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## Enhancing the Legal and Regulatory Environment for Investment in Social Enterprise

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# ENHANCING THE LEGAL AND REGULATORY ENVIRONMENT FOR INVESTMENT IN SOCIAL ENTERPRISE

*Dilpreet K. Minhas\**

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## I. INTRODUCTION

Beginning in the early 1970s, the world of entrepreneurship experienced profound change. An innovative investment vehicle—professionally managed venture capital—entered the market. Personal taxation rates were reduced; the Nasdaq market was established to raise equity and trade stocks in pre-profit companies; and in 1978, the Employee Retirement Income Security Act (ERISA) was amended so that corporate pension funds could participate in venture investment.<sup>1</sup> Throughout the 1970s and 1980s, various groups lobbied state and federal government to improve the environment for startup and early-stage ventures, and the venture capital community rallied for changes that would promote investment in venture funding.<sup>2</sup> Changes in the regulation and taxation of financial institutions further spurred the field of venture capital and led to the largely venture capital-funded high-tech boom of the 1990s.

The startup investment success that was achieved in that era has not been replicated with respect to social enterprise. There is still no universally accepted definition for social enterprises, also referred to as blended enterprises,<sup>3</sup> but the term is widely understood to encompass ventures

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\* The author is a graduate of the University of Michigan Law School (2013). Special thanks to Professor Vikramaditya S. Khanna for his guidance and the *Michigan Journal of Private Equity & Venture Capital Law* staff for their editorial assistance in connection with this Note.

1. Ronald Cohen, *Impact Capital is the New Venture Capital (Part II)*, REUTERS (July 13, 2011, 12:24 PM), <http://blogs.reuters.com/great-debate/tag/venture-capital>.

2. *Id.*

3. See Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 105 (2010).

having an underlying mission dedicated to generating social or environmental gains, rather than solely financial return. For the purposes of this note, social enterprise will be defined as it is by the Social Enterprise Alliance:<sup>4</sup> as an organization or venture that achieves its primary social or environmental mission via business methods, though the entity itself may be a nonprofit, for-profit, or hybrid.<sup>5</sup> As social enterprise is a steadily growing field, various academics have noted the need for increased academic inquiry into theory and practices underlying the field, particularly as compared to more traditional forms of commercial entrepreneurship.<sup>6</sup> For example, comparable tax incentives must be provided and our regulatory system should be amended to better support such mission-driven entrepreneurial ventures,<sup>7</sup> much the same way such systemic changes have provided the opportunity for profit-driven startups to thrive.

The objectives of this Note are: 1) to provide readers interested in social enterprise and entrepreneurship an introduction to these endeavors and the growing trend toward using them; 2) to present the challenges stemming from the legal and financial frameworks surrounding social investment activity, which can inhibit the survival and growth of social enterprises; and 3) to propose suggestions for addressing such challenges and limitations in order to better support the survival of social enterprise. Part II and Part III provide a broad perspective of the types of investment in and nurturing of social entrepreneurship in the U.S. Part IV analyzes the current business and regulatory framework supporting entrepreneurial ventures and provides suggestions to improve their potential to facilitate sustainable growth of social entrepreneurship.

## II. DISRUPTIVE INNOVATION AND THE RISE OF SOCIAL ENTERPRISE AND ENTREPRENEURSHIP

The term “disruptive innovation” refers to innovations that are introduced to the marketplace not merely to meet consumers’ existing needs, but rather to better serve the public.<sup>8</sup> These innovations seek to displace the current, traditional technologies or services available and result in meaningful social changes, such as expanding different demographics’ access to certain goods and services.<sup>9</sup> Successful disruptive innovations, such as cell phones, personal computers, and cheaper, no-frills air travel options for non-business travelers, have changed the course of business and the

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4. The Social Enterprise Alliance is an advocate of the field dedicated to building the social enterprise community.

5. Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 59 (2010).

