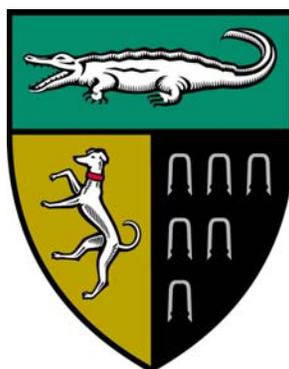


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## **THE ROLE OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS**

by

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# THE ROLE OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS

*Ofer Eldar*\*

Recent years have brought remarkable growth in hybrid organizations that combine profit-seeking and social missions. Despite popular enthusiasm for such organizations, legal reforms to facilitate their formation and growth – including, in particular, legal forms for hybrid firms – have largely been ineffective. This shortcoming stems in large part from the lack of a theory that identifies the structural and functional elements that make some types of hybrid organizations more effective than others. In pursuit of such a theory, this article focuses on a large class of hybrid organizations that has been relatively successful in addressing development problems, such as increasing access to capital and improving employment opportunities. These organizations, which are commonly referred to as “social enterprises,” include microfinance institutions, firms that sell fair trade products, work integration firms, and low-cost sellers of essential goods and services such as eyeglasses, bed-nets and healthcare. The common characteristic of social enterprises is that they have a transactional relationship with their beneficiaries, who are either purchasers of the firms’ goods or services or suppliers of input (including labor) to the firm. The essence of the theory is that through these transactions, social enterprises gather information on their patron-beneficiaries’ ability to transact with commercial firms (e.g., workers’ skills, borrowers’ creditworthiness and consumers’ ability to pay). That information permits social enterprises to tailor the form and amount of subsidies to the specific needs of individual beneficiaries. This “measurement” function makes social enterprises more effective vehicles for allocating subsidies than more traditional donative organizations and other forms of hybrid organization, particularly firms that pursue corporate social responsibility policies. Legal hybrid forms should therefore focus on promoting firms that commit to transacting with disadvantaged groups, rather than firms with general social purposes that are difficult to ascertain.

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## INTRODUCTION

In recent years, there has been remarkable increase in the number of organizations that combine profit-seeking with an altruistic or social mission. We can broadly term this class of entities “hybrid organizations,” though a variety of other terms have been used, including mixed-mission, blended value, triple bottom line, and creative capitalism.<sup>1</sup> In particular, much attention – as well as legislative activity – has focused on a broad but vaguely defined group of hybrid organizations which are commonly referred to as “social enterprises.” Common examples of social enterprises include microfinance institutions that provide credit to low-income borrowers, businesses that sell fair trade products, and companies that sell affordable products in developing countries. This pursuit of a mixed commercial and social mission is not exclusively the domain of a small set of specialized firms. Multinational corporations, such as Starbucks, Nike and J.P. Morgan, are increasingly engaged in a variety of corporate social responsibility initiatives. Investors are increasingly mindful of social and environmental indicators in their investment decisions, and some focus on investing in firms that purport to generate social impact.<sup>2</sup> Thus, there is a growing popular belief that combining profit and mission is an effective way of producing social wealth.

Despite these wide-ranging developments, hybrid organizations remain poorly understood. As a result, legal policy in this field has been haphazard and largely ineffective. First, there is some uncertainty about the extent to which business planners have the power to form businesses that combine profit and social missions. A recent Delaware case, *eBay v. Newmark*, has been viewed as casting doubt on the ability of corporations to commit to a social purpose.<sup>3</sup> Partly to address this issue, new legal forms have been introduced for incorporating

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<sup>1</sup> I redefine the term “hybrid organization” more formally in Part I.

<sup>2</sup> See ANTHONY BUGG-LEVINE & JED EMERSON, *IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE* (Jossey-Bass 2011); J.P. Morgan & The Rockefeller Foundation, *Impact Investments: An Emerging Asset Class* (November 29, 2010), available at <http://www.rockefellerfoundation.org/news/publications/impact-investments-emerging-asset>

<sup>3</sup> *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1. (Del. Ch. 2010). In this case, Chancellor Chandler stated: “The corporate form in which [the corporation] operates, however, is not an appropriate vehicle for purely philanthropic ends... Having chosen a for-profit corporate form, the [corporation’s] directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders.” *Id.*, at 28. The *eBay* case reflects the conventional view, dating back to *Dodge v. Ford Motor Company*, 170 N.W. 668 (Mich. 1919), that directors’ duty is to maximize shareholders’ profits. See also David Wishnick, Comment: *Corporate Purposes in a Free Enterprise System: A Comment on eBay v. Newmark*, 121 YALE L.J. 2405 (2012). I emphasize, though, that the *eBay* case involved heightened scrutiny of a poison pill adopted by management in order to entrench a social purpose to which the shareholders had never acquiesced in the company’s charter or otherwise.

businesses that have a social mission.<sup>4</sup> In particular, the Benefit Corporation is a legal entity that has a social mission but can nonetheless distribute profits to its owners. However, although these legal forms have been diffusing rapidly among states, most hybrid organizations continue to use the traditional corporate forms. Thus, it is questionable whether or not the new forms are actually necessary, and how such forms should be designed. Second, if hybrid organizations are desirable, they arguably deserve to receive tax or other subsidies. Malani & Posner, for example, propose that all for-profits should be provided with tax benefits for doing good things, such as selling fair trade products.<sup>5</sup> However, trusting profit-driven corporations to employ subsidies towards social missions is highly problematic, mainly because they have an obvious incentive to overstate the social value of their activities in order to enhance their reputations.<sup>6</sup> As a result, the IRS has so far resisted attempts to facilitate subsidized investments in hybrid legal forms.<sup>7</sup>

The state of legal policy in this area stems from the failure of economic and legal scholarship to identify the structural and functional attributes that make hybrid organizations effective in addressing social problems. Despite the numerous colorful terms that have been attached to hybrids, most of these terms boil down to the simplistic notion of combining for-profit and altruistic missions.<sup>8</sup> This approach is apparent in the definitions of hybrids under the statutes for

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<sup>4</sup> For reviews of the new legal forms, see Jill R. Horwitz & Rachel Culley, *Profits v. Purpose: Hybrid Companies and the Charitable Dollar*, (U. of Mich. L. & Econ. Res. Paper No. 12-006, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2055368](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2055368); Thomas A. Kelley III, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337 (2009); Matthew NC. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291 (2010); Dana B. Reiser, *Blended Enterprise and The Dual Mission Dilemma*, 35 VT. L. REV. 105 (2010); Dana B. Reiser, *Theorizing Social Enterprise*, 62 EMORY L.J. 681 (2013); Fabrizio Cafaggi and Paola Iamiceli, *New Frontiers in the Legal Structure and Legislation of Social Enterprises in Europe: A Comparative Analysis* (Eur. U. Inst. L. Working Papers 2008/16), available at <http://cadmus.eui.eu/handle/1814/8927>.

<sup>5</sup> Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007).

<sup>6</sup> The well-known exposition of this view is by the economist Milton Friedman, who urged corporations to focus on maximizing profits for the firm's owners while conforming to the basic legal and ethical rules of society; Milton Friedman, *The Social Responsibility of Business Is To Increase Its Profits*, N.Y. TIMES, Sep. 13, 1970; see also Henry G. Manne, *Milton Friedman Was Right*, WALL. ST. J., Nov. 24, 2006.

<sup>7</sup> William J. Callison & Alan Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273 (2010).

<sup>8</sup> For examples, see Gregory J. Dees, *Enterprising Nonprofits*, HARV. BUS. REV., Jan.-Feb. 1998, at 55; Bugg-Levine & Emerson, *supra* note 2; Jed Emerson, *The Blended Value Map: Tracking the Intersects and Opportunities of Economics, Social and Environmental Value Creation* (2003), available at <http://www.blendedvalue.org/bv-map-papers/>; Kim Alter, *Social Enterprise Models and Their Mission and Money Relationships*, in SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE 205 (Alex Nicholls ed., 2006); THE EMERGENCE OF SOCIAL ENTERPRISE (Carlo Borzaga & Jacques Defourny eds., 2001).

incorporating new organizational forms. For example, the Benefit Corporation is a corporation whose purpose is to create a material positive impact on society and the environment.<sup>9</sup> The main problem with the notion of mixed mission is that in most cases it is practically impossible to measure and verify the accomplishment of altruistic goals. Moreover, it reflects a tendency to treat the difference between corporate social responsibility and social enterprise as mainly one of degree, without delineating their different structures or functional roles.<sup>10</sup> In fact, the terms are often used interchangeably to denote essentially the same type of business.<sup>11</sup>

In this article, I offer a theory of social enterprise and hybrid organizations that can inform legal policy. The theory focuses on a set of organizations which are commonly referred to as “social enterprises,” such as microfinance institutions, firms that sell fair trade products, work integration social enterprises, and low-cost sellers. The main common characteristic of social enterprises is that they have a commitment to transacting with their beneficiaries, who are either purchasers of the firm’s goods or services or suppliers of input (including labor) to the firm. I will refer to such beneficiaries as “patron-beneficiaries.”<sup>12</sup> For example, microfinance institutions make loans to low-income borrowers, and work integration social enterprises employ disadvantaged workers. As will be explained in greater detail below, certain classes of disadvantaged individuals and businesses are unable to transact with standard commercial firms, either because of information asymmetries that make it costly for commercial firms to evaluate their abilities or because they lack sufficient abilities (e.g., to repay a loan). In these circumstances, such individuals may suffer from lack of access to capital, systematic unemployment and want of essential products and services. Social enterprises are committed to transacting with these individuals as patrons.

The essence of the theory is that social enterprises perform a *measurement* role. The financial viability of social enterprises depends in large part on the performance of their patron-beneficiaries. For-example, microfinance institutions

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<sup>9</sup> See *infra* section VIII.A.

<sup>10</sup> For example, see Dana B. Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2450 (2009) (arguing that “Social enterprises integrate philanthropy into their business models at a more basic level than companies that make corporate contributions or practice CSR [Corporate Social Responsibility]”); see also Kelley *supra* note 4, at 350-352; Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through A Legal Lens*, 81 TEMP. L. REV. 831 (2008), Alter, *supra* note 8; THE ECONOMICS OF SOCIAL RESPONSIBILITY: THE WORLD OF SOCIAL ENTERPRISES (Leonardo Becchetti & Carlo Borzaga eds., 2011).

<sup>11</sup> To take one example, firms that sell fair trade products have been referred to as a social enterprise (Becchetti & Borzaga eds., *id.*), corporate social responsibility initiative (Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV. 78, Dec. 2006, at 78), and corporate philanthropy (Malani & Posner, *supra* note 5).

<sup>12</sup> I use the term “patron” to refer to those who have a transactional relationship with the firm, i.e., investors, workers, suppliers, etc.

are financially dependent on the ability of their borrowers to repay their loans. Thus, social enterprises have incentives to measure or gather information on their patron-beneficiaries' attributes (e.g., workers' skills or borrowers' creditworthiness) in order to ensure that they are capable of performing their duties and tasks under their transactional relationship with the social enterprise firm. This information enables social enterprises to allocate subsidies (e.g., a training subsidy) to their beneficiaries (e.g., disadvantaged workers) effectively. In particular, social enterprises have the ability and incentives to tailor the form and amount of subsidies to their beneficiaries' abilities and preferences as well as the commercial needs of their business.

The measurement function makes social enterprises relatively efficient vehicles for allocating subsidies to promote development goals, such as increasing access to capital, enhancing productivity and employment opportunities, and enhancing consumer welfare. For example, microfinance institutions have grown substantially in the last few decades and now provide financial services to millions of poor customers in developing countries.<sup>13</sup> The relative success of microfinance contrasts with the limited effectiveness of many forms of donative organization,<sup>14</sup> including governments and aid agencies, in spurring development. Social enterprises also need to be contrasted with other forms of hybrid organizations, especially firms that engage in corporate social responsibility policies. Whereas social enterprises have incentives to utilize subsidies effectively, corporations that pursue socially responsible policies have incentives to exaggerate their social value.

Understanding the basic structure of social enterprises and the measurement function they perform is essential for informing legal policy. Given the apparent effectiveness of social enterprises, legal policy should primarily foster organizations that share their structural and functional attributes and avoid facilitating or subsidizing inefficient organizational forms. In the last section, I will outline how the transaction with beneficiaries and the measurement role of social enterprises can provide a normative framework for designing a legal hybrid form.<sup>15</sup> This article focuses on laying out the structural and theoretical underpinnings of social enterprises as well as other hybrid organizations.

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<sup>13</sup> BEATRIZ ARMENDÁRIZ & JONATHAN MORDUCH, *THE ECONOMICS OF MICROFINANCE* 12-15 (The MIT Press 2010) (2005); BRIGIT HELMS, *ACCESS FOR ALL: BUILDING INCLUSIVE FINANCIAL SYSTEMS* 2-5 (World Bank 2006).

<sup>14</sup> The term "donative organization" was defined by Hansmann to mean nonprofits that receive most or all of their income in the form of grants or donations; see Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 *YALE L.J.* 835, 840 (1980). In this article, I will argue that donative organizations are also characterized by the fact that they transfer a subsidy to their beneficiaries rather than transact with them as patrons; see *infra* section I.B.

<sup>15</sup> Details of the policy implications are discussed in Ofer Eldar, *Institutional Mechanisms to Encourage Business Organizations to Promote Social Goals: Hybrid Legal Forms versus Corporate subsidies* (unpublished manuscript) (on file with author).

The article proceeds as follows: Section I identifies the essential characteristics of social enterprises and hybrid organizations. Section II lays out my theory of the function of social enterprises. Section III applies the theory to different types of social enterprises (e.g., microfinance institutions). Section IV describes the legal devices by which social enterprises commit to transacting with their beneficiaries. Section V distinguishes social enterprises from other hybrid organizations, particularly corporations that engage in corporate social responsibility. Section VI discusses some disadvantages of social enterprises. Section VII criticizes other accounts of social enterprises and hybrid organizations. Section VIII explains why legal hybrid forms have limited utility, and outlines a proposal for reforming them. Section IX concludes.

## **I. THE ESSENTIAL CHARACTERISTICS OF SOCIAL ENTERPRISES AND HYBRID ORGANIZATIONS**

Though hybrid organizations are commonly defined as organizations that combine profit and altruistic or social mission, this definition is misleading. Even profit-maximizing firms pursue social purposes, albeit indirectly. Consider a food chain that improves the nutritional value of its products. Such a firm may be maximizing its profits by making its products more attractive to customers. Its activities may well generate positive externalities, for example, better health for society. However, this firm is not conceptually different from most other for-profit firms. The idea that firms generate positive externalities while pursuing profits dates back to Adam Smith's notion of profit-maximization.<sup>16</sup> A useful definition of hybrid organizations must identify in what way they differ from standard profit-maximizing firms.

Properly defined, a hybrid organization is a commercial enterprise that channels a subsidy to a class of beneficiaries. The simplest example is corporate charity, e.g., a for-profit firm that donates a percentage of its profits to charity. The subsidy need not be provided by government, and usually flows from the firm's customers and investors. To fund the charity, the owners of the firm may agree to some discount on their returns or the consumers may pay premium prices for the firm's products. Thus, I define "subsidy" expansively to include any contribution of value – monetary or other – which is provided to the ultimate beneficiary of the subsidy for no consideration. It need not be a direct subsidy, a grant or a donation, but also take the form of premiums over market prices paid by consumers or discounts to market returns on investment.<sup>17</sup>

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<sup>16</sup> ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

<sup>17</sup> The difference between premium prices or below-market rates and market prices or rates (as applicable) constitutes the subsidy.

It is important to note that the term “hybrid organization” can be used to describe a wide array of organizations. On the one hand, a hybrid organization may be profit-maximizing, as long as the subsidy is not provided by the owners, e.g., when a firm receives a grant from the government or when its consumers pay premium prices. On the other hand, hybrid organizations may be nonprofits. A commercial enterprise is any enterprise that receives a significant portion of its income from prices charged for its products or services, so that its viability or sustainability is dependent on such income.<sup>18</sup> Commercial enterprises include not only for-profit firms, but also commercial nonprofits, such as hospitals or universities that charge patients and students respectively for their services,<sup>19</sup> though they receive at least some subsidies in the form of donations and tax exemptions.

### **A. What Makes an Organization a Social Enterprise?**

The focus of this article is on a particular type of hybrid organization, usually referred to as “social enterprises.” Social enterprises are not only subsidized commercial enterprises, but they also possess another critical element, i.e., they have a commitment to transact with their beneficiaries as patrons, such as customers or providers of input (see Figure 1). This commitment arises in circumstances where such beneficiaries are unable to transact with commercial firms under standard commercial terms. For example, microfinance institutions lend money to their beneficiaries, disadvantaged individuals or businesses that face difficulties in obtaining capital from commercial lenders. I discuss the economic function of this transactional relationship in Part 0. I emphasize that social enterprises do not necessarily transfer subsidies to their patron-beneficiaries (e.g., discounts on loans or products), although many of them do. To count as social enterprises, it suffices that they have a commitment to transact with their beneficiaries, even if no actual transfer of subsidies is made to the beneficiaries

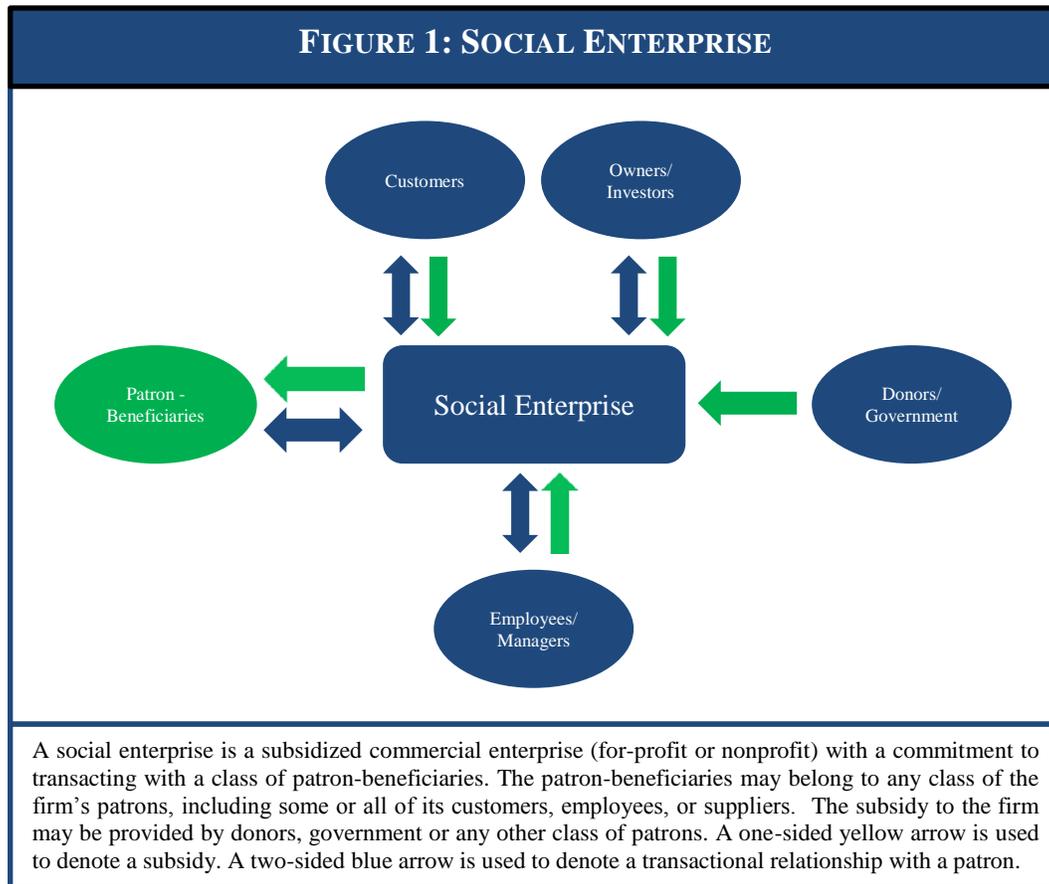
#### **1. Examples of Social Enterprises**

In the following paragraphs I describe the business and structure of different types of social enterprise. All the social enterprises I describe engage in development missions, such as increasing access to capital, improving productivity and employment opportunities, and enhancing consumer welfare. The description does not exhaust all forms of social enterprise; rather, I will provide an example of each of the main industries in which social enterprises operate. For present purposes, I focus on for-profit social enterprises, and discuss social enterprises

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<sup>18</sup> I make reference to “enterprise” rather than organizations or entities. An enterprise may comprise an entity or several entities, but may also be a segment of an organization that includes various types of enterprise.

