of consumer and investor confusion. This is because the recommended criteria are vague and depend on country-level rulemaking. The proposal would be far stronger if the rules were more specific. The EU could also go a step further and create its own social enterprise legal entity patterned on the European Company, which was created for traditional for-profit firms.

In Part I, this Article defines the term “social enterprise.” Part II models how regulations can best support these companies. Part III uses this model to review and critique laws related to social enterprises in the US and in the EU. It also assesses the EU’s recent proposal on social enterprise and makes reform recommendations.

## I. “SOCIAL ENTERPRISE”

A fundamental problem when discussing social enterprise is that there are differing definitions of the term.<sup>10</sup> Additionally, “social enterprise” is frequently defined in one way with examples that then belie the definition. This lack of clarity frustrates efforts to create legal technologies<sup>11</sup> that support these companies.

For example, the Social Enterprise Alliance defines these businesses as “[o]rganizations that address a basic unmet need or solve a social or environmental problem through a market-driven approach.”<sup>12</sup> The definition seems to apply only to companies with a business model that directly addresses a social problem. The most famous example of a business like this is Grameen Bank, which provides microloans to the poor, and won the 2006

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<sup>9</sup> European Parliament Resolution of 5 July 2018 With Recommendations to the Commission on a Statute for Social and Solidarity-Based Enterprises (2016/2237(INL)).

<sup>10</sup> See Dana Brakman Reiser, *Theorizing Forms of Social Enterprise*, 62 EMORY L.J. 681, 681 (2013) (“Social enterprise is a hotly contested term.”); Joan MacLeod Heminway, *Let’s Not Give Up on Traditional For-Profit Corporations for Sustainable Social Enterprise*, 86 UMKC L. REV. 779, 779 (2018) (“Definitions of social enterprise abound in legal scholarship and elsewhere.”); Alina S. Ball, *Social Enterprise Governance*, 18 U. PA. L. REV. 919, 926 (2016) (“The term ‘social enterprise’ does not have a precise definition and as such, while often used, it is also commonly misunderstood.”).

<sup>11</sup> We use the term “legal technologies” to include both legal and quasi-legal mechanisms that support social enterprise. A legal technology would include both privately issued certificates, such as the B Corp certification, and government regulations.

<sup>12</sup> SOC. ENTER. ALL., SOCIAL ENTERPRISE: WHAT IS A SOCIAL ENTERPRISE?, SOC. ENTER. ALL. <https://socialenterprise.us/about/social-enterprise/> (last visited Sept. 3, 2020) [<https://perma.cc/62M6-49FL>].

Nobel Peace Prize for its efforts.<sup>13</sup> The Alliance's example list, however, includes companies that engage in traditional commerce, but give a portion of their profits to charity.<sup>14</sup> Members also include companies that claim an ethical business model. BellaNove, for instance, rents maternity clothes.<sup>15</sup> The company markets this as a more ethical model for such clothes because the alternative is to buy inexpensive clothes and then throw them away.<sup>16</sup> While there seems to be an inclination to have a big-tent definition of social enterprise, we take a different approach.

A primary contribution of social enterprise law is to enable companies with a true social mission to distinguish themselves. Social enterprises must stand out from other types of business to market themselves to both consumers and investors.<sup>17</sup> Customers might be more willing to buy, or pay a little extra for, a product that supports a social cause. Similarly, investors may be willing to accept slightly lower returns because of the satisfaction they get from supporting a mission-driven firm. Ambiguity around the exact meaning of "social enterprise" compromises this potential.

We define social enterprises as investor-owned companies that are mission-driven rather than profit-driven.<sup>18</sup> Like Grameen bank, they might directly and creatively address a social problem. But they might also sell goods and services to support broader social goals. An example is Warby Parker. The company sells eyeglasses online and in stores. For every pair it sells, it donates a pair to the needy. According to the company, "[a]lleviating the problem of impaired vision is at the heart of what we do . . . ."<sup>19</sup>

It may be tempting to limit the term social enterprise to only companies like Grameen, but they are more accurately described as social entrepreneurs. These companies try to solve social problems in a new, usually market-driven, way. But they are a subset of social enterprise. Others engage in

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<sup>13</sup> *See id.*

<sup>14</sup> *Id.*; *see, e.g.*, EVERLY, *Giving Back*, <http://everlyclothing.com/giving-back/> (last visited Sept. 3, 2020) (describing Everly, a women's clothing line that donates to a community-development nonprofit) [<https://perma.cc/YPC2-GDAU>].

<sup>15</sup> Lauren Dekleva, *Maternity Clothing Just Got a Fashionable (& Ethical) Facelift*, SOC. ENTER. ALL. (Mar. 1, 2019),

<https://socialenterprise.us/2019/03/01/maternity-clothing-just-got-a-fashionable-ethical-facelift/> [<https://perma.cc/QXJ3-ETT3>].

<sup>16</sup> *See id.*

<sup>17</sup> *See* Reiser, *supra* note 10, at 684.

<sup>18</sup> Others have used similar definitions. *See, e.g.*, EUR. COMM'N, A MAP OF SOCIAL ENTERPRISES AND THEIR ECO-SYSTEMS IN EUROPE V (2015) (requiring that social enterprises have, among other things, a "primary and explicit social purpose"); Defourny & Nyssens, *supra* note 5, at 44 ("[A]ccording to the EMES conception of social enterprise, the social impact on the community is not just a consequence or a side-effect of the economic activity but it is the key motive of the latter."); Reiser, *supra* note 10, at 681 (defining a social enterprise as "an organization formed to achieve social goals using business methods.").

<sup>19</sup> *Buy a Pair, Give a Pair*, WARBY PARKER, <https://www.warbyparker.com/buy-a-pair-give-a-pair> (last visited Sept. 3, 2020) [<https://perma.cc/633U-7JFM>].

commerce to serve charitable causes, even if their commercial activities are unrelated to their cause.

Companies that neither innovate to serve a social mission nor donate significant proceeds to charity are not social enterprises. Patagonia, for instance, makes expensive outdoor gear. It gives one percent of its revenues to environmental charities,<sup>20</sup> treats its employees well,<sup>21</sup> and manufactures its products sustainably.<sup>22</sup> While all of this is admirable, the company does not pursue a social cause. It is an example of a profit-seeking company that operates in a socially responsible manner.

It is difficult, yet important, to draw this distinction. A company that strives to be a good citizen is not the same as one that is committed to a certain social goal. Social enterprises are good corporate citizens, but good corporate citizens are not necessarily social enterprises. It is not always easy to distinguish between companies like Patagonia, which make products in a socially responsible way and give back to the community, and companies like Warby Parker, which make products in a socially responsible way *to* give back to the community, especially because companies might inflate descriptions of their social agenda as part of their marketing efforts. But regulation can draw this line—companies that comply with specific legal criteria could earn the right to be called “social enterprises”; those that do not are merely (yet still laudably) socially conscious and can be otherwise recognized as such. Regulation can create an operational definition that supplants the somewhat intractable abstract one.<sup>23</sup> These firms would be defined by what they do rather than by how they describe themselves. This way the “social enterprise” label would send a clear signal to the market.

Similarly, employee-owned companies are not social enterprises. Nor are companies that include stakeholder input in corporate decision-making. Calling these firms social enterprises mistakes inclusive governance for a social mission. Firms are not social enterprises unless their social mission is their *raison d'être*.

Finally, nonprofits are not social enterprises. The key distinction is that nonprofits do not have equity owners.<sup>24</sup> Income over expenses must be

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<sup>20</sup> *1% for the Planet*, PATAGONIA, <https://www.patagonia.com/one-percent-for-the-planet.html> (last visited Sept. 3, 2020) [<https://perma.cc/NZ9Q-8797>].

<sup>21</sup> Brigid Schulte, *A Company that Profits as it Pampers Workers*, WASH. POST (Oct. 25, 2014), [https://www.washingtonpost.com/business/a-company-that-profits-as-it-pampers-workers/2014/10/22/d3321b34-4818-11e4-b72e-d60a9229cc10\\_story.html](https://www.washingtonpost.com/business/a-company-that-profits-as-it-pampers-workers/2014/10/22/d3321b34-4818-11e4-b72e-d60a9229cc10_story.html) [<https://perma.cc/5JDG-QRMJ>].