6. James Austin et al., *Social and Commercial Entrepreneurship: Same, Different, or Both?*, ENTREPRENEURSHIP THEORY & PRAC., Jan. 2006, at 1.

7. Cohen, *supra* note 1.

8. Clayton Christensen, *Disruptive Innovation for Social Change*, HARV. BUS. REV., Dec. 2006, at 94.

9. *Id.*

nature of the various industries into which they have been launched. In the past few decades, such disruptive innovations, often presenting the potential for large financial returns, have been funded by venture capitalists and other big players.<sup>10</sup>

Disruptive innovations are becoming an increasingly common characteristic of social entrepreneurial endeavors,<sup>11</sup> which typically involve the launch of new goods or services for a target population but are anchored by their social missions. Social enterprises often attempt to address some kind of market failure, environmental ill, or distributional inequality in society.<sup>12</sup> For example, a for-profit social enterprise may attempt to increase the supply of a certain public good, which might then improve the welfare of an economically disadvantaged population or community that constitutes a “charitable class.”<sup>13</sup> Social entrepreneurs undertake to establish organizations that embody their social missions, or existing organizations may be influenced by socially-minded individuals within them to shift business practices toward achieving sustainable social or environmental benefits. The steady trend of disruptive techniques and technologies and social enterprise efforts highlights the importance of recognizing the causal factors facilitating the survival and growth of disruptive innovation in various industries.

Since social enterprises can take on a variety of different organizational and legal forms, their funding and investment tend to come from a variety of sectors and financing models. For example, many social enterprises tend to be nonprofit or hybrid entities, rather than traditional for-profits, and are thus not very attractive to venture capital or institutional investment.<sup>14</sup> Because different sources of funding often lead to disparities in enterprises’ potential for sustainability, the legal entities and structures of the organizations in question must necessarily be examined.

Due to the nature of their resources and funding streams, social enterprises, particularly nonprofits, can have tremendous difficulty scaling.<sup>15</sup> Massive inefficiencies in capital allocation<sup>16</sup> in the social sector are reflected in social organizations’ failure to survive, due in part to donors’ typical refusals to help entrepreneurs cover overhead costs. This refusal

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10. Igor Sill, *Maximizing Venture Capital Investments*, RED HERRING (May 1, 2012), <http://www.redherring.com/startups/maximizing-venture-capital-investments/> (discussing how many of the most recent disruptive and innovative companies were funded by venture capitalists).

11. This note will not explore the different existing definitions for social entrepreneurship and social enterprise; here, these concepts shall be used interchangeably.

12. Katz & Page, *supra* note 5, at 89.

13. *Id.*

14. Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 354 (2009).

15. Ronald Cohen & William A. Sahlman, *Social Impact Investing Will Be the New Venture Capital*, HARV. BUS. REV. HBR BLOG NETWORK (Jan. 17, 2013, 8:00 AM), [bgs.hbr.org/cs/2013/01/social\\_impact\\_investing\\_will\\_b.html](https://hbr.org/cs/2013/01/social_impact_investing_will_b.html).

16. *Id.*

keeps organizations in a perpetual state of fundraising just to maintain their operations, rather than to scale.<sup>17</sup> The U.K.'s Social Investment Task Force, through its study of social sector organizations, found that almost all such entrepreneurial organizations are continually underfunded and possess as little as three months' working capital at any given time.<sup>18</sup> While this may seem similar to the plight of startups, generally, social sector organizations experience the further disadvantage of being largely ignored by the venture capital industry and other traditional investors, like banks. Such investors view the social component of entrepreneurial ventures as a discount on their potential return on investment.<sup>19</sup> Where there is some sort of financial cost associated with the business' social component, investment in such enterprises is often viewed even more unfavorably by these traditional investors.<sup>20</sup> For-profit social enterprises do not easily circumvent funding difficulties either, as they cannot obtain funding from foundations- and donation-based funding and grants that nonprofits typically receive.