<sup>19</sup> See Hansmann, *supra* note 14.



formed as nonprofits in the following section.

**Microfinance Institutions (“MFIs”)**: MFIs provide loans and other financial services to poor customers in developing countries who lack access to capital. MFIs specialize in making small short-term loans, which are unprofitable for commercial banks, but are essential for poor households and small businesses in developing countries. A well-known MFI is Compartamos, which lends mainly to the moderately poor. Compartamos is a for-profit owned by a consortium of NGOs, foundations and social entrepreneurs. Although it underwent an IPO in 2007, the consortium shareholders continue to own 51% of the shares.<sup>20</sup> The NGOs and the International Finance Corporation provided the initial subsidy to the firm in the form of seed capital which was funded by donations. In addition, the owners may be providing a subsidy to the firm to the extent that the firm

<sup>20</sup> Compartamos, S.A.B. de C.V., Annual Report 2012, available at <http://www.compartamos.com/wps/portal/Genera/InvestorRelations/AnnualInformation>, at 86; Banco Compartamos S.A., Offering Circular (Apr. 19, 2007), at <http://www.compartamos.com/wps/portal/Genera/InvestorRelations/AnnualInformation>, at 127-128.

forgoes opportunities to serve wealthier individuals. Although Compartamos has been very profitable, it could arguably be more profitable if it served more affluent borrowers.<sup>21</sup> Compartamos does not transfer subsidies directly to its customer-beneficiaries like other MFIs, for example in the form of lower rates,<sup>22</sup> rather, the main benefit it confers on them is the opportunity to borrow.

**Credit Development Financial Institutions (“CDFIs”):** CDFIs provide financial products to low-income customers in the U.S. that are generally not available from mainstream commercial banks, especially depository services, home mortgages and loans to small businesses. An example of a CDFI is the Carver Federal Savings Banks, a New York bank created to serve low-income African-American communities.<sup>23</sup> The bank is held by Carver Bancorp, Inc., a holding company whose shares are traded on the NASDAQ. CDFIs are certified as such by a government agency, the CDFI Fund, which provides subsidies to CDFIs in different forms, including subsidized equity investments, guaranties and grants.<sup>24</sup> To be certified, a firm must satisfy certain requirements to lend to low-income borrowers.<sup>25</sup> The CDFI Fund also enters into an Assistance Agreement with each CDFI that is awarded assistance.<sup>26</sup> The agreement incorporates performance goals to be accomplished by the CDFI, the scale of its activities, and the terms offered to low-income borrowers (e.g., below-market rates).<sup>27</sup> Equity investors in CDFIs are typically also eligible for tax credit incentives under the New Markets Tax Credits (“NMTCs”) program.<sup>28</sup>

**Social Investment Firms:** Social investment firms make relatively small investments in businesses which are perceived as too risky for commercial investors, such as private equity and venture capital firms, including investments in other social enterprises. While some social investment firms aim at earning

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<sup>21</sup> On the other hand, the most profitable strategy for Compartamos may be to specialize in loans to the moderately poor, in which case no further subsidy is provided by the owners (other than the seed capital).

<sup>22</sup> In fact, its rates are known to be as high as 100%; see Michael Chu, *Commercial Returns at the Base of the Pyramid*, INNOVATIONS, Winter/Spring 2007, at 115.

<sup>23</sup> Carver Bancorp, Inc., Annual Report 2012, available at <http://www.sn1.com/irweblinkx/FinancialDocs.aspx?iid=112079>.

<sup>24</sup> See CDFI Coalition, *CDFI Types*, available at <http://www.cdfi.org/about-cdfis/cdfi-types/>; Lehn Benjamin et al., *Community Development Financial Institutions: Current Issues and Future Prospects*, 26 J. URB. AFF. 177, 177-179 (2004).

<sup>25</sup> For example, an applicant for CDFI certification must serve a Target Market, which is defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national median family income, or where the unemployment rate is 1.5 times the national average; see 12 C.F.R. §1805.201 (2005).

<sup>26</sup> 12 C.F.R. §1805.802 (2005).

<sup>27</sup> 12 C.F.R. §1805.804 (2005).

<sup>28</sup> See Julia S. Rubin & Gregory M. Stankiewicz, *The New Markets Tax Credit Program: A Midcourse Assessment*, 1 COMMUNITY DEV. INVESTMENT REV. 1 (2005).

near-competitive returns, others expect below-market returns.<sup>29</sup> Triodos Bank N.V., a bank based in the Netherlands, lends to businesses and nonprofits that have some social or ecological benefit, such as MFIs, fair trade social enterprises (discussed below), organic farms, and renewable energy projects. The subsidy in the case of Triodos Bank flows from its equity holders that hold depository receipts and earn only moderate returns on equity.<sup>30</sup> The depository receipts are publicly listed and traded on a matched bargain system.<sup>31</sup> The voting rights in Triodos Bank are held by a foundation which makes voting decisions on behalf of the holders of depository receipts, and is required to exercise its voting rights in a manner consistent with its ethical goals and mission, its business interests, and the interests of the depository receipt holders.<sup>32</sup>

**Low-Cost Sellers:** There are various types of sellers that sell affordable products or services to poor customers in developing markets, such as bed-nets, eyeglasses, and healthcare services.<sup>33</sup> A to Z Textile Mills of Tanzania is a producer of long-lasting insecticide-treated bed-nets.<sup>34</sup> A to Z is a for-profit firm that entered into a partnership which includes the World Health Organization, NGOs, and other large commercial firms. Pursuant to the partnership, A to Z is committed to selling bed-nets in Tanzania and the other partners provide it with some forms of subsidy, such as free use of technology and loans at below-market rates to buy machinery and specialized chemicals.<sup>35</sup> A to Z employs a price differentiation scheme, whereby bed-nets are either sold at market price (\$5 each) or through the partnership to vulnerable groups at a discount paid by the partnership or the Tanzanian government.

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<sup>29</sup> J.P. Morgan & The Rockefeller Foundation, *supra* note 2; The Rockefeller Foundation, *Solutions for Impact Investors: From Strategy to Implementation* (Nov. 2009), available at <http://www.rockefellerfoundation.org/news/publications/solutions-impact-investors-from>; Monitor Institute, *Investing for Social And Environmental Impact: A Design for Catalyzing An Emerging Industry* (Jan. 2009), available at <http://www.monitorinstitute.com/impactinvesting>.

<sup>30</sup> Triodos Bank Annual Report 2010, available at <http://report.triodos.com/en/2010/servicepages/welcome.html>. The return on equity from 2008 to 2012 was between 3.4% and 5%; see <http://www.triodos.com/en/about-triodos-bank/who-we-are/key-figures/>.

<sup>31</sup> A matched bargain system is a system for trading stocks that matches a buy offer directly with a sell offer. Such a system tends to be less liquid than standard stock exchanges.

<sup>32</sup> Triodos Bank Annual Report 2010, *supra* note 30, at 119-121.

<sup>33</sup> See generally, Ashish Karamchandani, et al., *Emerging Markets, Emerging Models: Market-Based Solutions to the Challenges of Global Poverty* (Monitor Group, March 2009), available at <http://www.thegiin.org/cgi-bin/iowa/resources/research/5.html>; C. K. PRAHALAD, *THE FORTUNE AT THE BOTTOM OF THE PYRAMID: ERADICATING POVERTY THROUGH PROFITS* (Pearson Education 2010) (2005).

<sup>34</sup> See Winifred Karugu & Triza Mwendwa, *A to Z Textile Mills: A Public Private Partnership Providing Long-Lasting Anti-Malaria Bed Nets to the Poor* (UNDP, Sep. 2007), available at <http://cases.growinginclusivemarkets.org/documents/120>.

<sup>35</sup> Karugu & Mwendwa, *id.*

**Fair Trade Social Enterprises (“FTSEs”):** FTSEs buy their input (such as coffee beans) from small producers in developing countries.<sup>36</sup> The subsidies to FTSEs flow primarily from their consumers who are willing to pay a premium on fair trade products.<sup>37</sup> Sales of fair trade products have increased dramatically in the last 20 years. Large corporations, such as Starbucks and Nestle, sell fair trade products. There are also many firms that sell exclusively fair trade products, for example, Cafédirect, one of the largest hot drinks companies in the UK. Cafédirect products are certified by the Fair Labeling Organization (“FLO”).<sup>38</sup> The Fair Trade mark is attached to products that comply with the Fair Trade standards to signal to consumers that they deserve a premium over other products.<sup>39</sup> The Fair Trade standards certify *inter alia* that the producers are indeed “small producers,” broadly defined as those who produce labor-intensive products, but employ a limited number of permanent workers or rely on family labor.<sup>40</sup> Second, the FLO ensures, through audits and inspections, that the importer pays producers the fair trade minimum price, provides them with an additional premium that must be used for developing their community, and, when requested, extends them pre-financing of up to 60% of the orders.<sup>41</sup>

Though many FTSEs rely exclusively on subsidies from consumers, the subsidy in the case of Cafédirect is also provided by the shareholders who accept below-market returns. Cafédirect seems to use such subsidies to pay a higher price and a higher social premium than that mandated by the Fair Trade standards. The shares of Cafédirect are publicly listed and traded on a matched bargain exchange. While shareholders do have voting rights, there is also a guardian share, which is held by a subsidiary of Oxfam and a cooperative of producers that transact with the firm.<sup>42</sup> The guardian share has the right to block any changes to the company’s objectives to sell exclusively fair trade products and reinvest a third of the profits in growers’ communities.<sup>43</sup>

**Work Integration Social Enterprises (“WISEs”):** WISEs are businesses that employ disadvantaged employees who suffer from systemic unemployment.

<sup>36</sup> See generally, ALEX NICHOLLS & CHARLOTTE OPAL, *FAIR TRADE: MARKET-DRIVEN ETHICAL CONSUMPTION* (Sage 2005).

<sup>37</sup> Daniele Giovannucci & Freek Jan Koekoek, *The State of Sustainable Coffee: A Study of Twelve Major Markets*, (IISD, UNCTD and ICO, 2003) available at <http://www.iisd.org/publications/pub.aspx?pno=579>, at 40.

<sup>38</sup> Note though that fair trade standards do not exist for all products, including many types of fruits and handicrafts.

<sup>39</sup> Certification for products rather than firms enables the same firm to have and operate both a social enterprise and a profit-maximizing enterprise (e.g., Starbucks selling fair trade products).

<sup>40</sup> Section 2.1 of the Fairtrade Standard for Small Producer Organizations (May 1, 2011), available at <http://www.fairtrade.net/our-standards.html>.

<sup>41</sup> Section 4.2 and 4.3 of the Fairtrade Standard, *id*.

<sup>42</sup> Cafédirect Annual Report 2012, available at <http://www.cafedirect.co.uk/smallstory/shareholder-information/>.

<sup>43</sup> Cafédirect Annual Report 2012, *id*.

Disadvantaged employees include disabled people, ethnic minorities, individuals with a criminal record, and members of low-income communities.<sup>44</sup> WISEs usually sell products or services which require a large number of low-skilled employees in industries such as food, catering, custodial services, etc. A notable example is the Greyston bakery, a growing business that specializes in gourmet cookies and baked ice cream ingredients. The Greyston bakery hires workers in a low-income area in Yonkers, New York who have little or no education and employment record.<sup>45</sup> Unlike other WISEs that pay fair market wages to their worker-beneficiaries, the bakery pays its workers a salary that reflects their average productivity without a wage premium.

The Greyston Foundation, a nonprofit dedicated to promoting community development primarily through employment programs, owns the bakery. The bakery has received subsidies from various sources. The foundation provided the seed capital using donative funds. The foundation also provides training, housing assistance and childcare services to the workers. Moreover, the bakery has been receiving favorable trade terms from its well-known customer, the ice cream company, Ben & Jerry's, especially a willingness to adjust the terms of transactions if performance is not adequate or timely. The bakery also markets its social mission to attract premiums from consumers.<sup>46</sup>

## 2. The Structure of For-profit Social Enterprises

For-profit social enterprises are not only characterized by having a transactional relationship with a class of beneficiaries. In addition, all of them have some contractual relationship with a nonprofit entity. Each of the social enterprises above is either controlled or certified by a nonprofit or has a contract with one. I use the term nonprofit entity loosely to include not only nonprofit corporations, but also government agencies and multilateral organizations, such as the World Bank. All these entities are effectively subject to a constraint on distribution, i.e., those who control the organization cannot distribute earnings to themselves. I also include social entrepreneurs, i.e., individuals with a strong reputation for pursuing altruistic missions who may also be viewed as being subject to some constraint on distribution.<sup>47</sup>

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<sup>44</sup> Catherine Davister et al., *Work Integration Social Enterprises in the European Union: An Overview of Existing Models* (EMES Working Paper No. 04/04), available at <http://www.emes.net/index.php?id=49>; JERR BOSCHEE, SOCIAL ENTERPRISE SOURCE BOOK (Encore! Press 2001).

<sup>45</sup> Boschee, *id.*, at 78-83; Michael Barker, et al., *A Case Study on Greyston Bakery: The Do-Goodie Product Launch* (May 15, 2009) (on file with the author; hereinafter, *The Do-Goodie Product*); Michael Barker et al., *Greyston Bakery: The Costs and Benefits of an Open Hiring Policy* (May 15, 2009) (on file with the author; hereinafter, *Open Hiring Policy*).

<sup>46</sup> See Barker, et al., *The Do-Goodie Product*, *id.*

<sup>47</sup> Social entrepreneurs effectively pledge their reputation as a commitment not to pursue excessive profits at the expense of the interests of third-party beneficiaries.

The role of the nonprofit is essentially to ensure that the for-profit social enterprise indeed transacts with its beneficiaries as patrons, and in some cases also allocates a subsidy to them. There are essentially three mechanisms by which the nonprofit monitors the for-profit entity: **(1) Certification mechanisms:** firms or products are certified as a form of social enterprise in accordance with certain standards. As discussed above, the products of FTSEs are certified by the Fair Labeling Organization, to ensure that the firm transacts with “small producers” and extends them favorable terms. Likewise, CDFIs are certified as financial institutions that serve low-income communities. **(2) Contractual mechanisms:** a contract between the social enterprise and a nonprofit that requires the social enterprise to transact with disadvantaged individuals. As shown above, A to Z entered into an agreement with certain nonprofits to sell affordable bed-nets to low-income consumers. Likewise, CDFIs enter into an assistance agreement that dictates the terms extended by CDFIs to their consumers (e.g., discounted interest rates). **(3) Control mechanisms:** the for-profit is controlled, through ownership or voting rights, by a nonprofit that ensures that the for-profit transacts with a disadvantaged group. This mechanism is used by many forms of social enterprise, including MFIs such as Compartamos, social investment firms such as Triodos Bank, WISEs such as the Greyston bakery, and even FTSEs such as Cafédirect.

Each of these mechanisms essentially serves as a commitment device to subsidy providers – whether government, consumers or investors – that their subsidy is being used for its intended purpose. As explained in greater detail below, transactions with disadvantaged patrons are costly and require a subsidy. In the case of for-profit social enterprises, there is a clear risk that the subsidy they receive will be distributed to the firm’s owners or misused by the managers. Thus, for-profit social enterprises must adopt one or more commitment devices to assure subsidy-providers that the subsidy will not be expropriated. I discuss the choice of commitment device in greater detail in Part IV. For present purposes, I will assume that social enterprises are subject to some commitment device which ensures that they transact with a class of disadvantaged patrons.

### 3. Social Enterprises as Commercial Nonprofits

Social enterprises (as hybrid organizations) may be – and many of them are – formed as nonprofits. Nonprofit social enterprises fall under the definition of commercial nonprofits, i.e., they receive a substantial part of their income from selling products or services.<sup>48</sup> They are also hybrid organizations as they all

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<sup>48</sup> Hansmann, *supra* note 14, at 840-841. This raises the question whether many other commercial nonprofits, such as nursing homes and hospitals, should be viewed as social enterprises, especially those that do not engage in development missions. The answer turns on whether or not such organizations facilitate transactions with individuals that cannot transact with commercial firms. For example, nursing homes and day care centers that provide high quality services to affluent

receive some form of subsidy whether it is income tax exemption or some donations. In this case there is only one entity, the nonprofit social enterprise. For nonprofit social enterprises, the commitment device is simply the non-distribution constraint and the nonprofit form. Those who control the organization have limited incentives to compromise the mission of the organization, which is to transact with disadvantaged individuals.<sup>49</sup> There are many examples of nonprofit social enterprises. Some of the largest and most influential MFIs are nonprofits, for example, BRAC and ASA in Bangladesh. Community loan funds, a form of CDFIs that focus on loans to nonprofits and small businesses, are typically nonprofits.<sup>50</sup> The Acumen Fund is a nonprofit venture fund that makes investments in businesses in developing countries that promote a social good, such as A to Z discussed above. VisionSpring, a low-cost manufacturer and seller of affordable reading glasses, and The Aravind Eye Care, a provider of low-cost eye care services are nonprofits. Gulf Coast Enterprises, a WISE that provides custodial services and food services, and employs primarily disabled workers or workers with behavioral disorders, is a nonprofit.<sup>51</sup>

## B. Social Enterprises versus Donative Organizations

Social enterprises need to be distinguished from donative organizations. Donative organizations have been defined as nonprofits which are funded primarily by donations.<sup>52</sup> Oxfam International, a nonprofit devoted to promoting development and alleviating poverty, is a well-known example. I use the term “donative organization” to refer not only to certain nonprofit corporations but also to government agencies and multilateral organizations that allocate subsidies to promote development (e.g., the World Bank). These organizations may be viewed as nonprofits because they are effectively subject to a non-distribution constraint, i.e., those who control the organization are prohibited from appropriating its funds to themselves. Moreover, they are essentially dependent on a form of grant, i.e., an allocation of governmental funds. USAID and the World Bank are two common examples of such organizations.

There are two main distinguishing elements between social enterprises and donative organizations. The first is that the former are funded by earned income, whereas the latter are funded by donations. To be sure, as discussed above, social enterprises, as subsidized commercial enterprises, may receive donations or

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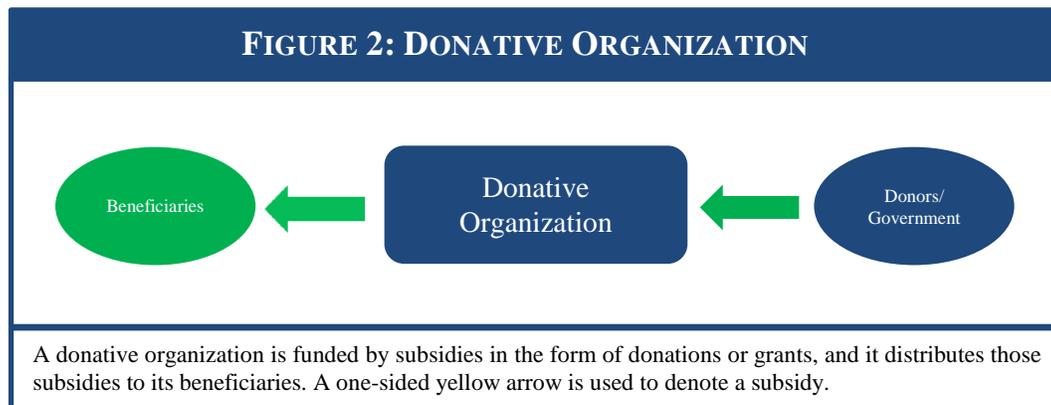
customers would not count as social enterprises. But, hospitals and universities that provide affordable services to low-income individuals would.

<sup>49</sup> The function of the non-distribution constraint was laid out in Hansmann, *supra* note 14. In addition, for a commercial firm, such as a bank or a bakery, to qualify as a tax-exempt organization under I.R.C. § 501(c)(3), it must satisfy the I.R.S. that it transacts with disadvantaged or poor individuals.

<sup>50</sup> CDFI Coalition, *supra* note 24.

<sup>51</sup> Boschee, *supra* note 44, at 90-96.

<sup>52</sup> Hansmann, *supra* note 14, at 840.



grants. The critical point, however, is that the financial viability of social enterprises is primarily dependent on earned income rather than donations. The second often overlooked element, which is central to the theory in this paper, is that donative organizations are engaged primarily in allocating subsidies to “external” beneficiaries, i.e., beneficiaries who are not patrons of the enterprise (see Figure 2).<sup>53</sup> Examples of subsidies to external beneficiaries include distribution of goods (e.g., bed-nets), subsidies towards the purchase of goods or services (e.g., voucher schemes or contribution of capital through credit subsidies), and professional training programs. To be sure, many social enterprises do allocate subsidies to their beneficiaries. MFIs may provide subsidized rates to their borrowers and FTSEs provide training subsidies to their farmers. However, whereas donative organizations are engaged exclusively in transferring subsidies to beneficiaries, social enterprises require their patron-beneficiaries to provide a nontrivial consideration (e.g., return of a loan with interest, or input provided by farmers) that reflects their capital and resources (e.g., ability to pay or productivity).

