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Challenges and Interests of the States in Social Mission / Hybrid Organizations

Hybrid Enterprises and the Application of State Charitable Regulatory Principles as a Guide Toward an Effective Regulatory Framework

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I. INTRODUCTION

In recent years, the convergence of several forces have contributed to the rapid adoption of legislation in many states enacting new organizational forms intended to encourage the development of social enterprises. These forms are sometimes referred to as "hybrids," meaning they share characteristics of both for-profit businesses and charities. The first such legislative effort was the low-profit limited liability company (L3C). The L3C legislative effort has been overtaken recently by the benefit corporation concept. Other variations are also emerging. Nonprofits have been the traditional vehicle through which people pursue charitable or social advancements and for-profits have been the vehicle through which people pursue financial gain. The goal of the hybrid movement is to create a new organizational form that facilitates the pursuit of both goals at the same time.

It is not difficult to understand the appeal of the hybrid concept. Our economy is slowly recovering from the Great Recession, which some attribute to large corporations' excessive interest in short-term profits at the expense of the welfare of the communities in which they are based. Social enterprises offer the promise of a kinder, gentler form of capitalism. In addition, there has been significant growth in the use of "cause marketing," in which businesses incorporate charitable appeals into the promotion of their own goods and services. Studies show that cause marketing is effective and provides a means to differentiate goods and services in a crowded market.[2] *When successful, cause marketing may result in a win-win-win situation for businesses, consumers, and charities. Moreover, it appears that many consumers are increasingly looking for "values" when making purchasing decisions, meaning not just traditional consumer interest in cost and quality, but for opportunities to make purchases that reflect consumers' personal values and views toward social progress. Add to this mix a growing*

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[2] *2013 Cone Communications Social Impact Study*, (89% of consumers are likely to switch brands to one that is associated with a good cause, given similar price and quality), available at conecomm.com.

body of entrepreneurs interested in creating businesses as a means to accomplish their personal vision for social improvement, and the hybrid movement emerges.

While there are many people interested in the success of the hybrid movement and in creating a new way of doing business, they may ultimately find that the existing hybrid legislation is a structurally inadequate framework on which to hang a new paradigm. If the hybrid movement is to fulfill its sated potential as a mechanism for social improvement, it would benefit from a more robust regulatory environment.

This paper sets forth some of the misconceptions and questionable hypotheses that appear to have played a role in the passage of the existing hybrid legislation. It next discusses the relevance of charitable regulation to the hybrid movement. This paper then discusses weaknesses in existing hybrid regulation.[3] *The last section discusses the components necessary for effective regulation.*

II. ADDRESSING MISCONCEPTIONS ABOUT THE CHARITABLE SECTOR AND QUESTIONING THE CLAIMED ADVANTAGES OF HYBRIDS

Some of the discussions related to encouraging the development of social enterprises have not displayed a full understanding or respect for the charitable sector.[4] It is important to have an informed discussion of existing organizational forms and their strengths and weakness in order to assess the potential benefits of new organizational forms. This includes addressing some of the myths and misconceptions about the nonprofit sector that sometimes emerge when people discuss the projected advantages of hybrids.

The claimed advantages of for-profit social enterprises include that they are "sustainable," and responsive to market forces, implying that nonprofits are unsustainable and inefficient because of a lack of market competition. The term "sustainable" in the context of hybrid discussions appears to refer to organizations that generate revenues through the sale of goods or services, as opposed to donations. In fact, the charitable sector has, in large part, moved to revenue models that generate income through charging fees for goods or services.[5] For-profit entities are not unique in this regard.

Moreover, the term "nonprofit" is something of a misnomer and does not mean that charities cannot turn a profit. Just like a for-profit company, if a charity fails to ensure that its revenues exceed its expenses, it will soon be out of business. Also, like for-profit organizations,

[3] This paper assumes some familiarity with L3C and benefit corporation legislation and does not generally describe the provisions of these legislative initiatives.

[4] Some use the term "social enterprise" to include both nonprofits and for-profits, but for purposes of this paper, I will use the term to refer to for-profit organizations.

[5] *Urban Institute, National Center for Charitable Statistics, Quick Facts about Nonprofits,* (In 2011, public charities reported over $1.59 trillion in total revenues, 72% of which came from program service revenues), available at http://nccs.urban.org/statistics/quickfacts.cfm.

nonprofits face a crowded marketplace and considerable competition for funding. Nonprofits must compete by providing a product or service that generates financial support, whether through sales or donations. Like for-profit companies, charities must market themselves in ways that attract funding. This is similar to the same market pressures that for-profits face.[6]

The most significant distinction between for-profit and nonprofit entities is not the ability to make a profit, but what the entities are permitted to do with those profits. A for-profit entity might chose to reinvest profits in the business to improve or expand its operations or it might chose to distribute any money left over after expenses to the company's owners. If the business is sold, the proceeds are distributed to the owners. On the other hand, nonprofit charitable organizations are required to reinvest any profits they have earned back into the organization to advance its charitable purposes. They cannot transfer profits to private individuals. If the organization decides to close or transfer its assets, the proceeds must be reinvested in other charitable organizations. These restrictions are referred to as the nondistribution constraint.

The nondistribution constraint does not interfere with nonprofits' ability to pay employees reasonable compensation for their services, and they can look to for-profit peers in setting compensation levels. Although employee compensation at nonprofits may generally lag behind for-profit counterparts, factors other than legal restrictions, such as a lack of financial resources, are more likely the cause of those differences. As evidenced from some media reports on nonprofit executive compensation, a few nonprofit organizations are able to provide generous compensation to their executive management.