### III. CHALLENGES PRESENTED BY THE CURRENT REGULATORY/ FINANCIAL SUPPORT FRAMEWORK AND POTENTIAL IMPROVEMENTS

#### A. *Venture Capital and 'Traditional' Funding for Startups— Social Enterprises are Left Behind*

Venture capital (VC) is a type of financing often provided in the form of unsecured capital by angel investors or venture capital funds to young entrepreneurial businesses.<sup>21</sup> As many startups typically lack equity and significant financial resources, they are not very attractive to banks or other traditional lenders.<sup>22</sup> Such entrepreneurial ventures often also have difficulty securing capital from traditional sources of investment due to factors such as their size, stage of development, assets, or revenue potential. However, regardless of the developmental stage of such startups, if they exhibit potential for rapid growth and revenue generation, venture capitalists (VCs) may be intrigued enough to consider investment. Young entrepreneurial ventures thus hope to secure venture capital as a means of gaining the equity needed to embark on a path toward long-term growth

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17. *Id.*

18. *Id.*

19. Olivia Khalili, *15 Social Venture Capital Firms You Should Know About*, CAUSE CAPITALISM (Apr. 21, 2010, 2:06 PM), <http://causecapitalism.com/15-social-venture-capital-firms-that-you-should-know-about>.

20. *Id.*

21. *Venture Capital*, U.S. SMALL BUS. ADMIN., <http://www.sba.gov/content/venture-capital-startups-high-growth-technology-companies> (last visited Apr. 25, 2014).

22. Brent Beshore, *The Non-Entrepreneur's Guide to Startup Funding*, FORBES (Feb. 19, 2013, 10:14 AM), <http://www.forbes.com/sites/brentbeshore/2013/02/19/the-non-entrepreneurs-guide-to-startup-funding/> (banks are a poor source of funding because they are both highly regulated and require collateral from the recipient).

and, in doing so, become more attractive to financial lenders and later-stage investors.<sup>23</sup>

Because early-stage startups present higher risk to investors, VCs choosing to invest in them typically take an active role in such companies, whether by advising on business decisions or sitting on the board of directors.<sup>24</sup> In this vein, venture capital investing tends to be long-term, enabling investors to add both value and capital to startups in order to help facilitate long-term growth and a higher return on initial VC investment.<sup>25</sup> With this focus on longer-term return on investment, rather than just quick turnaround, VC investors typically only invest in startups they believe can eventually generate significant profit.

Complicating the dynamic between startup needs and investor interests, vast informational disparities<sup>26</sup> exist in the field of venture capital, particularly between passive investors, active investors and venture funds, and VC recipients. This is largely due to varying levels of monitoring exercised by the different parties. Venture funds and angel investors often take a much more active role in the progress of the startups in which they invest, whereas passive investors have less incentive to monitor closely and so do not. The legal environment has addressed the potential risks arising from such informational asymmetries by creating “contractual governance and incentive techniques,” which are believed to effectively limit opportunism and thereby control the level of risk for investors.<sup>27</sup> For example, fund managers are frequently required to commit capital to target startups. Contractual techniques such as compensation arrangements between fund managers and investors can also help to align interests.<sup>28</sup>

The duration of a venture fund is typically ten years with a five-year investment period, enabling investors to reasonably estimate the period of time in which the fund can make new investments and when it can begin to recover its investment and profits earned.<sup>29</sup> Clawback provisions, which are triggered if fund managers receive a greater amount of carried interest during a startup’s early stages than they should, based on what the compensation agreement entitles them to in later stages, are a source of protection for fund investors.<sup>30</sup>

Negotiable contractual elements of a VC fund’s legal form, which are often flexible business forms such as limited partnerships, may also provide investors with faith in the alignment of fund managers’ interests and

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23. *Venture Capital*, *supra* note 21.

24. *Id.*

25. *Id.*

26. Erik P. M. Vermeulen & Diogo Pereira Dias Nunes, *The Evolution and Regulation of Venture Capital Funds* 1, 3 (Lex Research Topics in Corp. Law & Econ., No. 2012-1, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2163193](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2163193).