<sup>22</sup> *Our Footprint*, PATAGONIA, <https://www.patagonia.com/our-footprint/> (last visited Sept. 3, 2020) [<https://perma.cc/C5QA-RNGJ>].

<sup>23</sup> This is similar to how the EU treats corporate purpose. As discussed *infra* pp. 12–13, corporate purpose is seen as stemming from governance structure.

<sup>24</sup> See Reiser, *supra* note 10, at 686.

reinvested back in the nonprofit's business.<sup>25</sup> Social enterprises have owners that expect some monetary return in addition to the psychic return they enjoy for backing a good cause. This is a key innovation and the cause of much of the complexity of social enterprise law. Also, social enterprise connotes a firm that solely engages in market activities. Nonprofits, on the other hand, typically rely on donations or grants for all or much of their funding.<sup>26</sup> Although social enterprises and nonprofits are closely related, distinguishing them fits with how the terms are understood, at least implicitly. For example, a nonprofit hospital or school is not typically thought of as a social enterprise. And social enterprises are typically thought of as companies that earn at least some profit.<sup>27</sup>

In fact, the distinction from nonprofits is what makes social enterprises exciting, even revolutionary. Because nonprofits cannot have outside investors, they must fund their activities through cash flows, donations, and government support.<sup>28</sup> This is a limited pool of capital. Thus, it inevitably limits the scale of these ventures. Adding investors to the funding mix opens the door to more social good. This is the key reason why regulators should take these ventures seriously and design legal rules that provide them with support.

## II. A FRAMEWORK FOR SOCIAL ENTERPRISE LAW

Social enterprise law should provide legal technologies that allow investor-owned firms with a social mission to thrive. To that end, the law should require that the first-order purpose of these companies be to serve a social mission, and that firms adhere to accountability and transparency mechanisms that police adherence to this purpose. Firms that comply should earn recognition as “social enterprises”—a clear signal of their beneficent intentions to consumers and investors.

Since entity law is largely enabling, it is tempting to think that entrepreneurs can create social enterprises within the existing for-profit legal structure. In addition to laying out a framework for social-enterprise law, this Section demonstrates that private ordering is inadequate.

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<sup>25</sup> See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) (“A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.”).

<sup>26</sup> See Child, *supra* note 4, at 146.

<sup>27</sup> Cf. EUR. COMM’N, *supra* note 18, at v (distinguishing social enterprises from nonprofits).

<sup>28</sup> Nonprofits can borrow money, but it is difficult and expensive because they do not have an equity cushion and may lack significant collateral. Deborah Kolsovsky & Sylvia Diez, *Nonprofits See Increasing Need to Borrow*, N.C. ST. UNIV.: PHILANTHROPY J. (Apr. 10, 2017), <https://pj.news.chass.ncsu.edu/2017/04/10/nonprofits-see-increasing-need-to-borrow/> [<https://perma.cc/CR4R-NK4Y>].

### A. *Mission-Driven Purpose*

Laws should mandate that social enterprises put the firm's social mission above shareholder wealth or even stakeholder values. The way that we have defined social enterprises, they operate with a corporate purpose that is fundamentally at odds with for-profit corporations. This is true regardless of whether the for-profit company adheres to the shareholder primacy or stakeholder model of the firm. This leads to tension with traditional corporate laws and norms.

Much of the literature on corporate purpose and social enterprise starts from the false premise that the US requires for-profit companies to put shareholder interests first (in adherence with the shareholder primacy model) while European countries direct firms to look out for stakeholders.<sup>29</sup> While the story in both regions is more subtle, neither approach fits social enterprises.

It is true that the leading theory in US corporate law, which is dominated by Delaware jurisprudence, is that the purpose of a corporation is to maximize shareholder value.<sup>30</sup> It is also true that the default rule is that managers are required to run firms in accordance with this maxim.<sup>31</sup> Compliance, however, is measured by reference to "long-term shareholder value."<sup>32</sup> This metric is consistent with many stakeholder interests. For example, treating the environment well is good for almost all companies in the long term. Thus, stakeholder-oriented actions are permissible so long as they are defended on the grounds of shareholder primacy.<sup>33</sup>

Such flexibility, however, does not give firms sufficient latitude to put a social mission first. Devotion to a social mission means subjugating profits. While keeping stakeholders happy is often, at least arguably, consistent with long-term shareholder value, prioritization of a social mission at the expense of shareholders is not.

Social enterprises would have to change the default structure, but the legality of doing so is unclear. Delaware law gives entrepreneurs the freedom to alter the corporation's purpose in the company's Certificate of Incorporation.<sup>34</sup> This likely gives founders room to state that they intend to

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<sup>29</sup> See Reiser, *supra* note 10, at 683.

<sup>30</sup> See Jeff Schwartz, *De Facto Shareholder Primacy*, 79 MD. L. REV. 652, 669 (2020).

<sup>31</sup> See *id.*

<sup>32</sup> See *id.* at 670.

<sup>33</sup> See *id.*

<sup>34</sup> DEL. CODE tit. 8, § 102(a)(3) (2020) ("It shall be sufficient to state, either alone or with other businesses or purposes, that the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware . . .").



balance stakeholder interests.<sup>35</sup> It is uncertain, however, whether they can go further and explicitly elevate the firm's social mission above profits. In finding that the founders of craigslist acted improperly in prioritizing the firm's social mission, the Delaware Supreme Court stated as follows:

The corporate form in which craigslist operates . . . is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. Jim and Craig opted to form craigslist, Inc. as a *for-profit Delaware corporation* and voluntarily accepted millions of dollars from eBay as part of a transaction whereby eBay became a stockholder. Having chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders. The "Inc." after the company name has to mean at least that.<sup>36</sup>

The implication from the above is that for-profit firms are *for profit*, and that this means promoting shareholder wealth. This would seem to foreclose the adoption of a social purpose. The court does create some ambiguity when it says that "philanthropic ends" are inappropriate "when there are other stockholders interested in realizing a return on their investment."<sup>37</sup> This suggests that if the shareholders unanimously adopt a Certificate of Incorporation that envisions a social purpose for the firm, it would be respected.

Nevertheless, a social enterprise is an awkward fit under existing for-profit corporate rules. There are also deeper structural issues with forming a social enterprise as a corporation. Corporate law embeds shareholder values. The law is primarily about rendering management accountable to shareholders. Shareholders vote for board members to represent their interests. This governance structure is ill-suited for firms that wish to focus on their social mission.

Moreover, under corporate law, management owes fiduciary duties of loyalty and care. In general, this means that they must put the corporation's interest above their own and that they must diligently handle their responsibilities. Shareholders enforce these obligations. In the social enterprise context, management will often face the tradeoff between profits and mission. Fiduciary duties as they are typically understood would require managers to put profits first.<sup>38</sup> Even if founders explicitly state a mission-

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<sup>35</sup> See Strine, *supra* note 1, at 783 ("It may well be the case that a certificate of incorporation that said that a for-profit corporation would put other constituencies' interests on par with stockholders would, in view of § 101(b), be respected and supersede the corporate common law.").

<sup>36</sup> eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 34 (Del. Ch. 2010).

<sup>37</sup> *Id.*

<sup>38</sup> See *id.*

centric purpose, they could not change fiduciary duties to align.<sup>39</sup> Moreover, even if they could, shareholders may not vigilantly enforce this obligation. There would be an inherent bias towards profitmaking, which founders would not be able to erase through clever drafting.

The availability of limited liability entities (“LLCs”) solves many of these structural issues, but this legal form is not a panacea. These entities were designed to provide wide-ranging flexibility to entrepreneurs. Thus, an agreement among all of the parties that the firm exists to form a social purpose is likely uncontroversial.<sup>40</sup> Entrepreneurs could also restructure fiduciary duties and firm governance to better align with their social mission.

The very flexibility that LLCs allow, however, is also a drawback. Creating a structure to render management accountable to a public mission looks far different in a social enterprise. And each entrepreneur is tasked with figuring out an optimal structure. A legal regime that puts in place a default structure for social enterprise would eliminate these costs. Similarly, investors would have to carefully inspect the terms of each social-enterprise LLC to determine precisely how it is set up. This increases their costs and may lead to mistrust, thus chilling the market. In the end, the transaction costs savings that supports a default structure for traditional firms apply with equal force to social enterprises.

