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Challenges And Interests Of The States In Social Mission / Hybrid Organizations

Crashing The Party: A State Regulator's Observations and Suggestions Regarding The Near-Term Supervision of The Simultaneous Pursuit of Margin And Mission Through Social Enterprise, Philanthrocapitalism, And Mixed-Purpose Entities or Hybrids

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INTRODUCTION

The question is not whether we will have state involvement in the activity of social enterprise or social mission organizations; additionally, the question is not whether we will have state involvement in the activity of for-profit/nonprofit hybrids. At minimum, states supervision through both criminal and civil proceedings will continue for allegations of fraud. Also, it is quite likely that local and state governments will be called upon to intervene and, perhaps, provide a remedy when there has been a failure of a social mission or hybrid organization in delivery of a public or government service. Rather, the questions about social mission or social hybrid organizations relate to the level of involvement. How do we tailor a reasonable state regulatory framework to incent and effectively supervise the social mission or social hybrid organizations especially in areas in which the entities seek to relieve the burdens of government? Further, when the activity involves charitable assets or includes the assertion that the activity has a charitable motive or produces charitable benefit, how does it impact the regulatory framework for the social enterprise organization?

*As we look into t**h**e future, at least for the near term – the next five to ten years, there is a need to make some assumptions regarding the community of state charity regulators. For this discussion, with one exception for the purpose of considering a specific scenario, the assumption is that Congress will not make any major changes to the Internal Revenue Code; therefore, our discussion holds the Internal Revenue Code and Treasury Regulations constant. A second assumption is that the majority of state charity regulators will not see an extraordinary or unusual increase in in-house personnel or expert assistants and consultants. So, we anticipate that the level of resource available to the state charity regulator will remain constant, and*

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hopefully it will not decline. Finally, the assumption is that mixed-purpose entities and hybrid arrangements are here to stay.

The purpose of these assumptions is to discuss the state charity regulatory response through a "what is" framework rather than a "what if" framework. State charity regulators should not expect the Internal Revenue Service to provide additional services to assist in the pursuit of state regulatory goals. State charity regulators should not wait for additional resource in pursuing, tailoring, and implementing a regulatory response.[2]

I. THE FOR-PROFIT/NONPROFIT DIVIDE: MARGIN VERSUS MISSION

In very simple form; the traditional or standard for-profit corporation operates to make a profit and generate a return on investment for its shareholders. The directors of the corporation, as agents for the investors, have fiduciary duties to the investors. The for-profit corporation or business entity seeks financial "margin" through earnings for distribution to shareholders and enhancing the value of their investment.

Again, in very simple form; the traditional or standard nonprofit operates to deliver a service or meet a "mission," a purpose other than the production of income or wealth for investors. For example, homeowners can incorporate a homeowners association. These organizations usually have a restraint against the distribution of profits or assets to the members, and these organizations can frequently obtain favorable tax benefits such as exemptions from taxation. For these organizations, margin is not the focus; instead, the focus is mission.

For many nonprofit entities, the arrangements are private matters. The typical state charity official has very little interest in (much less resource for devotion to) disputes relating to whether the board of a homeowners association is following its bylaws or whether the board's decision relating to the proper carpet for a common area reflects an abuse of discretion. There is, however, another type of nonprofit that is of particular interest to the state charity official, namely the charitable nonprofit.

A charitable nonprofit holds or controls assets dedicated to a charitable or public purpose. As with its for-profit cousin, the nonprofit has directors, and these directors have fiduciary duties. The directors of a charitable nonprofit can fairly be described as agents of the public interest or the state's interest in the proper use of charitable assets. State regulators of charitable nonprofits seek to prevent or remedy the conversion of charitable assets to a private or non-charitable purpose, prevent or remedy the misapplication of charitable assets, and, as importantly, to prevent the waste or mismanagement of charitable assets.

While mission rather than margin is the goal of the charitable nonprofit, it does not follow that nonprofit corresponds to non-revenue or non-cash flow. Some charitable nonprofits generate a remarkable amount of income. Charitable nonprofit hospitals, for example, house both margin and mission. There are other nonprofit organizational arrangements through which

[2] This is not to suggest that state regulators should not pursue additional resource or identify the additional resource necessary for effective regulation. Rather, it is to acknowledge that the proverbial cavalry may not be on its way in the near term.

charitable nonprofits hold for-profit subsidiaries. Still, for the charitable nonprofit, the principal purpose or goal is mission.

