Nonprofit Sector Research Fund

Mixing Mission and Business: Does Social Enterprise Need A New Legal Approach?

Highlights from an Aspen Institute Roundtable

By Thomas J. Billitteri

January 2007

THE ASPEN INSTITUTE

Mixing Mission and Business: Does Social Enterprise Need A New Legal Approach?

Highlights from an Aspen Institute Roundtable

by

Thomas J. Billitteri

January 2007

THE ASPEN INSTITUTE

Nonprofit Sector Research Fund

The Nonprofit Sector Research Fund (NSRF) was established at the Aspen Institute in 1991 to increase understanding of the nonprofit sector and philanthropy through the support of high-quality research. Since its founding, the Fund has awarded over $11.5 million in research grants to 420 projects examining a broad range of issues facing nonprofit organizations, philanthropy, and the people they serve.

The Fund is a program of The Aspen Institute's Nonprofit Sector and Philanthropy Program, which is supported by the Atlantic Philanthropies, Carnegie Corporation of New York, Ford Foundation, Bill and Melinda Gates Foundation, William Randolph Hearst Foundation, Ewing Marion Kauffman Foundation, W.K. Kellogg Foundation, John D. and Catherine T. MacArthur Foundation, Charles Stewart Mott Foundation, Northwest Area Foundation, The David and Lucile Packard Foundation, Skoll Foundation, and Surdna Foundation.

Publications

The Nonprofit Sector Research Fund produces a variety of publications, including *Snapshots*, concise research briefings that highlight practical and policy-relevant findings reported by Fund grantees; the *Aspen Philanthropy Letter*, an e-newsletter on new developments in the field of philanthropy; books, such as *Building Wealth* and *Organizing Foundations for Maximum Impact*; and working papers that present findings of Fund-supported research.

A complete list of publications is available from the Fund by visiting our website at www.nonprofitresearch.org. Publications may be ordered through the Aspen Institute Fulfillment Office at (410) 820-5338.

Working Papers

Working papers are not formally peer-reviewed. The Fund invites reader feedback on working papers and can convey reader comments to author(s).

A complete list of Working Papers is available from the Fund by visiting our website at www.nonprofitresearch.org. Individual copies may be ordered through the Aspen Institute Fulfillment Office at (410) 820-5338.

About the Author

Thomas J. Billitteri is an independent writer and researcher, specializing in nonprofit issues. He is a former news editor and staff reporter of *The Chronicle of Philanthropy* and has held reporting and editing positions at the *St. Petersburg Times*, *Dallas Times Herald*, *Religion News Service*, and *Florida Trend* business magazine, among other media outlets.

Nonprofit Sector Research Fund Council

Nonprofit Sector Research Fund Staff

For further information on the Nonprofit Sector Research Fund, contact:

Nonprofit Sector Research Fund
The Aspen Institute
One Dupont Circle, NW
Suite 700
Washington, DC 20036
(202) 736-2500 / (202) 293-0525 (fax)
e-mail: nsrf@aspeninstitute.org
www.nonprofitresearch.org

Fueled by an explosion in federal spending for health and welfare programs, the nonprofit world grew rapidly in the 1960s and 1970s as a key partner with government in the delivery of social services. The eminent sociologist Amitai Etzioni called philanthropy the "Third Sector" for the important societal role it began to play alongside public bureaucracies and private enterprise.

Now, some of the leading thinkers in the business and nonprofit worlds believe they see an evolutionary step in that decades-old model. They point to an emerging "Fourth Sector" of social enterprise organizations that combine charitable missions, corporate methods, and social and environmental consciousness in ways that transcend traditional business and philanthropy. This new generation of hybrid organizations is taking root in a fertile space between the corporate world, which is constrained by its duty to generate profits for shareholders, and the nonprofit world, which often lacks the market efficiencies of commercial enterprise.

The question of how to nurture this trend – and whether new laws and tax regimens are needed to do it – was the focus of a daylong meeting in Washington in late September sponsored by the Aspen Institute's Nonprofit Sector and Philanthropy Program. The meeting, titled "Exploring New Legal Forms and Tax Structures for Social Enterprise Organizations," marked a rare opportunity for some of the leading thinkers in the social enterprise movement to meet in one place and discuss this emerging segment of the economy. The meeting drew more than 40 participants from such fields as nonprofit law, finance, technology, and management, plus founders and executives of several pioneering social enterprise groups.