Traditional Company Law in the EU is similarly inappropriate for social enterprises. While the EU is much more amenable to stakeholder values,<sup>41</sup> it is not designed for firms that wish to put a social mission first. Unlike in the United States, there is no robust debate about shareholder primacy versus stakeholder theory; the distinction is operational rather than abstract.<sup>42</sup> Firms serve stakeholders to the extent their interests are represented in corporate governance and protected under company law.<sup>43</sup> Germany is the leading European example of stakeholder oriented company law. Management owes fiduciary duties to stakeholders rather than just shareholders.<sup>44</sup>

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<sup>39</sup> Delaware law limits the extent to which fiduciary duties can be altered. See Ann E. Conaway, *Lessons to Be Learned: How the Policy of Freedom to Contract in Delaware’s Alternative Entity Law Might Inform Delaware’s General Corporation Law*, 33 DEL. J. CORP. L. 789, 794–95 n.15 (2008).

<sup>40</sup> See Reiser, *supra* note 10, at 688–89.

<sup>41</sup> Jurgens et al., *Stakeholder Theory and Practice in Europe and North America: The Key to Success Lies in a Marketing Approach*, 39 INDUS. MKTG. MGMT. 769, 772 (2010); Veronique Magnier & Darren Rosenblum, *Quotas and the Transatlantic Divergence of Corporate Governance*, 34 NW. J. INT’L L. & BUS. 249, 275–76, 297 (2014).

<sup>42</sup> Jurgens et al., *supra* note 41, at 771 (“The strategies of European firms, on the other hand, aim to meet the needs of those stakeholders with vested interests in the company’s welfare by assuring those groups board representation.”); Magnier & Rosenblum, *supra* note 41, at 275–76.

<sup>43</sup> See Jurgens et al., *supra* note 41, at 771.

<sup>44</sup> See Amir N. Licht, *The Maximands of Corporate Governance: A Theory of Values and Cognitive Style*, 29 DEL. J. CORP. L. 649, 735 (2004).

As noted above, however, inclusivity and stakeholderism are not synonymous with social enterprise. There is still a void for social enterprise to fill. As in the US, European countries tend to have two broad categories of for-profit entities—one where law is more restrictive and one which provides entrepreneurs greater flexibility.<sup>45</sup> Where law provides more flexibility, it may be possible for firms to adopt a social enterprise mission and internal rules that support it. Even so, social enterprise law is useful. As noted, it allows entrepreneurs to economize on transaction costs and provides a clear signal to consumers and investors.<sup>46</sup> The prevalence of social enterprise laws in the EU implicitly acknowledges the value of distinguishing these companies even where stakeholder theory predominates and even where firms have the flexibility to alter their governing documents.

The starting point of social enterprise law—and where it first diverges from existing entity law—is a clear mission-first mandate.<sup>47</sup> Management would have a duty to put the firm's mission first, and governance and accountability rules that support this duty.

### B. *Mission-Driven Firm Governance*

Social enterprises should have governance structures that support and align with their social missions. As in for-profit firms, the law should require social enterprises to have a board that oversees and selects managers. That board should be elected by a mix of constituents, potentially including management, employees, customers, shareholders, and direct representatives of the company's mission.

Social enterprises face several key governance challenges. There are the familiar risks that management will put their interest ahead of the company through expropriation or shirking. More importantly, there is also the risk that they will improperly balance mission and profits. The most prevalent fear is that managers will overemphasize profits,<sup>48</sup> but they might also focus so much on the mission that the business becomes unviable or other stakeholders are harmed. To mitigate the risk of management veering off course, social enterprises should have a board of directors consisting of those who share a common interest in the firm's mission but have otherwise varied interests. The common interest in the mission would elevate it above all other

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<sup>45</sup> See Klaus J. Hopt, *Directors' Duties and Shareholders' Rights in the European Union: Mandatory and/or Default Rules?* 2 (Eur. Corp. Governance Inst., Working Paper No. 312/2016, 2016), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2749237](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2749237) [<https://perma.cc/Q8RA-WDJM>].

<sup>46</sup> See *supra* p. 8.

<sup>47</sup> Professor Reiser has also made this suggestion. See Reiser, *supra* note 10, at 704.

<sup>48</sup> Alnoor Ebrahim et al., *The Governance of Social Enterprises: Mission Drift and Accountability Challenges in Hybrid Organizations*, 34 RSCH. IN ORGANIZATIONAL BEHAV. 81, 82 (2014).

goals, and the diverse views would guide a balanced approach for pursuing it.

Those directly tied to the firm's social cause are an obvious choice for board representation because they would focus solely on the firm's social mission. It might be difficult, however, to foster their direct participation. Whether it is possible, and who the participants might be, depends on the firm. For instance, Grameen's social mission is to provide microloans to the poor. To represent the mission, the company could allow these borrowers to nominate board members. Along the same lines, firms that give to specific charities could allow representatives of the recipient charities to elect board members. But in some social enterprises, there may be no obvious group to fill this role. If this is the case, firms should be required to devise another mechanism for their input, perhaps through surveys or impact studies.<sup>49</sup>

Managers and workers should also be given a say. Since they chose to work for a social enterprise, likely at reduced wages, the firm's mission is undoubtedly important to them. At the same time, because they work there, they also care about employee satisfaction and firm viability.

In the United States, the typical way that employees gain a voice in corporate affairs is through employee stock ownership plans. This makes employees shareholders, which gives them a say in who is elected to the board. This mechanism is a poor fit to social enterprise, though, in that it aligns employee interest with shareholders rather than the company's mission.

European firms incorporate employee views in a more direct manner. German firms, for instance, are required to have works councils.<sup>50</sup> These councils negotiate collective bargaining agreements and must be consulted on layoffs, plant closings, and related activities, as well as on fundamental changes to the company's business.<sup>51</sup> In addition, under the German system of codetermination, public firms are run by a two-tiered board structure.<sup>52</sup> The management board oversees day-to-day operations; the supervisory board appoints members of the management board and approves major corporate decisions.<sup>53</sup> Employees elect representatives to this latter board. In companies with over 2,000 employees, they elect half of the board.<sup>54</sup>

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<sup>49</sup> See *id.* at 93.

<sup>50</sup> See Katharine V. Jackson, *Towards a Stakeholder-shareholder Theory of Corporate Governance: A Comparative Analysis*, 7 HASTINGS BUS. L. J. 309, 367–68 (2011).

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 367.

<sup>53</sup> See Jodie A. Kirshner, "An Ever Closer Union"? in *Corporate Identity?: A Transatlantic Perspective on Regional Dynamics and the Societas Europaea*, 84 ST. JOHN'S L. REV. 1273, 1328 (2010); Other countries, including Austria, Portugal, and Poland, also have two-tiered board structures. Klaus J. Hopt, *Comparative Corporate Governance: The State of the Art and International Regulation*, 59 AM. J. COMP. L. 1, 20–21 (2011).

<sup>54</sup> See Kirshner, *supra* note 53, at 1332.

Other European countries have oversight models that similarly incorporate employees into corporate governance.<sup>55</sup> These approaches, where employees can represent their own interest through voting rights as employees qua employees, would be a cleaner way to incorporate their views.<sup>56</sup>

Customers should also participate. Companies are constantly surveying their customers on various matters. Although it might not be feasible for all firms, it is easy to imagine them sending customers voting materials on board representatives. Their customers have an interest in the quality and prices of the company's products, and because they chose to do business with a particular social enterprise, they likely also have a connection to its cause. These balanced wishes make them a valuable governance voice.

The final vote should come from shareholders. They have an interest in profits, and like customers, they also likely have a connection to the firm's cause because they chose to invest.

A board so constituted would provide oversight and select managers that focus on the firm's mission without ignoring other stakeholder values. Social enterprises should, therefore, be required to include representatives of these groups on their boards. If it is infeasible to include customers or direct representatives of the firm's mission, then rules should require companies to otherwise incorporate their views.<sup>57</sup>

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<sup>55</sup> See *id.* at 1290.