II. SOCIAL ENTERPRISE, PHILANTHROCAPITALISM, AND MIXED-PURPOSE ARRANGEMENTS.[3]

There are very active and very effective movements through which changes in state and federal laws are being sought and, in some instances, obtained for the purpose of removing the divide between mission and margin or, alternatively, allowing a bridge over the divide between mission and margin. Advocates march behind a variety of banners including "social enterprise," "philantrocapitalism," and the so-called "low-profit" entity. While the combination of mission and margin in the same entity or arrangement is a common thread, the motivations and goals of the various groups differ significantly.

A. Social Enterprise: "It is not simply about making money; however, it is not necessarily about charity."

From this commentator's perspective and for this discussion, the social enterprise movement, in no small part, demonstrates a recognition that not all individuals ascribe to the belief that the maximization of financial profits on behalf of the investors should be the only end of a for-profit entity. For the social enterprise advocate, margin remains a primary goal; however, financial margin is not the only consideration.

There is no reason to dispute the belief that there are presently individuals who are willing to invest in for-profit businesses without an intent to maximize profits or squeeze every dime out of the investment. Indeed, these types of individuals have been for around a long time. There is evidence that the aggregation of capital for the construction of turnpikes and toll roads during the 19th Century serves as an example of this fact.[4] In terms of current day examples, it is not terribly difficult to find a farmer who continues to operate a farm on land that is likely much more valuable as property for development. Likewise, it is not terribly difficult to find individuals who have a desire to continue to independently run a business and decline lucrative offers to sell or merge their business.

There are no doubt plenty of examples of sole proprietorships or other closely-held or small entities with owners that consider more than financial margin in decisions relating to the performance of their businesses and, in turn, their investments. One basic power of social enterprise available through the creation of mixed-purpose for-profit corporations is greater ability of investors who consider more than financial margin to pool or aggregate financial resources on a much larger scale than may otherwise be possible.

Nonetheless, it is important to point out that this type of pooling or aggregation does not necessarily relate to relieving a burden of government. It is not, of itself, principally charitable

[3] The author acknowledges that each term may be considered a term of art by other commentators who use different definitions.

[4] Daniel B. Klein and John Majewski, *Economy, Community, and Law: The Turnpike Movement in New York, 1797-1845*, Law & Society Review, Vol. 26, No. 3, page 500 (1992) ("[B]uying stock was much like making a charitable contribution to a community improvement (or public good)."); compare Gerald Gunderson, *Privatization and the 19th-Century Turnpike*, Cato Journal, Vol. 9. No. 1, page 193 (Spring/Summer 1989) ("Americans generally recognized that such investments would not match the dividends of competing investments.").

or governmental. While it may be the case that a farmer who does not develop farmland may create a social benefit of sorts for individuals who do not like development, it does not otherwise relieve the burdens of government. That lots of like-minded individuals get together with a goal to do something other than maximize their wealth, such as the farmer does on an individual basis, does not change the result. The activity simply allows for the creation of social benefit on a larger scale. To be clear, there is nothing *per se* wrong with the pursuit of the creation of social benefit.

At some stage, it is important to point out that social benefit and its creation, like beauty, is very much in the eye of the beholder. For example, the person who continues to farm land rather than sell it to developers may be generating a social benefit (perhaps without any intention to do so) for individuals who dislike development or who believe that a community should have a lot of farmland. That same farmer and farm may be an anathema to those in the community who dislike the farmer's otherwise lawful land management practices, use of chemicals, labor practices, choice of crops, etc. In fact, this second group may find that the farmer's operations have a negative social impact on the community. For this latter group, another farmer down the road who does not use genetically modified seed is the farmer providing social benefit.

At the moment, the primary area of concern for the state charity official with regard to this type of activity is not settling this type of dispute. Rather, the more pressing challenge involves the representations made by organizations and the cottage industry of certifiers, groups or entities that purport to measure and verify the production of social benefit.[5] The reason for the concern stems from the fact that social enterprise proponents (sometimes known as "social entrepreneurs") either have no understanding or little interest in the fact that however well-intended or seemingly popular a cause (such as, for example, community supported agriculture or a buy-local movement), "social benefit" and "social return" are not flawlessly or neatly interchangeable with the concepts of "charitable benefit" and "charitable return." Therefore, there is, as always, a need to prevent and address fraud. Further, though, with social enterprise, there is a legitimate need for the regulatory community to discourage and address misrepresentations and misleading communications that may fall short of fraud but are still detrimental to the public because they improperly blur the line or fail to recognize the distinction between activity that is charitable and activity that, however well-intended, is not charitable.