Wide Range of Models

As quickly became apparent from the discussion, no single definition of social enterprise exists, and no single organizational model covers all possible approaches. Some efforts are decades old. For example, Ashoka, a group that bills itself as a global association of social entrepreneurs, has provided startup financing and other support since 1980 to people who offer systemic solutions to pressing social problems, from health crises to human rights.

Then, too, some ideas for blending the nonprofit and for-profit worlds are truly avant garde. In a paper published in September by the University of Chicago law school, professors Anup Malani and Eric A. Posner argue in favor of "for-profit charities."[1] The authors write: "There may be good arguments for recognizing the nonprofit form and good arguments for providing tax subsidies to charities or donors to charities, but there is no good argument for making those tax subsidies available only to charities that adopt the nonprofit form." They contend that for-profit groups that engage in charitable activities should enjoy the same tax benefits bestowed on charitable nonprofit groups. "[T]he charitable activities of many commercial firms suggest that in the absence of discriminatory tax treatment[,] for-profit charities would flourish," Mr. Malani and Mr. Posner write. "Current tax benefits for charitable nonprofits should be extended to for-profit charities, and to the charitable activities of for-profit commercial firms."

[1] "The Case for For-Profit Charities," Anup Malani and Eric A. Posner, John M. Olin Law & Economics Working Paper No. 304 (2nd Series), The University of Chicago Law School, September 2006. The paper is available at http://www.law.uchicago.edu/Lawecon/index.html.

At the Aspen meeting, much of the discussion centered on less-revolutionary approaches to social enterprise than the one proposed by Mr. Malani and Mr. Posner. The organizations under consideration at the meeting, sometimes called "hybrid" groups, typically work within the capitalist system, earning income and operating in a businesslike manner, but their goals are not purely financial and their duty is far broader than serving just the interests of shareholders. They strive not only to succeed financially but also to do good, using a blend of traditional corporate methods and progressive social approaches such as sharing governing power with employees and community members and hewing to rigorous outcome standards. Some groups are tax-exempt while others are for-profit organizations.

Like traditional corporations, social enterprise groups may put assets at risk in the marketplace in an effort to sustain and expand their programs, and they may seek to develop a unique charitable "brand" like the brands of consumer products. But their financing might come from a blend of traditional business sources, such as bank loans and stock offerings, and philanthropic sources, such as foundation investments. Some groups form partnerships with established for-profit companies, while others work on their own.

With the outlines of the "Fourth Sector" only slowly taking shape, participants at the Aspen meeting took some of the first steps toward defining its characteristics and setting an agenda for its development. Aspen hopes to coordinate follow-up activities to explore in more detail such topics as testing new social enterprise models, setting accountability standards for them, expanding access to capital for social enterprise projects, using "knowledge aggregation" techniques to share information about this emerging part of the economy, and developing a clear "brand" strategy to raise the profile and credibility of social enterprise groups.

Skeptics and Advocates of New Laws

As interest in these hybrid organizations grows, a pressing question emerges—the one that was at the heart of the Aspen conference: Are wholly new legal forms and tax structures needed to accommodate the next generation of social enterprise organizations? Or can existing laws be used, perhaps with some modest adjustments? Put another way, is the growth of social enterprise being hindered by the limitations of traditional corporate structures and non-profit tax laws?

Some participants at the Aspen meeting expressed skepticism that new laws are needed. John Simon, Augustus Lines Professor Emeritus of Law at Yale University, was prominent among those who suggested that current law already allows nonprofit groups to operate broadly at the intersection of philanthropy and business. He noted, for example, that one form of "cross-border activity"—program-related investments, or PRI's—was approved nearly 40 years ago, in the Tax Reform Act of 1969.

A program-related investment allows a foundation to support a charitable activity by making a financial investment that has the potential to return the foundation's capital in a set period. The investment might be a loan, loan guarantee, or even an equity investment in a commercial enterprise that has a charitable purpose. At present, relatively few foundations make program-related investments, in part because of the strict limitations placed on them. For example, a foundation must assume the risk of evaluating and monitoring the legitimacy and performance of a recipient organization, and the foundation can incur penalties if the IRS decides an investment is inconsistent with the foundation's mission.