In addition, like for-profits, nonprofits are permitted to seek capital in the form of loans and can pay market-rate interest for those loans, although it may still be difficult to find lenders. Again, that leaves the nondistribution constraint as the most significant difference between for-profit and nonprofit entities. Because of the nondistribution constraint, nonprofits cannot obtain capital by offering an equity stake in the organization because paying returns on that capital violates the constraint. In contrast, for-profit organizations can offer an equity interest to those who invest capital in the enterprise.[7]

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[6] Charities that hold IRS tax-exempt status can and do earn revenues from the sale of goods and services, but they are subject to some restrictions in that regard. In order for those activities to be tax exempt, they must be related to the purposes of the charity. If the charity engages in unrelated business activity, those activities are taxed. If the nonprofit engages in excessive amounts of business activity, it risks its tax-exempt status. Similarly, nonprofit organizations can be denied or lose tax-exempt status for excessive "commerciality," meaning that if a nonprofit operates in a manner that appears to directly compete with businesses, it may lose its tax-exempt status. However, restrictions on a charity's business activities and commerciality stem from the tax advantages accorded IRS 501(c)(3) organizations and the principle that tax-exempt organizations would incur an unfair advantage if they were in direct competition with taxable enterprises. Under state law, it is possible to be a taxable, charitable nonprofit, in which case the restrictions on commerciality would not necessarily apply.

[7] Another reason why entrepreneurs may be attracted to the ability to issue equity is because they can ensure their continued control over the organization in a way that is not necessarily possible with the nonprofit organizational form. As a practical matter, nonprofit founders are often able to maintain control over the nonprofits they establish by selecting an initial slate of directors that are allied with or deferential to the founders' management. However, over time, differences can arise such that the board may no longer agree with the founder's management or vision for the organization. Directors sometimes opt to remove a founder from control over the nonprofit that the founder created. In contrast, in a for-profit organization, a founder can opt to maintain control over the organization by

Proponents of hybrids contend that on one hand, nonprofits' inability to offer equity limits their ability to attract social investment capital or to incentivize innovation. On the other hand, hybrid proponents suggest for-profits are hindered in their efforts to achieve social benefits because of directors' legal fiduciary obligations to maximize profits. These limitations are specifically addressed by the benefit corporation legislation. That legislation creates a new organizational form that authorizes the pursuit of social benefits, even at the expense of profits, by eliminating any fiduciary obligation to maximize profits. The legislation also omits any type of nondistribution constraint traditionally associated with organizations whose stated objectives include the pursuit of social benefits.

It is unclear how much for-profit entities' behavior will actually change in terms of generating increased social benefit as the result of legislation relaxing for-profit fiduciaries' legal obligations to maximize profits. There is already a fair amount of legal latitude with respect to any obligation to maximizate profits. The existing limited liability company format allows for the owners of such entities to agree to alter the obligation of profit maximization.[8] Furthermore, most states already have constituency statutes that enable for-profit directors to consider social impact in their decisions.

While the obligation to maximize profits may become most pronounced when entities are faced with buy-out offers, in connection with day to day operations, businesses engage in many forms of corporate social responsibility apparently with relatively little concern that they will face shareholder legal actions for failing to maximize profits. The existing business judgment rule provides broad protections for corporate fiduciaries. In addition, as evidenced by successful cause marketing campaigns, which may generate sales revenues that exceed charitable expenditures, it may be the case that some social enterprises will pursue social benefit only to the extent it is perceived as generating increased profits. Hybrid legislation may, in fact, have little substantive effect on enterprise behavior or in attracting capital to advance social objectives.[9]

It is not clear that the elimination of existing constraints on organizational forms will have the desired transformative effects, and it is also worth bearing in mind that social enterprises may have their own limitations in achieving social benefit. Hybrid organizations may be a tool to add to the "social benefit" tool box, useful in some circumstances, but in some ways, social enterprises have a narrower vision and range than charitable nonprofits. Social enterprises are focused on creating benefits or addressing social issues through the sale of goods and services. There are many other ways to create social benefits and many social problems will not be solved through the sale or purchase of goods and services.

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controlling a majority of an enterprise's stock, although that will limit the enterprise's ability to attract outside capital.

[8] Benefit corporation advocates state the investors find the corporate form more attractive and may be less likely to provide capital to a limited liability company.

[9] Nonprofits, for-profits, and hybrids all depend upon funding whether in the form of donations or capital to be successful. Obtaining funding for any enterprise is inherently difficult and claims that it will be significantly easier for hybrids to attract capital for social enterprises might be viewed with some skepticism.

Because nonprofits are able to attract donations in addition to generating revenues from the sale of goods or services, they have more flexibility to consider a broad array of alternatives for creating social benefits. Moreover, being freed from the constant need to balance social enterprises' twin objectives of generating profits for investors and achieving positive social impact may make charitable nonprofits more, not less, innovative in their approaches to creating social benefit and more interested in measuring and maximizing social benefit. For example, the fiduciaries of a successful social enterprise based upon a "buy one, give one" model may have little incentive to evaluate the effectiveness of the social benefits being created or to consider alternative to approaches to social benefits if those approaches might undermine sales.

In addition, nonprofits are able to harness the power of volunteers. By emphasizing the importance of financial rewards in making organizations efficient and in motivating people, the hybrid movement tends to overlook the valuable contributions and motivations of those who work to improve our communities without any expectation of financial gain. One of the strengths of the nonprofit sector is that it provides an alternative to the for-profit sector's preference for monetizing all transactions.