Social enterprise may result in activity that a large portion of the community enjoys and finds worthy, but the cause of cause of social enterprise is not, of itself, an act that relieves the burdens of government. While it is true that some social enterprise activity could be charitable or have a charitable character, it should not be assumed to be present in all social enterprise arrangements.

So, for the next five to ten years, the focus of the state charity regulator, with regard to social enterprise, will be to protect the public against fraud relating to claims of charitable benefit or charitable purpose for activity that may have a social benefit, but does not relieve the burdens of government or otherwise constitute charitable activity. A business that engages in social enterprise activity that is not charitable should not be allowed to hold itself out as a charity or

[5] Additionally, it is the case that other agencies of a state government may have a regulatory role to play. For example, the portion of state government that regulates securities and investments may have a separate interest in monitoring claims or statements made to investors regarding the entity.

mislead investors or consumers.[6] Additionally, it is quite possible that the state charity regulators will be called upon to police the community of certifiers providing review of the generation and measurement of social benefit. As with the preceding, protection against fraud in the certification process and by certifiers will be the focus. Finally, even in the absence of fraud, the state charity official has a legitimate interest in advocacy and actions to prevent any improper blurring or a failure to observe the distinction between charitable and non-charitable activity that may be detrimental to the public or the charitable sector.

B. Philantrhocapitalism: "The generation of return to financial investors is the best method to enhance charitable benefit."

From this commentator's perspective and experience, the most vocal and visible collection of individuals who refer to themselves as philanthrocapitalist are those who assert that the pursuit of profit – financial margin, is the best means to advance mission. Such a philanthrocapitalist focuses upon economic development and the support of the for-profit community as the producers of charitable benefit. As with the social entrepreneur, the philanthrocapitalist frequently speaks of both social benefit and social return. However, with regard to philanthrocapitalism, the terms "social benefit" and "social return" are no more interchangeable with "charitable benefit" and "charitable return" as they are for the social enterprise discussion.

From the vantage point of the author, there are two basic factors or characteristics that distinguish the philanthrocapitalist from the social entrepreneur. First, the utilization of assets clearly dedicated to a charitable purpose or the resources of a charitable entity are part of any philanthrocapitalism arrangement. Second, the for-profit participant in any philanthrocapitalist arrangement is not expected to consider any factor other than financial margin with regard to the for-profit's investment or stake in the enterprise or arrangement. Thus, while a social benefit corporation or a flexible purpose corporation, each of which appear designed for fostering social enterprise activity, could be a participant in a philanthrocapitalist arrangement or venture, there is no requirement or expectation that the for-profit participant in a philanthrocapitalist enterprise be anything other than a traditional for-profit acting in a manner wholly-consistent with its fiduciary duties to its investors.

The practice of what is known in some circles as "cause marketing" is a very good example of philanthrocapitalism. Through the use of the following hypothetical, we can see the players and their roles in philanthrocapitalism. For-profit corporation has a product to sell. For this hypothetical, the for-profit corporation sells tuna. For-profit corporation approaches a charity that drills water wells in developing countries, and for-profit conveys a proposal. For every can of tuna that for-profit sells, for-profit will donate five cents to the charitable nonprofit. In exchange, the for-profit is allowed to use the name and logo of the charitable nonprofit in its advertising and on its product. The for-profit experiences an increase in sales. The charitable nonprofit experiences an increase in its revenues (and will argue that the for-profit's marketing campaign raises awareness of the charitable nonprofit's cause). And, untold numbers of the consuming public will be happy that their purchase and consumption of tuna helps provide

[6] The fact that a social enterprise entity provides charitable benefit does not, of itself, convert the entity into a charity. A for-profit corporation can make a charitable donation; however, that donation will not convert the for-profit into a charity. A social enterprise corporation that is otherwise a for-profit entity does not experience a conversion into a charity simply because it provides support to a charity or charitable cause.

drinking water in developing countries. This is philanthrocapitalism in the undiluted state, for-profit margin advancing mission.