<sup>56</sup> The EU, however, did not fully embrace the stakeholder-oriented corporate governance model. After 40 years of negotiation, it created the *Societas Europaea*, a legal form for use anywhere in the EU. See *id.* at 1289. Companies that choose this form need not adopt a two-tiered board with employee participation. See *id.* at 1291.

<sup>57</sup> Nonprofits face a similar governance dilemma. Their mission is their primary objective, but they must earn enough to remain viable. Since there are no shareholders, the typical way of electing board members is inapt. Some nonprofits have members, usually donors. Lawrence J. Trautman & Janet Ford, *Nonprofit Governance: The Basics*, 52 AKRON L. REV. 971, 975 (2018). They may elect board members. *Id.* at 1001. Much more commonly, board members are appointed by founders, and then reappoint themselves. See Stephen R. Block & Steven Rosenberg, *Toward an Understanding of Founder's Syndrome: An Assessment of Power and Privilege Among Founders of Nonprofit Organizations*, NONPROFIT MGMT. AND LEADERSHIP, 357–58 (June 2002), [https://www.researchgate.net/publication/227952324\\_Toward\\_an\\_Understanding\\_of\\_Founder's\\_Syndrome\\_An\\_Assessment\\_of\\_Power\\_and\\_Privilege\\_Among\\_Founders\\_of\\_NonProfit\\_Organizations](https://www.researchgate.net/publication/227952324_Toward_an_Understanding_of_Founder's_Syndrome_An_Assessment_of_Power_and_Privilege_Among_Founders_of_NonProfit_Organizations) [<https://perma.cc/JWC9-UQZQ>]. In either case, the board is commonly made up of inside directors (i.e., management) and donors. See Greg McRay, *Nonprofit Board Members – Choose Wisely*, FOUND. GRP. (May 4, 2017), <https://www.501c3.org/nonprofit-board-members-choose-wisely/> [<https://perma.cc/5QR2-FLBT>]. As in social enterprises, because managers have chosen to work for a mission-driven company, they likely internalize the values of the nonprofit's social cause (though there may be problems of self-dealing or shirking as they are being asked to oversee themselves). Alan J. Abramson & Kara C. Billings, *Challenges Facing Social Enterprises in the United States*, NONPROFIT

### C. Mission-Driven Financial Limits

An additional option to render management accountable to the company's mission is to legally restrict the company's spending on other things. Regulations could accomplish this by keying regulations to certain balance sheet items.

One approach, which is common in existing social enterprise laws in Europe,<sup>58</sup> is to limit the percentage of profits paid out to shareholders as dividends.<sup>59</sup> While the idea is to prevent value appropriation by shareholders, it is an imprecise mechanism for doing so. Shareholders profit from the growth of the business regardless of whether money is paid out to them. In addition, while dividend limits force companies to retain earnings, there is no guarantee that the money will be spent wisely. Firms might, for instance, spend resources on lower value projects or overpay employees.

A better approach would be to target internal use of profits and profitability. In the common social enterprise model, where the company's commercial activities fund, but are not directly related to, its social ambitions, there could be a requirement that a certain percentage of profits from its sales go toward its charitable goals. A rule that required that the donation equal some percentage of the company's profits would cement the importance of the social mission. While a requirement that is too onerous would threaten to leave companies without sufficient money to run their operations, at a minimum, fifty-one percent of a firm's profits should go toward its mission for it to legitimately claim that it puts mission first.

For social entrepreneurs (i.e., firms that serve their mission through their commercial activities, rather than use commercial activities as a way to fund pursuit of their mission), a limit on profit margin, rather than profits themselves, would be a better fit. These firms contribute to the social good directly through their activities, not through how they allocate their profits, so a limit on profit distribution would not fit. For instance, it would make little sense to instruct Grameen to allocate fifty-one percent of its profits to its social cause. Its business is its social cause.

Profit margin is a profitability ratio that divides profit by revenues. It shows the relationship between price and costs. A profit margin of fifteen percent means that eighty-five percent of the company's revenues are spent to generate its profits. If social entrepreneurs have a high profit margin, it suggests that they are prioritizing profits at the expense of their mission. If

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POL'Y F. 4 (2019) (addressing governance challenges specifically as they relate to accountability); Ball, *supra* note 10, at 937–42 (noting the lack of internal oversight within nonprofits). Similarly, donors represent a reasonably good proxy for the nonprofit's social mission. They want to see that their money is being well spent.

<sup>58</sup> See *infra* notes 120–124 and accompanying text.

<sup>59</sup> This limitation is also employed in the United Kingdom, where community interest companies (CIC) may only pay out 35% of their profits as dividends. Ebrahim et al., *supra* note 48, at 86.

Grameen has a high profit margin on its loans, it would suggest that it is not charging fair rates to its impoverished clients. If a restaurant that employs people with disabilities has high profit margins, it suggests it is not paying its employees enough.

Profit margins vary by firm, but the S&P 500 average hovers around eleven percent.<sup>60</sup> A profit-margin limitation of something like ten percent may, therefore, be reasonable. It would require that social entrepreneurs be no more profitable than the average large public company.

#### D. Mission-Driven Disclosures

A final tool is disclosure. A way to police a company's devotion to its social mission is to require that it disclose the attainment of, or progress toward, its social purposes. Since these companies are established to aid the public good, these disclosures should be publicly available. Disclosures are best if they are clear, consistent, and comparable. Because missions are diverse, however, this is difficult in the social enterprise space. That said, there are two key ways that companies can track progress toward their social goals. The first is to measure their outputs—the steps taken toward their social mission. In Grameen's case, this would be the number and value of loans they make. The second would be the company's impact on social welfare. This is more abstract. For Grameen, it would mean an assessment of the status of those who receive the loans. Were the loans able to lift people from poverty?<sup>61</sup>

Though the securities laws require financial disclosures from public companies,<sup>62</sup> and shareholders have the right to demand information in

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<sup>60</sup> John Butters, *S&P 500 Reports YOY Decline in Net Profit Margin for 4th Straight Quarter*, FACTSET tbl. 1 (Jan. 21, 2020), <https://insight.factset.com/sp-500-reports-yoy-decline-in-net-profit-margin-for-4th-straight-quarter#:~:text=The%20blended%20net%20profit%20margin,Q4%202008%20through%20Q3%202009> [<https://perma.cc/L6E8-WW35>].

<sup>61</sup> See Ebrahim et al., *supra* note 48, at 87 (discussing output and outcome metrics).

<sup>62</sup> See Jeff Schwartz, *Fairness, Utility, and Market Risk*, 89 OR. L. REV. 175, 176 (2008). The U.S. generally does not require socially-oriented disclosures of public companies, but the EU rules are more expansive. They define a category of companies as "public-interest entities." These are listed companies, banks, insurance companies, and companies otherwise designated by member states as such. See Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 Amending Directive 2006/43/EC on Statutory Audits of Annual Accounts and Consolidated Accounts, 2014 O.J. (L158/196). Public-interest entities with over 500 employees are required to disclose information related to, among other things, environmental and employee matters, as well as human rights and board diversity. See Directive 2014/95/EU of the European Parliament and of the Council of 22 October 2014 Amending Directive 2013/34/EU as Regards Disclosure of Non-Financial and Diversity Information By Certain Large Undertakings and Groups, 4014 O.J. (L 330/1); EUR. COMM'N, NONFINANCIAL

private firms,<sup>63</sup> private firms face no ongoing disclosure requirement like the one proposed here.<sup>64</sup> It may seem, therefore, that social enterprises would be subjected to a heightened level of scrutiny.

The justification has to do with the unique nature of social enterprise law. Compliance therewith allows firms to earn recognition as a “social enterprise.” Unlike the generic “corporation” status that is conferred on typical for-profit firms, the social enterprise moniker carries an important message. Transparency around the firm’s efforts and progress towards its social mission is necessary for that message to have credibility.