Mr. Simon and some others suggested that program-related investments have untapped potential as social enterprise vehicles. "Whether or not we need new structures is something I'm quite dubious about," Mr. Simon said.

Yet many participants argued in favor of broad change. They advocated such steps as changing the federal tax code to accommodate new kinds of social enterprise vehicles and passing state laws to nurture the growth of "socially responsible corporations" that serve not only the interests of shareholders but also those of society at large.

"We're stuck in a for-profit/charity" model, said Allen R. Bromberger, a lawyer in who represents for-profit and nonprofit social ventures and nonprofit organizations with earned-revenue activities. "We can create a different type of business structure … that could potentially become a dominant form of business in this country," Mr. Bromberger said. "Why can't we break out of the box?" A new kind of enterprise, he said, "could unlock tremendous energy."

Mr. Bromberger offered several strategies for linking the worlds of business and charity, including an approach already available under current law: the use of the limited-liability corporation. A "Charitable LLC," as Mr. Bromberger called it, can be structured as a partnership or joint venture between a for-profit and nonprofit entity, with the charitable activity free from income taxes and maintaining its separate identity. However, he warned that IRS rules severely limit the circumstances in which this approach can be used.

Mr. Bromberger also told the conference that he sees room for an entirely new kind of hybrid company that today's tax laws aren't shaped to accommodate. This new model, he said, would balance business and charity in revolutionary ways beyond any existing legal framework.

Some of the features that a new type of hybrid company might have, Mr. Bromberger said: More than a third of its net profit would support its charitable work; the company could raise capital through stock offerings, but also accept foundation grants and tax-deductible contributions that would be segregated on the books and used only for charitable purposes; shareholders would have economic rights, but other stakeholders—or "members"—would also have certain governance powers; and the company would be required to issue an annual "Social Impact Report" outlining its progress toward achieving its social mission.

R. Todd Johnson, a Silicon Valley lawyer, pointed to what many have seen as an unbridgeable chasm between for-profit enterprise and the charitable world. "Everybody thinks with their brain in a left-right axis, and it's divided by the tax code," said Mr. Johnson, whose work includes advising a half-dozen companies in what he calls the for-benefit sector, including Pura Vida Coffee, an enterprise that donates its net profits for social-welfare projects in five countries. He suggested that both business and philanthropy should work at bridging that divide, concentrating on new forms of legal structures, capital acquisition, and organizational governance.

'New Class of Organization'

Many of the sentiments expressed at the Aspen meeting reflected those in a working paper that helped to inform the day's discussion. Titled "The Emerging Fourth

Sector,"[2] the paper argues that "a new class of organizations with the potential for generating immense economic, social, and environmental benefits is emerging at the intersection of the public, private, and social sectors."

The context for the emergence of this new category of organizations, the paper asserts, is a "new world" characterized by a series of global trends. They include the supremacy of free-market capitalism and its hallmarks of entrepreneurship, innovation, and self-reliance; the spread of democracy; environmental degradation and a widening gap between rich and poor; and a growing "fortress mentality" as nations seek to protect themselves against terrorism.

"The result of these and other changes is a globalized, massively interdependent society where accelerated change is the norm, fear and anxiety are dominant emotions, and people have unprecedented freedom to choose what values to hold, what identities to embrace, and what people to associate with," the paper says. "While the typical for-profit, non-profit, and governmental organization models have much to offer, they were designed at a time when this kind of world wasn't even remotely conceivable." As a result, the paper continues, "there is a considerable gap between what people want from the organizations they interact with as stakeholders and what they are actually getting. Required are new organizational models that can do a better job of meeting people's needs under these new and unprecedented circumstances."

Current Efforts

Numerous charities and entrepreneurs are engaged in social enterprise activities, some in concert with traditional corporations. For example, KaBOOM!, a decade-old

---

[2] "The Emerging Fourth Sector," Executive Summary, developed by the Fourth Sector Network Concept Workgroup with support from the Aspen Institute and the W.K. Kellogg Foundation, Sept. 19, 2006.

nonprofit group that builds or renovates neighborhood playgrounds, and The Home Depot, its largest funding partner, last year announced plans to create or refurbish 1,000 play spaces in 1,000 days. The Home Depot is investing $25-million and nearly 1 million volunteer hours in the program. KaBOOM!'s largest non-corporate partner, The Omidyar Network, started by eBay founder Pierre Omidyar and his wife, Pam, made a three-year, $5-million investment. Tony Deifell, KaBOOM!'s chief strategist, said KaBOOM!'s annual budget has doubled in the past 24 months to roughly $20 million.