And, to be clear, it is not that such arrangements are by definition improper or bad. There are instances in which actual material charitable benefit is realized when a charitable nonprofit teams with or partners with a for-profit entity. And, to be equally clear, the role of the state charity regulator is not to prohibit activity that is otherwise lawful or permissible. But, the rise of philanthrocapitalism is creating an additional burden of supervision for the state charity regulator distinct from protecting the public from fraud or the enforcement of consumer protection laws. Namely, philanthrocapitalism requires the state regulator to examine these arrangements to see if charitable assets are being converted to a private use, misapplied, or wasted or mismanaged. And, philanthrocapitalist are not necessarily happy about state charity officials looking into their arrangements.

When the philanthrocapitalist succeeds in obtaining charitable assets for a for-profit venture under the premise that advancing the for-profit's interests will relieve the burdens of government or otherwise materially and meaningfully advance charitable ends, there is a risk that the burdens of government will not be relieved by the venture or arrangement. There is an opportunity cost with regard to the use of the charitable assets. And, there is the related risk that if the venture results in a loss of the charitable assets or the charitable assets lose value or become worthless, the government may have to fund a remedy. In this latter instance, there is an out-of-pocket cost to the government plus the loss of the charitable assets.

Philanthrocapitalism includes a lot more than "cause marketing" campaigns. Philanthrocapitalist pitch ideas through which charitable nonprofits utilize resource, including the investment of charitable dollars, to advance for-profit ventures ranging from pharmaceutical research to the rehabilitation of factories to software development. For the state regulator, these arrangements can be extremely difficult to review. At the moment, the Internal Revenue Code and the Internal Revenue Service provide the first line of defense or the first screen for detecting and preventing the misuse of charitable assets. For example, the so-called limited liability company or L3C is a means for aggregating charitable assets with for-profit investment. The IRC provisions regarding program-related investment and excise taxes for jeopardizing investments will continue to provide an, although not complete, effective safeguard with regard to the improper formation of hybrids through this model.

For the next five to ten years, the state regulator may be able to continue to rely upon the Internal Revenue Code and the IRS for assistance in the protection of charitable assets. If, though, we move away from this assumption by considering a scenario in which the IRC undergoes a change through which these arrangements receive less scrutiny or are easier to effect under the Federal Tax structure, then a significant source of protection in place for the state charity regulator will vanish. If the state charity regulator is unable to apply resource in response to the loss of protection at the Federal level, then the risks of the misdirection, misapplication, and waste of charitable assets through philanthrocapitalism will increase substantially.

C. Mixed-Purpose Arrangements: Neither Friend or Foe.

Each of the two prior discussions is quite centric to the groups that are backing specific types of entities or organizational arrangements. At this stage, we consider the more general question of whether mission and margin can exist in a charitable entity or a venture with a charitable participant. And, the short answer is yes, they can. There are a number of well-run

charitable nonprofit hospitals that house both mission and margin. In fact, nonprofit hospital executives can convey, with a completely straight-face, that without margin there is no mission. So, margin is not a foe *per se*. Margin can exist alongside of mission in a charitable nonprofit or charitable venture.

Nonetheless, margin is not necessarily always a friend. An examination of the encounters that some charitable nonprofit hospitals are having with local property tax administrators and state legislatures is consequent to a concern or premise that the charitable nonprofit hospitals are not sufficiently distinguishable from their for-profit counterparts. Further, the Unrelated Business Income Tax (UBIT) provisions in the Internal Revenue Code also signal that pursuit of margin by the nonprofit is not without consequence. As activity of a charity becomes more commercial, concerns and regulatory responses relating to the use of the charitable assets necessarily follow.

In that mixed-purpose arrangements involving charitable organizations and charitable resource are here to stay, and in that such arrangements are neither inherently good nor bad, then we must address the role that they can play in relieving the burdens of government. And, we must design an effective state law regulatory framework to incent and supervise their performance.