The direct audience for these disclosures would be the stakeholders of the firm. But making the disclosures public also allows for social-enterprise intermediaries to consume them and publish their results. Several organizations, for example, dissect corporate sustainability disclosures and rank companies based on them.<sup>65</sup>

### E. *Social Mission Lock-In*

Firms founded on high-minded ideals may gravitate towards profit-making as management turns over and shares change hands. This is a common concern in the field.<sup>66</sup> It is particularly worrisome if there is ever to be a public market for social enterprises. This may be hard to imagine, but there is no conceptual reason why social enterprises cannot have their shares trade on a regulated exchange.

The public markets have traditionally been an important source of capital for emerging firms.<sup>67</sup> Public markets also offer shareholders liquidity, which increases the value of firm shares.<sup>68</sup> Both the access to capital and the liquidity would be valuable to social enterprises. If this is to ever happen,

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REPORTING, [https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting\\_en](https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/non-financial-reporting_en) (last visited Sept. 3, 2020) [<https://perma.cc/RD29-S8QF>]. Many are pushing for EU-style disclosures in the US. See, e.g., Alexandra Farmer & Sarah Thompson, *The Ripple Effect of EU Taxonomy for Sustainable Investments in U.S. Financial Sector*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 10, 2020), <https://corpgov.law.harvard.edu/2020/06/10/the-ripple-effect-of-eu-taxonomy-for-sustainable-investments-in-u-s-financial-sector/> [<https://perma.cc/8F9D-C26B>] (“As U.S. investors increasingly take ESG factors, and particularly climate change, into account, they should monitor and, where warranted, incorporate emerging EU guidelines.”).

<sup>63</sup> See Schwartz, *supra* note 30, at 671.

<sup>64</sup> See *id.*

<sup>65</sup> Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923, 945–46 (2019).

<sup>66</sup> See Ebrahim et al., *supra* note 48, at 82.

<sup>67</sup> See Jeff Schwartz, *The Twilight of Equity Liquidity*, 34 CARDOZO L. REV. 531, 538 (2012).

<sup>68</sup> See *id.* at 537.



though, laws must make it extremely difficult to pivot from mission to profits.

In today's public markets, the pressure on companies to maximize share prices is intense. They face pressure from institutional investors to generate ever growing quarterly returns;<sup>69</sup> hedge-fund activists threaten managers that fail to do everything they can to squeeze profits for shareholders.<sup>70</sup> Moving a social enterprise off of its mission and towards the goal of maximizing profits would make for easy gains.

Etsy is a case in point. It was founded as a quirky, stakeholder-oriented firm, that sells crafts made by independent artists online.<sup>71</sup> When it went public, it prided itself on its corporate culture, which put the interests of employees and craftspeople ahead of shareholders.<sup>72</sup> Shortly after going public, it was attacked by a hedge fund activist.<sup>73</sup> The activist forced the company to fire the CEO and significantly cut staff.<sup>74</sup>

Rules that keep firms from abandoning their social mission would provide the necessary insulation from market pressure. The constitution of the board described above provides a natural barrier. Since shareholders would not make up the majority of the board, they could not force a shift in the firm's mission. Other measures could provide additional reassurance. If managers owed a *mandatory* fiduciary duty to advance the mission of the social enterprise, then it would be impossible for hedge funds to buy up stakes and force different policies. In an extreme case, a fund could seek to reincorporate a social enterprise as a for-profit firm. To prevent that, laws could be put in place regarding what vote is required and who is given the right to vote, that could make this essentially impossible. For instance, perhaps the move could require consent of seventy-five percent of the employees.

While a flexible organizational structure is essential for social enterprises because of their varied structures and goals, certain mandatory rules that cement mission over profits provide necessary assurance that firms will stay true to their social-purpose goals.

#### F. *The Contributions of Social Enterprise Law*

The key contribution of social enterprise—the pursuit of a public mission with private investors—is an ill fit with traditional corporate law. These companies are not driven by profits; nor are they profit-driven firms that strive to do business sustainably. They are driven by their social mission. Unlike nonprofits, though, they have investors and strive to provide them

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<sup>69</sup> See Schwartz, *supra* note 30, at 688.

<sup>70</sup> See *id.* at 679.

<sup>71</sup> See *id.* at 656.

<sup>72</sup> See *id.*

<sup>73</sup> See *id.*

<sup>74</sup> See *id.*

with a return. Social enterprise law can help social enterprises through rules designed with their unique structure and purpose in mind.

Essentially the same logic that supports corporate law as distinct from contract law also supports the need for social enterprise law. Corporate law is efficient because it provides a structure that works for most firms. The law frees entrepreneurs from the need to derive a system of corporate governance and related rules from scratch. It also serves to protect investors. The system corporate law puts in place provides them with tools to police firm managers. The same is true in social enterprises. Without a legal structure devoted to social enterprises, firms would be forced to contract for a social-enterprise structure within the for-profit corporate-law paradigm. It is inefficient to force firms to do this and leaves investors and other stakeholders potentially exposed.

Just as importantly, social enterprise laws can provide these companies with clear and credible ways to distinguish themselves from purely for-profit entities and entities like Patagonia, which have varying degrees of social mindedness, but are not social enterprises. Many investors and consumers are drawn to companies with a social mission. A significant number of Warby Parker's customers likely buy glasses from them to support their cause. Compliance with social enterprise law can help companies like this signal their charitable intentions. A firm would only be permitted to call itself a "social enterprise" if it is committed to a social mission and complies with the legally imposed accountability structure that supports it. Different legal technologies are available to provide this structure.

### *G. Mechanisms of Social Enterprise Law*

There are two ways to provide a legal (or lawlike) structure for social enterprises. One approach is to layer certifications on existing legal rules for conventional for-profit firms. The other is to create a new type of legal entity. A key contribution of both is that founders of social enterprises would no longer need to individually adjust the corporate default rules to meet their needs. The certificate or legal framework would also provide accountability and credibility to firms that call themselves social enterprises. Under either system, companies would commit themselves to a social mission and obey rules that backstop that commitment.

Because they would impose a social-enterprise structure on these firms, certificates are an improvement over pure private ordering. But there are two key reasons to prefer the legal-entity approach. The first is that the necessary alterations to corporate purpose and the fiduciary and structural obligations that underpin it may not be valid under U.S. state laws. As noted above, it is unclear whether Delaware corporations can completely reject their for-profit

roots.<sup>75</sup> And even if they could, firms could not change fiduciary duties to elevate mission over profits.<sup>76</sup>

This problem does not exist with LLCs, and other states may not be as rigid as Delaware. Nevertheless, this means the certificate would have different legal implications based on where firms are incorporated and the underlying legal entity. For example, only some certified companies would have fiduciary duties that align with their missions. The legal uncertainty undermines the value of the certification. An EU-wide certificate would run into a similar problem. Its value would be compromised because it would depend on how the certification interacts with the laws of member states, which may have lower or higher social enterprise standards or no social enterprise law at all. A new legal entity, in contrast, would provide clarity of purpose and structure.

There is also a more fundamental problem with certificates when they are granted to for-profit firms. It sends the wrong signal. This is an example of how law can have an expressive function.<sup>77</sup> Laws may “convey a social meaning that reinforces or changes the norms of a community, beyond its role in establishing and enforcing rules.”<sup>78</sup> When awarded to a for-profit company, the certificate implies that a company is basically for-profit, but with a social conscience. A new type of company, on the other hand, suggests that there is something completely different happening. And social enterprises are completely different. Their involvement in commerce is a means to a social end rather than to profits. As discussed above, the concept of a for-profit firm is fundamentally at odds with social enterprise. Social enterprises are not “for profit.”

Layering a social enterprise certification on top of a for-profit firm may offer a temporary solution, but this approach is ultimately clumsy and inappropriate. It makes little sense to take a set of laws designed to support one type of structure, for-profit firms, then take advantage of the default nature of the rules to create a certificate that signifies something completely at odds.

### III. SOCIAL ENTERPRISE LAWS IN THE UNITED STATES AND THE EUROPEAN UNION

The ideal legal structure for social enterprises would be based on the principles set forth above. The rules would clearly identify the purpose of social enterprises and set out a structure that supports them—a structure that includes a blend of governance restrictions, financial limitations, and

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<sup>75</sup> See *supra* note 37 and accompanying text.

<sup>76</sup> See *supra* note 39 and accompanying text.