Benetech, a California nonprofit organization, is another example of a group that has stepped aggressively into the social-venture waters. Functioning something like a Silicon Valley startup, it uses cutting-edge technology and business methods to address such issues as literacy, human rights, and landmine detection. Its revenue comes from a combination of grants, donations, licensing of software, and sales of services. Peggy Gibbs, Benetech's vice president of business development, told the conference that high-level venture capitalists and technology experts often do not understand the social enterprise model. "They have a hard time grasping what real social enterprise is," she said. "I am anxious to elevate that conversation to where it's not an anomaly but instead it is a truly great business solution."

Challenges and Caveats

Indeed, as social entrepreneurs contemplate development of a vibrant Fourth Sector, they must first overcome a number of such challenges, participants at the Aspen conference suggested.

Not least among those challenges is creation of a coherent and marketable image of what it means to be a social enterprise organization—a brand, that is identifiable in the marketplace and reassuring to a wide segment of the public. And no segment is harder to reassure than investors. A number of participants at the Aspen meeting spoke of the difficulty under present laws of attracting investment capital, whether from bank loans, venture capital, or some other form.

Still another challenge is figuring out where the line lies between social enterprise and purely commercial interest. Jon Pratt, executive director of the Minnesota Council of Nonprofits, cautioned that in some cases corporate partners of social entrepreneurs can be more motivated by the public-relations value of the relationship than the charitable mission. A company might engage with a nonprofit organization, for example, simply to assuage public feelings about a controversial business practice. "A problem is trying to distinguish between social enterprise and indulgence," Mr. Pratt warned.

A Breakthrough Idea?

Notwithstanding the caveats, interest in social entrepreneurship runs high, and ideas on how to link business methods with charitable missions abound. A proposal that seemed to draw the most robust attention from participants at the Aspen meeting was offered by Marcus Owens, a Washington lawyer who headed the Internal Revenue Service's Exempt Organizations Division until early 2000.

Mr. Owens suggested that rather than undergo an arduous, state-by-state process of creating entirely new legal forms to foster the social enterprise sector, the IRS and Treasury Department could shape the existing tax code to a similar end. By applying a new set of regulatory standards to existing law on program-related investments, Mr. Owens said, the federal government could allow the development of specially designated "social benefit organizations"—nonprofit or for-profit groups that are IRS-certified as operating in a businesslike manner and also having an underlying charitable mission. Such a designation, he said, would encourage more foundations to provide financial support for activities that combine business and charity. "What if the IRS decided to foster charity instead of just taxing?" he said.

Under Mr. Owens' proposal, the IRS would give a special designation to bona fide social-benefit organizations, whether tax-exempt or not. Those organizations could borrow money, show a profit or loss, and otherwise function as commercial entities while also carrying out a social mission. Financial support could come not only from traditional sources, such as bank loans and stock offerings, but also from foundations in such forms as loans, grants, and equity investments. A foundation could treat its support as a PRI and therefore count it toward its minimum payout obligation.

Certification would help raise the profile of the social-benefit category and create a comfort zone for those who wanted to invest in it, Mr. Owens suggested. "It would give you an identification, validation, and visibility," he said. "You could have a Web site with a list of validated public-benefit organizations."

Corporate Approaches

Apparently no one had yet approached the IRS about an idea like the one proposed by Mr. Owens. And the IRS, already dogged by a huge backlog of work, may seem unlikely to agree to a new regulatory burden.

On other fronts, however, several efforts have been moving forward.

Among the most ambitious outlined at the Aspen meeting was one that concerned development of a discrete, highly branded segment of the economy called the "For-

Benefit" sector, which proponent Jay Coen Gilbert described as "private enterprise for public purpose."