Even if one supports facilitating the development of social enterprises, hybrid legislation has been enacted with relatively little analysis as to the assumptions that underlie the legislation. For example, in the initial stages of the enactment of L3C legislation, there appeared to be unquestioning acceptance of the premise that adoption of the L3C format would have a significant impact in attracting private foundation investment in relatively high risk economic development projects and in subsidizing the investment returns of for-profit partners. In fact, L3Cs have attracted negligible foundation investments. The factors motivating private foundations' interest in program-related investments (PRI) are more complex than suggested by L3C proponents and while there may be the occasional PRI that involves the subsidization of for-profit investors, such forms of private foundation PRI are likely to be the exception rather than the rule.[10]

Similarly, although the nonprofit sector has struggled for years with the difficult issue of how to measure social impact, the benefit corporation legislation is founded on the premise that an entity's general public benefit can be easily measured through the application of a standardized set of questions or criteria.[11] It is possible that requiring social enterprises to fit into some generalized and preexisting model of social benefit may, in fact, limit innovation and prevent enterprises from focusing their energies on the particular areas where it is likely to have the greatest potential impact.

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[10] By focusing on PRI in large-scale economic development projects that require capital infusion from a consortium of investors, L3C proponents tend to overlook other types of PRI that do not involve market investors, such as micro-lending. Even assuming that a private foundation determined that a high-risk investment in a large scale economic development project was the most effective way to accomplish its charitable objectives, it would have an interest in locating those investors that require the least amount of subsidization, such as other private foundations.

[11] The benefit corporation legislative requirement that such corporations are required to have a general public benefit is intended to prevent the possibility of "greenwashing," in which a company claims to accomplish a particular benefit, but engages in other socially detrimental activities. Whether the benefit corporation legislation is actually effective in preventing greenwashing remains to be seen.

Another assertion made by hybrid proponents that has essentially gone unchallenged is that hybrids should be subject to limited regulation because, unlike tax-exempt organizations, hybrids will not receive any tax advantages.[12] The tax consequences of operating a hybrid organization have not been adequately explored such that one can definitively conclude there will be no tax advantages that stem from selection of new hybrid forms. Existing for-profit businesses are permitted to deduct ordinary and necessary expenses from their income. Hybrid proponents suggest that, in order to accomplish social benefits, hybrids will spend their revenues in ways that are atypical of other types of for-profit businesses. Presumably, social enterprises plan on deducting from their gross income amounts spent on achieving social or charitable purposes, even though such expenditures might not be considered deductible as ordinary and necessary for other types for-profit businesses.

Similarly, the tax code currently limits corporate charitable deductions to no more than 10 percent of taxable income. Will hybrid organizations be able to claim that payments to charities are deductible business expenses that can be claimed without regard to existing limitations on charitable deductions? Will the founders or investors in closely –held hybrids be able to use those entities to accomplish personal charitable objectives while circumventing existing limits on personal charitable tax deductions? If hybrids or their investors are able to reduce their taxable income by deducting expenses or charitable contributions in ways not available to other types of businesses or investors, then hybrids would be receiving a tax preference akin to tax exemption or at least a partial tax exemption on their income. This paper does not attempt to address the tax issues associated with hybrids, but merely points out that the issue of tax benefits to hybrid organizations may be more nuanced than has been generally suggested to date. In any event, as explained in more detail in the next section, the tax status of entities is not particularly relevant to state regulation of entities that represent they are engaged in charitable activities.

III. STATE CHARITABLE REGULATION IS RELEVANT TO THE REGULATION OF HYBRID STRUCTURES

A. *Hybrids Fall within Existing State Charitable Regulations*

Some hybrid proponents appear to presume that as long as hybrid organizations do not seek tax-exempt status from the IRS, they will not be subject to state regulation applicable to charitable organizations. This reflects a lack of understanding of the nature of state regulation of charities. While there is overlap between IRS and state regulation of charities, there are also significant differences. The IRS is responsible for ensuring that entities that have tax-exempt status comply with the regulations pertaining to that status. Ultimately, IRS regulation of charities is driven by tax considerations. In contrast, state regulation is generally not dependent upon the tax status of the entity. State regulation is intended to protect the public interest in charitable assets, including by preventing or redressing the diversion of charitable assets for

[12] In fact, there already have been proposals to provide local tax or contracting advantages to benefit corporations, even if benefit corporations are not seeking IRS tax-exempt status.

private gain and preventing waste or mismanagement. States are also interested in preserving donor intent and preventing misleading solicitations.

Many states have charitable registration and reporting laws that reflect variations on the Model Charitable Solicitations Act ("Model Act")[13] State solicitation laws apply broadly not only to traditional charities but to organizations that solicit funds for charitable purposes. Section 1(a)(2) of the Model Act defines a charitable organization to include those persons or entities that employ any appeal that has a tendency to suggest a charitable purpose. Some state laws also define solicitations to include not only donations but transactions involving the sale of goods and services. Accordingly, if social enterprises hold themselves out as advancing charitable purposes, then they are likely to fall within the scope of existing statutes related to charitable solicitations, including registration and reporting requirements.[14] While IRS 501(c)3 status is dependent upon an organization operating "exclusively" for charitable purposes, state jurisdiction over charities is not similarly limited. Assets held for charitable purposes are subject to Attorney General oversight regardless of the form of the entity that holds such assets.

Illinois is the only state that has explicitly adopted provisions in its L3C statute that the officers and managers of an L3C are charitable trustees.[15] Nevertheless, it doesn't seem particularly remarkable to conclude that the officers and managers of L3Cs have fiduciary duties to advance L3Cs' charitable purposes, in light of the statutory requirements that L3Cs operate to significantly further such purposes and would not have been formed but for the accomplishment of charitable purposes. Furthermore, in light of the traditional role of Attorneys General in enforcing common law and statutory requirements related to charitable fiduciaries, it seems reasonable to conclude that Attorneys General would have the ability to enforce such requirements as they relate to L3Cs. While other hybrid forms do not necessarily require as a matter of statute that the entities advance charitable purposes, existing benefit corporation and similar legislation does allow for the adoption of particular charitable purposes. Accordingly, state charitable regulation may depend upon the whether the hybrid adopts such purposes or makes representations to the public about its charitable purposes.