Finally, it should be emphasized that joint ventures or other contractual arrangements between donative organizations and for-profits may effectively create social enterprises. In fact, these arrangements may underlie the contractual and control mechanisms discussed above. First, a donative organization may enter into a contract with a for-profit firm pursuant to which the former provides subsidies, and the latter commits to transacting with certain beneficiaries. The for-profit essentially becomes a social enterprise by dint of this contract. The agreement discussed above between A to Z, a for-profit seller of bed-nets, and a partnership consisting of donative organizations is one example. Similarly,

<sup>53</sup> Donative organizations may have a contract with their beneficiaries that requires them to use subsidies for their intended purpose (e.g., using medical supplies to treat patients). But, the critical point is that the beneficiaries are not required to provide a nontrivial consideration for the benefit received.

donative organizations often agree to provide training subsidies and quality control to farmers in developing countries if a for-profit firm – essentially an FTSE – contractually commits to buying its supplies from those producers.<sup>54</sup> Second, control mechanisms often include a donative organization which provides subsidized equity investment to the social enterprise entity. In this case, part of the activities of an organization which for the most part are donative in nature, involve social investment. One example is the Greyston Foundation, the owner of the Greyston bakery. Its regular activities concentrate on providing professional training to external beneficiaries, the unemployed, but with respect to the bakery, it operates like a social investment firm.<sup>55</sup>

### C. Social Enterprise versus Other Hybrid Organizations

As stated above, a common form of hybrid organization is corporations that engage in corporate charity and corporate social responsibility (“CSR”). The major difference between these organizations and social enterprises is that they do not involve a commitment to transacting with beneficiaries. In most cases, similarly to donative organizations, such policies involve the transfer of a subsidy to an external beneficiary.<sup>56</sup> Many corporations donate a portion of their profits to charity. Often such donations are made to a donative organization (for example, the Global Fund) that channels them to external beneficiaries (e.g., people with HIV in developing countries). CSR policies are largely identical to corporate charity in economic terms, except that CSR usually refers to a broader range of methods for passing on subsidies. Google.org for example has vowed to use one percent of its profits and its employees’ time to create solutions to global problems, such as climate change and poverty alleviation.<sup>57</sup>

Accordingly, the key distinction I draw in this paper is between organizations that provide charity through giving subsidies and social enterprises that commit to transacting with disadvantaged groups. The distinction between giving and transacting transcends the traditional distinction between for-profits and nonprofits. As shown in Table 1, “giving” organizations include both donative organizations and for-profit corporations that engage in charity, and as shown above, social enterprises may be formed as for-profit or nonprofits. The focus of this article is to highlight the advantages of social enterprises in utilizing

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<sup>54</sup> See Aneel Karnani, *Reducing Poverty through Employment*, INNOVATIONS, Spring 2011, at 73, 82-86 (describing a partnership between Technoserve and entrepreneurs to establish cashew nut plants in Mozambique).

<sup>55</sup> I.e., the bakery is the patron-beneficiary.

<sup>56</sup> More difficult cases of CSR where the subsidy is channeled to a patron yet there is no “true patron-beneficiary” are discussed in section V.A.

<sup>57</sup> See Reiser, *supra* note 10.

<b>TABLE 1: GIVING VERSUS TRANSACTING</b>		
	<b>Giving</b>	<b>Transacting</b>
<b>For-profit</b>	<b>Corporate Charity</b>	<b>For-profit Social Enterprise</b>
<b>Nonprofit</b>	<b>Donative Organization</b>	<b>Nonprofit Social Enterprise</b>

subsidies to promote development, although I discuss other forms of hybrid organizations in more detail in section V.

Finally, I note that not all firms fit neatly into a specific category. Many social enterprises adopt corporate social responsibility initiatives. Similarly, a donative organization may comprise a social enterprise.<sup>58</sup> Accordingly, the categories identified herewith should be considered as ideal types rather than mutually exclusive and exhaustive categories.

## **II. A THEORY OF SOCIAL ENTERPRISE**

The theory of social enterprise set out herewith explains how the transactions with their patron-beneficiaries make social enterprises relatively effective in addressing complex development missions as compared to other forms of organization. To be sure, for the purposes of this Part, I am indifferent as to whether social enterprises are formed as for-profits or nonprofits, as long as they are under a commitment to transacting with a class of disadvantaged patrons.

Standard economic theory is suspicious of subsidizing corporations. There is a general concern that subsidies fail to achieve their purpose and may be expropriated by those who control the organization. In the case of donative organizations, the non-distribution constraint mitigates the possibility that managers will expropriate the subsidies (i.e., the donations). The non-distribution constraint on its own is a relatively crude mechanism that works well especially when donative organizations simply transfer subsidies to beneficiaries (e.g., soup kitchens). However, in many cases, the goal of subsidies is to address complex

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<sup>58</sup> E.g., Donative organizations that operate training programs may also employ disadvantaged workers.

development missions, for example, increasing access to capital and improving employment opportunities. It is unrealistic to expect the non-distribution constraint to assure donors that their subsidies will be used effectively when the mission is highly complex.

While there may be many reasons why subsidies fail, their ineffectiveness stems from information asymmetries. Subsidies are transactions, in which the provider of the subsidy gives something of value (cash, goods or a service), to a recipient, but may be unable to evaluate how that subsidy was used at the time that the subsidy was given. If I donate \$100 to fund a training program for low-income workers, there may be uncertainty as to whether the training subsidy was effective in increasing employment. Whether or not the training is effective depends on the attributes of each beneficiary. The beneficiaries may already be productive, and their unemployment is possibly due to other economic factors. Alternatively, workers may lack very basic skills (e.g., attentiveness), and therefore complicated technical training may be inappropriate. An ineffective subsidy is not simply a distribution of wealth, but constitutes waste, as the provider of the subsidy presumably intended it to be utilized effectively.

Social enterprises are designed to deal with the uncertainty of subsidies' effectiveness when subsidies are intended to address complex development missions, such as increasing access to capital and enhancing productivity. Employing subsidies effectively to address such problems requires differentiating among beneficiaries in terms of their attributes, including creditworthiness, productivity, and ability to pay. Such complex problems merit specific attention. Consider a worker from a disadvantaged community that suffers from systemic unemployment. Rephrasing the issue, the problem is that such a worker cannot find employment at a standard commercial firm. Likewise, poor individuals cannot get a loan from a commercial bank; small producers have difficulty in selling their products to multinational corporations; and individuals in rural communities cannot buy essential products and services.

This inability of disadvantaged people to transact with commercial firms may derive from two sources. The first is that commercial firms have difficulty in evaluating the abilities of individuals that belong to disadvantaged groups. As a result of such information asymmetries, commercial firms fail to transact with them, even if such individuals have fully competitive ("FC") abilities to carry out their transaction with the firm. A substantial body of research shows that although many members of disadvantaged communities may be too poor or lack technical skills, a significant number of them have ample capabilities to transact with commercial firms, e.g., buy products, repay debt, or work at a factory.<sup>59</sup> While any commercial firm has to deal with information asymmetries with respect to the attributes of its patrons, e.g., workers' skills or borrowers' creditworthiness, there are various mechanisms to mitigate these problems, for example, education helps

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<sup>59</sup> See Part III below.

workers signal their abilities, or credit-rating bureaus collect information on borrowers' creditworthiness. Such mechanisms are often absent in developing countries or low-income communities. Moreover, the high proportion of individuals who lack FC abilities in disadvantaged communities makes it harder for commercial firms to identify those who have such abilities. Consequently, in transacting with disadvantaged individuals, firms may face a higher risk of transacting with individuals with less than FC abilities (e.g., very risky borrowers).<sup>60</sup> Transacting with disadvantaged patrons therefore entails opportunity costs, and hence leads commercial firms to ignore them altogether.

Second, many disadvantaged individuals fall short of FC abilities. Commercial firms wouldn't transact with them even if they were able to observe their abilities. The traditional approach to dealing with this problem is for a donative organization, a government agency or a nonprofit, to provide them with some form of assistance – essentially a subsidy. Such assistance may take several forms, for example, distribution or subsidization of goods (e.g., fertilizer), credit subsidies or professional training programs. As stated above, however, for such a subsidy to be effective there must be information on the abilities of its beneficiaries. An effective subsidy would only be allocated to those who have below-competitive (“BC”) abilities, but could reach FC abilities if they receive the subsidy. It would be of limited effectiveness if allocated to people who already have FC abilities, or to individuals who have no competitive (“NC”) abilities, i.e., individuals who are unable to acquire FC abilities even if they receive assistance.<sup>61</sup> For example, a training subsidy should be administered only to workers who have some basic skills and could perform at a fully competitive level if they received professional training.<sup>62</sup>

The problem with donative organizations however is that they have limited means to gather information on their beneficiaries' attributes. By definition, there is no transactional relationship between the organization and the beneficiaries.<sup>63</sup> A contractual transaction enables commercial enterprises to elicit information about their patrons, especially their abilities and preferences. It shows that patrons have at least some capabilities to perform the contract. For example, repayment of a debt or performance as an employee reveals information on one's abilities. By

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<sup>60</sup> In general, firms can adjust their contracts to reflect the lower abilities of disadvantaged patrons, for example, by reducing wages or increasing interest rates to borrowers. But as wages fall or interest rates increase, more capable patron-beneficiaries will exit the market, a process which leads to rationing and often a collapse of the market; see Joseph Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV., 393 (1981); Chapter 2 in Armendáriz & Morduch, *supra* note 13, at 29-66.

<sup>61</sup> Of course, this categorization is somewhat crude, but nonetheless helpful in elucidating the advantages of social enterprises.

<sup>62</sup> To be sure, charitable transfers (e.g., cash or food stamps) to those with NC abilities is desirable; the point is that at a very low level of abilities, professional training would be a wasteful way of allocating subsidies to them.

<sup>63</sup> See Figure 2.

contrast, as donative organizations do not transact with their beneficiaries, they need to rely on available information to the extent that such exists.<sup>64</sup>

If donative organizations had information on beneficiaries' attributes they would be able to allocate the appropriate amount and type of subsidy. But, without such information, there is a risk that they will prescribe wasteful programs with limited effect<sup>65</sup> that do not address the needs and attributes of their beneficiaries.<sup>66</sup> The waste in this case includes the costs of the subsidy (e.g., the costs of the training) to those with FC abilities (as they do not need any training) and those with NC abilities (for whom training would be useless). The social costs also include the waste from having trained effectively those with BC abilities, who nonetheless fail to obtain employment with firms that choose to ignore disadvantaged individuals anyway. Accordingly, subsidies will tend to be wasteful when there is a high proportion of individuals with FC or NC abilities, or if commercial firms ignore disadvantaged groups anyway.

The thrust of my theory is that transacting with the beneficiaries gives social enterprises the tools and incentives to utilize subsidies effectively. Social enterprises perform a *measurement* function with respect to the attributes of their beneficiaries. Unlike donative organizations, social enterprises are subject to a commitment to transacting with their beneficiaries as patrons.<sup>67</sup> The commitment device ensures that they cannot transact with other more capable patrons, for example, more productive workers from high-income communities.<sup>68</sup> Because transacting with disadvantaged patrons entails opportunity costs, social enterprises must receive some subsidies. However, as explained above, social

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<sup>64</sup> It can be argued that donative organizations could conduct impact studies of their programs to address this problem. However, these studies are often prohibitively costly. For example, following every worker that undergoes a training program to record their employment and performance is unlikely to be practical in most cases. Moreover, it has been argued that donative organizations have only modest incentives to carry out such studies because it may highlight to donors the ineffectiveness of their programs; Bertin Martens, *The Role of Evaluation in Foreign Aid Programs*, in Martens et al. eds., *supra* note 65, at 154-177.

<sup>65</sup> There is ample literature on the disappointing effectiveness of aid provided by government agencies or international organizations; see THE INSTITUTIONAL ECONOMICS OF FOREIGN AID (Bertin Martens et al. eds., 2002); William Easterly, *Can the West Save Africa?*, 47 J. OF ECON. LITERATURE 373 (2009); William Easterly, *Was Development Assistance a Mistake?*, 97(2) AM. ECON. REV., 328 (2007); Claudia Williamson, *Exploring the Failure of foreign Aid: The Role of Incentives and Information*, 23 THE REV. OF AUSTRIAN ECON. 17, 27-31 (2010).

<sup>66</sup> Without information, the rational strategy is to provide the same subsidy to all beneficiaries in the same amount that would help those who have BC abilities attain FC abilities. The reason is that disbursements in any other amount and type will always be inefficient, whereas such disbursements will at least be efficient with respect to beneficiaries that have BC abilities.

<sup>67</sup> Compare Figures 1 and 2.

<sup>68</sup> The form of commitment device adopted by the social enterprise is of limited relevance for present purposes. For a discussion of choice of commitment devices and organizational form, see Part IV.

enterprises must still earn revenues to remain financially viable.<sup>69</sup> For social enterprises to earn revenues, the patron-beneficiaries must be able to perform their tasks and duties under their transactions with the social enterprise firm at a reasonable level: A WISE would suffer financially if its workers were not competent; an MFI must ensure that its borrowers are sufficiently creditworthy; if the quality of input is low FTSEs will not be able to sell their products; and for a low-cost seller to be commercially viable, its consumers must be able to purchase the products or services it offers.

Consequently, social enterprises have the tools and the incentives to measure their beneficiaries' abilities to make sure that they have at least FC or BC abilities.<sup>70</sup> For example, as discussed below, WISE closely evaluate the productivity and performance of their worker-beneficiaries. Social enterprises use the information on their patron-beneficiaries to tailor the amount and type of subsidies to their specific needs. If the subsidies transferred to beneficiaries are excessive, the social enterprise will be less profitable. If the subsidy is insufficient or inadequate, the patron-beneficiaries may not perform well, and again the business will suffer. For example, a WISE will employ those with FC abilities, but has no need to allocate them a training subsidy. It will then allocate a subsidy only to those who have BC abilities. In particular, given its contractual relationship with its worker-beneficiaries, it is able to ensure that workers with BC abilities are actually productive and that the training program is indeed adapted to the commercial needs of the firm.<sup>71</sup> Note also that there are welfare gains to patron-beneficiaries with FC or BC abilities who would not otherwise be able to transact with commercial firms.<sup>72</sup> Contrast this with a donative organization which allocates wasteful subsidies to beneficiaries with FC and NC abilities, and has no practical way to ensure that its beneficiaries are actually employed. Accordingly, the use of social enterprises results in more effective utilization of subsidies.

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<sup>69</sup> An example is a social enterprise that employs disadvantaged workers and makes a 10% annual return on a \$1 million investment, while a profit-maximizing firm would make a 30% annual return on the same investment; the subsidy being the 20% annual return that investors are willing to forgo. It is noteworthy that a social enterprise may also make negative returns on invested capital as long as it also receives additional subsidies to ensure that the firm remains solvent; for example, where the return on investment is -10% and the firm receives a government grant to cover accounting losses. Even in this case, the firm needs to earn substantial revenues to be viable.

<sup>70</sup> Depending on the business model, some social enterprises transact only with individuals who have FC abilities, whereas others transact also with those who have BC abilities.

<sup>71</sup> A social enterprise will sever its transactions with those who have NC abilities as they are unable to perform the job, but they may still seek relief from a donative organization; see J.P. Morgan & The Rockefeller Foundation, *supra* note 2, at 45 (noting that a portion of the population with the lowest income levels will remain reliant on aid).

<sup>72</sup> These welfare gains are equal to the economic surplus they derive from their transactional relationship with the social enterprise.

In this way, the commitment to transacting with a disadvantaged group effectively aligns the profit and social missions of social enterprises.<sup>73</sup> More specifically, it aligns the interests of the subsidy-providers with the profit interest of those who control the social enterprise, i.e., the owners in the case of for-profit social enterprises<sup>74</sup> or the managers in the case of nonprofit social enterprises who presumably want to maximize spending on perquisites.<sup>75</sup> In order for social enterprises (for-profits or nonprofits) to remain financially viable, they must ensure that their patron-beneficiaries perform well and that subsidies are not wasted. Thus, the incentives of social enterprises to allocate subsidies effectively are present even if, and in fact in large part because, the owners and/or managers are motivated by profit. The same incentives exist when the owners and/or managers are altruistic, because even an altruistic owner or manager does not derive utility from wasting subsidies and must make sure that the business is viable for it to achieve its development mission.

Social enterprises employ three main mechanisms to measure their beneficiaries' attributes: (1) ***Due diligence***: Social enterprises study the attributes of their beneficiaries *ex ante* entering into a contract with them in order to decide whether or not to transact with them. (2) ***Intensive monitoring***: In the course of transacting with the beneficiaries, the social enterprise monitors their performance, thereby acquiring information on their abilities. This information is used for deciding on whether to continue the contractual relationship and the type of subsidies to be allocated to such beneficiaries. (3) ***Incentive mechanisms***: Social enterprises may utilize the relationship with the patron-beneficiaries as the basis for developing incentive mechanisms to reveal information on patron-beneficiaries' abilities and efforts. In order to be eligible for a subsidy, beneficiaries with BC abilities must reveal their abilities to perform the contract; if they were to represent themselves as having NC abilities, they would not be able to transact with the social enterprise. While those with FC abilities may have an incentive to pretend they have BC abilities in order to qualify for certain subsidies (e.g., longer grace periods on loans), the contract may provide for various mechanisms to mitigate their incentives to understate their abilities (e.g., a promise of a future loan on better terms if they timely repay a loan, thereby revealing their FC abilities).

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<sup>73</sup> Note that this is subject to the risk of mission-drift discussed in section VI.A below.

<sup>74</sup> When a for-profit social enterprise adopts a control mechanism as a commitment device, the owners or some of them may be nonprofits that provide subsidies to the social enterprise. Nonetheless, even such nonprofit owners have a profit motive to increase their income, so that they have more funds to apply towards their social missions.

<sup>75</sup> In line with the model of nonprofits offered by Glaeser & Shleifer, managers of nonprofits want to increase profits because they can extract a proportion of such profits in the form of higher salaries and perks; ; Edward L. Glaeser & Andrei Shleifer, *Not-For-Profit Entrepreneurs*, 81(1) J. OF PUB. ECON. 99 (2001).

To be sure, these mechanisms are not conceptually different from those used in contracts between standard commercial firms and their patrons. The main difference is that employing these mechanisms with respect to disadvantaged persons is more costly than with respect to non-disadvantaged ones and may require social enterprises to develop specialized techniques to measure the attributes of disadvantaged individuals; hence, the need for a subsidy. For example, doing diligence in rural markets on the creditworthiness or ability to pay of low-income people may be extremely costly; intensive monitoring of workers with different levels of ability requires a great deal of effort on the part of managers; additionally, as shown below, incentive mechanisms used by social enterprises can be highly specialized and entail high transaction costs.

It follows that the primary role of subsidies is not to fund direct allocations to beneficiaries (e.g., discounted prices or rates). As shown above, many social enterprises do not make any such allocation. Compartamos, for example, may be viewed as transacting exclusively with poor borrowers who have high, presumably FC abilities, charging them rates that reflect their creditworthiness. The primary role of the subsidies is to fund the costs associated with transacting with patron-beneficiaries, especially the costs of measuring or evaluating beneficiaries' attributes. In this respect, social enterprises also have incentives to economize on the costs of measurement by employing a variety of creative mechanisms. As shown below, many social enterprises have developed efficient mechanisms for measuring their patron-beneficiaries' attributes through diligence, monitoring and incentive mechanisms.

Finally, it is important to emphasize that social enterprises have efficiency advantages over donative organizations only when there are information asymmetries with respect to beneficiaries' attributes. When there are no information asymmetries, a donative organization is equally effective in allocating subsidies. The most conspicuous example is distribution of food aid in the midst of a natural crisis, e.g., an earthquake. There is relatively little risk that such aid will be employed ineffectively. Likewise, if there is available information on beneficiaries' abilities to pay or skill level, donative organizations could simply tailor subsidies to their needs.

The measurement role of social enterprise is thus *essential* only when it is necessary to differentiate among beneficiaries. Evaluating the abilities of different types of beneficiaries is critical in the context of development goals, such as enhancing access to capital or increasing productivity. Allocating subsidies to facilitate development requires screening creditworthy borrowers from risky ones; differentiating between productive workers and those who lack basic skills; and evaluating the ability of consumers to pay for products and services. Social enterprises have the ability and incentives to gather this information and, as a result, are likely to use subsidies effectively.