Mr. Gilbert, a former basketball footwear and apparel entrepreneur, is co-founder of a nonprofit organization called B Lab, whose mission includes creating a new type of company called a "B corporation." Those entities would differ from traditional socially responsible companies in two ways, Mr. Gilbert said: They would institutionalize stakeholder governance—meaning they would take into account not only shareholder interests but also the interests of their employees and the communities and environments where they operate; and they would meet a set of social and environmental performance standards.

A goal of B Lab is to create a unified brand that makes it easy for consumers and investors to identify socially responsible businesses, Mr. Gilbert said. A number of participants at the Aspen conference said that such a consistent brand for the social enterprise world does not now exist.

Another of Mr. Gilbert's goals is to form a holding company for "B corporations" and eventually to take it public as a way of attracting the kind of investors "who have been driving the consumer market for social responsibility."

Mr. Gilbert said his group was working to develop a legal framework that would allow B corporations to operate under existing corporate law. Over the long run, he said, he hopes to gain state-by-state designations for B corporations to help unify the brand, and to explore the possibility of tax preferences for such entities.

A Limited-Liability Approach

Another potential approach involves use of the limited-liability company to advance a social mission, as noted by Mr. Bromberger in his discussion of a "Charitable LLC."

A conference participant who is proceeding along an LLC-related path is Robert Lang, a cosmetics-company CEO who also is chief executive officer of the Mary Elizabeth & Gordon B. Mannweiler Foundation Inc., in Cross River, N.Y. Mr. Lang said he has developed a plan that would allow foundations, as well as individuals and government agencies, to invest in low-profit limited liability companies through purchase of an equity position or other means, such as loans. Such investments would provide capital for socially beneficial activities such as keeping a small-town factory in business or building low-cost housing.

Mr. Lang calls these limited liability companies "L3Cs," a hybridization of the LLC acronym used for traditional limited liability corporations. Under his plan, a foundation could put money into the L3C through a program-related investment, then later sell its stake to another foundation or an individual donor and recycle the proceeds into another PRI project. Profits made by the L3C could be used for its programs and also to pay modest dividends to its investors, who, in the case of foundations, could then use that money to make more program-related investments or traditional grants. If an L3C stopped pursuing its charitable mission, a foundation investor would have to divest its stake.

Mr. Lang said he has had discussions with several large banking and brokerage companies about underwriting an L3C and making its shares available to investors. He said he believes he can proceed with an L3C under current tax law, but that a private-letter ruling from the IRS would make foundations more comfortable with investing in such a vehicle. With that goal in mind, the Mannweiler Foundation, with partners, is in the beginning stages of applying for a letter ruling for its first project, Mr. Lang said: an effort to save endangered jobs in the North Carolina furniture industry.[3]

State legislation

Because traditional corporations have a duty to maximize financial returns for shareholders, broadening that mandate to include a duty to a social mission could require revisions in state corporate law. In Minnesota, State Rep. Bill Hilty and State Sen. John Marty this year introduced a bill[4] that would allow privately held or publicly traded companies to operate under a voluntary "Socially Responsible Corporation" designation – with "SRC" instead of "Inc." after their name -- that lets them focus on both financial success and social responsibility.

Governance would be shared with representatives of employees and of the "public interest," according to a background document on the legislation prepared by Marjorie Kelly, chair of the advisory board of Citizens for Corporate Redesign, a grassroots organization in Minneapolis. Ms. Kelly said in an interview that the advisory board, which drafted the proposed law, includes Mr. Marty and Mr. Hilty.

Under the proposal, a corporation that is publicly traded would have to file a "public interest report" alongside its annual financial report, and companies with the SRC designation would have to seek "advisory input from stakeholders," the background document states.

---

[3] A detailed outline of Mr. Lang's plan is available by writing to: L3C, P.O. Box 361, Cross River, NY 10518.

[4] Senate bill 3786 is available on the Minnesota Senate's Web site at http://www.senate.leg.state.mn.us/

Creation of this new designation, which does not allow for favorable tax treatment, "would allow companies the benefits of having equity investors, but would free them from the demands of short-term profit maximization … leaving boards empowered to keep their focus on serving the long-term health of the company, its customers, and its stakeholders," the document states. It adds: "Corporations would no longer be required by law, as they are now, to maximize short-term profits. Instead, they would have an affirmative duty to protect and serve a variety of stakeholders, including stockholders, employees, the community, suppliers, and the environment."