With hybrid forms still in their nascent state, state regulators have not faced many situations in which they have been called upon to apply existing regulations to these new organizational forms, but if the movement becomes as significant as its proponents intend, that will change. Inevitably, there will be conflicts and ambiguities as existing law is applied to these new forms. For example, state charity regulators may impose reporting requirements on benefit corporations that state an intention to advance a particular charitable purpose and those reporting requirements may be different from the benefit report specified in legislation. Even if a benefit corporation makes no representations about having specific charitable purposes, it is not clear that the requirement that benefit corporations create a general positive social benefit is sufficiently different from a charitable purpose to place benefit corporations outside the scope of

[13] The Model Act can be found at http://www.nasconet.org/category/info-charities.

[14] Hybrids might be classified under state regulations as charitable organizations or, possibly, as professional fundraisers.

[15] 805 Ill. Comp. Stat. 180/1-26(d).

charitable solicitation statutes.

Some hybrid proponents seem content to allow the issues unaddressed by hybrid legislation to be resolved through litigation, although if one thing seems certain, more work for lawyers is probably not the type of social benefit the hybrid legislation was intended to achieve. The development of the hybrid sector may be hindered by the enactment of statutes that lack legal certainty. It will also be hindered by under-regulation that inadequately protects the purposes and goals of the hybrid movement. Even if one contends that hybrid organizations are not inherently engaged in charitable activities, it is reasonable to conclude that if an organization claims to be acting in the public interest, there should be some regulatory authority in a position to ensure claims of public benefit are fulfilled.

While the hybrid legislation may alter the nondistribution constraint that has traditionally divided the for-profit and charitable sectors, the existing state charitable regulatory framework still provides the regulatory model that comes closest to facilitating the goals of the hybrid movement. Some modifications may be appropriate, but state charitable regulation provides the foundation for appropriate regulation of the emerging hybrid movement and a better regulatory framework than that contained in existing hybrid legislation, which generally leaves regulation in the hands of investors or shareholders.

Because social enterprises and charities may be virtually indistinguishable in the eyes of the public, failed experiments with hybrids have the potential not only to undermine the development of an emerging fourth sector and its potential to create social benefits, but also to undermine the already fragile confidence in the charitable sector. Accordingly, some caution is warranted in proceeding with hybrid legislation that does not contain adequate provisions to protect the public interest in organizations that represent they are advancing public objectives. The similarities between charities and social enterprises and the need for similar regulatory treatment is discussed in more detail below.

B. The Public is Likely to Perceive Social Enterprises as Similar to Charities and to Support Them for Similar Reasons

As noted previously, social enterprises are in the business of selling goods or services, many of which are likely to include products marketed to ordinary consumers. Consumers are interested in supporting social enterprises for much the same reasons as they support charities. People are interested in participating in shared collective action for the common good and in giving back to their communities. Purchasing decisions are easier to make if they are perceived as meeting not only one's own goals and desires, but advancing broader and more altruistic purposes. From consumers' perspectives, purchasing from a social enterprise has a donative aspect. Consumers may spend a little more when purchasing from hybrids in the belief that the extra money will go toward helping others, similar to the motivations that prompt consumers to donate an extra dollar or two at the cash register. It is a convenient way to make a contribution. Consumers' charitable intentions and contributions should not be disregarded simply because they occur in the context of a purchase.

Even though hybrid legislation does not explicitly include any type of distribution constraint, the public would have good reason to believe that some such constraint exists. The very name "low-profit limited liability company" suggests that the owners have agreed to limitations on their profits.[16] Similarly, a stated need for the benefit corporation legislation is to enable corporate directors to choose social benefits over profits without the threat of shareholder litigation. Naturally, consumers are likely to believe that entities that promise to accept less in the way of profits in order to accomplish public purposes would have some obligation to do exactly that.

Social enterprises' commitment to forego some profit to achieve objectives beneficial to the public is similar in substance to nonprofits' nondistribution constraint and prohibitions against private inurement. If profit distribution is thought of as a continuum with nonprofits at one end and for-profits at the other, social enterprises would appear to fall somewhere in the middle of that continuum, but no one yet knows where that point is and the existing hybrid legislation provides little guidance on that point.

C. Like Charities, the Success of Social Enterprises Will Depend Upon Public Trust, Which is Enhanced by Effective Regulation

Like charities, the success of social enterprises will depend heavily on the public's trust in the enterprise to use the funds they receive from the purchase of goods and services in the manner described to the public. Consumers are unlikely to have any practical ability to independently evaluate the accuracy of representations concerning the social benefits the enterprises claims to produce.

Markets in which consumers are unable to readily evaluate the goods they are purchasing function best when reasonable regulations exist to promote consumer confidence. The marketplace for goods (which for the purpose of this discussion includes services) can be divided into three categories: search goods, which consumers are able to obtain adequate information in advance of purchase to make an informed decision; experience goods, which can only be effectively evaluated after purchase; and credence goods in which consumers are unable to adequately evaluate the product or service even after purchase. Classic credence goods include medical services or dietary supplements because consumers have little ability to evaluate the efficacy of the treatments even after they are completed.