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

the security of their investments. For example, profit distribution arrangements can keep fund managers' compensation in check (in terms of the share of profits received) if they require VC firms to provide a preferred return to investors before distributing the "carry" to fund managers.<sup>31</sup> When such preferred returns exist, in order to keep managers incentivized, the distribution arrangements often include catch-up provisions that entitle those who fulfill their hurdle rate requirements to receive a larger share of the profits, up to the amount of the contractually specified profit split between the investors and managers involved.<sup>32</sup>

Unsurprisingly, the recent recession has taken a serious toll on the venture capital industry, which has not yet fully recovered. Many VCs are having difficulty raising funds and, as of May 2013, approximately 400 venture capital firms have either temporarily stopped investing or shut down altogether.<sup>33</sup> The challenges posed by the limited venture capital available to early-stage or emerging companies are exacerbated by the fact that only certain types of startups tend to attract VC investors in the first place. Venture capital investment typically "focuses on young high-growth companies, invests equity capital, rather than debt, takes higher risks in exchange for potential higher returns, has a longer investment horizon than traditional financing, monitors portfolio companies actively via board participation, strategic marketing, governance, and capital structure,"<sup>34</sup> and favors companies that present the opportunity for a smooth exit strategy.

Unfortunately, these types of "qualifying" characteristics tend to make social entrepreneurial endeavors, which may be structured as for-profit but are also heavily concerned with generating social benefit (often at the expense of generating revenue), much less attractive than purely profit-oriented startups. A review of literature synthesized and presented by O.M. Lehner reveals the following key differences that frequently exist between social enterprises and traditional for-profit entrepreneurial ventures, which often make the former less attractive for VC and traditional forms of financing:

- ambiguous and sometimes dichotomous aims of [social enterprises], torn between the social and commercial;
- alien corporate governance and legal and organizational structures in [social enterprises] that are difficult to accept for traditional investors and lenders;
- cultural and cognitive distance-related barriers between for-profit investors and [social enterprises] that hinder communication;

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31. *Id.* at 4.

32. *Id.*

33. John Tozzi, *One Bright Spot for VCs? Impacting Investing*, BLOOMBERG BUSINESSWEEK (May 2 2013), <http://www.businessweek.com/articles/2013-05-02/one-bright-spot-for-vc-impact-investing>.

34. *Venture Capital*, *supra* note 21.

- social entrepreneurs' narrations that are being hooked in the 'social' sphere and are lacking the managerial terminology, which leads to severe skepticism in their managerial capabilities.<sup>35</sup>

As a result of such differences, traditional means of financing have proven to be unsatisfactory or inadequate when it comes to launching and sustaining the growth of various kinds of social entrepreneurial endeavors.<sup>36</sup>

#### B. *How Legal Entity and Structure Affect a Social Enterprise's Access to Capital*

Traditionally, nonprofits and for-profits obtain different sources of capital with which to grow, presenting different long-term funding realities for social entrepreneurs to consider. Nonprofits with 501(c)(3) tax-exempt status redirect profits generated back into organizational operations, so as to continue carrying out their missions for public benefit.<sup>37</sup> As nonprofits are not usually permitted to issue stock or distribute profits to their owners,<sup>38</sup> nonprofit social enterprises cannot offer equity to VCs or other for-profit investors considering investment.<sup>39</sup> Though nonprofits are able to receive traditional debt financing, debt instruments are often less flexible than equity financing and are also more expensive.<sup>40</sup> Additionally, traditional lenders like banks are often hesitant to offer loans at competitive rates to nonprofits, as they anticipate that the nonprofits' access to other sources of capital is likely low, which could present future difficulties with repayment.<sup>41</sup>

Tax-exemption requirements that a nonprofit dedicate all assets to an exempt purpose upon dissolution and that none of its assets inure to the

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35. O.M. Lehner, *Crowdfunding Social Ventures: A Model and Research Agenda*, 15 ROUTLEDGE VENTURE CAP. J. (forthcoming 2013) (internal citations omitted).