There are a variety of potential candidates for examination. This discussion focuses upon three. The base case or hypothetical is an entity or arrangement that has as a central or primary purpose the assumption of a burden of government. Further, the entity or arrangement has at least one participate that supplies charitable assets to the venture or is itself a charitable entity. Finally, the entity has at least one for-profit entity that manages or shares in the management of the venture and is supplying capital or resource to the venture.[7]

Charities, traditionally, have been favorites of the law because they can provide primary and supplemental support to the public by delivering or aiding governmental functions. The provision of the support by a charity can reduce the overall burden on the government. In one sense, when a charity provides a service to relieve the burdens of government, it represents an outsourcing of all or a portion of a government's service. It is a provision of government service by a non-governmental third-party.

Unremarkably, governments frequently provide charities with privileges such as exemptions from income tax or property tax. Governments may also provide other privileges such immunity from tort liability in certain scenarios. The coordination of the provision of services and use of privileges is not without trouble or friction.

While there is a debate regarding the proper extent and, in some corners, even the wisdom of the government providing a safety net of services, governments on the local, state, and federal level are providers of services such as, without exhausting the list, access to health care, temporary shelters, housing, and access to meals.

The following hypothetical scenario helps identify one source of trouble or friction. Nonprofit A is incorporated under the nonprofit corporate laws of State B. Nonprofit A obtains an exemption from property from the local property tax administrator, and Nonprofit A also obtains exemptions from income tax from federal and state taxing authorities. The mission of

[7] It is important to note that a for-profit commercial bank that makes a normal market-rate loan to a nonprofit is not engaging in social enterprise or engaging in charitable activity, at least in the context of this discussion.

Nonprofit A is to create and maintain affordable housing for individuals at or below 200% of the Federal Poverty level. Nonprofit A obtains various grants, donations, and loans and builds several apartment buildings. The local, state, and federal governments have quite effectively deputized and helped provided resource to Nonprofit A to carry out a function to relieve the burdens of government.

The typical state charity official is without resource to monitor the activity of all the nonprofit charities or entities providing governmental services within the jurisdiction. It is frequently the case that the state charity official is called upon to take action upon a report or discovery of a problem. In our hypothetical, after a few years of operation, a discovery is made that all is not well.

The apartment buildings are in disrepair, and some of the units do not appear habitable. Thus, we have individuals with an immediate need for housing. The state of one building is such that the cost to repair may be greater than the value of the building. An examination of the books and records of the nonprofit reveal that meager amounts have been spent on maintenance. In terms of cash on hand, meager amounts are available to fund operations. The loans are in default, and there are large passed due balances to several creditors. The executive director, though, has been quite well-paid as has a sibling of the executive director who serves as the chair of Nonprofit A's board of directors. And, these two individuals are also now, as a practical matter, judgment proof.

There are real costs that correspond to deputizing entities to perform government functions. The extension of tax exempt status to the entity is at a cost. There are also costs that correspond to the government's funding of the venture as well as the government response that will be necessary to address the failure.

One tool is to require a performance bond or otherwise a financial instrument that activates in favor of the government when there is a failure of the private party or non-governmental party to perform. This requirement is not simply directors and officers insurance. There are two problems with such insurance. One, many nonprofits executing a government function do not purchase it. Two, many nonprofits executing a government function allow insurance policies to expire when funds are tight.

Allowing the government to insure property or an operation if the nonprofit fails to obtain or maintain coverage is an option, but it involves the government spending its own money to protect itself from having to spend more of its own money. It is an assumption of risk by the government when the party in the best position to manage and protect the enterprise against the risk is not the government. Thus, requiring a performance bond may be a very good tool for protecting the public and more clearly assigning responsibility for managing risks. The government can utilize such financial devices for, say, private utilities providing sewerage service to provide protection against a failure of the private utility to be able to meet its mission. It is not clear that performance bonds are any less legitimate or advisable for other government functions relieved through a charitable operation.