Another classic credence good is charity. Donors have relatively little ability to evaluate whether charities used donations accordance with donors' intentions, and the same can be said of purchases made from social enterprises that promise the purchase will result in social benefits. When purchasing credence goods, consumers look to government regulation to make up for a lack of information and to provide some assurances regarding quality. When the market at issue is particularly dependent upon trust, regulation enhances the development of a market.

[16] More apt names for the L3C might include the mixed-profit limited liability company or the subsidized-profit limited liability company. The L3C is premised on the notion that it will attract capital to social enterprises by facilitating tranched investments in which private foundations or other investors interested in charitable objectives agree to subsidize the returns of those who are focused on maximizing profits.

The public's willingness to support charities depends, in part, upon a regulatory structure that offers at least modest assurances that there are protections in place to prevent or redress abuses of public trust. Similarly, the development of social enterprises is likely to be hindered if the public perceives it as the "Wild West" in terms of the protection of public interests.

D. Public Trust in Social Enterprises will be Undermined if Public Investment in Social Enterprises is not Protected

Not only is regulation important to ensuring that charities and social enterprises are providing the services they purport to provide, but the nondistribution constraint is important to protecting the public's investment in charitable organizations. Like charities, public support for the goals of the social enterprise will contribute to the entity's value. However, in the event a successful social enterprise changes hands or chooses to pursue profits over social benefits, under existing hybrid legislation, shareholders might very well reap a financial windfall while the public that placed their trust in the enterprise's commitment to social benefits may have very little to show for their less formally-designated investment in the enterprise.

To provide an example of the potential disparities that may result between similarly situated organizations under existing statutes, let's assume Joe, a social entrepreneur and former teacher decides to open a coffee shop, with a goal of providing a venue for community gatherings and a place where students can get help with their homework. He forms an L3C in which he is the sole member (or alternatively, a benefit corporation in which he is the sole shareholder.) Joe doesn't have much money of his own to invest, but he gets some below market rate loans to purchase the coffee shop/community center from lenders motivated by his social mission, secured by the real estate he is purchasing. Customers support the shop in droves, happily paying a little more for their coffee because they know it is going to a good cause. Joe pays off his loans in record time and he now owns the building free and clear. Along comes a development company and offers Joe a price for his property that he feels he cannot refuse. Despite the fact that his neighbors are unhappy with the development company's plans for the land, Joe takes the money and dissolves his L3C. He feels a little sad about letting down all the people who supported his venture, but he is now able to retire and pursue his dream of world travel.

Take the same facts, but instead of filling out the forms to organize as an L3C, Joe incorporated as a public benefit nonprofit (but did not pursue IRS 501(c)(3) status because Joe expected that almost all income would be in the form of fees for goods or services.) Since Joe and the other board directors will not financially benefit from the sale to the development company, they may be less interested in pursuing that option unless they believe the sale will enable the accomplishment of additional socially beneficial purposes. Ultimately, the board of the nonprofit could still decide to dissolve and sell the property to the development company (subject to review by the Attorney General's office for compliance with the directors' fiduciary duties.) But Joe won't be retiring and travelling the world. Instead, because of the nondistribution constraint, the accumulated assets of the coffee shop/community center must be conveyed to another charitable organization to use for similar purposes. As a result, the community center may be relocated, but the public will continue to benefit from their contributions.

One might argue that similar disparities can presently emerge between for-profits and nonprofits. This may be true, but the distinction is that hybrids emphasize that they are legislatively distinct from other for-profit enterprises in their commitment to socially beneficial purposes. While the hybrid movement seeks to create a middle ground between for-profits and nonprofits, the existing legislation fails to provide any mechanism to protect that middle ground or to warrant public trust in these new forms. Instead, existing hybrid legislation facilitates for-profit organizations' ability to portray themselves in ways that sound similar to nonprofit organizations without imposing any limitations on any subsequent transformation of public support into private gain. It may take only a few publicized instances of social enterprises abandoning their commitment to social benefit in favor of private profits for the public to lose faith in and support for the hybrid movement. The weaknesses in the existing hybrid legislation framework are described in more detail below.

IV. EXISTING HYBRID LEGISLATION IS INADEQUATE TO PROTECT THE PUBLIC INTEREST IN, AND THE PURPOSES AND GOALS OF THE HYBRID MOVEMENT

Hybrid legislation is intended to facilitate the development of social enterprises that will use market- based solutions to pursue socially-beneficial objectives. The proponents of the hybrid legislation have suggested that a market-based approach to regulation is also appropriate and that the regulation of hybrids should be similar to that of other for-profit organizations. In benefit corporation legislation, standing to bring any action related to the corporation's failure to pursue claimed public benefits is limited to shareholders and directors. Despite the hybrid movement's recognition that hybrids share many similarities with the more regulated charitable sector, the legislation fails to incorporate any similar regulatory oversight. Of course, if market forces were consistently effective in finding solutions to social issues, there would be little need for hybrid movement or for the charitable sector.