36. See generally HILARY BROWN & EMMA MURPHY, THE FINANCING OF SOCIAL ENTERPRISES: A SPECIAL REPORT BY THE BANK OF ENGLAND (2003), available at [http://www.uk.coop/sites/storage/public/downloads/bank\\_of\\_england\\_the\\_financing\\_of\\_social\\_enterprises\\_0\\_0.pdf](http://www.uk.coop/sites/storage/public/downloads/bank_of_england_the_financing_of_social_enterprises_0_0.pdf); Alessandro Fedele & Raffaele Miniaci, *Do Social Enterprises Finance Their Investments Differently from For-Profit Firms? The Case of Social Residential Services in Italy*, 1 J. SOC. ENTREPRENEURSHIP 174 (2010); Rory Ridley-Duff, *Social Enterprise as a Socially Rational Business*, 14 INT'L J. ENTREPRENEURIAL BEHAV. & RES. 291 (2008); Ajay Agrawal et al., *Entrepreneurial Finance and the Flat-World Hypothesis: Evidence from Crowd-Funding Entrepreneurs in the Arts* (NET Inst., Working Paper No. 10-08, 2010).

37. *Exemption Requirements – 501(c)(3) Organizations*, INTERNAL REVENUE SERV., <http://www.irs.gov/Charities-&-Non-Profits/Charitable-Organizations/Exemption-Requirements-Section-501%28c%29%283%29-Organizations> (in order to qualify as a 501(c)(3) organization, an entity cannot distribute its earnings to "any private shareholder or individual.").

38. I.R.C. § 501(c)(3) (2010); Treas. Reg. §§ 1.501(c)(3)-1(c)(2) (2008) (providing that nonprofits can neither distribute earnings, including dividends, to individuals during the life of the organization nor distribute assets in the event of the nonprofit's dissolution).

39. Kelley, *supra* note 14, at 353-54.

40. *Id.* at 354.

41. *Id.*



benefit of individuals may provide comfort to social enterprise investors worried about mission drift, but these requirements also limit an enterprise's "ability to restructure and attract investors who want to participate in the business gains upon dissolution."<sup>42</sup> Thus, startup/expansion capital is often difficult for social enterprises to raise, and this alone can be prohibitive to social entrepreneurs wishing to engage in the nonprofit space. Further, fundraising issues are not necessarily solved by instead establishing a for-profit entity, since such status forecloses the opportunity to receive funds from those typically most inclined to donate to social organizations: the government and private foundations.<sup>43</sup> For-profits are also unable to receive tax-exempt donations.<sup>44</sup> Additionally, the for-profit structure of "double-bottom line" (designed to achieve both financial and social returns) social enterprises does not necessarily aid in capitalization efforts, as venture capitalists, institutional investors (e.g., pension funds), and other common sources of for-profit investment often have expectations of market-rate returns, which such hybrid social enterprises are often unequipped to deliver.<sup>45</sup> Ultimately, the financial costs of a startup's social component may be seen by investors as a discount on return on investment (ROI), rendering the enterprise a relatively less worthwhile investment opportunity than other startups.

As a result of the perceived unattractiveness of investing in this space, most startup social enterprises are relegated to settling for "patient capital,"<sup>46</sup> which is difficult to secure and frequently a poor solution to the woes of undercapitalization, even if such startups restrict their goals to merely achieving slow, steady growth.<sup>47</sup> Currently, charitable donations from foundations represent the most significant source of financing for so-

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42. Keren G. Raz, *Toward an Improved Legal Form for Social Enterprise*, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 294-95 (2012) (citing Jim Fruchterman, *For Love or Lucre*, STAN. SOC. INNOV. REV., Spring 2011, at 46, available at [http://www.ssireview.org/articles/entry/for\\_love\\_or\\_lucre](http://www.ssireview.org/articles/entry/for_love_or_lucre)).