### III. APPLICATION OF THE THEORY

In this part, I apply the theory to various forms of social enterprise. I divide the discussion into different types of development goals. With respect to such goals, I describe how information problems preclude standard commercial firms from transacting with disadvantaged groups, explain why donative organizations fail to assist them, and show how social enterprises use their measurement role to address the problem.

#### A. Access to Capital: Microfinance Institutions, Credit Development Financial Institutions and Social Investment Firms

(1) *Commercial Firms*: Commercial banks have traditionally avoided transacting with poor individuals in low-income communities in both developing and developed countries. Commercial lenders rely on credit scores to evaluate their borrowers. They also require collateral or other security to mitigate the risk of default. In low-income communities, credit scores are usually not available, as borrowers lack a credit history, employment track record and, in some cases, even proof of identity. In addition, poor borrowers usually lack collateral to pledge as security for a loan.<sup>76</sup> Moreover, the presence of many risky borrowers who have limited earning capacity makes it harder for banks to identify those who can repay their debts. Likewise, investment firms tend to ignore small businesses, especially in developing countries.<sup>77</sup> In developed markets, investment firms, such as private equity firms, rely on audited financial information, the track record and reputation of their investees' management, and general market information. By contrast, in developing markets, the balance sheet of businesses may not be a reliable source of information, as financial standards either do not exist or are not enforced, and, more generally, data on the relevant market may be scarce. Moreover, evaluating the potential of a small business with no track record can be difficult.

(2) *Donative Organizations*: Many low-income individuals or small businesses cannot pay commercial rates for loans or generate commercial returns. Governments of developing countries have for many years subsidized credit in an attempt to increase access to capital, especially for small farmers. These subsidies have taken different forms, in particular, the allocation of cheap loans through credit subsidies. However, credit subsidies in whatever form have been grossly inefficient.<sup>78</sup> Repayment rates at such programs have been very low, with default

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<sup>76</sup> See CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY (Margaret J. Miller ed., 2003).

<sup>77</sup> See BRIGIT HELMS, ACCESS FOR ALL: BUILDING INCLUSIVE FINANCIAL SYSTEMS 2-5 (World Bank 2006); Prahalad, *supra* note 33; Benjamin et al., *supra* note 24.

<sup>78</sup> Armendáriz & Morduch, *supra* note 13, at 9-12; Juan J. Buttari, *Subsidized Credit Programs: The Theory, the Record, the Alternatives* (USAID Evaluation Special Study No. 75, 1995); UNDERMINING RURAL DEVELOPMENT WITH CHEAP CREDIT (Dale Adams et al. eds., 1984);

rates ranging from 40 to 95 percent.<sup>79</sup> Impact studies have attributed low repayment rates in large part to information problems, for example, inadequate program design that wrongly assumed that borrowers, mainly farmers, necessarily had good projects, uncertainty regarding the ability of borrowers to meet payment obligations, and failures to monitor borrowers who often diverted loan funds to other purposes, including consumption.<sup>80</sup> Moreover, many borrowers lacked knowledge and input, and therefore their projects were likely to fail. These subsidized programs collected too little revenue and either ran out of money or drained government accounts.

(3) **Social Enterprises:** MFIs, CDFIs and social investment firms tailor the terms of their investments to the creditworthiness and business potential of their investees. Compartamos charges market rates on its loans to the moderately poor. Thus, it does not directly allocate subsidies to its beneficiaries; rather, it utilizes the subsidies it has received to measure its beneficiaries' creditworthiness. As a result of such measurement, default rates tend to be very low, despite the high interest rates charged to borrowers.<sup>81</sup> Simply transferring credit subsidies to borrowers in circumstances when they can afford taking a loan or, even worse, when they have no good projects is clearly an inferior solution. On the other hand, MFIs, CDFIs and social investment firms that transact with less capable individuals provide them with different types of subsidies. For example, MFIs, such as BRAC and ASA, provide their borrowers with reduced rates and business training. Similarly, while some social investment funds seek to make near-competitive returns,<sup>82</sup> others, such as Triodos Bank and the Acumen Fund, charge below-market rates and provide business training to their investees. Thus, prices and subsidies allocated are adjusted to the beneficiaries' abilities.

The effectiveness of subsidies channeled through social enterprises is simply evidenced by their ability to sustain themselves. When borrowers of MFIs and CDFIs pay back their loans, and investees of social investment firms generate reasonable returns, this is an indication that the subsidies are effective, as the patron-beneficiaries are performing well. In particular, measurement of borrowers has been particularly successful for MFIs whose loan repayment rates tend to be very high.<sup>83</sup> As discussed above, social enterprises use three main mechanisms to measure their beneficiaries:

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Avishai Braverman & Luis Guasch, *Rural Credit Markets and Institutions in Developing Countries: Lessons for Policy Analysis from Practice and Modern Theory*, 14 *WORLD DEV.* 1253 (1986).

<sup>79</sup> Armendáriz & Morduch, *supra* note 13, at 11.

<sup>80</sup> See especially, Buttari, *supra* note 78; Braverman & Guasch, *supra* note 78.

<sup>81</sup> Default rates for Compartamos were historically less than 1%, whereas the average default rate on consumer loans by other Mexican banks was 4.4%; see Compartamos Offering Circular, *supra* note 20, at 83.

<sup>82</sup> For example, the IGNIA Fund, discussed in section IV.C.

<sup>83</sup> There is mixed data on delinquency rates of CDFIs' loans, though they generally appear to be comparable to industry averages; see Michael Swack et al., *CDFI Industry Analysis: Summary*

(i) *Due diligence*: CDFIs use alternative mechanisms to collect information on the creditworthiness of low-income borrowers, such as utility bills, house visits and personal interaction with borrowers.<sup>84</sup> To reduce the costs of information, they also tend to specialize in specific industries, such as housing finance.<sup>85</sup> Social investment firms invest effort and resources in due diligence, including vetting the character and qualifications of the management team and financial analysis of their investees.<sup>86</sup> By contrast, MFIs that make very small loans to borrowers tend to conduct a less onerous diligence process and rely more extensively on other mechanisms.

(ii) *Intensive monitoring*: MFIs as well as CDFIs evaluate the performance of their borrowers throughout their loans, and over time they accumulate data on borrowers' business projects and repayment rates. MFIs use frequent repayment installments of very small amounts, in order to allow their credit officers an early opportunity to assess borrowers' performance.<sup>87</sup> Repayment of the loan on time is a clear indication of a borrower's abilities, and she may then be given additional loans. At some stage, it may become evident that borrowers no longer need a subsidy. They then may indeed obtain loans at commercial rates; for example, the interest rates may be lowered and the loan size increased, not as a disbursement to the borrower, but to reflect the lower risk of lending to a borrower with higher abilities. On the other hand, if borrowers default, they receive no further loans.<sup>88</sup> Through this process, MFIs and CDFIs have compiled a sizeable database on the creditworthiness their target markets. Although social investment firms tend to rely more on diligence, they also exercise substantial monitoring over their investees. The monitoring may consist of appointing directors to the board of the investee and requiring board consent for certain business decisions, including not only major transactions, such as a merger, but also managerial decisions regarding business strategy.<sup>89</sup>

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*Report* (Carsey Institute, 2012), available at [http://www.cdfifund.gov/news\\_events/CDFI-2012-12-CDFI-Fund-Releases-In-Depth-Examination-of-State-of-the-CDFI-Industry.asp](http://www.cdfifund.gov/news_events/CDFI-2012-12-CDFI-Fund-Releases-In-Depth-Examination-of-State-of-the-CDFI-Industry.asp).

<sup>84</sup> Katy Jacob, *Reaching Deeper: Using Alternative Data Sources to Increase the Efficacy of Credit Scoring* (The Center for Fin. Services Innovation, March 2006), available at <http://cfsinnovation.com/node/2510>.

<sup>85</sup> See Ronald Grzywinski, *The New Old-Fashioned Banking*, HARV. BUS. REV., May-June 1991, at 87; Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1578-1579 (1995).

<sup>86</sup> J.P. Morgan & The Rockefeller Foundation, *supra* note 2, at 70. For a useful illustration of the process, see William Davidson Institute, *Acumen Fund: Valuing a Social Venture* (Michigan Ross School of Business note 1-428-788, May 2009); William Davidson Institute, *Acumen Fund: Valuing a Social Venture (B)* (Michigan Ross School of Business note 1-428-872, Oct. 2009).

<sup>87</sup> Armendáriz & Morduch, *id.*, at 145-153.

<sup>88</sup> For example, Shore Bank, a known CDFI, experimented with loans to small businesses that suffered from high default rates before it started focusing on housing finance; see Grzywinski, *supra* note 85.

<sup>89</sup> For example, see William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, *supra* note 86, at 21-24.

(iii) *Incentive mechanisms*: Many MFIs rely on a specialized incentive mechanism known as group lending. The gist of it is that loans are made to a group of borrowers who are jointly liable for the debts of each other borrower in the group.<sup>90</sup> Group lending gives rise to a process of assortative matching whereby safe (risky) borrowers form groups with other safe (risky) borrowers. The risky borrowers effectively pay higher rates than the safe ones because their groups default more often. In this way, group lending generates information on borrowers' abilities *ex ante* a loan. Group lending also reduces moral hazard *ex post* a loan contract, as group members monitor each other to make sure they repay their loans, and failure to pay results in social stigma.<sup>91</sup> Group lending has been very effective in ensuring very high repayment rates. Despite its effectiveness, though, many MFIs are gradually shifting away from it to using more standard mechanisms, mainly because conducting group meetings involves high transaction and social costs.<sup>92</sup> In particular, MFIs promise borrowers an opportunity to borrow more capital on better terms if they repay their existing loans on time.<sup>93</sup> Thus, loans may be made for larger amounts, longer terms, and at better interest rates. This addresses the risk that borrowers will not pay once project returns have been realized.

## **B. Improving Productivity: Fair Trade Social Enterprises**

(1) *Commercial firms*: Multinational corporations buy their input from well-established commercial producers or middlemen and avoid buying input directly from small producers.<sup>94</sup> The major concern of commercial firms is the quality of products supplied by small producers. In a fragmented market of numerous suppliers, and with respect to products the quality of which is not observable by cursory inspection, it is too costly to evaluate each item of input. Coffee beans and bananas are two notable examples.<sup>95</sup> There is great difficulty in distinguishing

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<sup>90</sup> For a detailed explanation, see Chap. 4 in Armendáriz & Morduch, *supra* note 13.

<sup>91</sup> Armendáriz & Morduch, *supra* note 13, at 157.

<sup>92</sup> Nitin Bhatt & Shui-Yan Tang, *The Problem Of Transaction Costs In Group-Based Microlending: An Institutional Perspective*, 26 *WORLD DEV.* 623 (1998).

<sup>93</sup> Armendáriz & Morduch, *supra* note 13, at 140-144.

<sup>94</sup> Small producers sell their products to middlemen known as "coyotes" who are often in a position to exploit their monopsonist power. Thus, a common explanation for fair trade is that it is a solution to monopsonist pricing; see Nicholls & Opal, *supra* note 36, at 33-34; Mark Hayes, *On the Efficiency of Fair Trade*, 64 *REV. OF SOC. ECON.* 447 (2006). This view ignores a more fundamental question, which is why there is no competition in the first place. If multinational corporations traded directly with small producers, competition for the products of small producers would raise prices. The problem is that information asymmetries preclude direct trading between corporations and small producers. This problem is similar to the problem of monopolist moneylenders with respect to lending to poor borrowers (see Armendáriz & Morduch, *supra* note 13, at 31-33). When commercial lenders refrain from lending to the poor because of information problems, monopolist moneylenders may step in and lend at exploitative rates.

<sup>95</sup> See Nicholls & Opal, *supra* note 36, at 81, 87.

among producers with different levels of abilities, especially as many small producers in developing countries do not meet the quality standards of export markets.<sup>96</sup> It is also costly to monitor small producers to ensure that they exert a sufficient level of effort. Small producers may try to establish a reputation for high quality by using marketing tools, but with few exceptions, they tend to be too segregated or too poor to establish a brand. Accordingly, many producers, especially farmers, in developing countries have difficulties in selling their products to multinational corporations even if they can meet high quality standards.

**(2) Donative Organizations:** Many farmers lack training with respect to quality standards, production methodologies and organizational skills.<sup>97</sup> Donative organization may provide them with assistance in the form of subsidized input, such as fertilizer, professional training and technical assistance. Subsidizing fertilizers to enhance farm productivity has a longstanding history in attempts to jumpstart African agriculture.<sup>98</sup> These programs, however, were found to have high costs and questionable benefits. In particular, programs have suffered from a variety of problems, including: little actual use of fertilizers by farmers, lack of information on the benefits of fertilizers and how to properly use them, excessive use which may in fact reduce yields, delivery after the optimal fertilization period, and lack of complementary measures (e.g., quality inputs).<sup>99</sup> Although yields do seem to increase following subsidization or distribution,<sup>100</sup> there is a consensus that these programs tend to be inefficient. The record of training programs, known as agricultural extension, has been even more dismal. Agricultural training requires dealing with individual farmers, and each farmer's needs are different.<sup>101</sup> Among other problems, training programs have been found to suffer from lack of knowledge as to farmers' abilities and needs, difficulties in attributing impact to training efforts, little effort to learn from experience, and limited incentives to provide quality information to farmers.<sup>102</sup> Moreover, given the difficulty of

<sup>96</sup> See Nicholls & Opal, *id.*, at 35-38.

<sup>97</sup> See DEAN KARLAN, MORE THAN GOOD INTENTIONS: IMPROVING THE WAYS THE WORLD'S POOR BORROW, SAVE, FARM, LEARN, AND STAY HEALTHY 168 (Penguin 2011); Nicholls & Opal, *supra* note 36, at 34-39. Ashish Karamchandani, et al., *supra* note 33, at 5.

<sup>98</sup> Easterly, *Can the West Save Africa*, *supra* note 65, at 416; Michael Morris et al., *Fertilizer Use in African Agriculture: Lessons Learned and Good Practice Guidelines* (The World Bank, 2007), available at <http://documents.worldbank.org/curated/en/2007/01/7462470/fertilizer-use-african-agriculture-lessons-learned-good-practice-guidelines>.

<sup>99</sup> Morris et al., *id.*, at 31-44.

<sup>100</sup> Esther Duflo et al., *How High Are Rates of Return to Fertilizer? Evidence from Field Experiments in Kenya?*, 98(2) AM. ECON. REV.: PAPERS & PROC. 482 (2008).

<sup>101</sup> Easterly, *supra* note 98, at 419.

<sup>102</sup> See Jock R. Anderson & Gershon Feder, *Agricultural Extension: Good Intentions and Hard Realities*, 19(1) WORLD BANK RES. OBSERVER 41 (2004); Jock R. Anderson et al., *The Rise and Fall of Training and Visit Extension: An Asian Mini-drama with an African Epilogue* (World Bank Pol'y Res. Working Paper 3928, May 2006), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=917499](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917499); IEG, *World Bank Assistance to*

attributing outcomes, program staff tends to focus excessively on reporting input indicators (e.g., visits made) rather than material impact.<sup>103</sup> There is also evidence that the training is only useful to farmers with higher skills,<sup>104</sup> though it is presumably administered to all farmers in a given community.

(3) **Social Enterprises:** FTSEs have a clear advantage in adjusting their subsidies to the attributes of their producers. Cafédirect's business development programs, which include building capabilities in marketing, quality control, and crop management, are tailored to producers' specific needs.<sup>105</sup> FTSEs have incentives to subsidize fertilizers and high-quality input to the extent that small farmers cannot afford to purchase them as well as to teach farmers how to use them effectively. The effectiveness of their training and fertilizer subsidies is simply evidenced by their financial sustainability. The profitability of Cafédirect is itself an indication that the quality of the product is high, that the subsidies it allocates to its producers are sufficient to enable them to reach fully competitive abilities. FTSEs measure their beneficiaries' attributes in the following ways.

(i) *Due diligence:* FTSEs invest in studying the capabilities of producers. They send expeditions to developing countries to visit producers in order to sample the quality of their products. Often a donative organization will partner with a FTSE and assist with sampling and training.<sup>106</sup>

(ii) *Intensive monitoring:* FTSEs almost invariably sell high-quality products, mainly to address concerns that the poor cannot produce quality products.<sup>107</sup> Therefore, they naturally need to monitor the quality of the input they buy from producers. Although their relationship with their producer-beneficiaries is generally expected to be long-term (as discussed below), there is no commitment to transacting with producers who turn out to be unable to perform. FTSEs learn which producers are more capable than others, as the quality of the input affects the quality of the end product. If consumers buy the product, this is an indication of its high quality, and vice versa.

(iii) *Incentive mechanisms:* First, the Fair Trade standards require small producers to be members of cooperatives, an arrangement under which producer-members have equity ownership proportional to the quantity of product they sell through the cooperative.<sup>108</sup> The function of the cooperative, other than to enable

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*Agriculture in Sub-Saharan Africa*, (2007), available at <http://web.worldbank.org/WBSITE/EXTERNAL/EXTOED/EXTASSAGRISUBSAHAFR/0,,menuPK:4422655~pagePK:64829575~piPK:64829612~theSitePK:4422577,00.html>, at 44, 54-56.

<sup>103</sup> Anderson et al., *id.*, at 6.

<sup>104</sup> *Id.*, at 5.

<sup>105</sup> *Id.*

<sup>106</sup> See Karnani, *supra* note 54. For examples of cooperation by Starbucks with various donative organizations, see James E. Austin & Cate Reavis, *Starbucks and Conservation International* (Harv. Bus. Sch. Case 9-303-055, 2002), at 12; Paul Argenti, *Collaborating with Activists: How Starbucks Works with NGOs*, 47 CAL. MGMT. REV. 91, 108-110 (2004).

<sup>107</sup> Nicholls & Opal, *supra* note 36, at 24.

<sup>108</sup> Nicholls & Opal, *supra* note 36, at 24; Section 4.2 of the Fairtrade Standard, *supra* note 40.

producers to pool resources and capital, is to address information asymmetries. The formation of cooperatives leads to assortative matching among producers, like group lending in the case of MFIs. Producers with sufficiently high capabilities will partner with producers with similar capabilities in order to ensure that their cooperative will supply products of sufficient quality, so that FTSEs continue to transact with them. Once the cooperative starts transacting, producers have incentives to monitor each other to ensure that each of them supplies high-quality input in timely fashion.

Second, Fair Trade standards contain requirements which enhance producers' incentives to invest in the quality of their products by insuring producers against risks outside their control. FTSEs are expected to transact with small producers on a long-term basis,<sup>109</sup> and importers that cut-off small producers without good reason are likely to face reputational costs. Moreover, importers must pay either the market price or floor price of a commodity, whichever is higher, and must pre-finance up to 60% of orders.<sup>110</sup> The reason for this is not only to transfer wealth to the producers; rather, the primary reason is that producers, who lack access to credit and insurance products, may have to cut costs at the expense of quality if they are subject to unexpected adverse shocks. Income-smoothing and price insurance assure producers that they will not face short-term capital constraints or severe loss as a result of a sharp decline in commodity prices or a drought. Being given a price that reflects their efforts and the promise, albeit informal, of future transactions if they perform well, producers have stronger incentives to invest in quality.

### C. Employment Opportunities: Work Integration Social Enterprises

*(1) Commercial firms:* Low-income individuals and other disadvantaged groups, such as disabled persons or people with a criminal record, tend to suffer from systemic unemployment.<sup>111</sup> The reason for this appears to be the costs associated with evaluating their abilities. In any hiring decision, commercial firms face asymmetric information with respect to workers' abilities. In developed labor markets, workers typically use their educational and professional qualifications, job referrals and even their social background to signal their abilities to prospective employers. Such signaling mechanisms are particularly important in the case of low-skill jobs where employers care primarily about soft skills, such as discipline and attentiveness, which are difficult to observe prior to hiring. Poor workers in disadvantaged communities tend to lack access to education and have

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<sup>109</sup> Section 4 of the Fairtrade Standard, *id.*

<sup>110</sup> See *supra* note 41.

<sup>111</sup> TIMOTHY J. BARTIK, JOBS FOR THE POOR: CAN LABOR DEMAND POLICIES HELP? 55-58 (Russell Sage Foundation 2001).

no employment track record.<sup>112</sup> Moreover, the presence of a large number of workers with low skills makes it even harder for firms to identify those who have sufficient abilities. In these circumstances, firms often assume that all workers who belong to a disadvantaged group are unlikely to be capable workers.