The Minnesota bill gained no traction in the 2006 legislature, but Sen. Marty told the Aspen conference that backers "plan to pursue it vigorously" in 2007.

International Efforts

The quest for socially responsible businesses is not confined to the United States, and neither are organized efforts to develop and promote them.

Four years ago, people from the social enterprise movement in Britain created the Social Enterprise Coalition, an organization for groups formed under various legal structures that operate with a social or environmental mission. Jonathan Bland, the coalition's chief executive, told the conference that the organization now comprises some 8,000 social enterprises, which range from housing associations and credit unions to registered charities, a coffee company and a newspaper published by homeless people. The coalition promotes a unified voice for social enterprise companies, lobbies government in favor of policies that support them, and identifies best practices among those engaged in social enterprise work.

In 2005, the British government created a new legal structure that lies between traditional corporate forms and charity. The new approach allows the creation of "Community Interest Companies," which are limited-liability companies designed to use their profits and assets to achieve social missions. "The government recognized a range of solutions where social enterprise could play a bigger role," Mr. Bland said. "One thing they looked at was a new legal structure."

A Community Interest Company, or CIC, has several distinguishing features. For example, it must pass a "community interest test" that ensures that it operates in the public interest. It must file an annual report detailing payments to directors, dividends paid on shares, interest paid on loans, and the ways it has fostered involvement of stakeholders in the company's activities. It also must operate under an "asset lock," which prohibits it from distributing its assets or profits to its members except in cases where shareholders have an equity stake in the company. In those cases, returns to shareholders must be modest and are capped so that most of the profits are distributed to the broader community. Charities cannot qualify as CICs, but they can invest in them or own them.

Unlike charities, CICs enjoy no special tax breaks, something that Mr. Brand said his group is lobbying to change. He said he also wants to see a "social enterprise bank" to provide what some have called "patient capital" for people who invest in Community Interest Companies.

So far, some 500 Community Interest Companies have been registered with the British government, and more are in the pipeline, Mr. Brand said. "The potential to grow is big," he said. A recent survey showed that more than 40 percent of the CICs said they had sought that status to "prove their social purpose," Mr. Brand said.

Moving Forward

While ideas abound both here and abroad for social enterprise activities, much work needs to be done before the hybrid segment of the economy grows to its full potential. As a first step, the Aspen Institute has created a Google Groups listserv called Hybrid Legal Forms and Tax Structures (HLFTS) to help people who run or support hybrid organizations share their knowledge and introduce new ideas. In addition, participants in the Aspen meeting agreed to work in small groups on a series of steps aimed at advancing the social enterprise movement.

Those steps include:

- Knowledge aggregation, including development of an online "Wiki" site that allows people to share information about social enterprise. This site would include information on best practices, a "frequently asked questions" (FAQ) resource, a database on social enterprise, and links to Web sites on hybrid organizations and social entrepreneurship, such as xigi.net and changemakers.net.
- Development and testing of hybrid models. Some advocates of social enterprise want to consider concrete steps for changing state or federal laws that govern nonprofit and for-profit corporate structures. This might include exploring a new tax designation for "social-benefit" organizations. Others wish to foster social enterprise using existing legal models. Many participants expressed interest in developing Mr. Owens' idea on program-related

investments. As part of the overall examination of legal structures, participants want to clarify the risks that may arise from shareholder lawsuits or other controversies in cases where social goals are given priority over financial returns.

- Accountability standards. Participants want to formulate a clear definition of a socially responsible business. They also seek to develop specific tools to assess the performance, accountability, and social value of hybrid organizations.
- Research. There is still much to learn about social-venture organizations, including how to create more efficient markets for financing them. Participants expressed strong interest in working on research projects or encouraging foundations and other institutions to support such projects.

With so much groundwork still to be laid, the emergence of a new, hybrid segment of the economy will no doubt occur incrementally, and its success will depend on the efforts of many: entrepreneurs, nonprofit practitioners, researchers, policy officials, consumers, and others. A key message of the Aspen meeting was that no single individual or group can bring about the development of a vibrant social enterprise sector. Teamwork and partnerships are vital.

That, too, is the conclusion of the Aspen working paper on "The Emerging Fourth Sector." "How do we go about creating a new sector?" the paper posits. "The strategy … is this: participation augmented by collaboration."

THE ASPEN INSTITUTE