43. Kelley, *supra* note 14, at 354 (citing Jed Emerson, *The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and the Blended Value Proposition* 10 (Harvard Bus. Sch. Soc. Enter. Series, Working Paper No. 17, 2000)).

44. I.R.C. §§ 170(a), (c) (2010).

45. Kelley, *supra* note 14, at 354 (citing Victor Fleischer, *Urban Entrepreneurship and the Promise of For Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 95 (2007); SUSTAINABILITY & THE SKOLL FOUND., GROWING OPPORTUNITY: ENTREPRENEURIAL SOLUTIONS TO INSOLUBLE PROBLEMS 18 (2007)).

46. A single universal definition for patient capital has not been established, but it is widely agreed to be characterized as long-term capital, where investors of patient capital are not expecting short-term market rate returns, but do expect some social return. BROWN & MURPHY, *supra* note 36, at 62. More specifically, the Acumen Fund defines patient capital as a "debt or equity investment in an early-stage enterprise providing low-income consumers with access to healthcare, water, housing, alternative energy, or agricultural inputs." *What is Patient Capital?*, ACUMEN, <http://acumen.org/ideas/patient-capital> (last visited Nov. 17, 2013).

47. Kelley, *supra* note 14, at 354-55.

cial enterprises.<sup>48</sup> However, contrary to the potential implication that social enterprises can rely on securing funding from foundations, it is in fact not in the interest of sustainability for social enterprises to rely on these foundations for significant or consistent funding. Foundations' interests are often project driven and, thus, more aligned with supporting social enterprises' particular programs or projects that address specific problems, rather than funding the organizations in a general, unrestricted manner.<sup>49</sup> Ultimately, this often means that foundations are "less interested in the overall organizational abilities and the long-term needs of a social enterprise."<sup>50</sup>

Foundation funding can be a problematic approach for public benefit corporations, since financial gifts directed to particular projects are generally not unrestricted funding and do not give entities the flexibility to utilize donations for those purposes that *they* deem most important. This presents an obstacle for recipient social enterprises that want to develop long-term strategies and programs: they may instead have to use any funds received for other short-term activities<sup>51</sup> specified by the donor. Thus, because foundation donations are currently the most significant source of financing, social enterprises often (and easily) find themselves undercapitalized. A serious consequence of such undercapitalization is that it can force social entrepreneurs to focus their attention on raising more funds simply to maintain their operations, rather than devote time and resources to carrying out their actual mission and programming. The result is a problematic cycle: slow development of programs and lack of long-term progress can lead to even greater difficulty in obtaining the necessary attention and future investments for further development or scaling.<sup>52</sup>

Furthermore, because the allocation of funds from foundations tends to be based more on an organization's needs than its performance, foundations "pay little attention to thinking in strategic terms and measuring the grant recipients' results"<sup>53</sup> and, therefore, do not know whether their donations led to successful programmatic outcomes for recipients. This detachment from the ultimate outcome of the donation likely does little to fuel increased or repeat donations to the same organizations, a proposition that is bolstered by the fact that foundations are known to contribute various small donations to different organizations rather than large ones to a smaller recipient pool.<sup>54</sup> Finally, because of the lack of monitoring of out-

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48. Mariarosa Scarlata & Luisa Alemany, *Philanthropic Venture Capital: Can the Key Elements of Venture Capital Be Applied Successfully to Social Enterprises* 7 (Feb. 2008), available at <http://ssrn.com/abstract=1099277>.

49. *Id.* at 6.

50. *Id.*

51. *Id.* at 6-7.

52. *See id.* at 7.

53. *Id.* at 1, 7; *see also* Michael E. Porter & Mark R. Kramer, *Philanthropy's New Agenda: Creating Value*, *HARV. BUS. REV.*, Nov.-Dec. 1999, at 121-30.