<sup>77</sup> See generally Cass Sunstein, *On the Expression Function of Law*, 144 U. PA. L. REV. 2021 (1996).

<sup>78</sup> Thomas A.J. McGinn, *The Expressive Function of Law and Lex Imperfecta*, 11 ROMAN LEGAL TRADITION 1, 1 (2015).

disclosure requirements. Companies that comply with these rules would have a clear designation that would signal their social purpose to the market.

In the U.S., there are a patchwork of certificates and legal forms available to socially-minded companies. While these mechanisms roughly map onto the outline we describe, they do not concretely define or specifically support social enterprises. The concept of social enterprise is much better developed in the EU, but concerns remain. While the basic idea of social enterprise is broadly consistent among member states, the supporting regulatory structures vary greatly. Some are too lax; others too strict. More generally, the lack of uniformity means that there is no precise pan-European definition of what it means to conduct business as a social enterprise.

### A. *Social Enterprise Law in the United States*

US law does not distinguish social enterprises from firms that incorporate a social mission into their business. Social enterprises exist as an undefined subset of this group. Socially minded companies typically signal their intentions through a B Corp certification or by incorporating as benefit corporations.<sup>79</sup> The scheme is problematic for all socially-minded firms and wholly inadequate for true social enterprises.

#### 1. *B Corp Certification*

To earn a B Corp certification, companies must commit to a social purpose, and demonstrate, and make disclosures related to, their commitment to stakeholder values.

The social-purpose commitment comes in the form of a declaration of interdependence. This declaration describes certified B Corps as “purpose-driven” firms that “create[] benefit[s] for all stakeholders, not just shareholders.”<sup>80</sup> These companies aspire “to do no harm and benefit all.”<sup>81</sup>

To back up this declaration, companies must complete the B Impact Assessment.<sup>82</sup> The assessment consists of a series of questions related to the company’s impact on various stakeholders and indicates how the company’s impact on those stakeholders compares to other companies. An example question is “What % of energy (relative to company revenues) was saved in

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<sup>79</sup> This is a nonexhaustive list. There are also benefit LLCs, flexible purpose corporations, social purpose corporations, and L3Cs, but these are less common. See DANA BRAKMAN REISER & STEVEN A. DEAN, *SOCIAL ENTERPRISE LAW: TRUST, PUBLIC BENEFIT, AND CAPITAL MARKETS* 61–66 (2017).

<sup>80</sup> *About B Corps*, CERTIFIED B CORP., <https://bcorporation.net/about-b-corps> (last visited Sept. 5, 2020) [<https://perma.cc/9VXA-EU52>].

<sup>81</sup> *Id.*

<sup>82</sup> *Certification Requirements*, CERTIFIED B CORP., <https://bcorporation.net/certification/meet-the-requirements> (last visited Sept. 5, 2020) [<https://perma.cc/DAJ5-XYZW>].

the last year for your corporate facilities?”<sup>83</sup> Companies are measured and scored against other companies that take the assessment. To qualify, B Corps must achieve a certain minimum score.<sup>84</sup> Once qualified, they are measured against the assessment every three years and must maintain the minimum.<sup>85</sup>

The score is also made available on B Corp’s website, and it is broken down into categories. For instance, there is a section on workers. Here, companies are scored on things like “financial security,” “career development,” and employee “engagement [and] satisfaction.”<sup>86</sup>

As part of the process, companies must also complete disclosures about their industry, whether they have been penalized or fined in connection with their business activities, and whether they engage in questionable activities.<sup>87</sup> Companies must answer true/false questions like “company or company suppliers do not use any workers who are prisoners.”<sup>88</sup>

Within three years of certification, companies must also either incorporate as a benefit corporation or, in Washington, as a social purpose company.<sup>89</sup> Those that incorporate as a social purpose company must also adopt the B Corp legal amendment language.<sup>90</sup> The language sets out a stakeholder agenda for the firm. Companies must amend their governing documents to include the following purpose: “The purpose of the Company shall include creating a material positive impact on society and the environment, taken as a whole, from the business and operations of the Company.”<sup>91</sup> Companies must further specify that, rather than privilege shareholder interests, the board of directors must consider the best interests of a range of constituencies, including employees, customers, the community, society, and the environment.<sup>92</sup>

Although some of the wording is ambiguous, the impact assessment questions and related disclosure rules more than anything else make clear that certification is meant for stakeholder-oriented firms. The transparency

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<sup>83</sup>*Step 1: Assess Your Impact*, B IMPACT ASSESSMENT, <https://bimpactassessment.net/how-it-works/assess-your-impact#see-sample-questions> (last visited Sept. 5, 2020) [<https://perma.cc/LX9C-AKY5>].

<sup>84</sup> CERTIFIED B CORP., *supra* note 82.

<sup>85</sup> *Id.*

<sup>86</sup> *See, e.g., B Impact Report, Patagonia*, CERTIFIED B CORP., [https://bcorporation.net/directory/patagonia-inc?\\_ga=2.171954336.1270324507.1595442070-927962066.1595442070](https://bcorporation.net/directory/patagonia-inc?_ga=2.171954336.1270324507.1595442070-927962066.1595442070) (last visited Sept. 6, 2020) [<https://perma.cc/B8PM-R9ZK>].

<sup>87</sup> *See Disclosure Materials*, CERTIFIED B CORP., [https://blab-mktg-bcorporation-production.s3.amazonaws.com/B\\_Corp\\_DisclosureQuestionnaire-blank.pdf](https://blab-mktg-bcorporation-production.s3.amazonaws.com/B_Corp_DisclosureQuestionnaire-blank.pdf) (last visited Sept. 6, 2020) [<https://perma.cc/KGG9-YW8Z>].

<sup>88</sup> *Id.*

<sup>89</sup> *Agreement for B Corporation Certification*, B LAB 2 (2018); *US Corporation – Washington – No*, CERTIFIED B CORP., <https://bcorporation.net/us-corporation-washington-no> (last visited Sept 6, 2020) [<https://perma.cc/JV4G-NURE>].

<sup>90</sup> *See Agreement for B Corporation Certification*, *supra* note 89.

<sup>91</sup> CERTIFIED B CORP., *supra* note 86.

<sup>92</sup> *Id.*

surrounding stakeholder impact is similar to, yet analytically distinct from, transparency about the firm's public purpose. The latter involves disclosures about the firm's impact on its mission rather than on employees and other stakeholders. This is missing from the B Corp disclosure regime.

The roster of certified companies further supports this conclusion. The vast majority are not social enterprises.<sup>93</sup> Because B Corp certification is meant for, and populated by, stakeholder-oriented firms, it is clearly inapt for social enterprises, which are destined to get lost.

## 2. *Benefit Corporations*

Benefit corporations are companies that have formed under a state's benefit corporation statute rather than its corporate law statute. Thirty-six states have benefit corporation legislation.<sup>94</sup> B Corp certifications and benefit corporations are closely related. The certificate is essentially for companies that already incorporated as for-profit firms (but are willing to change their legal form to a benefit corporation or social purpose company within three years) and for those that have formed as benefit corporations or similar entities and want the imprimatur of certification.

While in practice benefit corporation statutes cast a wide net, the statutory language makes it sound a lot like the firms are social enterprises. According to the model benefit corporation statute, “[a] benefit corporation shall have a purpose of creating general public benefit.”<sup>95</sup> The statute goes on to define “general public benefit” as “[a] material positive impact on society and the environment, taken as a whole, from the business and operations of a benefit corporation assessed taking into account the impacts of the benefit corporation as reported against a third-party standard.”<sup>96</sup> Companies may also “identify one or more specific public benefits” that the company plans to pursue.<sup>97</sup>

To reinforce its public commitment, companies also have the power to elect a benefit officer and director. A benefit officer would put together the company's annual benefit report in which benefit directors would opine on such things as “[w]hether the benefit corporation acted in accordance with its general public benefit purpose and any specific public benefit purpose in all

<sup>93</sup> *B Corp Directory*, CERTIFIED B CORP., <https://bcorporation.net/directory> (last visited Sept. 5, 2020) [<https://perma.cc/XE5R-L6DN>].

<sup>94</sup> *State by State Status of Legislation*, BENEFIT CORP., <https://benefitcorp.net/policymakers/state-by-state-status> (last visited Sept. 5, 2020) [<https://perma.cc/F8J2-FK5Q>].