**(2) Donative Organizations:** When workers lack sufficient capabilities, donative organizations may provide them with training with the goal of integrating unemployed and economically disadvantaged workers into the workforce. Many studies however show that the effectiveness of training programs tends to be partial at best. The benefits to participants in terms of earnings and employment are modest and do not persist over time.<sup>113</sup> Interestingly, many studies suggest that the least able participants among the low-skilled populations benefit the least from them.<sup>114</sup> This indicates that many programs are wasteful in the sense that training is provided to those whose abilities may be too low. In addition, training programs have been criticized for failing to meet the needs of commercial businesses.<sup>115</sup> Thus, the evidence as a whole suggests that training programs have limited effectiveness.

**(3) Social Enterprises:** WISEs have a clear advantage in adjusting training programs to the skill level of their beneficiaries and the particular needs of the business. The Greyston bakery conducts multiple training sessions designed specifically to enhance the performance of its workers. The bakery's profitability is itself an indication that the subsidies are effective in helping its workers reach a competitive level. Again, there are three ways in which WISEs gather information.

*(i) Due diligence:* Many WISEs, like any business, conduct diligence *ex ante* hiring decisions. WISEs may rely on referrals from training agencies, nonprofits or welfare departments, and some conduct rigorous screening of referrals through interviews and tests.<sup>116</sup> The Greyston bakery on the other hand does not conduct any diligence *ex ante* hiring; rather, it relies on intensive monitoring and incentive mechanisms *ex post* hiring.

*(ii) Intensive monitoring:* The Greyston bakery hires workers on a "no questions asked" basis (i.e., no *ex ante* diligence). At this stage it has limited

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<sup>112</sup> Bartik, *id.*, at 57; Giulia Galera, *Social Enterprises and the Integration of Disadvantaged Workers*, in Becchetti & Borzaga eds., *supra* note 10, at 106-107.

<sup>113</sup> See James Heckman et al., *The Economics and Econometrics of Active Labor Market Programs*, in HANDBOOK OF LABOR ECONOMICS, VOLUME 3B 1865 (Orley Ashenfelter & David Card eds., 1999), at 2050-2054; Bartik, *supra* note 111, at 88-110; IEG, *Using Training to Build Capacity for Development: An Evaluation of the World Bank's Project-Based and WBI Training* (World Bank 2008), at 36-38.

<sup>114</sup> Heckman, *id.*, at 2060-2064.

<sup>115</sup> See Bartik, *supra* note 111; John P. Martin & David Grubb, *What Works and for whom: A Review of OECD Countries' Experiences with Active Labour Market Policies* (OECD Working Paper 2001:14), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=348621](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=348621); IEG, *supra* note 113, at 36-38.

<sup>116</sup> Bartik, *supra* note 111, at 219.

information on its newly hired employees, who may have different levels of ability.<sup>117</sup> The management then monitors their performance and gathers information on their abilities, especially their attitude, punctuality and productivity. After one year's apprenticeship, during which they are evaluated on a biweekly basis, they may be hired as fulltime employees. In the course of their employment they receive ongoing professional development training, which includes intensive bi-weekly performance evaluations. By contrast, such intensive monitoring is not necessary in standard commercial bakeries, because workers tend to have higher abilities. Over time, the firm gathers information on employees. Workers who perform well may be promoted to a better position, or move to working for higher salaries at commercial firms. On the other hand, workers who fail to meet certain minimum standards are laid off. The average turnover rate at Greyston is relatively high and entails high costs for the firm.

(iii) *Incentive mechanisms*: As mentioned above, the workers of the Greyston bakery who perform adequately may be hired as fulltime employees after a year's apprenticeship, and may later be promoted to better positions, including managerial ones.<sup>118</sup> In addition, the bakery provides positive reinforcement to its employees, including a monthly award of distinction. Workers thus have incentives to reveal their true abilities. Workers have little incentive to understate their abilities because they may either lose their jobs or forgo opportunities to gain awards, a promotion, or a better salary.

#### **D. Enhancing Consumer Welfare: Low-cost Retailers and Service Providers**

(1) *Commercial firms*: Although multinationals are increasingly penetrating emerging markets, many rural markets remain underserved.<sup>119</sup> Consequently, many essential products and services are often lacking in such markets. Examples include eye glasses, health services, water purifiers, bed-nets, etc. Many poor customers in developing markets actually have substantial purchasing power.<sup>120</sup> In mature developed markets, commercial firms may produce affordable products designed specifically for low to moderate income customers at a profit. The growth of low-cost retailers and food chains, such as Walmart and McDonalds, is a pertinent example. In rural markets, however, the problem seems to be the costs of gathering information on consumers' abilities and preferences. Rural communities typically include a large proportion of very low-income consumers.<sup>121</sup> Identifying those consumers who have sufficient abilities to buy

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<sup>117</sup> Barker et al., *Open Hiring Policy*, *supra* note 45.

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

<sup>119</sup> Prahalad, *supra* note 33.

<sup>120</sup> DARYL COLLINS ET AL., *PORTFOLIOS OF THE POOR: HOW THE WORLD'S POOR LIVE ON \$2 A DAY* (Princeton University Press 2009).

<sup>121</sup> SANAL KUMAR VELAYUDHAN, *RURAL MARKETING: TARGETING THE NON-URBAN CONSUMER* 74-76 (Response 2005) (2007).

existing or hypothetical products may be prohibitively costly. In addition, consumers' preferences are difficult to observe. Traditional distribution channels, lack of effective means of communication, and language and cultural differences make it costly for firms to observe consumers' spending patterns and tailor their products to consumers' needs and preferences.<sup>122</sup>

(2) **Donative Organizations:** Distribution of essential goods and services raises similar concerns to other subsidies, although the evidence is more equivocal. Empirical studies that compared the effect of distribution versus selling products have yielded different results. Many studies concentrate on bed-nets and water purifiers. On the one hand, there is significant evidence that bed-nets donated by NGOs were inappropriately used as fishing nets, not used at all, or even resold to others.<sup>123</sup> Moreover, another study relating to chlorine shows that consumers who pay higher prices are more likely to use it in their drinking water.<sup>124</sup> On the other hand, many other studies suggest that demand for bed-nets and health products is very sensitive to price and usage rates decline sharply even when fees are very low.<sup>125</sup> The reason appears to be limited knowledge about the benefits of bed-nets and health products in preventing disease. These studies arguably support the view that bed-nets and other essential products should be distributed to the poor for free.

Nonetheless, this evidence needs to be qualified.<sup>126</sup> First, to the extent that consumers are able to pay for goods or services, as accepted in virtually all studies, subsidies are inherently wasteful. As many poor individuals can afford to pay at least a portion of the market price of a product, clearly the efficient policy would be to use fewer subsidies per beneficiary and produce more bed-nets with the savings. Second, none of these studies compares donative organizations to social enterprises, such as low-cost sellers. The sale of products under these studies is done through a randomized process. Consequently, these studies cannot capture the incentives of social enterprises to create a market for their products

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<sup>122</sup> See Karamchandani et al., *supra* note 33; Prahalad, *supra* note 33. Moreover, household income of the poor tends to be not only low, but also irregular and unpredictable (Collins, et al., *supra* note 120, at 16-17; Karamchandani et al., *id.*, at 36-39; Karamchandani et al., *Is the Bottom of the Pyramid Really For You?*, HARV. BUS. REV., March 2011, at 3, 3-5).

<sup>123</sup> Noboru Minakawa, et al., *Unforeseen Misuses of Bed Nets in Fishing Villages along Lake Victoria*, 7 MALARIA J. 165 (2008); *Insecticide-Treated Mosquito Nets: A WHO Position Statement* (World Health Organization, 2007), available at <http://www.who.int/malaria/publications/atoz/itnspospaperfinal/en/index.html>.

<sup>124</sup> Nava Ashraf et al., *Can Higher Prices Stimulate Product Use? Evidence from a Field Experiment in Zambia*, 100 AM. ECON. REV. 2383 (2010).

<sup>125</sup> See Easterly, *Can the West Save Africa*, *supra* note 65, at 411.

<sup>126</sup> There is also a concern that the subjects of these studies refuse to pay for products because they anticipate receiving them for free in the future. See also Dani Rodrik, *The New Development Economics: We Shall Experiment, but How Shall We Learn?*, in WHAT WORKS IN DEVELOPMENT? THINKING BIG AND THINKING SMALL 24 (William Easterly & Jessica Cohen eds., 2009).

and educate consumers about the benefits of the products and how to use them. Therefore, these studies do not prove that giving subsidies for free is necessarily a good policy.

(3) **Social Enterprises:** Low-cost sellers have incentives to gather information on consumers' ability to pay for their products, and to create a market for the product. Consider A to Z. The investment of the Acumen Fund in A to Z together with the other subsidies has facilitated the production of millions of bed-nets per year. Although distribution of bed-nets remains essential for very low-income individuals, a social enterprise that differentiates among consumers in accordance with their ability to pay is clearly a preferable approach to channeling subsidies. For a given investment, many more bed-nets will be sold by a social enterprise than delivered by a donative organization that bears the full costs of each bed-net.<sup>127</sup> Tiered price schemes that differentiate among consumers are employed by other low-cost sellers, including both nonprofits such as VisionSpring, a low-cost manufacturer and seller of affordable reading glasses,<sup>128</sup> and The Aravid Eye Care, which provides low-cost eye-care services,<sup>129</sup> and for-profits such as Ziqitza Healthcare Limited ("ZHL"), a private ambulance service provider in areas lacking high-quality emergency services.<sup>130</sup> The output of each of these firms (e.g., glasses sold or eye-surgeries performed) and their financial sustainability serve as an indication of the effectiveness of their subsidy allocation policies.

Low-cost sellers measure their beneficiaries' attributes mainly by using due diligence, given that their transactions with the consumer-beneficiaries are discrete rather than ongoing as in the case of loans or employment. Low-cost sellers invest more capital than a commercial enterprise would in research on the relevant market in order to learn about consumers' spending patterns and preferences as well as distribution channels in these markets. In addition, they invest in marketing and educating consumers on the benefits of certain products, such as bed-nets and eye-care products. A to Z with its nonprofit partners developed a marketing, retail and pricing system to publicize and create demand for bed-nets among the poor. Moreover, low-cost sellers design business models

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<sup>127</sup> The Acumen Fund estimated that it would cost it less than \$0.02 to protect one individual from malaria for one year by making an investment in A to Z, compared to \$0.84 through a donative organization; See *The Best Available Charitable Option* (Acumen Fund, Jan. 2007), available at <http://acumen.org/idea/the-best-available-charitable-option/>.

<sup>128</sup> See William Davidson Institute, *Scojo Foundation: A Vision for Growth at the Base of the Pyramid* (Michigan Ross School of Business note 1-428-610, Apr. 2008); Nico Clemminck & Sachin Kadakia, *What Works: Scojo India Foundation* (Columbia Business School, June 2007).

<sup>129</sup> The Aravid Eye Care provides free surgeries to its poorest customers; see Karamchandani et al., *supra* note 33, at 30, 62-63.

<sup>130</sup> ZHL charges patients who request to be taken to full-service hospitals a standard fee and offers a discounted rate to those taken to government hospitals; see Gita Johar & Joanna Harries, *Dial 1298 for Ambulance Marketing EMS in Mumbai* (Columbia Business School CaseWorks ID#100507, June 28 2010).

tailored to the needs and preferences of low-income households, including not only tiered pricing, but also innovative cost-cutting methods and specialized distribution channels. The Aravind Eye Care service is reducing the demand on doctors' time by training paraskilled paramedics to undertake standardized clinical tasks, so that doctors' time is spent on surgeries.<sup>131</sup> VisionSpring has created an innovative distribution system that relies on a web of local entrepreneurs with good reputations and connections in rural communities. Finally, after they start offering new products, low-cost sellers further continue to evaluate consumers' preferences, adjust pricing, and design new products.<sup>132</sup>

#### IV. COMMITMENT DEVICES AND CHOICE OF LEGAL FORM

In the foregoing part, I assumed that social enterprises have a commitment to transacting with disadvantaged individuals. As explained above, for-profit social enterprises may use one of three commitment devices: certification, contract, and control mechanisms,<sup>133</sup> while nonprofit social enterprises rely on the non-distribution constraint.<sup>134</sup> The purpose of this Part is to examine in greater detail the structure and function of different commitment devices.

Social enterprises are invariably recipients of subsidies. In theory, it would be ideal if social enterprises could provide detailed information on the use of subsidies and their effects on beneficiaries' welfare. However, monitoring the use of subsidies and evaluating their benefits is very costly. Hence, the solution is simply to create organizations that have incentives to use subsidies effectively. Transacting with the patron-beneficiaries is the mechanism that gives social enterprises incentives and tools to use subsidies effectively. The essence of commitment devices is that a nonprofit is responsible for identifying a class of patron-beneficiaries, such as borrowers or workers, and verifying the transactions with them. While it is very costly to evaluate the effectiveness of subsidies in achieving development missions, it is relatively simple for nonprofits to verify transactions with patron-beneficiaries. Thus, transacting with the beneficiaries not only underlies the measurement role of social enterprises, but also facilitates the formation of social enterprises as for-profits.

To be sure, commitment devices may go beyond verifying the transaction with beneficiaries. Where the subsidy-providers expect a social enterprise to transact with beneficiaries with below-competitive abilities who need some form of subsidy (e.g., a better price or training), the commitment devices also verify

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<sup>131</sup> Karamchandani et al., *supra* note 33, at 62-63.

<sup>132</sup> See, for example, William Davidson Institute, *supra* note 128 (describing how VisionSpring adjusts its strategy and pricing to market demand).

<sup>133</sup> See *supra* section I.A.2.

<sup>134</sup> See *supra* section I.A.3.

that such subsidies are indeed distributed to beneficiaries.<sup>135</sup> Otherwise, there is a risk that social enterprises will transact exclusively with patron-beneficiaries with fully competitive abilities (who do not need subsidies), and that part of the subsidies will be appropriated by those who control the organization.<sup>136</sup> A good example is the Fair Trade standards which require producers to provide a floor price and a social premium.

Before embarking on the analysis of different devices, I note that the ability of social enterprises to form as both for-profits and nonprofits gives some credence to the claim that the distinction between the for-profit and nonprofit forms has been gradually eroding.<sup>137</sup> Nonetheless, it is important to emphasize that all the commitment devices of for-profit social enterprises rely on organizations that are subject to the non-distribution constraint to monitor the for-profit entity. Accordingly, contrary to some recent claims that the non-distribution constraint has lost its force as a commitment device,<sup>138</sup> it remains a key component of the commitment devices associated with for-profit social enterprises. The rationale is that organizations which are subject to a non-distribution constraint can be trusted to monitor for-profits.

### A. Certification Mechanisms

Certification mechanisms consist of a nonprofit or government that evaluates whether or not firms satisfy certain standards. Certification is feasible only when it is possible to create uniform standards with respect to both the class of beneficiaries and the type of subsidies that should be allocated to them. The best known example is Fair Trade certification described above. The Fair Labeling Organization (“FLO”) certifies the class of patron-beneficiaries as “small producers,” and it ensures through audits and inspections that the producers are allocated subsidies in the form of the fair trade minimum price, a social premium, and pre-financing of up to 60% of the orders.<sup>139</sup> Because coffee and other agricultural products, such as bananas, are traded on global commodity

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<sup>135</sup> In fact, the same commitment devices can be used to commit to any form of hybrid form of organization, for example, corporate charity; see *infra* Part V.

<sup>136</sup> I discuss this risk, which is often referred to as “mission-drift,” in section VI.A.

<sup>137</sup> See *Enterprising Organizations, New Asset-based and Other Innovative Approaches to Solving Social and Economic Problems* (The Aspen Institute, 2005), at <http://www.aspeninstitute.org/publications/enterprising-organizations-new-asset-based-other-innovative-approaches-solving-social-e>; Joseph J. Cordes & C. Eugene Steuerle, *Nonprofits and Business: a New World of Innovation and Adaptation*, in *NONPROFITS AND BUSINESS* (J. Cordes & C. Steuerle eds., 2008); Nicholls ed., *supra* note 8; Jonathan Conning & Jonathan Morduch, *Microfinance and Social Investment*, 3 ANN. REV. FIN. ECON. 407, 413-414 (2011).

<sup>138</sup> See Malani & Posner, *supra* note 5; DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 116-125 (Tuft University Press 2008); Clara Miller, *The Equity Capital Gap*, STAN. SOC. INNOVATION REV., Summer 2008, at 41.

<sup>139</sup> See *supra* note 41.

exchanges, it is possible to identify commodity prices and prescribe standards relating to financing and premiums. Small producers can also be identified relatively easily, albeit imperfectly, by simply referring to those farmers who rely on family labor. By contrast, in industries such as banking and investment, where prices and business practice can vary from one firm to another, it is harder to create a uniform standard.

A unique feature of fair trade certification is that the certification is per each unit of product. The Fair Trade label is attached to products that comply with the fair trade standards. The certification signals to consumers that products are deserving of a subsidy. Certification per product enables firms to have both a social enterprise and a profit-maximizing enterprise operated by the same organization (e.g., Starbucks selling fair trade products).

When the subsidies flow from other sources, such as the government, a common approach is to use certification of the firm as a whole. An example discussed above is certification by the CDFI Fund, which provides below-market rate investment and guarantees to eligible CDFIs. The class of beneficiaries is defined by reference to aggregate wealth measures of the relevant market, defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national average, or where the unemployment rate is 1.5 times the national average.<sup>140</sup> Another example is incorporation under certain European hybrid legal forms (e.g., the Italian social cooperative), which require that at least a certain percentage of the workers of the incorporating firm belong to a class of disadvantaged individuals.<sup>141</sup> Disadvantaged workers typically include disabled people, ex-offenders, welfare recipients or recipients of unemployment insurance.<sup>142</sup> Incorporation as a hybrid essentially constitutes a certification of the firm as a WISE, and makes the firm eligible for certain government subsidies.

## B. Contractual Mechanisms

An alternative commitment device is a contract with a nonprofit organization stipulating that the subsidies will be used for their intended purpose.<sup>143</sup> Contractual mechanisms are typically used when the subsidy to the social enterprise is provided by a donative organization. Contractual mechanisms allow greater flexibility than certification and individual tailoring in defining the class of beneficiaries and the type of disbursements allocated to them. Low-cost sellers may need flexibility in adjusting their prices and discounts to different customers who

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<sup>140</sup> 12 C.F.R. §1805.201 (2005).

<sup>141</sup> See Cafaggi & Iamiceli, *supra* note 4, at 7-15.

<sup>142</sup> See Francine J. Lipman, *Enabling Work for People with Disabilities: A Post-Integrationist Revision of Underutilized Tax Incentives*, 53 AM. U. L. REV. 393 (2003).

<sup>143</sup> See Allen Bromberger, *A New Type of Hybrid*, STAN. SOC. INNOVATION REV., Summer 2011, at 49.

have different levels of wealth. As discussed above, as part of its partnership with various nonprofit organizations, including the World Health Organization and NGOs, A to Z is committed to marketing and selling the bed-nets at different discounts funded by the partnership or the local government. With respect to CDFIs, as mentioned above, the CDFI Fund is required to enter into an Assistance Agreement with certified CDFIs that are awarded a subsidy.<sup>144</sup> The agreement must specify, *inter alia*, the CDFI's performance goals and the terms offered to low-income borrowers.<sup>145</sup> While certification is used to define the class of beneficiaries, greater flexibility is necessary to tailor the terms provided to the beneficiaries' economic and social conditions.

### C. Control Mechanisms

The most flexible commitment device is control by a nonprofit. The controlling nonprofit typically provides subsidies to the social enterprise, for example subsidized seed capital. Control allows the nonprofit owner to determine the class of beneficiaries and the type of disbursements (if any). The Greyston bakery is owned by a sole owner, the Greyston Foundation.<sup>146</sup> Complete ownership of the social enterprise, however, is not necessary. As shown above, 51% of the shares of Compartamos, whose shares are publicly listed, are owned by nonprofits, such as NGOs and foundations. This mechanism provides the nonprofit owners reasonable assurance that the firm will not change the firm's mission if lending to low-income persons entails opportunity costs.

An example of a social investment firm is the IGNIA Fund, which invests in businesses in developing countries, in various fields, such as healthcare services and organic farming. The fund is structured as a limited partnership (i.e., a for-profit entity), but is owned by the International Finance Corporation, foundations and social entrepreneurs.<sup>147</sup> Many low-cost sellers also use control mechanisms. Ziqitza Healthcare Limited ("ZHL") is a low-cost private ambulance service provider, operating 100 ambulances in India in areas lacking high-quality emergency services.<sup>148</sup> ZHL is owned by the Acumen Fund, a nonprofit social investment firm, and social entrepreneurs.