54. Scarlata & Alemany, *supra* note 48, at 7.

comes and the trend of smaller, individual donations, foundations have little incentive to put extensive effort into staking out worthy social enterprises that have the greatest potential to grow and benefit from their funding. Rather, nearly any organization with some sort of a positive mission on a foundation's radar could be seen as a "worthy" recipient, even if not otherwise well positioned to succeed in the long term.<sup>55</sup>

In light of this, Porter and Kramer argue that foundations "create value when achieving an equivalent social benefit with fewer dollars or when creating greater social benefits for a comparable cost" and should screen potential investments the way for-profit investors do, with an eye toward recipients who will generate real results and a return on investment.<sup>56</sup> If charities were to select the best possible recipients for donation funding, they would be able to fuel those organizations that are highly productive and more likely to put the donations to good use over the long-term. Through adopting such investment decision practices, including better tracking of the return (monetary and social) on grants made, foundations could measure the value they help to create in recipient organizations and potentially help attract other donors to those same organizations. Such an outcome could result in "improving the return on a larger pool of philanthropic resources. Furthermore, the performance of a non-profit can be magnified by moving the foundation from the role of a mere capital provider to the role of a fully engaged partner."<sup>57</sup> If effectuated in this way, donations can have sustainable value beyond just their immediate impact. In addition to having a social impact on a particular grantee, foundation donations might also increase the effectiveness of other organizations by virtue of the fact that grantees can learn from one another's successes, if they pay attention to and replicate good practices.<sup>58</sup>

### C. Is "Social Venture Capital" the Answer?

For the aforementioned reasons, foundation donations and venture capital, as they currently exist, are not consistent or sustainable models of financing nonprofit or for-profit social enterprises, respectively. In fact, only 0.04 percent of U.S. startups and small business are funded by VCs and only 0.91 percent are funded by angel investors.<sup>59</sup> For-profit social enterprises face the challenge of seeking capital investment while fulfilling their dual objectives of increasing shareholder value and carrying out their social mission (e.g., to benefit the environment or target community). These simultaneously critical, though seemingly conflicting objectives place additional pressure on social entrepreneurs to navigate tradeoffs

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55. *See id.* at 1, 8.

56. Porter & Kramer, *supra* note 53, at 126.

57. Scarlata & Alemany, *supra* note 48, at 1, 8.

58. Porter & Kramer, *supra* note 53, at 124; Scarlata & Alemany, *supra* note 48, at 1, 8.

59. Jamie Farrell, *The JOBS Act: What Startups and Small Businesses Need to Know*, FORBES (Sept. 21, 2012, 12:21 PM), <http://www.forbes.com/sites/work-in-progress/2012/09/21/the-jobs-act-what-startups-and-small-businesses-need-to-know-infographic>.

that may arise in finding a successful strategy to achieve both (and grow).<sup>60</sup>

Philanthropic venture capital (PhVC) investment, or venture philanthropy, is a form of social venture capital that presents a promising alternative funding model, and it is becoming steadily more widespread. According to a 2008 study, the first U.S. PhVC fund was established in 1980 and 69 percent of U.S. PhVC funds were established between 1998 and 2008.<sup>61</sup> PhVC consists of “the application of the strategies and the techniques developed within the venture capital industry to the financing of social purpose enterprises.”<sup>62</sup> A synthesis of various perspectives on PhVC yields the following summary of key aspects of PhVC investment:

a) the provision of capital as well as expertise; b) the implementation of risk management practices in the invested company; c) the prevalence of an accountability-for-results process; d) a managing partner relationship between the investor and the recipient company; e) a long-term investment perspective (3-6 years business plans); f) the definition of a clear exit strategy. As such, venture philanthropy is based on the principles of entrepreneurial business and combines practices typically implemented in long-term for-profit VC investments with the mission-driven principles of the social sector.<sup>63</sup>