<sup>95</sup> MODEL BENEFIT CORPORATION LEGISLATION, § 201(a) (2017), available at [https://benefitcorp.net/sites/default/files/Model%20benefit%20corp%20legislation%20\\_4\\_17\\_17.pdf](https://benefitcorp.net/sites/default/files/Model%20benefit%20corp%20legislation%20_4_17_17.pdf) [<https://perma.cc/7NG6-QURV>].

<sup>96</sup> *Id.* at § 102. Also, § 401 requires that the company prepare an annual report and that the report be assessed against a third-party standard.

<sup>97</sup> *Id.* at § 201(b).

material respects.”<sup>98</sup> The public-benefit mandate is also backed by an enforcement mechanism. Shareholders with a certain minimum ownership stake may sue the corporation, its officers, and directors for injunctive relief (but not monetary relief) for failure to “pursue or create” a general or specific public benefit.<sup>99</sup>

This focus on a public benefit comes within a stakeholder paradigm. Directors of a benefit corporation are, among other things, instructed to consider the interests of shareholders, employees, customers, and the community in their decision-making.<sup>100</sup> The aforementioned annual report also includes an assessment of the company’s “social and environmental performance” measured against a third-party standard.<sup>101</sup> There are a number of third-party standards that benefit corporations can use,<sup>102</sup> including the B impact assessment tool used for the B Corp certificate.

Despite rhetorical flourishes in the statute suggesting the contrary, as with B Corp certifications, a look at the companies that have incorporated as benefit corporations shows that it is the stakeholder orientation that defines them rather than their mission. While a number of companies have chosen the benefit corporation form, only a few would qualify as social enterprises as we have defined the term.<sup>103</sup> Rather, a benefit corporation is typically one that has chosen to run its business sustainably, with an eye toward stakeholders, not merely shareholders. Patagonia, for example, is a benefit corporation.<sup>104</sup> While laudable, such firms do not specifically put a social mission first, nor do they necessarily have a particular social mission in mind.

Ultimately, benefit corporations and B Corp certifications serve as complementary and overlapping mechanisms for firms to signal their commitment to social values. The structure fits the outline for social enterprises that we describe in Part I. As we suggest, these mechanisms

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<sup>98</sup> *Id.* at § 302(c)(1).

<sup>99</sup> *Id.* at §§ 102, 301(c), 305(a)(1), 305(c).

<sup>100</sup> *Benefit Corporations: Frequently Asked Questions*, B LAB, [https://benefitcorp.net/sites/default/files/FAQs%20Directors%20and%20Officers\\_6\\_17.pdf](https://benefitcorp.net/sites/default/files/FAQs%20Directors%20and%20Officers_6_17.pdf) (last visited Sept. 6, 2020) [<https://perma.cc/K7NH-D6L3>] (“By committing to consider the interests of other stakeholders, a benefit corporation may create value through employee engagement, customer loyalty and similar attributes, thereby improving outcomes for all stakeholders -- including the owners. Furthermore, certain profit making opportunities may not be available without a true commitment to other stakeholders.”).

<sup>101</sup> MODEL BENEFIT CORPORATION LEGISLATION, *supra* note 95, at § 401(a)(2).

<sup>102</sup> *How Do I Pick a Third Party Standard*, BENEFIT CORP., <https://benefitcorp.net/how-do-i-pick-third-party-standard> (last visited Sept. 6, 2020) [<https://perma.cc/3J2T-C7M5>].

<sup>103</sup> *See Find a Benefit Corp*, BENEFIT CORP., <https://benefitcorp.net/businesses/find-a-benefit-corp> (last visited Sept. 29, 2020) [<https://perma.cc/9FQ6-8Y58>].

<sup>104</sup> *B Lab*, PATAGONIA, <https://www.patagonia.com/b-lab.html> (last visited Sept. 6, 2020) [<https://perma.cc/Q3KW-UP5K>].

reorient corporate purpose and create an accountability and transparency structure to support socially minded firms.

But this multilevel structure comes with a few major drawbacks. One drawback of certification is its reliance on B Corp as both the standard setter and enforcer of its standard. To remain viable, it must strike a balance between credibility and relevance. Credibility depends on relatively strict standards, but if the standards are too strict, there will be too few firms for the certificate to be meaningful and viable. A drawback of both B Corp certifications and benefit corporations is that the overlap between them undoubtedly creates consumer and investor confusion. Finally, the biggest drawback for social enterprises is that neither structure fits them. Because firms of varying levels of social-mindedness make use of these structures, they do not serve to distinguish social enterprises from firms with a much more limited connection to a social cause.

### B. *Social Enterprise in European Union*

The concept of social enterprise is much more well-understood in the EU, where these organizations have a long history. Social enterprises originally arose as a way to fight unemployment among traditionally excluded groups<sup>105</sup>—and this remains the most common mission.<sup>106</sup>

Sixteen EU countries have legal forms that roughly capture social enterprises.<sup>107</sup> Many countries use a definition of social enterprise that aligns with our proposal. For example, Denmark has “Registered Social Enterprises.”<sup>108</sup> These firms are required to have a “social purpose.”<sup>109</sup> Italy is similar.<sup>110</sup> Many countries do not stop there. They specify the types of missions that social enterprises must pursue. In line with their history, the most prevalent specified mission is employment of disadvantaged groups.

For the most part, EU social enterprise law does not conflate social mission with corporate social responsibility. This might be because social responsibility is already part of corporate law and culture. It could also stem from the European conception of corporate purpose. As discussed above, it is operational rather than abstract.<sup>111</sup> Social enterprises are social enterprises because they are structured in a way that supports the company’s mission. This structure leaves no room for ambiguity about the firm’s social-purpose commitment.

The drafting that puts mission first, however, is not always perfectly clear. In Slovenia, for instance, profits must not be the exclusive or main

<sup>105</sup> Defourny & Nyssens, *supra* note 5, at 34.

<sup>106</sup> EUR. COMM’N, *supra* note 18, at ix.

<sup>107</sup> EUR. SOC. ENTER. L. ASS’N, SOCIAL ENTERPRISE IN EUROPE: DEVELOPING LEGAL SYSTEMS WHICH SUPPORT SOCIAL ENTERPRISE GROWTH 10 (2015).

<sup>108</sup> EUR. COMM’N, *supra* note 18, at 58 box 5.1.

<sup>109</sup> *See id.*

<sup>110</sup> *See id.*

<sup>111</sup> *See supra* text accompanying notes 4141–44.



objective.<sup>112</sup> Because the definition does not clearly require that profits are subsidiary to a social mission, the language is ambiguous.

Country laws include various accountability mechanisms to align management with the firm's social mission. But the rules are patchy. Some countries specify inclusive mission-driven governance practices.<sup>113</sup> France, for instance, requires that board membership include workers, users, and a final group that aligns directly with the company's mission.<sup>114</sup> Italy includes a similar requirement.<sup>115</sup> Many countries lack such concreteness, however. Instead, they simply mandate that social enterprises adhere to principles of democratic governance.<sup>116</sup>

Italy is the only country with a mandatory and standardized disclosure scheme.<sup>117</sup> But compliance is reportedly weak.<sup>118</sup> The majority of countries do not incorporate disclosure into their regulatory scheme.<sup>119</sup>

Financial limitations, however, are fairly common.<sup>120</sup> France, for instance, uses detailed requirements related to operating expenses and financial ratios.<sup>121</sup> It also caps executive compensation.<sup>122</sup> In the Czech Republic, at least fifty-one percent of profits need to be allocated toward the firm's mission.<sup>123</sup> Some countries disallow any distributions to shareholders.<sup>124</sup> This clearly goes too far as it turns social enterprises into nonprofits.

In addition to the wide variation in substantive requirements, EU countries diverge on the mechanisms of social enterprise law.<sup>125</sup> Some take a certificate-style approach. In these countries, firms can earn social enterprise status regardless of their legal form so long as they comply with the relevant criteria.<sup>126</sup> Belgium, Denmark, and Finland, for instance, take this approach.<sup>127</sup> Other countries, like Greece, France, and Poland, have enacted specific legal forms.<sup>128</sup> As noted previously, legal forms are the superior approach. There is an incongruence of corporate purpose when a

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<sup>112</sup> EUR. COMM'N, *supra* note 1818, at 58 box 5.1.