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<sup>144</sup> 12 C.F.R. §1805.802 (2005).

<sup>145</sup> 12 C.F.R. §1805.804 (2005).

<sup>146</sup> As the Greyston bakery is wholly owned by a nonprofit, it may be argued that it should simply form as a nonprofit. However, as pointed out in section I.A.1, the bakery pays below-market wages to its workers, and therefore it is arguably not operating exclusively for an exempt purpose under I.R.C. § 501(c)(3). Second, the Greyston Foundation may possibly be contemplating the sale of a stake in the bakery to private investors. In fact, seemingly for this reason, the Greyston bakery recently reincorporated as a New York Benefit Corporation; see *infra* section VIII.A.

<sup>147</sup> Interview with Alonso Bustamante Guerra of the IGNIA Fund, October 19, 2009; see also <http://www.ignia.com.mx/bop/investors.php>.

<sup>148</sup> See William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, *supra* note 86, at 2.

Another way to implement a control mechanism is to place the voting rights, at least on fundamental issues, in the hands of a nonprofit. For example, the shares of the social investment firm, Triodos Bank, are held by a foundation which makes voting decisions on behalf of the holders of depository receipts.<sup>149</sup> Similarly, as described above, the guardian share of Cafédirect is held by a subsidiary of Oxfam International and a cooperative of producers that transact with the firm. The guardian share has the right to block any proposal, including a takeover that might compromise the firm's social mission.<sup>150</sup>

As compared to other commitment devices, control mechanisms allow social enterprises flexibility in deciding which beneficiaries merit assistance and what kind of subsidies should be given to them. This appears to be the reason why MFIs and social investment firms use control mechanisms. Creating a uniform standard for developing countries in the fields of banking, investment, retail and services may be difficult. For example, Compartamos lends mainly to the moderately poor and the vulnerable non-poor.<sup>151</sup> Other for-profit MFIs that have adopted control mechanisms transact with customers who need greater assistance and discounted interest rates.<sup>152</sup> Similarly, whereas the IGNIA Fund seeks to generate returns which are equivalent to those of private equity firms, Triodos Bank earns moderate returns on equity.<sup>153</sup>

By contrast, the CDFI regime is more specific in nature. The certification of CDFIs and their contracts with the CDFI Fund (i.e., the Assistance Agreements) determine specific standards. In developed countries where measures of poverty and income are widely available and the banking system is well developed, there is better information on which customers should count as beneficiaries and what terms should be afforded to them. It is harder to create specific standards in developing countries, where there is a greater variety of investees in terms of abilities.

The flexibility of control mechanisms is also reinforced by their use by FTSEs, such as Cafédirect. Unlike other FTSEs, such as Starbucks, Cafédirect sells exclusively fair trade products. The control mechanism allows the firm to commit to more demanding standards than those prescribed by the FLO. Thus, Cafédirect buys input from producers who are less capable than other small producers that qualify as such for the purpose of certification, pays larger premiums to its producers than those required by the FLO, and provides more training to them. Thus, control mechanisms enable firms to tailor the fair trade standards to their own business model.

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<sup>149</sup> For a detailed description, see section I.A.1.

<sup>150</sup> See section I.A.1.

<sup>151</sup> Compartamos Offering Circular, *supra* note 20, at 77.

<sup>152</sup> See Thomas Dichter, *Basix (India): The Challenges of Permanently Pioneering* (Dev. Fin. F. Case Series, Jan. 20, 2009) (on file with author).

<sup>153</sup> Triodos Bank Annual Report 2010, *supra* note 30.

In addition, control mechanisms usually serve as a commitment by the firm to the owners who provide the subsidy to the firm. Certification and contractual mechanisms provide assurance mainly to external subsidy-providers, such as customers or government agencies. The subsidy to MFIs and social investment firms is usually provided by their nonprofit owners in the form of seed capital and below-market returns. The nonprofit owners of Compartamos can ensure that their firm will not change its business and cease to serve low-income customers. In the case of FTSEs, certification per product is directed towards customers, but is inadequate to assure nonprofit owners that their subsidies will be committed to the long-term mission of the firm. Firms that use product certification, such as Starbucks, may abandon their fair trade business without expropriating any subsidies, because the subsidies, i.e., the premiums over market prices, are per product. But, owners may want to ensure that the firm will remain committed to transacting with disadvantaged individuals, at least for as long as they continue to own it. This is another reason why Cafédirect uses a control mechanism in addition to certification.

#### **D. The Nonprofit Form**

Many social enterprises continue to form as commercial nonprofits.<sup>154</sup> A key reason for choosing the nonprofit form is its tax advantages in sourcing donations and income tax exemptions.<sup>155</sup> When social enterprises are likely to have low profitability they are more likely to be reliant on donations and income tax exemptions. When beneficiaries' abilities are lower, their performance negatively affects the firm's profitability, and the amounts of subsidies needed to help them enhance their abilities are naturally higher. Consequently, social enterprises that transact with a greater proportion of beneficiaries with lower abilities are likely to form as nonprofits, while those that transact principally with beneficiaries with higher abilities will form as for-profits.

Several examples illustrate this point: at the Greyston bakery, most employees are required to display a competitive level of productivity and the bakery does not receive donations on a regular basis. On the other hand, Gulf Coastal Enterprise ("GCE"), a firm that provides custodial and food services, is a nonprofit. GCE employs workers with substantial developmental or physical disabilities and behavioral disorders.<sup>156</sup> GCE presumably needs to source more subsidies, and it is less likely to attract equity capital. Similarly, as mentioned above, Compartamos makes loans primarily to moderately poor borrowers and charges high interest rates. By contrast, nonprofit MFIs, such as ASA and BRAC, provide very small loans to poorer borrowers, mainly women, charge relatively

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<sup>154</sup> See *supra* section I.A.3.

<sup>155</sup> Nonprofit social enterprises also have stronger incentives to transact with beneficiaries with lower abilities; see *infra* section VI.A.

<sup>156</sup> Boschee, *supra* note 44, at 90-96.

low interest rates, and provide a range of services to their borrowers, including schooling, training and help with business and marketing plans.<sup>157</sup> Lastly, while the Acumen Fund, a nonprofit, targets investments such as bed-nets or ambulance services, which are unlikely to generate substantial returns, and partly relies on donative funding, the IGNIA Fund, a for-profit limited partnership, seeks to make commercial returns on its investments.

## V. OTHER FORMS OF HYBRID ORGANIZATION

Most accounts of hybrid organizations do not distinguish between social enterprise and all other types of hybrid organization. From a policy perspective, equating social enterprises to other hybrid organizations may yield ill-advised policy recommendations. The reason is that many hybrid organizations, especially corporations that engage in corporate social responsibility and corporate charity, do not perform the measurement role of social enterprise. In fact, as I show below, most of them engage in transferring or giving subsidies to beneficiaries, and therefore, are less likely to be effective in addressing complex development missions. Thus, policy recommendations to extend tax benefits to organizations with a mixed mission are likely to be misguided.<sup>158</sup>

### A. Corporate Social Responsibility and Corporate Charity

In its most standard form, corporate social responsibility (“CSR”) policies and corporate charity involve the allocation of a subsidy from a for-profit firm to external beneficiaries, whether it’s a monetary donation to a donative organization (e.g., Oxfam) or a training subsidy to the poor.<sup>159</sup> At any rate, in either of these cases, the firm has no commitment to transacting with beneficiaries as patrons. As a result, the effectiveness of CSR and corporate charity are subject to the same problems as subsidies allocated by donative organizations. In the absence of information on external beneficiaries, subsidies are unlikely to be effective. Moreover, most for-profit corporations that engage in CSR or corporate charity do not usually adopt a commitment device. Accordingly, there is a clear risk that for-profit corporations will exaggerate the magnitude and effectiveness of their CSR policies in order to enhance their reputation among consumers.<sup>160</sup> Drawing goodwill and additional revenues from consumers by exaggerating the effect and extent of CSR policies may be viewed as an expropriation of subsidies from

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<sup>157</sup> Armendáriz & Morduch, *supra* note 13, at 22.

<sup>158</sup> One example is Malani & Posner’s proposal to extend tax benefits to for-profits for their charitable or socially responsible activities; Malani & Posner, *supra* note 5.

<sup>159</sup> See *supra* section I.C.

<sup>160</sup> See references *supra* note 6.

consumers.<sup>161</sup> An example of the limited effectiveness of CSR is in fact Google's celebrated charitable arm described above. Although Google continues to donate generously to charitable causes, Google.org has so far failed to live up to its ambitious goal of creating novel solutions to poverty alleviation and climate change.<sup>162</sup>

Some corporations do actually adopt commitment devices that implement CSR policies or corporate charity, and to this extent there is a lesser risk of expropriation. RedF is an example of a certification mechanism.<sup>163</sup> RedF is an LLC that licenses the Red trademark to commercial firms, including, Apple, Starbucks and Gap.<sup>164</sup> These firms attach the Red label to certain products. When customers buy Red products the firm is committed under its contract with RedF to making a certain donation, for example to the Global Fund, a donative organization dedicated to fighting AIDS.<sup>165</sup> Thus the firm adjusts the amount of its donations in accordance with the volume of purchases of Red products by customers. However, while this may be a novel mechanism for firms to market their charitable activities and receive feedback from customers concerning their desired volume, it is essentially a form of corporate charity rather than a social enterprise.

Finally, it is noteworthy that in some cases CSR policies actually do involve the allocation of a subsidy to a patron-beneficiary, rather than an external one. Although the distinction is a subtle one, such CSR policies are distinguishable from social enterprises. Consider multinationals, such as Nike and Levi's, that pay premium wages to their workers in developing countries and avoid transacting with sweatshops. Such firms appear structurally similar to WISEs because they channel subsidies to their workers. However, these policies are mainly driven by the perceived unfairness of low wages and harsh working conditions as compared to equivalent standards in developed countries,<sup>166</sup> even though in economic terms, wages and working conditions are both efficient and higher than those offered by local firms.

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<sup>161</sup> In fact, CSR policies may even be used by inefficient managers to entrench themselves by gaining stakeholders' and media support. Giovanni Cespa & Giacinta Cestone, *Corporate Social Responsibility and Managerial Entrenchment*, 16(3) J. OF ECON. & MGMT. STRATEGY 741 (2007).

<sup>162</sup> See Brian Galle, *Social Enterprise: Who Needs It?*, 54 B.C.L. REV. 2025, 2034-2035 (2014); Stephanie Strom & Miguel Helft, *Google Finds it Hard to Reinvent Philanthropy*, N.Y. TIMES, Jan 29, 2011.

<sup>163</sup> For an example of a control mechanism, see Kevin Jones, *Mission Insurance: How to Structure a Social Enterprise So Its Social and Environmental Goals Survive Into the Future*, 5(2) COMMUNITY DEV. INVESTMENT REV. 1 (2009).

<sup>164</sup> Sarah Dadush, *Profiting In (Red): The Need For Enhanced Transparency in Cause-Related Marketing*, 42 N.Y.U. J. INT'L L. & POL. 1269 (2010).

<sup>165</sup> The exact amount of the donations is not actually transparent, and to this extent there is in fact a risk of expropriation; see Dadush, *id.*

<sup>166</sup> See Geoffrey Heal, *Corporate Social Responsibility: An Economic and Financial Framework*, 30 THE GENEVA PAPERS 387, 389, 392-393. (2005).

These policies are different from WISEs with regard to the type of problems they are designed to address, especially the inability of capable workers from disadvantaged backgrounds to obtain employment. In this case, the workers are already employed and receive an efficient wage. Accordingly, it does not make sense to view Nike or Levi's as having a commitment to transacting with their workers, as it is already profit-maximizing to transact with them even without a subsidy. The workers are not individuals that suffer from systemic unemployment, and employing them does not serve the measurement role performed by social enterprises. Premium wages and better working conditions are simply a disbursement of a subsidy to the existing patrons of the firm.

To be sure, this type of subsidy may be desirable where governments fail to regulate workers' rights and minimum working conditions, especially in developing countries. However, such CSR policies are typically implemented only as a response to blatant governmental failures and where commercial firms face high reputational costs. Additionally, firms that make these subsidies do not usually adopt a commitment device. Therefore, without appropriate government regulation or at least NGO supervision, working conditions at standard commercial firms are likely to suffer.<sup>167</sup>

## **B. Socially Responsible Investing**

In recent decades, institutional investors, such as pension funds and mutual funds, have become increasingly engaged in socially responsible investing ("SRI"). As of 2012, \$3.31 trillion in total assets under professional management in the United States used at least one SRI strategy.<sup>168</sup> SRI refers to investment strategies that consider both financial return and some social good, especially environmental social governance ("ESG") issues. ESG issues range from environmental efficiency, through human rights and diversity, to corporate governance. The most common manifestations of SRI are negative screening of companies that engage in alcohol, tobacco, gambling, etc., and shareholder advocacy on ESG issues. Under SRI some forms of social enterprise are also commonly included, usually referred to as "community investing," such as CDFIs and social investment firms. Though community investing is growing at a rapid rate as an asset class, its assets are only a marginal fraction of SRI.

At any rate, to view SRI and social enterprise as synonymous is misguided. First, it is not clear whether SRI (other than community investing) is a subsidized form of organization. In fact, some studies find that returns on SRI funds are

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<sup>167</sup> To be sure, WISEs like any other firm may also engage in CSR and corporate charity by providing premium wages; the key point is that this is not a role that WISEs need to perform to qualify as social enterprises.

<sup>168</sup> The Forum for Sustainable and Responsible Investment, *Report on Sustainable and Responsible Investing Trends in the United States* (2012), available at [http://www.ussif.org/store\\_product.asp?prodid=5](http://www.ussif.org/store_product.asp?prodid=5).

better than on other funds<sup>169</sup>. Additionally, the recent trend to treat corporate governance as an ESG issue appears to be motivated by a desire to enhance shareholder value rather than transfer subsidies to third parties. Therefore, SRI funds are not necessarily a type of hybrid organization. Second, even if SRI in its most common form qualifies as a subsidized commercial enterprise (i.e., a hybrid organization), SRI funds do not transact with their beneficiaries. As a result, measuring the social impact of SRI as compared to a standard form of investing is inherently imprecise. In addition, it is noteworthy that commitment devices may be weak in some SRI funds. While some funds can change their social criteria only with a shareholder vote, other funds can alter investing policy without consulting the shareholders.<sup>170</sup> Hence, there is some risk that capital raised under one set of ESG issues will be applied to advance a weaker or stronger set of issues.

### C. Social Ratings

Partly to address the measurement problem inherent in social missions, new social rating mechanisms for evaluating the social impact of for-profit firms are being developed by different organizations. There is, however, uncertainty regarding which factors should be included in such standards. The Global Reporting Initiative (“GRI”) is a nonprofit that certifies companies’ sustainability reports in accordance with certain standards. The Global Impact Rating System (“GIIRS”) is a nonprofit that rates companies’ social and environmental impact using a different set of standards, the Impact Reporting and Investment Standards (“IRIS”). The Social Return on Investment (“SROI”) Network trains practitioners to quantify in monetary terms the social and environmental impact of companies in accordance with the SROI principles. B-Lab is a nonprofit that certifies companies as “B-Corps” and rates them in accordance with certain criteria relating to governance, workers, community and the environment.

To a certain extent, the criteria embedded in these standards correspond to the elements that characterize social enterprises, such as the percentage of disadvantaged employees, or whether the firm provides services to poor customers. For example, B-Lab’s rating does reward companies for employing disadvantaged workers. However, these standards go far beyond these elements to include a host of standards whose value is debatable.<sup>171</sup> First, these metrics

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<sup>169</sup> See, for example, Michael L. Barnett & Robert M. Salomon, *Beyond Dichotomy: The Curvilinear Relationship between Social Responsibility and Financial Performance*, 27 STRATEGY MGMT. J. 1101 (2006). Christopher C. Geczy, et al., *Investing in Socially Responsible Mutual Funds* (2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=416380](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=416380).

<sup>170</sup> Geczy, et al., *id.*, at 12.

<sup>171</sup> Recently, the Greyston bakery has obtained a B-Corp certification. Interestingly, Greyston ranks high on measures of “community” but below the median on measures of “workers” which evaluate how the firm treats its workers through compensations, employment opportunities, health and safety, etc.

include activities whose benefits flow to external beneficiaries, such as corporate charity or environmentally-friendly policies. But, as I argue throughout this article, the benefits to external beneficiaries are hard to measure and subject to uncertainty. There is little evidence that any standard created a credible way to track and quantify such benefits. Second, the utility of many of the policies advocated by these standards, such as employee ownership or involving stakeholders in decision-making, is either questionable or context-dependent. Third, certain policies, such as strong corporate governance provisions, are potentially profit-maximizing, and it is not clear why they should be mixed up with standards that measure social impact. Finally, some of these standards and their implementation tend to be opaque and depend on subjective assessment of impacts.<sup>172</sup> There is a concern that subsidies provided by trusting consumers may be expropriated by managers of firms that obtain a social rating that exceeds their true contribution to altruistic causes.

#### **D. Environmentally-Friendly Firms**

Firms that adopt environmentally-friendly policies be viewed as hybrid organizations mainly because their consumers pay subsidies in the form of price premiums, which the firm uses to produce public goods.<sup>173</sup> There are two main types of environmentally-friendly firms. The first type includes firms such as Walmart and IBM that have adopted environmentally-friendly policies as part of their corporate social responsibility agenda to boost reputation and goodwill.<sup>174</sup> Many of these firms have not adopted a commitment device, and therefore there is a risk that they will draw goodwill and subsidies from consumers while overstating the extent of their contribution to the environment, a practice known as green-washing.<sup>175</sup>

The second involves firms that have adopted a commitment device. An example is Patagonia, a firm which produces outdoor clothing using materials that are less harmful to the environment, for example organic cotton, and environmentally-friendly production processes, including reduction of its carbon

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<sup>172</sup> See Alnoor Ebrahim & Kasturi V. Rangan, *The Limits of Nonprofit Impact: A Contingency Framework for Measuring Social Performance* (HBS Working Paper Number: 10-099, 2010), available at <http://hbswk.hbs.edu/item/6439.html>, at 9-13; Bugg-Levine & Emerson, *supra* note 2, at 163-186.

<sup>173</sup> To be sure, some environmentally-friendly policies may be profit-maximizing without a subsidy, for example, reducing the use of gas or fuels.

<sup>174</sup> See DANIEL ESTY & ANDREW S. WINSTON, *GREEN TO GOLD: HOW SMART COMPANIES USE ENVIRONMENTAL STRATEGY TO INNOVATE, CREATE VALUE, AND BUILD COMPETITIVE ADVANTAGE* (Yale University Press 2009) (2006).

<sup>175</sup> In fact, even British Petroleum, an oil company that was involved in a series of environmental initiatives had a troubling record of violating safety regulations, culminating in the recent oil spill in the Gulf of Mexico in 2010.

emissions and the use of recycled materials.<sup>176</sup> Patagonia's consumers appear to pay a premium for the environmental quality of its products,<sup>177</sup> and its sole owner seems willing to accept lower rates to fund the firm's environmental mission.<sup>178</sup> Patagonia has adopted several commitment devices. First, the firm is owned by a social entrepreneur who has a reputation for his commitment to the environment. Second, some of its products are certified by the bluesign® system, a certification awarded to textile products that comply with standards relating to energy use, water consumption and use of hazardous chemicals. Moreover, the firm has obtained certification as a B-Corp, which includes environmental performance.

Although Patagonia's commitment to environmental causes is laudable, the true benefits of its policies are difficult to measure. Despite a growing consensus on the benefits of protecting the environment, such benefits are not easily observable and may be difficult to quantify. One possible explanation for this is that the beneficiaries of environmentally-friendly, or more generally public goods, firms are external. Public goods are non-rival and non-excludable, so that in principle anyone can consume them. Environmentally-friendly firms thus cannot transact with their beneficiaries who consume those public goods – anyone can enjoy the cleaner air and water that result from the firms' policies. Accordingly, they have limited tools to evaluate the benefits of their environmental policies, such as use of organic cotton.

To be sure, environmentally-friendly firms perform an important function. Given their commitment to adopting environmentally-friendly processes, these firms have a profit incentive to reduce the costs of producing public goods. The subsidies in these firms are used to fund the costs of creating an efficient business model that generates public goods. In some cases, such business models may fail. For example, there have been several unsuccessful attempts to make shoes from recyclable materials.<sup>179</sup> On the other hand, Patagonia has successfully developed innovative processes for making clothes from organic cotton.<sup>180</sup> Reducing the production costs of environmentally-friendly products is important for the sake of leading other firms to adopt similar policies or making a case for environmental regulation.