One tool available to the Internal Revenue Service through the Internal Revenue Code is an excise tax such as the one applicable to jeopardizing investments or the one applicable to situations in which a Private Foundation fails to make sufficient qualifying distributions. Through the application of these excise taxes, the Federal Government can take charitable assets out the hands of a Private Foundation. A notable aspect of this process is that the Federal

Government is not operating under a *cy pres* or equitable deviation framework. Otherwise stated, funds that become taxable are not necessarily transferred to another charity in the same community providing a service as near as possible to the charitable foundation. The purpose of the excise taxes are to incent prudent investment and qualifying distributions rather than to ensure the continuation of benefit in the same community. Could a similar tool to create a forfeiture of sorts be effective on a state level?[8]

A state excise tax or forfeiture provision could be consistent with a compelling goal of regulation, namely, that assets are properly applied to provide charitable benefit. If an entity is unwilling or unable to properly apply assets, then an excise tax could relieve the entity of the responsibility. And, in the design of the state excise tax, the mechanism could incorporate *cy pres* or equitable deviation considerations such that the assets collected through the application of the tax remain in the same community providing the same or similar charitable services through reassignment or distribution to a qualifying charitable recipient. A state excise tax provision could also extend liability to any director or officer of the entity.

A state excise tax would have a variety of limitations. It works well with regard to investments of the entity; however, it is not easily applied to the programs or operations of the nonprofit. And, an excise tax or forfeiture mechanism is of no separate value when the nonprofit is not a going-concern and, along with its officers and directors, is judgment proof (or does not hold anything worth seizing). The state excise tax would also be difficult if not impracticable with regard to nonprofits that have secured creditors. Comparatively, the upfront bonding requirement is far more effective than the ability to apply an excise tax in the aftermath of bad management or mismanagement.

One more tool is the option of allowing an equity position in a charitable enterprise, investors who will supervise directors of the charitable enterprise. And, the introduction of a for-profit mindset and the features of a for-profit framework can offer significant improvements in many instances. In fact, the social enterprise, philanthrocapitalism, and low-profit hybrids movements are each seeking this type of blending or combination. Because we do not want to rely upon a change in the Internal Revenue Code, which would be necessary for allowing an equity position in a charitable nonprofit, we have to utilize an entity that permits investors to occupy the same house or structure as a charitable participant. A charitable hybrid or low-profit entity seems a reasonable candidate for discussion.

While I am not a particular fan of the L3C model, I concede that it may offer three remarkably important features. First, it allows an equity position or a for-profit position in an arrangement that aggregates capital for the purpose of a charitable enterprise. Second, if the for-profit entity is one in which fiduciary duties permit consideration of purposes other than margin, then the for-profit investors or participants could act with sufficient loyalty to the charitable enterprise. Finally, if the payment of a reasonable return to investors is dependent upon the actual satisfaction of the governmental function, then the for-profit investor would certainly have incentive to use best efforts for seeing that the function is carried out.

While some of the L3C proponents may not like the following suggestion, in that the risky tranche[9] or investment position in the L3C model belongs to the charity, there is evidence

[8] The tax would be a tool for the transfer of charitable assets short of an involuntary dissolution and liquidation through a state proceeding against the nonprofit.

[9] Fancy French word for slice.

that the development of turnpikes and toll roads in this country during the Nineteenth-Century shows that assignment of investment positions, or tranches, in an L3C deserves a lot more discussion. The assumption that a for-profit investment position must occupy the first place in line in an L3C merits examination. An L3C agreement that renders the distribution of earnings or value contingent upon the satisfaction of a social or charitable function provides the enterprise, and its for-profit investors, with an incentive to see that the enterprise is successful.

Charitable nonprofits are to pursue mission. For-profit corporations are to pursue margin. Nonetheless, without destroying this divide, there is, through the charitable hybrid, an ability to combine or house the pursuit of margin and mission in the same enterprise or arrangement. Furthermore, if the structure is an L3C, perhaps the benefit corporation or flexible purpose corporation rather than the standard for-profit is the type of for-profit entity or participant extremely well-suited to make the L3C model work most effectively in producing charitable return.

CONCLUSION

If we are not expecting an increase in resource to supervise the activity of mixed-purpose enterprises or hybrid organizations, then we have to have strong and effective "up-front" measures to incent proper performance of the charitable enterprise and protect the government from the failure of the enterprise or organization. With regard to the state charity officials' regulatory response to social enterprise that implicates charitable assets, there are means available (without changes to the Internal Revenue Code) through which directors of a charitable enterprise can be incented to properly perform functions that relieve the burdens of government. There are means available to bond performance. Borrowing from the lessons regarding the aggregation of capital for turnpikes and toll roads, we may actually be very close to having structures that house both mission and margin and that can function to relieve the burdens of government without an increase in the risk that charitable assets will be converted to private use, misapplied, or wasted or mismanaged.