<sup>113</sup> Defourny & Nyssens, *supra* note 55, at 18.

<sup>114</sup> Defourny & Nyssens, *supra* note 55, at 19 n. 32.

<sup>115</sup> EUR. COMM'N, *supra* note 18, at 114.

<sup>116</sup> *Id.* 18annex 2 at 109–18.

<sup>117</sup> *Id.* at 87 & tbl. 5.6.

<sup>118</sup> *Id.* at 87.18

<sup>119</sup> *Id.* 18

<sup>120</sup> *See id.* 18 at 56.

<sup>121</sup> *See* EUR. SOC. ENTER. L. ASS'N, *supra* note 107, at 26.

<sup>122</sup> *See id.*

<sup>123</sup> EUR. COMM'N, *supra* note 1818, annex 2 at 110; Ebrahim et al., *supra* note 4848, at 86 (noting CICs are capped at 35%).

<sup>124</sup> Defourny & Nyssens, *supra* note 55, at 47–48 n.21; EUR. COMM'N, *supra* note 1818, at 56.

<sup>125</sup> EUR. COMM'N, *supra* note 1818, at 51.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

social enterprise label is layered on top of for-profit firms. This is true even in European countries where even for-profit firms have a stakeholder orientation.

It is beyond the scope of this essay to pick apart the laws of each country, but this brief review illustrates the gap between current law and the standards of accountability and transparency we outlined in Part I. Countries could more clearly define social enterprises, more specifically outline mission-centric governance practices, more narrowly tailor financial limitations, and implement mandatory disclosure requirements. In addition, the disharmony of the rules means that there is no clarity of what constitutes a social enterprise across the EU.

The lack of uniformity limits the potential impact of these laws. One reason for the formation of the EU was to lower the cost of doing business across EU countries. The lack of harmonization here creates the same problem. Potential social enterprise investors from one EU country cannot easily invest in social enterprises in another. For locally targeted firms, this may not be overly disconcerting. Investors from abroad may have little interest. But some social enterprises have much broader ambitions. For these, a recognizable and credible EU regulatory framework would be beneficial.

### C. *European Union Proposal*

In July 2018, the EU Parliament recommended that the European Community adopt a “social economy label.” This builds on programs in place since 2011 to support social enterprises.<sup>129</sup>

To receive the label, an entity must meet the following criteria:

- (a) the organisation should be a private law entity established in whichever form available in Member States and under EU law, and should be independent from the State and public authorities;
- (b) its purpose must be essentially focused on the general interest or public utility;
- (c) it should essentially conduct a socially useful and solidarity-based activity, i.e. via its activities it should aim to provide support to vulnerable groups, to combat social exclusion, inequality and violations of fundamental rights, including at the international level, or to help protect the environment, biodiversity, the climate and natural resources;

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<sup>129</sup> See EUR. COMM’N, SOCIAL ENTERPRISES, [http://ec.europa.eu/growth/sectors/social-economy/enterprises\\_en](http://ec.europa.eu/growth/sectors/social-economy/enterprises_en) (last visited Sept. 6, 2020) [<https://perma.cc/KNH7-MTH9>].

(d) it should be subject to an at least partial constraint on profit distribution and to specific rules on the allocation of profits and assets during its entire life, including at dissolution; in any case, the majority of the profits made by the undertaking should be reinvested or otherwise used to achieve its social purpose;

(e) it should be governed in accordance with democratic governance models involving its employees, customers and stakeholders affected by its activities; members' power and weight in decision-making may not be based on the capital they may hold;

The European Parliament considers that nothing prevents conventional undertakings from being awarded the European Social Economy Label if they comply with the above-mentioned requirements, in particular regarding their object, the distribution of profits, governance and decision-making.<sup>130</sup>

The proposal also recommends that such entities be required to post an annual report “on their activities, results, involvement of stakeholders, allocation of profits, salaries, subsidies, and other benefits received.”<sup>131</sup>

The EU proposal is a close fit to our definition of social enterprise and how law should support it. It provides a label for true social enterprises and appropriate credibility mechanisms. It falls short, however, in two areas. The first is that the label may overlay any type of business entity. This ignores the fundamentally different corporate purpose that motivates social enterprises.

Second, the ambiguity of its requirements significantly drains the label of value. The proposal leaves to member states the task of specifying such things as governance requirements, limits on profit distributions, and the substance of the disclosure requirement.<sup>132</sup> This flexibility undermines the signaling function of the label. As just discussed, countries have vastly different requirements in these regards.<sup>133</sup> That being the case, investors would not know how committed any particular entity is to its social purpose goals without further research.

The EU can cure each of these problems by creating objective rules for each of its requirements. This would provide potential investors and consumers with far more guidance. Further still, it could create its own EU entity, along the lines of the European Company. This would clear up any

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<sup>130</sup> European Parliament Resolution of 5 July 2018 With Recommendations to the Commission on a Statute for Social and Solidarity-Based Enterprises (2016/2237(INL)), Recommendation 1.

<sup>131</sup> *Id.* at Recommendation 4.

<sup>132</sup> See J S Liptrap, *European Parliament Recommends Creating EU-Wide Social Enterprise Legal Status – A Misstep?*, OXFORD BUS. L. BLOG (Sept. 21, 2018), <https://www.law.ox.ac.uk/business-law-blog/blog/2018/09/european-parliament-recommends-creating-eu-wide-social-enterprise> [<https://perma.cc/9BUG-RA77>].

<sup>133</sup> See *supra* text accompanying notes 112–25.

doubt about the definition and regulation of social enterprises across the continent.

#### D. *Summary of Comparative Insights*

The above analysis shows that the US and EU have opposite strengths and weaknesses. US law in the vicinity of social enterprise tends to have strong substantive requirements. The B Corp transparency scheme, for instance, is laudable. But because the requirements are linked to social mindedness, the law is inapt for true social enterprises—those that put mission above all else. They are lost in a sea of firms with varying commitments to social causes.

In the EU, the concept of social enterprise is well defined. But the substantive requirements are too-often toothless. This similarly undermines the value of social enterprise law. Just as in the US, investors and consumers do not know what they are getting with a social enterprise. The answer on both continents is US-style substantive requirements tailored to fit the EU definition of social enterprise.

#### \*\*\* A WORD ON CORPORATE SOCIAL RESPONSIBILITY

Some may argue that the true challenge is to make traditional for-profit firms more socially responsible—or more controversially, to end shareholder primacy. This essay does not contravene this goal. At its core, it argues for clear and transparent legal rules that fit social enterprises. The label, “social enterprise,” would be available to only those firms that meet the strict criteria. Socially responsible firms could still earn labels that accurately characterize their values. They just no longer would be conflated with social enterprises. The only firms potentially harmed would be those trading off confusion as to the extent of their commitment to the social good. This is not a group about which we should be concerned. And any loss in value to these firms should be more than made up for by the gain in value that accrues to those firms that are able to truly signal their intentions. Indeed, this is the logic behind much of market regulation.<sup>134</sup> Strong social enterprise regulation is a complementary avenue to more sustainable business.

#### IV. CONCLUSION

This essay defined social enterprises and set out a model for how regulations can support them. It then assessed US and EU laws against this model. Both legal regimes fall far short, but in completely different ways. The US has yet to instantiate the concept of social enterprise into its laws.

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<sup>134</sup> See generally George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970) (arguing that quality uncertainty undermines markets and justifies market regulation).

European countries understand social enterprise but do not have strong rules to support them. The normative takeaway is clear—both continents need a clear definition of social enterprise backed by regulations that match the definition. We provide a roadmap.

Our discussion only skims the surface of this vast and underappreciated topic. In putting social good above profits, social enterprise is a paradigm shift. Flipping these two motives represent a different way of organizing economic activity that somewhat uncomfortably challenges the basics of economics, markets, and firms. While social enterprises are a small fragment of the global economy, they represent a big idea. Perhaps the absence of thoughtful regulation is what holds them back from realizing their considerable conceptual appeal.