The proponents for self-regulation suggest that investors will ensure that hybrid enterprises remain true to their commitment to balance profits and social benefits because, presumably, investors are motivated to invest in hybrids because of their desire to achieve positive social impact and will seek to protect that interest. In fact, hybrid legislation places investors in roles they have not previously held as creators of social benefit and protectors of the public interest. It is far from certain how investors will perform in those roles, particularly when faced with choices that may have a detrimental impact on their own personal financial interests.[17]

[17] The "benefit corporation" legislation combines relatively distinct concepts or goals. The first is that investors should be able to choose a form of entity that does not require fiduciaries to maximize profits, but enables them to pursue other goals even at the expense of profits, and it makes sense that investors would be responsible for bringing actions to enforce their selection of relationships. If the goals of the legislation were merely limited to investor relationships, then there would be less concern about leaving enforcement of those relationships in the hands of investors. But the benefit corporation legislation also contains provisions that are outwardly directed at the general public and related to creating a positive public perception of benefit corporations, including the legislative requirement to create a general positive social impact. Whether the organization is fulfilling statutory requirements to create a positive social impact is a matter of interest not only to investors, but to the public as well. Shareholders

Furthermore, the self-regulatory model is premised on the assumption that hybrids will have a broad base of investors in a position to exercise some control over the managers of the enterprise. While hybrid proponents envision a day in which shares in social enterprises are widely held and commonly publicly traded, that day appears some distance off. For the foreseeable future, it seems likely ownership in the vast majority of social enterprises is likely to be closely held. In fact, there is nothing to prevent L3Cs or benefit corporations from being owned by a single individual. Under such circumstances, there are no real checks and balances to prevent abuses of the hybrid form to the detriment of the public interests at stake. Furthermore, without such checks and balances, the hybrid form is likely to attract those who have no real interest in creating social benefits but hope to gain financially from the attractiveness of the legislative "branding" of hybrids as socially beneficial and the related public support.

If an investor does find officers and directors drifting away from the social mission that prompted the investor's interest, a rational reaction might to quietly cash in one's stock and search for another suitable investment opportunity. Even assuming hybrids will have a broad base of investors willing to sacrifice their financial interests in order to achieve social benefits , the traditional model of shareholder governance does not seem especially well-suited to promoting the development of social enterprises that behave differently that existing for-profit entities. There is no clear consensus that the traditional mechanism of shareholder governance has been particularly effective in preventing corporate wrongdoing or mismanagement. The ability of shareholders to influence corporate decisions still remains relatively indirect and shareholder derivative actions are fraught with difficulties. Furthermore, relying exclusively on shareholders to monitor the firm's commitment to social benefits does little to advance the legislative goals of encouraging social enterprises to be broadly accountable to a variety of stakeholders.

Existing hybrid legislation also takes an unduly traditional and narrow view in treating only shareholders as investors in the social enterprise. As discussed above, consumers are also investors in social enterprises. Moreover, crowdfunding platforms like Kickstarter demonstrate that investors can include people who do not necessary receive stock in exchange for their provision of capital, but who nevertheless have an interest in an enterprise's achievement of its goals.

The benefit corporation legislation eliminates the traditional fiduciary obligation to maximize profits, but it fails to provide any enforceable standard to guide the enterprise's pursuit of social benefits.[18] The legislation requires that directors "shall consider" the interests of other

may not be an appropriate proxy through which to represent the public interest, particularly when shareholders have an inherent conflict of interest.

[18] This section of this paper primarily focuses on benefit corporation legislation. The L3C legislation suffers from similar deficiencies, as well as containing statutory inconsistencies and failing to accomplish its original stated objectives to attract private foundation investments. Those deficiencies have been detailed elsewhere and are not discussed here. *See e.g.*, Callison, J. William and Vestal, Allan, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*

stakeholders in addition to shareholders.[19] However, that requirement imposes no meaningfully enforceable obligation on directors. It is difficult to imagine any investor bringing a lawsuit based upon directors' failure to "consider" other interests or that anything of substance would be achieved by such a lawsuit.

In fact, arguably, by weakening or blurring directors' fiduciary duties, hybrid legislation gives directors carte blanche to pursue their personal objectives since they have neither a clear obligation to maximize profits, nor to promote social benefits. Benefit corporations may be attractive to some entrepreneurs not because they are interested in pursuing social benefits but because, as a practical matter, the legislation may make it more difficult for shareholders to prevail in holding officers and directors monetarily liable for breaches of fiduciary duty. The benefit corporation legislation explicitly provides that directors and officers cannot be held monetarily liable for any failure of the benefit corporation to pursue or create general or public benefit.[20] With the elimination of any duty to maximize profits, short of some conduct equivalent to embezzlement, it is difficult to imagine any lawsuit against the officers and directors of a benefit corporation resulting in a finding of monetary liability.

Although the benefit corporation legislation is ostensibly intended to encourage investment in social enterprises, investors that are genuinely interested in influencing an enterprise's pursuit of social benefits and want to ensure a meaningful level of control may be better of becoming a member of a traditional limited liability company (LLC). The LLC format enables members to craft operating agreements that more clearly define and tailor relationships between investors and the enterprise objectives.

Not only does hybrid legislation provide relatively weak protections for shareholders interested in social benefits, it also provides very little protection against abuses of public trust. Hybrid proponents suggest that existing consumer protection laws that prevent fraud or deceptive practices adequately protect the public. However, by including a shield against officers' and directors' monetary liability for failing to pursue a corporation's stated public benefit, the benefit corporation legislation at least arguably shields them from monetary liability for deception against the public, substantially weakening the potential effectiveness of consumer protection laws.

Another reason why traditional consumer protection laws may not be particularly helpful in this context is, as noted above and unlike many other types of consumer transactions, consumers are not well-positioned to evaluate the truthfulness of claims of social benefit. Like donors to charities, consumers of social enterprises may not directly experience or receive the advertised social benefits. State and federal consumer protection offices typically rely on

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(September 1, 2010), Drake University Law School Research Paper No. 11-07; Vermont Law Review, Vol. 35, p. 273, 2010. Available at SSRN: http://ssrn.com/abstract=1755283 and Kleinberger, Daniel S., *A Myth Deconstructed: The 'Emperor's New Clothes' on the Low-Profit Limited Liability Company* (2010). Delaware Journal of Corporate Law (DJCL), Vol. 35, No. 3, 2010. Available at SSRN: http://ssrn.com/abstract=1742554.