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<sup>176</sup> See Reinhardt et al., *Patagonia*, Harvard Business School Case 9-703-035 (2004) (henceforth "*Patagonia 1*"); Reinhardt et al., *Patagonia*, Harvard Business School Case 9-711-020 (2010) (henceforth "*Patagonia 2*").

<sup>177</sup> See Reinhardt et al., *Patagonia 1*, *id.*, at 10 (Patagonia's products sell for 15% to 50% or more above other similar brands, although this premium may be due to product quality);

<sup>178</sup> Reinhardt et al., *Patagonia 2*, *supra* note 176, at 4,27 (following the shift to use of organic cotton, Patagonia's margins decreased).

<sup>179</sup> See, for example, Paul W. Hardy, *DEJA SHOE (A): Creating The Environmental Footwear Company* (University of Michigan CEPM Case Study, 1996).

<sup>180</sup> Reinhardt, et al., *Patagonia 1*, *supra* note 176, at 26, 27.

### **E. Using Hybrid Organizations to Increase Donative Capital**

While social enterprises may involve collaborations between nonprofits and for-profits, not all such collaborations necessarily create a social enterprise. Sometimes a donative organization will simply set up a for-profit in order to make investments that increase the size of its assets. It then invests donative capital in the for-profit entity, and the returns on that investment are distributed to external beneficiaries of the donative organization. One notable example that has existed for many years in the U.S. is museum shops that sell books and artwork to museum visitors. The shop is typically a for-profit entity owned by the nonprofit museum. The shop qualifies as a hybrid organization, because it receives subsidized capital, but it has no commitment to transacting with disadvantaged individuals. Another more recent example is Housing Works, an organization dedicated to combating AIDS and homelessness.<sup>181</sup> It is composed of several businesses, including a coffee shop, a secondhand bookstore, and a secondhand clothing store. The profits made by the shops are distributed to the owner, i.e., the donative organization, and used to allocate subsidies to external beneficiaries, especially through housing assistance.

## **VI. DISADVANTAGES OF SOCIAL ENTERPRISE**

### **A. Mission-Drift**

A common criticism of for-profit social enterprises is that they have incentives to seek profits at the expense of their social mission. This criticism may broadly be divided into two claims. First, social enterprises have an incentive to transact only with patron-beneficiaries with fully competitive abilities and avoid those who have below-competitive abilities. However, this is only a problem where the subsidies provided to the social enterprise are intended also to be used as disbursements to patron-beneficiaries with below-competitive abilities. Such subsidies may be distributed to the owners as profits or simply wasted. In this situation, the commitment device should identify the beneficiaries as including those with below-competitive abilities and specify the disbursements afforded to them. In practice, though, there do not seem to be many known cases of such problems.<sup>182</sup>

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<sup>181</sup> See the website of Housing Works at <http://www.housingworks.org/>.

<sup>182</sup> One situation when this may be possible is where the definition of patron-beneficiary is inadequate. Arguably, under the Fair Trade standards, small producers may not always be disadvantaged, for example, where small producers' cooperatives have sufficient capital and resources; see Marc Sidwell, *Unfair Trade* (Adam Smith Institute 2008), available at <http://www.adamsmith.org/research/reports/unfair-trade>. There have also been concerns that some WISEs only employ workers with higher abilities; see Carlos Borzaga & Monica Loss, *Profiles and Trajectories of Participants in European Work Integration Social Enterprises*, in *SOCIAL ENTERPRISE AT THE CROSSROADS OF MARKET, PUBLIC POLICIES AND CIVIL SOCIETY* 169 (Marthe Nyseens ed., 2006).

Organizations that focus on patron-beneficiaries with higher abilities are usually committed to serving only such patrons. For example, Compartamos, which is often criticized for neglecting the destitute, is admittedly committed only to serving the vulnerable non-poor and the moderately poor.<sup>183</sup> There presumably is scope both for organizations that serve only patrons with fully competitive abilities and for those that also serve patron-beneficiaries with lower abilities. Thus, nonprofit MFIs tend to focus more on small loans to poorer borrowers and women, while for-profit MFIs tend to make larger loans to less-poor borrowers.<sup>184</sup>

Second, the profit motive may induce for-profit social enterprises to exploit their patron-beneficiaries by offering them unfavorable terms. The most conspicuous example is the recent criticism of predatory lending practices employed by MFIs in some regions, which include exorbitant rates, misleading advertising, excessive penalties, and aggressive or illegal collection methods.<sup>185</sup> Compartamos, for example, has been criticized for its loan rates, which may exceed 100 percent.<sup>186</sup>

The problem, however, seems to lie in the lack of effective regulatory frameworks in many developing countries to protect consumers and employees.<sup>187</sup> In general, there are two main strategies to address this problem. The first is the adoption of industry standards and private monitoring in areas such as labor standards and consumer protection. For example, in the context of MFIs, there have been initiatives to introduce consumer protection standards to address the risk of predatory lending.<sup>188</sup> The second strategy is to adopt the nonprofit form, or allocating ownership rights to the beneficiaries. The rationale for this approach is that these mechanisms mitigate the incentives of social enterprise firms to pursue profit, and therefore they are less likely to exploit the beneficiaries.<sup>189</sup> Of course, as is well-known, the downside of eliminating investor ownership is that it may inhibit the firm's ability to raise capital and lower incentives for socially valuable innovation.

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<sup>183</sup> Compartamos Offering Circular, *supra* note 20, at 77.

<sup>184</sup> Conning & Morduch, *supra* note 137, at 413-414.

<sup>185</sup> See Conning & Morduch, *id.*, at 411-412; Eric Bellman & Arlen Chang, *India's Major Crisis in Microlending*, WALL. ST. J., OCT. 28, 2010; Keith Epstein & Geri Smith, *The Ugly Side of Microlending*, BUS. WK., Dec. 13, 2007.

<sup>186</sup> See Elisabeth Malkin, *Microfinance's Success Sets off a Debate in Mexico*, N.Y. Times, Apr. 5, 2008.

<sup>187</sup> The high rates that Compartamos charges its borrowers are also partly due to the lack of competition in the Mexican banking industry. See Chu, *supra* note 22.

<sup>188</sup> See Brigit Helms & David Porteous, *Protecting Microfinance Borrowers* (CGAP Focus Note No. 27, 2005), available at <http://www.cgap.org/publications/protecting-microfinance-borrowers>.

<sup>189</sup> See Ryan Bubb & Alex Kaufman, *Consumer Biases and Mutual Ownership*, 105 J. PUB. ECON. 39 (2013) (arguing that credit unions are less likely to engage in predatory pricing practices).

## B. Difficulties in Attracting Capital

Although for-profit social enterprises are generally better at attracting capital than traditional nonprofits, they face difficulties in attracting equity capital. In particular, social enterprises that rely on control mechanisms that vest control of the firm in the hands of a small group of nonprofits and social investors have difficulty tapping equity capital markets since dispersed profit-seeking investors may fear that the firm will forego profits to pursue some unverifiable social mission. While some social enterprises do issue public shares, such issuances are usually of relatively small amounts of shares with limited voting rights, and the shares are often traded on matched-bargain systems that lack the liquidity afforded by large stock exchanges.<sup>190</sup>

Social enterprises are better able to attract capital primarily in two situations. The first is where the costs of gathering information are low and the subsidies made to patron-beneficiaries are relatively small. Firms like Compartamos, which primarily serves the moderate and marginally poor, but not the destitute, face few information asymmetries and therefore do not need a significant subsidy to begin with. Moreover, over time, Compartamos has reduced the costs of lending to low-income borrowers. Thus, the subsidy it needs from its investors is minimal, and the firm can generate substantial profits. The second is where the subsidies are not paid by investors, but rather by consumers, donors or the government. Fair trade products are one prominent example. Usually subsidized by the consumers, fair trade products have become profitable businesses for large corporations.

Nonetheless, there is a growing trend among institutional investors to invest in socially responsible businesses, and the social investment sector is gradually expanding.<sup>191</sup> Recent reports suggest that there is a great deal of untapped capital from socially responsible funds, foundations, high net worth individuals and even public investors.<sup>192</sup> However, altruistic investors presumably want assurance that their funds are well used. Such investors may in principle use control or contractual mechanisms to monitor the social enterprise, but for many investors such monitoring may be too costly. Consequently, passive investors tend to resist investing in social enterprises whose efficacy they cannot oversee. Currently, with some exceptions, no institutional mechanisms exist to signal a credible

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<sup>190</sup> See the discussion of Triodos Bank and Cafédirect, in section I.A.1; Jamie Hartzell, *Creating an Ethical Stock Exchange* (Oxford Said Business School, Skoll Centre for Social Entrepreneurship Research Paper, Aug. 2007), available at <http://www.sbs.ox.ac.uk/ideas-impact/skoll/research/social-finance-reports-resources/creating-ethical-stock-exchange>.

<sup>191</sup> See *supra* section V.B.

<sup>192</sup> J.P. Morgan & The Rockefeller Foundation, *supra* note 2; The Rockefeller Foundation, *Accelerating Impact: Achievements, Challenges and What's Next in Building the Impact Investing Industry* (2012), available at <http://www.rockefellerfoundation.org/blog/accelerating-impact-achievements>.

commitment to such passive investors. One possible solution may be a certification mechanism. The Fair Trade certification, albeit imperfect, has proven to serve as a reasonably effective commitment to many dispersed consumers. In section VIII below, I consider a broader certification mechanism for a wider class of social enterprises which would be partly directed towards altruistic investors as well as consumers who have limited means to control or directly contract with the firm.

## VII. OTHER ACCOUNTS OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS

There are several other theories that have attempted to explain social enterprises and hybrid organizations. As I will show below, these theories have failed to provide a convincing account of social enterprise and hybrid organizations.

### A. Stakeholder Theories and the Costs of Decision-Making

The upshot of stakeholder theories is that managers should maximize the interests of all stakeholders of the firm, including employees, customers and even the public at large.<sup>193</sup> Some commentators have advanced a view of social enterprise and hybrid organizations as a form of for-profit that maximizes the interests of its stakeholders.<sup>194</sup> The major problem with these theories is that they fail to explain how managers should balance competing claims. Without providing clear criteria as to how the stakeholders' interest should be considered in corporate decision-making, broad managerial discretion enables managers to pursue their own interests.<sup>195</sup> Hybrid organizations with a broad social and environmental mission are particularly vulnerable to this risk, because of the difficulty of defining and verifying what kind of action maximizes the social mission.

Stakeholder theories also advocate allocating voting rights and decision-making power to specific stakeholders.<sup>196</sup> In fact, in some social enterprises, such

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<sup>193</sup> There are numerous articles on the topic. For example, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, VA. L. REV. 247 (1999); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005). To be sure, most proponents of shareholder primacy agree that a corporation can and should act in the interests of its stakeholders and society as a whole to the extent that doing so indirectly promotes the shareholders' interest; see Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14(3) J. OF APPLIED CORP. FIN. 8 (Fall 2001); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).

<sup>194</sup> See generally Borzaga & Defourny eds., *supra* note 8; Becchetti & Borzaga eds., *supra* note 10; Nyseens ed., *supra* note 182.

<sup>195</sup> Jensen, *supra* note 193; Hansmann & Kraakman, *supra* note 193, at 447-449.

<sup>196</sup> See Jacques Defourny, *Introduction: From Third Sector to Social Enterprise*, in Borzaga & Defourny, eds., *supra* note 8, at 1.

as FTSEs, there may be board members that represent a class of beneficiaries<sup>197</sup> or a class of beneficiaries that owns some shares in the firm.<sup>198</sup> However, only rarely do beneficiaries truly take an active part in decision-making, mainly because such a decision-making process could be highly cumbersome due to potential conflicts among different stakeholders. In fact, decision-making in social enterprises seems relatively efficient in resolving conflicts among stakeholders; the reason is that the commitment device not only resolves the potential contract failure in utilizing subsidies, but also addresses the problem of decision-making.

The commitment device essentially defines how the firm utilizes its subsidies. Certification and contractual mechanisms define the class of beneficiaries and the terms of their transactions with the enterprise. Control mechanisms may potentially be susceptible to tension between investors who want to maximize profits and the nonprofit controllers who are satisfied with below-market returns. But as long as the nonprofit maintains clear control of the social enterprise firm, there seems to be relatively little scope for conflict. Accordingly, managers are left with the task of pursuing profits, subject to the commitment to transacting with a class of beneficiaries. In this way, the commitment device effectively defines how to balance the profit and nonprofit missions against each other, and the margin of discretion left to managers is relatively limited.

## B. Economies of Scope

Malani & Posner (“MP”)<sup>199</sup> and Henderson & Malani (“HM,” and together “MPH”)<sup>200</sup> argue that for-profits are more efficient than nonprofits in pursuing social goals because they benefit from economies of scope.<sup>201</sup> A car company may have more ample resources and knowledge to invest in research on hybrid engines than government or nonprofits. However, other examples provided by MPH have questionable theoretical and empirical support. For example, they suggest that multinational coffee companies are more efficient in disbursing charity to poor farmers. But, as discussed above, multinational companies have generally avoided transacting with poor disaggregated farmers primarily because the costs of transacting with those farmers tend to be high. In fact, the contacts between most large firms and small farmers are initiated and fostered by

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<sup>197</sup> E.g., the producers of Cafédirect, an FTSE that sells hot drinks, have the right to appoint two directors to its board.

<sup>198</sup> For example, the borrowers of Grameen Bank, a prominent MFI in Bangladesh, hold approximately 94% of its shares as well as 75% of the voting rights.

<sup>199</sup> Malani & Posner, *supra* note 5.

<sup>200</sup> M. Todd Henderson and Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 111 COLUM. L. REV. 571 (2009).

<sup>201</sup> For elaborate criticisms, see James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010); Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1212 (2010).

nonprofits.<sup>202</sup> To take another example, MPH argue that clothing and footwear manufacturers, such as Nike's, are better positioned than nonprofits to monitor the working conditions in factories in developing countries. Surely, every organization that is contravening certain standards is best positioned to ensure that such standards are held in compliance. But clearly, such manufacturers have an obvious incentive to shirk on the quality of working conditions to save costs. In fact, the pressure on such manufacturers comes from various nonprofits. Accordingly, the efficiency claim is not convincing.

MPH also claim that for-profits are just as trustworthy or committed as nonprofits. Donors or subsidy-providers do not need to patronize a nonprofit to use their funds for charitable purposes; rather, they can simply channel their donation or subsidy through a for-profit firm. The non-distribution constraint is not essential as a commitment device. For-profits can simply commit by a contract not to distribute profits and a private auditor can monitor this commitment.<sup>203</sup> However, the feasibility of this contract depends on the availability of measurable standards.<sup>204</sup> Moreover, even if firms could enter into such a contract, in practice virtually all the examples of for-profit charities discussed by MPH do not involve such a contract. These examples include: Google's charitable arm; fair trade coffee sold by Starbucks; and Nike's abstinence from purchasing supplies from sweatshops. None of these firms have contracted to not distribute profits to its owners. Accordingly, MPH fail to describe what substitutes for the non-distribution constraint have been adopted by for-profits as a commitment device.

### C. Public Good Theories

The above discussion has assumed that social enterprises are designed for the benefit of a specified class of patrons, such as consumers or employees. In practice, however, many commentators have viewed the role of social enterprises as being to generate public goods. For example, MFIs and CDFIs are widely regarded as tools for alleviating poverty. Social enterprises, on this view, are supposed to benefit external beneficiaries who are affiliated with the patron-beneficiaries. A borrower that receives a loan from an MFI or works at a WISE may be able to send his or her children to school and obtain better healthcare services. Likewise, the availability of healthcare services, medicines or products, such as eye-glasses, enhances productivity and reduces the costs of illness.

However, the evidence on the effects of social enterprises as providers of public goods is largely equivocal. MFIs are a case in point. Empirical studies show no clear evidence that MFIs uniformly alleviate poverty and improve the

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<sup>202</sup> For examples, see Austin & Reavis, *supra* note 106; Argenti, *supra* note 106.

<sup>203</sup> Malani & Posner, *supra* note 5, at 2035-2036.

<sup>204</sup> For a detailed criticism of private monitoring of the non-distribution constraint, see Galle, *supra* note 201, at 1218-1221.

standard of living in a given community in areas such as healthcare and education.<sup>205</sup> On the other hand, there is strong evidence that access to credit has improved the lives of the borrowers themselves.<sup>206</sup> It seems to be the case, then, that the patron-beneficiaries of MFIs have substantially benefited from the ability to transact with them, while the benefits to the community at large are inconclusive.

The distinction between patron-beneficiaries and external beneficiaries may be the reason for these results. The positive externalities which arguably flow to external beneficiaries of MFIs are somewhat uncertain and may depend on numerous factors. For example, the availability of credit may improve a family's financial situation, but without educational opportunities or the availability of healthcare services, it will do little to improve education or health. There is similar empirical data with respect to fair trade and its effect on communities of small farmers.<sup>207</sup> The ability to transact with FTSEs has increased the income of individual farmers and their households, but though there is some evidence of modest positive effects on education and health, it is inconclusive and falls short of showing clear results.<sup>208</sup>

In fact, consistent with my claim, most social enterprises simply evaluate their impact by measuring the extent to which they transact with patron-beneficiaries, for example, the total output sold to low-income consumers (e.g., bed-nets sold or surgeries performed), the number of disadvantaged workers employed, or the number of loans made. Note that by definition these transactions would not have taken place without social enterprises. Accordingly, it appears to be relatively easier to measure the effects of social enterprises on their patron-

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<sup>205</sup> See, for example: David Roodman & Jonathan Morduch, *The Impact of Microcredit on the Poor in Bangladesh: Revisiting the Evidence* (Center for Global Dev. Working Paper #164, June 2013), available at <http://www.cgdev.org/content/publications/detail/1422302>; Abhijit Banerjee et al., *The Miracle of Microfinance? Evidence from a Randomized Evaluation* (MIT Dep't. of Econ. Working Paper No. 13-09, 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2250500](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2250500); Dean Karlan & Jonathan Zinman, *Expanding Microenterprise Credit Access: Using Randomized Supply Decision to Estimate the Impacts in Manila*, (Yale Econ. Dep't Working Paper No. 68, 2009), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1444990](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1444990).

<sup>206</sup> Banerjee et al., *id.* (finding that microcredit supports household borrowing and investments and the creation and expansion of small businesses, but has no impact on health, education and women's decision-making); Karlan & Zinman, *id.* (finding that the introduction of micro-lending to new populations leads to an increase in business profits for male borrowers, but no overall effects on income or poverty); Collins et al., *supra* note 120 (claiming that microfinance may be most effective at smoothing out borrowers' cash flows, so that poor borrowers are less vulnerable to fluctuations in their income).

<sup>207</sup> For a review of impact studies, see Chapter 9 in Nicholls & Opal, *supra* note 36, at 201-228; Anne Le Mare, *The Impact of Fair Trade on Social and Economic Development: A Review of the Literature*, 2/6 GEOGRAPHY COMPASS 1922 (2008).

<sup>208</sup> Nicholls & Opal, *id.*, at 208-209; Mare, *id.*

beneficiaries.<sup>209</sup> Vis-à-vis their external beneficiaries, social enterprises are in a similar position to donative organizations; unless the benefits to external beneficiaries are measurable at reasonable cost, they remain uncertain.

#### D. Sustainability and Scale

Several commentators have suggested that social enterprises have emerged as a solution to capital constraints faced by donative organizations. According to this view, social enterprises are more financially sustainable than donative organizations because they can generate revenues. Donative organizations are ineffective in pursuing their mission due to limited funding from donors.<sup>210</sup> Greater sources of revenue enable social enterprises to scale the firm's operations.<sup>211</sup> Without scaling, firms cannot reach a large number of beneficiaries and have a substantial social impact. For example, an MFI with a small number of borrowers arguably has only a modest social impact, whereas one with numerous branches and borrowers has a larger social impact. Some go further by arguing that the ability to distribute profits and tap equity capital is critical to obtaining the capital necessary to scale the firms' operations, and hence their social impact; for example, a for-profit MFI can reach more borrowers than a nonprofit MFI.<sup>212</sup>

These views, however, suffer from several weaknesses. First, there is no systematic evidence that earned income is more sustainable than donative income.<sup>213</sup> Donative organizations, such as large foundations and aid agencies, have very substantial funds. The real problem is that the utilization of these funds, particularly towards development goals, has often been ineffective.<sup>214</sup> In fact, there is little reason to believe that simply increasing the amounts of donations would generate different results. Second, evidence suggests that nonprofits with no access to equity capital can achieve a substantial scale similar to that of for-profits. Nonprofit MFIs, such as ASA and BRAC, serve millions of borrowers and have as wide a reach as for-profit MFIs. In some cases, attracting equity capital may be necessary for scaling. As explained above, however, when social

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<sup>209</sup> To be sure, certain methodological difficulties exist also when measuring impact with respect to patron-beneficiaries, and most studies are subject to some weaknesses, including (a) difficulties in assessing counterfactuals, i.e., the hypothetical situation if patron-beneficiaries had not transacted with the social enterprise, and (b) selection biases, i.e., social enterprises that choose to transact with patron-beneficiaries with higher abilities.