[19] Model Benefit Corporation Legislation, Section 301(a)(1).

[20] Model Benefit Corporation Legislation, Section 301(c)(2) and 301(c)(3).

consumer complaints to identify businesses that may be engaged in deceptive practices, but deceptive claims of social benefit are unlikely to generate significant numbers of consumer complaints. Consumers have no way of knowing at the time of the transaction whether or not the company in fact pursued the social benefit in the manner described.[21]

In fact, if charities were not subject to extensive mandatory disclosures, it would be even more difficult to detect fraud or deception in the charitable sector that is presently the case. Hybrid proponents suggest that disclosure requirements can effectively substitute for government oversight but we already know from our experience with the charitable sector that is not the case. Charitable organizations are subject to even more extensive disclosure requirements than that proposed in hybrid legislation, and while mandated public disclosures enhance the effectiveness of government oversight, it has not eliminated the need for such oversight.

Moreover, benefit corporation legislation's disclosure requirements are not particularly robust and are not adequate to enable the public or others to fully evaluate claims of social benefit. The benefit corporation legislation requires the preparation of an annual benefit report that assesses the corporation's performance in creating a general public benefit against a third party standard. The stated purposes in requiring the preparation of such reports is to give investors and the public a means to evaluate whether the entity is living up to its claimed benefit corporation status. However, without access to financial information, it will be difficult to place a company's benefit claims into any meaningful context. Not only does the benefit corporation legislation fail to ensure public access to financial information, it specifically provides that compensation and financial information may be omitted from any public version of the benefit report, making benefit corporations much less transparent than charitable nonprofits. Information on profits, compensation, distributions, and expenditures on social benefits are likely to be highly relevant to evaluating an enterprise's commitment to social benefits.

Moreover, the mandated content of the benefit report is described in a very generally way, giving organizations wide latitude relative to the information included in the report. The benefit report is likely to also to serve a public marketing function in addition to informing investors, so there will be substantial incentive to place a positive gloss on any enterprise deficiencies in meeting social objectives. This is particularly true if the only people that can hold one accountable for the contents or release of the report are directors or investors, who even if they are concerned about the enterprise's progress in achieving social benefits, may be more interested in working quietly behind the scenes to address issues, rather than publicly announcing the organization's difficulties. [22]

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[21] Another potential source of information about corporate fraud or mismanagement may be lower level employees or other insiders, but the lack of clear government oversight over hybrids may leave such persons to conclude there are no appropriate agencies to whom they can express their concerns and as a result their voices may be effectively silenced.

[22] The model legislation's optional inclusion of provisions relating to the inclusion of a benefit director or officer, if enacted, may result in more detailed benefit reports, but it is still difficult to conclude that the benefit officer or director position will be sufficiently strong to overcome corporations' natural disinclination to avoid reporting bad news. Furthermore, just as the use of certified public accountants to prepare audited financial statements is not a failsafe against financial mismanagement or improprieties, the existence of a benefits director or officer would not appear sufficient to prevent mismanagement or unwarranted claims with respect to social benefit.

The fact that the benefit corporation is obligated to assess its performance against some publicly available third party standard is not likely to be particularly effective in ensuring the public has information necessary to an appropriate evaluation. The legislation requires only a self-assessment against the third party standard, not an independent audit.[23] From the perspective of the public, it may be inherently confusing for corporations to claim they meet some third party standard when the third party has no role in evaluating the accuracy of the claim. In addition, market forces are such that, if there is the potential for money to be made, third party standard or certification organizations will arise that will make it as easy as possible for aspiring benefit corporations to claim that they met the third party standard with flying colors. This may result in a proliferation of third party standards and a watering down of any true measurement of the organization's pursuit of social benefit, facilitating greenwashing claims, instead of limiting them. There is nothing to prevent a proliferation of third party standards and no one responsible for ensuring the quality of the standards that emerge. If a proliferation of third party standards does arise, consumer confusion will result and the benefit corporation label will not have any reliable meaning.

In addition to the fact that there may not be contemporaneous information available to the public to enable public assessment of social benefit claims, there may also be temporal issues associated with hybrid organizations that are not generally a factor in consumer fraud cases. Hybrid organizations may truthfully claim at the time of the transaction to be working toward a stated benefit, but the organization may subsequently change direction. In the L3C and benefit corporation legislation is that the only explicit consequence that results from abandoning statutory requirements to pursue socially beneficial purposes is that the entity reverts to a more traditional organizational form, such as standard limited liability corporation or business corporation. While this may mean that the entity may no longer be able to use the publicly appealing statutory label for its operations, this provides little protection for the public and little disincentive for converting public support for the goals of the social enterprise into private financial gain, particularly if the owners are more interested in short-term profits than long-term reputational issues.

It is also worth noting that even in cases where it could be established that a hybrid organization had engaged in public deception about its purposes, the charitable regulatory framework would still provide a more appropriate lens through which to examine the entities' practices and to craft appropriate remedies. Traditionally, consumer protection cases are focused on recovering financial losses to consumers, who either failed to receive the advertised products or services or the products or services failed to work in the manner described. Consumers that support social enterprises may receive the advertised product or service, but what they did not receive is the fulfillment of the company's promise to spend the money it receives in certain ways, which is more akin to a charity's failure to abide by donor intent than to a typical consumer transaction. The appropriate remedy in such cases would be to use the concept of *cy pres* to ensure that company revenues were applied to purposes similar to those advertised.

[23] Model Benefit Corporation Legislation, Section 401(c).