<sup>210</sup> Dees, *supra* note 8; Jerr Boschee & Jim McCurg, *Toward a Better Understanding of Social Entrepreneurship* (Minnesota, MN: Institute of Social Entrepreneurs, 2003); MUHAMMAD YUNUS, *CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM* (Public Affairs 2008); Pallotta, *supra* note 138.

<sup>211</sup> Yunus, *id.*; J.P. Morgan & The Rockefeller Foundation, *supra* note 2, at 13.

<sup>212</sup> Chu, *supra* note 22.

<sup>213</sup> Beth Battle Anderson & Gregory J. Dees, *Rhetoric, Reality, and Research: Building a Solid Foundation for the Practice of Social Entrepreneurship*, in Nicholls ed., *supra* note 8, at 144, 148-150.

<sup>214</sup> See references *supra* note 65.

enterprises transact with beneficiaries with lower abilities, equity capital is less likely to be available, and subsidies in the form of donations and income tax exemption remain essential.

To be sure, social enterprises are better than donative organizations at scaling their social impact. But the reason for this is that social enterprises allocate subsidies more efficiently. For example, while a donative organization might distribute a good (e.g., a bed-net) worth \$5 to say 200 beneficiaries, a social enterprise using the same amount of subsidies (i.e., \$1,000) may be able to distribute the good to 100 beneficiaries that cannot afford to pay for the bed-net, and sell the rest for say, \$3 to 250 beneficiaries (i.e., \$2 subsidy per beneficiary) that can afford to pay this amount. In this example, the social enterprises can reach more beneficiaries (350 as compared with 100) because they have more information on beneficiaries' abilities to pay. The measurement role of social enterprise thus enables them to scale their social impact as compared to donative organizations.

### VIII. LEGAL HYBRID FORMS AND HOW TO REFORM THEM

Many U.S. states and different countries have introduced new legal hybrid forms in recent years. The main purpose of such legal forms is to facilitate the flow of subsidized capital to for-profit social enterprises from a growing class of altruistic investors, ethically conscious consumers, private foundations and even governments. As discussed above, a great deal of untapped capital is potentially available for investments in firms that promote social purposes at below-market returns,<sup>215</sup> and there is evidence that ethically-conscious consumers are increasingly willing to pay significant premiums over market prices for products of firms that do good.<sup>216</sup>

Gaining access to this capital is a particular problem for for-profit social enterprises. This is because they lack a standardized commitment device (such as the non-distribution constraint) to assure their investors, customers and the government that they utilize subsidies effectively, and there is an obvious risk that those who control the organizations will expropriate the subsidies they receive.<sup>217</sup> Most investors and consumers do not have the resources to closely monitor the social purposes of the firms they invest in or buy products from, especially when objective measurement of social impact is difficult. The costs of control and contractual commitment devices are high and require substantial monitoring.

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<sup>215</sup> See *supra* section VI.B.

<sup>216</sup> The mean premium for socially responsible products was recently estimated to be about 17 percent over market prices of equivalent products; Stephanie M. Tully & Russell S. Winer, *Are People Willing to Pay More for Socially Responsible Products: A Meta-Analysis*, (March 27, 2013), available at SSRN: <http://ssrn.com/abstract=2240535>.

<sup>217</sup> As explained above, this is essentially role of the non-distribution constraint in the case of nonprofit corporations.

Foundations in particular face substantial regulatory hurdles in making investments in social enterprises also known as “program related investments” (“PRIs”), because they may be subject to tax penalties or even lose their exempt status if they fail to monitor the social purpose of such investments.<sup>218</sup> To reassure providers of subsidized capital and income, legal hybrid forms must identify a particular structure that gives hybrid organizations incentives to utilize subsidies effectively. In this way, such forms can verify that certain for-profits firms can be trusted to employ subsidies to benefit third parties.

As I argue below, existing legal hybrids fail to do this, mainly because they are premised on vague definitions of combining for-profit and social missions. Consequently, most social enterprises continue to use the existing legal forms. Although an increasing number of small businesses are using these forms mainly for marketing purposes,<sup>219</sup> few of them seem to have a particularly important social impact, and those that do usually retain the same structure and social mission that they had before conversion from the for-profit form.<sup>220</sup> In addition, no legal hybrid form has issued public shares to date, and it is unlikely that these forms will facilitate liquid public markets for social enterprises. Finally, despite lobbying attempts to allow some form of tax subsidy for businesses that incorporate as legal hybrids, no such subsidy has been introduced.<sup>221</sup> Perhaps more importantly, investments in legal hybrid forms have not been recognized as PRIs, and therefore few foundations have made investments in such firms.<sup>222</sup>

In the following discussion, I first describe the legal hybrid forms, specifically the L3C and the Benefit Corporation. I then outline a potential reform that can address the deficiencies in such forms. In particular, I argue that in order to serve as a credible commitment device, the design of legal hybrid forms should

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<sup>218</sup> A detailed analysis of PRIs is outside the scope of this article. In summary, PRIs are subsidized investments by private foundations in firms that promote a well-known exempt purpose, such as an educational, scientific, literary or charitable purpose (I.R.C. § 4944(c)). The main advantage of PRIs is that they count towards foundations’ minimum annual distribution requirements (Treas. Reg. § 53.4942(a)-3(a)(2)). The main problem with PRIs is that for an investment to qualify as a PRI, foundations need to follow detailed and costly procedures which are set out in the expenditure responsibility rules, including monitoring the investees and making reports to the IRS (I.R.C. § 4945(h); Treas. Reg. § 53.4945-5). Failure to follow these rules could result in the foundation’s paying significant tax penalties or even losing its tax exempt status; see Callison & Vestal, *supra* note 7. Consequently, few foundations make any PRIs; see *Leveraging the Power of Foundations: An Analysis of Program-Related Investing* (Lily Family School of Philanthropy, Indiana University, 2013), available at <http://www.philanthropy.iupui.edu/research-by-category/PRIreport>, at 2.

<sup>219</sup> Kate Cooney *et al.*, Benefit Corporation and L3C Adoption: A Survey, STAN. SOC. INNOVATION REV., Dec. 15 2014, available at <http://www.ssireview.org/blog/entry/benefit-corporation-and-l3c-adoption-a-survey>

<sup>220</sup> The Greyston bakery discussed below is one example.

<sup>221</sup> See Lloyd Hitoshi Mater & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387 (2014)

<sup>222</sup> Callison & Vestal, *supra* note 7.

be based on the notion of transacting with the beneficiaries advanced in this article.

### A. Legal Hybrid Forms

Two prominent examples of hybrid forms are the Low-Profit Limited Liability Company (“L3C”) and the Benefit Corporation. The L3C is a Limited Liability Company (“LLC”) that significantly furthers the accomplishment of one or more charitable or educational purposes, and no significant purpose of the company is the production of income or the appreciation of property.<sup>223</sup> Realizing profit and enhancing value can be purposes of the enterprise as long as they are not significant purposes. This definition reflects the notion of mixed mission that underlies most definitions of hybrid organizations. Merely stating that a firm has a mixed mission, however, is unlikely to give subsidy-providers reasonable assurance that their subsidy is being used effectively, given the difficulty of measuring social impact. Moreover, it is hard to see what the L3C adds to the standard LLC form, as members of an LLC can simply add a provision to the LLC agreement that contractually commits all of them to a particular social purpose.

Benefit Corporations are defined as corporations whose purpose is to create a “general public benefit.” General public benefit in most states’ statutes means “a material positive impact on society and the environment.”<sup>224</sup> Specific benefits include some activities associated with social enterprises as defined above, such as providing beneficial services and products to low-income communities. However, they go further to include largely any social purpose, including for example “...conferring any other particular benefit on society or the environment.”<sup>225</sup> Accordingly, just like the L3C, the Benefit Corporation is based on the concept of mixed mission. Partly to address the uncertainty inherent in this concept, the Benefit Corporation statutes of most states requires that impact on society and the environment be measured by a third-party standard,<sup>226</sup> i.e., a social rating certifier.<sup>227</sup> As discussed above, however, social ratings themselves are

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<sup>223</sup> See 11 V.S.A. § 3001(27) for the Vermont L3C Act.

<sup>224</sup> MODEL BENEFIT CORP. LEGIS. §102.

<sup>225</sup> MODEL BENEFIT CORP. LEGIS. §102. Under the Delaware Code, “Public benefit” means “a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature”; Del. Code Ann. tit. 8, §362(b).

<sup>226</sup> Third-party standard is defined as “a recognized standard for defining, reporting, and assessing corporate social and environmental performance”; MODEL BENEFIT CORP. LEGIS. §102. Note that under Delaware law certification by a third-party standard is only optional; see Del. Code Ann. tit. 8, §366(b).

<sup>227</sup> The certifier is often B-Lab, although other certifiers may be used.

subject to many imperfections, and may provide poor information to consumers or other subsidy-providers on the social value of hybrid organizations.

In addition, Benefit Corporation statutes include strong constituency provisions which require directors and officers to consider the interests of different stakeholders, including customers, employees, the interests of the community in which the firm operates, the local and global environment, and the interests of any other group that the directors deem appropriate.<sup>228</sup> The major risk of such provisions is that directors may use them mainly to entrench themselves at the expense of shareholders and other stakeholders. Although shareholders with more than two percent holdings could sue the directors for failure to pursue public or specific benefits,<sup>229</sup> the directors have ample discretion as to the weight they choose to give to the interests of different groups, and they need not give priority to any particular consideration or factors.<sup>230</sup> Moreover, as in standard business corporations, directors and officers have the protection of the business judgment rule, which largely means that if they were informed and acted in good faith, they are considered to have fulfilled their duties.<sup>231</sup> The ease with which Benefit Corporation directors may entrench themselves, coupled with the weakness of many social rating standards, make the Benefit Corporation a questionable vehicle for attracting subsidies from consumers, investors and the government.

To be sure, the Benefit Corporation form does include helpful provisions for owners that want to commit to some social purpose. In particular, the termination of a Benefit Corporation's status must be approved by a qualified majority – typically two-thirds – of the shareholders.<sup>232</sup> This provision effectively gives one third of the shareholders control over the mission. In fact, the Greyston bakery recently converted into a New York Benefit Corporation, probably in anticipation of the Greyston Foundation's selling a stake to for-profit investors, in order to maintain control of the firm.<sup>233</sup> However, while this provision is helpful in creating some control mechanism, the same commitment device can be created with existing legal forms, for example, by adding a charter provision that gives a nonprofit control over the firm's mission.<sup>234</sup> Moreover, this type of control

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<sup>228</sup> MODEL BENEFIT CORP. LEGIS. §301(a), 303(a).

<sup>229</sup> MODEL BENEFIT CORP. LEGIS. §305(c).

<sup>230</sup> MODEL BENEFIT CORP. LEGIS. §301(a)(3); For example, the Delaware Benefit Corporation statute states that directors need to balance the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation; see Del. Code Ann. tit. 8, § 365(a).

<sup>231</sup> MODEL BENEFIT CORP. LEGIS. §301(e), 303(e).

<sup>232</sup> 11A V.S.A. §21.07.

<sup>233</sup> New York law actually requires a three-fourths majority for terminating the Benefit Corporation status; see 17 N.Y. § 1702(D). Similarly, Patagonia, an environmentally-friendly firm discussed *supra* section V.D., reincorporated as a California Benefit Corporation to benefit from a similar provision; see CAL. CORP. CODE. §14604.

<sup>234</sup> See section IV.C. As discussed above, though, some statements by Chancellor Chandler in *Ebay v. Newark*, *supra* note 3 suggest that it is not possible to commit a Delaware corporation to a

mechanism on its own may have limited utility in committing to a large class of consumers who may not know which owners control the social mission.

## B. Outline for Reform

The core of the following reform proposal is to shift the focus of legal hybrid forms from organizations with mixed missions to firms that commit to transacting with disadvantaged groups as investees, workers, producers, consumers, etc. This reform may be achieved by simply modifying the Benefit Corporation and certification system. I will discuss the details of this reform in future work,<sup>235</sup> and for present purposes, I simply outline its main features.

First, a new form of certification is required for social enterprise. Certification would be awarded if a certain percentage of the firm's business, including that of its affiliates, is based on transactions with carefully defined classes of beneficiaries. The beneficiaries would be defined by reference to certain criteria of need (for example, levels of income, disability, location, etc). Certification may be conducted by a private organization, similar to the Fair Trade certification. It may also be conducted by a new government agency, similar to the CDFI Fund. The main innovation from the CDFI Fund is that the certification would apply to a wider class of beneficiaries, including for example, low-income workers. To keep the certification sufficiently flexible, different types of beneficiaries (e.g., workers or borrowers) may be divided into sub-classes in accordance with some measures of need.<sup>236</sup> Most states' Benefit Corporation statutes do recognize the need for certifying social impact. However, they are misguided in requiring firms to certify a comprehensive social impact standard that is inherently uncertain. If the B-Corp or other certification, private or governmental, focused primarily on verifying the transactional relationship with disadvantaged groups, it could serve as a credible commitment device.

Second, Benefit Corporations would be required to obtain this certification. Whereas under the current version of the Benefit Corporation Model Legislation ("MBCL"), firms may choose a third party standard to measure their social purpose, firms would be limited to one type of certification. Certification would also require Benefit Corporations to include an explicit commitment in the firm's certificate of incorporation (or other equivalent constitutional document) to transacting with one or more classes of disadvantaged groups. Moreover, the

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social purpose. But, as pointed out *supra* note 3, the *eBay* case did not involve a specific charter provision that required the firm to pursue a social mission, but rather, the court reviewed the legality of a poison pill mechanism adopted by management against minority shareholders' will.

<sup>235</sup> Eldar, *supra* note 15.

<sup>236</sup> To be sure, creating standards for different classes of beneficiaries would be particularly challenging if these criteria were extended to developing countries. However, collaboration among a federal agency, multilateral organizations such as the World Bank, and NGOs should be able to address this challenge; see Eldar, *supra* note 15.

name of Benefit Corporation would be changed to include “BC” (for “Benefit Corporation”) or “SE” (for “Social Enterprise”) as a suffix. This way, when investors buy shares in these companies or when consumers buy their products, they will have notice that the firm transacts with a class of beneficiaries, and hence it is likely to use subsidies effectively.<sup>237</sup>

In this respect, some of the provisions of Benefit Corporations may be superfluous while others remain valuable. Provisions requiring managers to consider the interests of all stakeholders have limited utility in any case, and would be completely unnecessary under this proposal. Subject to the certification, Benefit Corporations could pursue profits like any other commercial firms. On the other hand, there is value in keeping the provisions that require a super-majority vote to terminate Benefit Corporation status. This way investors, whether individuals or foundations, will have assurance that the firm will not change its mission after they have invested capital to support the social mission of the firm.

This proposal is not as provocative as it may first appear. As discussed above, CDFIs already operate well under a federal certification regime that verifies that they serve specified target markets, and Fair Trade certification has become part of mainstream retail. Additionally, many European jurisdictions have hybrid legal forms which certify firms as WISEs if a percentage of their workers belong to disadvantaged groups.<sup>238</sup> A centralized federal agency focused on development missions could be established to certify a wider range of social enterprises. In fact, even the nonprofit form may be viewed as a system whereby there is a government certifier, i.e., the Internal Revenue Service, that primarily ensures that nonprofits are precluded from distributing profits (and hence, more likely to distribute them to their beneficiaries), and state corporation law governs the internal affairs of the firm.

This reform has the potential to unlock much needed capital for social entrepreneurs. It would enable dispersed investors and consumers to donate more funds to social enterprises, and may also enable social enterprises to issue public shares. Moreover, it could potentially serve as the basis for allocating tax benefits to social enterprises. Investments in the reformed Benefit Corporations could qualify automatically as PRIs, thus eliminating the complicated and cumbersome process which prevents foundations from making PRIs; the reason is that certified

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<sup>237</sup> The certification mark attached to products may also signal the type of beneficiaries to consumers and investors, for example, “SE workers” or “SE consumers,” etc. The mark may further differentiate among sub-classes of beneficiaries, in accordance with some measures of need. For example, “SE workers 3” could refer to workers who belong to a community where the unemployment rate is much higher (say three times) than the national average, whereas “SE workers 2” would correspond to a community where the unemployment is lower, but still higher than the national average (e.g., two times). A social enterprise would be able to signal to subsidy-providers that it transacts with beneficiaries who have lower abilities, and therefore needs larger subsidies.

<sup>238</sup> One prominent example is the Italian Type B social cooperative; see Cafaggi & Iamiceli, *supra* note 4, at 7-15.

Benefit Corporations would have clear development missions, and it is likely that they will be use funds effectively towards those missions. In practice, most PRIs are actually made in businesses that have transactional relationships with their beneficiaries, such as businesses that employ low-income individuals.<sup>239</sup> By streamlining the PRI process and relieving foundations of potential liability for making PRIs, this proposal could facilitate the flow of substantial capital to social enterprises.

## IX. CONCLUSION

Social enterprise and other hybrid organizations are often discussed as an alternative to traditional capitalism, which is based on the norms of profit-maximization and shareholder primacy. These accounts tend to define social enterprise and hybrids simply as organizations that mix profit with social missions or cater to multiple stakeholders, and thereby consider the many forms of commercial firms that channel subsidies to beneficiaries indistinguishable. These theories however fail to identify the circumstances under which combining profit and mission works well, and how to ensure that the firm's managers have an incentive to pursue such missions.

The main contribution of my theory is to identify the measurement role of social enterprises. A social enterprise's commitment to transacting with its beneficiaries is the key element in assuring subsidy-providers that their subsidies will be used effectively. This commitment aligns the commercial interests of the firm with those of the subsidy-providers. Given that their profits depend on the performance of their beneficiaries, social enterprises have an interest in ensuring that the subsidies are not wasted, and that beneficiaries are provided with the adequate amount and type of disbursement. In this way, the interests of social enterprises are aligned with the interests of subsidy-providers who presumably want their subsidies to be used effectively.

The theory I offer may inform legal policy. First, it indicates that the success of social enterprises does not necessarily entail a dramatic shift in the role of corporations from profit-maximizing firms to corporations with duties to maximize wide and unascertainable public benefits. The theory I advance in this paper is not intrinsically inconsistent with the traditional role of corporations. Social enterprises can be profit-maximizing if the subsidies they receive flow from government or consumers rather than owners. Even if the owners do provide the subsidies by relinquishing some of the profits, social enterprises may be viewed as acting consistently with the shareholder primacy norm as long as the

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<sup>239</sup> 26 C.F.R. §53.4944-3; these examples include businesses owned by members of economically disadvantaged or minority groups, businesses that sell agricultural products sourced from low-income farmers in depressed rural areas, and a variety of low-cost providers of essential goods and services, such as vaccines sold in developing countries.

owners agree to provide such subsidies. Thus, even the traditional conception of the corporation can accommodate firms with a commitment to pursuing social missions.

Second, it suggests that legal policy and in particular, legal hybrid forms should focus on a specific set of enterprises that serve a measurement function. The limited usefulness of new legal hybrid forms, such as the L3C or the Benefit Corporation, is largely due to their questionable theoretical underpinnings. Existing legal forms for incorporating firms with mixed missions inevitably fail to identify the essential elements that make firms effective in utilizing subsidies or to prescribe adequate commitment devices. It is therefore not surprising that such forms have generally failed to attract subsidies from tax authorities,<sup>240</sup> which tend to view them with suspicion.

Finally, I have outlined a summary proposal for reforming the Benefit Corporation and introducing a certification mechanism for social enterprises that transact with a wide range of disadvantaged groups. This proposal which builds on the success of both private certifications such as Fair Trade, and government programs such as the CDFI Fund, has the potential to facilitate the flow of capital and income to social enterprises from a wide range of altruistic investors and consumers. It may also serve as the basis for allocating tax benefits and government subsidies to social enterprises.

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<sup>240</sup> Callison & Vestal, *supra* note 7.