V. ALTERNATIVE APPROACHES TO HYBRID LEGISLATION

The task of crafting legislation that promotes the development of a new type of enterprise that balances the dual missions of profit and social benefits is not easy, but the paradigm the hybrid movement is attempting to create is not necessarily impossible. In many types of for-profit and nonprofit entities, the leadership must constantly balance competing objectives. Nonprofits must balance the need to spend on existing programs, increase their reserves, or spend on infrastructure to enhance future activities. Similarly, for profit organizations face similar choices between short term profit goals and long-term direction.

However, the existing hybrid legislation is not well-balanced, largely favoring the immediate interests of entrepreneurs seeking to attract investor and public support, without factoring in the long-term objectives of the hybrid movement. The existing hybrid legislation enables adopters of these new forms to proclaim they are legally distinct from other types of for-profit organization in their commitment to social benefits, but the legislation imposes few safeguards to ensure those commitments are fulfilled. Without such safeguards, the development of hybrid enterprises is likely to be limited and the legislative efforts may be dismissed as nothing more than failed marketing campaigns.

One way to develop more effective legislation is to include more constituencies in the process of drafting model legislation. Ironically, for legislation intended to encourage the development of business forms that consider the interests of a variety of stakeholders in addition to shareholders, existing hybrid legislation appears to have been drafted with relatively little input from varied interest groups. Hybrid legislation implicates many different areas of law, including not only corporate governance and charitable regulation, but also taxation, securities, and consumer law. In addition, the development of hybrids is of interest not only to social entrepreneurs, but also to investors, private foundations, public charities, and to the general public and potential beneficiaries of the social benefits sought to be advanced.

The legislative discussion should also address whether some type of explicit distribution constraint is necessary to prevent or limit the extent to which public financial support of hybrids can be captured for private financial gain.[24] Should the public be encouraged to support hybrids if there are no effective methods in place to protect their support or to address or remedy the potential for abuse? The legislative discussion of hybrids has not included much discussion of the United Kingdom's Community Interest Company (CIC), which shares goals similar to hybrids in the United States. However, the CIC is subject to "asset lock" requirements to protect the public interest, in addition to other requirements enforced by the government.[25] The UK experience with CICs may help to inform the legislative discussion of hybrids in the United

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[24] As the hybrid legislation stands now, courts may be faced with having to determine whether there are no limits on the abilities of hybrids to distribute profits or alternatively, if hybrids are subject to reasonable, but unquantified, limitations based upon hybrids' obligation to pursue dual objectives.

[25] For more information on Community Interest Companies, see http://www.cicregulator.gov.uk/faq.shtml

States.

If the "asset lock" provisions of the CIC are perceived as unduly limiting investments in social enterprises, it may be worth considering whether hybrid legislation should at least include some statutory requirement to "share the gain" with charities with similar missions. Those who express an interest in forming or investing in social enterprises indicate a willingness to accept a reasonable rate of return. If there were legislative requirements for profit sharing or to share gains in the value of the social enterprise upon transfer or dissolution with charitable organizations, it would help to protect the public interest in social enterprises, ensure that the public shares in any financial windfalls that might result from the enterprises' activities, and help prevent private capture of public financial support. In addition, a provision requiring social enterprises to "share the gain" that could be enforced by the government would help to alleviate the problem of greenwashing. Organizations that were only interested in greenwashing would likely opt against adopting a form of enterprise that could limit their financial returns.

Some have suggested that given the current lack of state resources devoted to charitable regulation, there is no point in including legislative provisions for state regulation of hybrids and such regulation would only detract from the limited resources devoted to charitable regulation. To point to a lack of existing state regulatory resources as a reason to refrain from imposing effective regulation on hybrids would appear to destine the hybrid movement to failure before it begins. It is inevitable that without regulation, the hybrid sector will attract not just those with good intentions, but also those who will exploit the public appeal of hybrids for their own financial gain. Regulation will be necessary to curb such abuses and to encourage public trust in hybrids. The socially responsible solution to the lack of regulatory resources is to identify funding mechanisms and to incorporate those mechanisms in legislation.

Other components of an effective regulatory structure can be modeled after provisions included in state statutes related to charitable oversight. These provisions include registration and reporting requirements to enable monitoring of the enterprise's activities and use of funding. The legislation should also provide for appropriate notification of major events in the life cycle of the social enterprise, including merger, transfer of assets outside of the ordinary course, and dissolution. In addition, the oversight agency must have the ability to obtain additional documents and information to investigate potential abuses or failure to comply with statutory requirements. The agency must also have the authority to enforce legal requirements through court action, to identify situations in which assets have been diverted in ways not permitted by the legislation, such as excess distributions, and to prevent and remedy such situations. This may include the ability to request a court to impose *cy pres* remedies where necessary to protect the public interest and to hold individual officers and directors personally liable when appropriate.[26]

[26] To the extent hybrid proponents are concerned that regulation will hinder the growth of social enterprises, it does not appear to have hindered the growth of the charitable sector. The United States now has more than 1 million recognized charities. Presently, the lack of regulatory resources necessary to maintain public confidence in the charitable sector appears to be a greater threat to success than regulatory barriers to entry and we can anticipate the same dynamic will be true for social enterprises.

VI. CONCLUSION

While drafting balanced legislation that facilitates the development of dual mission hybrid enterprises may be difficult, the energy behind the hybrid movement and the public interest in creating a new paradigm suggests that the task may be worthwhile. Effective hybrid legislation will promote investor and public confidence in social enterprises, which will, in turn, contribute to the development of the sector. A lack of effective regulation of hybrids will only hasten public distrust of the concept. While further hybrid legislative efforts should include a variety of perspectives, state regulation of charities provides a relevant framework to guide such legislation and will better serve the long-term interests of the hybrid movement.