PhVC has been utilized by a variety of the organizational models subsequently described in this note and constitutes anything from multi-donor funds mimicking traditional VC funds and investment practices to funding from more traditional charities or grant-making bodies.<sup>64</sup> Three overall categories of philanthropic venture capital include: 1) venture-generated philanthropic funds, 2) venture-influence philanthropic funds, and 3) venture-parallel philanthropic funds.<sup>65</sup> Philanthropic venture capitalists (PhVCs)<sup>66</sup> are additionally referred to as social venture capitalists, highly-engaged philanthropies, or venture philanthropy investors.<sup>67</sup> PhVCs finance target organizations based on the achievement of performance milestones and essentially engage in a “value-added partnership”<sup>68</sup> with the target organization. In addition to their capital contributions, PhVCs mon-

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60. Linda Rottenberg & Rhett Morris, *New Research: If You Want to Scale Impact, Put Financial Results First*, HARV. BUS. REV. HBR BLOG NETWORK (Jan. 9, 2013, 2:09 PM), [http://blogs.hbr.org/cs/2013/01/new\\_research\\_if\\_you\\_want\\_to\\_sc.html](http://blogs.hbr.org/cs/2013/01/new_research_if_you_want_to_sc.html).

61. Scarlata & Alemany, *supra* note 48, at 5 (listing three overall categories of philanthropic venture capital: 1) venture-generated philanthropic funds; 2) venture-influence philanthropic funds; and 3) venture-parallel philanthropic funds).

62. *Id.* at 2 (defining PhVC through a synthesis of various academic definitions of the concept; as a relatively young financing model, it is still inconsistently defined).

63. *Id.* at 3.

64. *Id.* at 1, 4.

65. *Id.* at 4.

66. *Id.* at 3 (“Philanthropic venture capitalists are social subjects whose aim consists of investing those funds raised from various donors - who may be wealthy individuals, enterprises, and/or foundations - in organizations with high social impact.”).

67. Scarlata & Alemany, *supra* note 48, at 3.

68. *Id.*

itor the progress of their target organizations and provide expertise and strategic guidance in an effort to achieve greater social return on investment.<sup>69</sup>

The emerging presence of such investors and so-called “social venture capital” may be part of the answer to the funding challenges of social enterprises. Ashoka, a global nonprofit dedicated to creating the largest network of high impact social entrepreneurs around the world, embodies the spirit of social venture capital activity and directly invests in high potential social entrepreneurs. Hybrid organizations, such as Acumen Fund, Bridges Ventures, and Root Capital, instead channel patient capital to high social-return investments globally.<sup>70</sup> The Acumen Fund’s focus, for example, is to reduce poverty worldwide through patient capital investment, as it believes that neither capital markets nor charity/aid are enough to develop sustainable solutions to curing systemic poverty. Acumen sees patient capital as a means of

bridging the gap between the efficiency and scale of market-based approaches and the social impact of pure philanthropy. . . . [It] has a high tolerance for risk, has long time horizons, is flexible to meet the needs of entrepreneurs, . . . is unwilling to sacrifice the needs of end customers for the sake of shareholders . . . [and] ultimately demands accountability in the form of a return of capital: proof that the underlying enterprise can grow sustainably in the long run.<sup>71</sup>

Such dedicated approaches taken by various organizations are positive developments in the world of investment in social enterprise but, ultimately, are not enough.

#### IV. RECOMMENDATIONS FOR FACILITATING GREATER INVESTMENT IN SOCIAL ENTREPRENEURSHIP

##### *A. How Could Changes to our Legal/Regulatory System Provide Greater Incentives for Investment in Social Enterprise?*

In light of the economic downturn’s impact on venture capital activity and venture capitalists’ highly critical approach to startup candidates, policymakers and regulators believe that to increase emerging companies’ access to venture capital investment, a stronger “venture capital cycle”<sup>72</sup> must be created. This can be achieved by “(1) boosting venture capital fundraising (particularly from institutional investors), (2) promoting venture capital and other risk capital investments in promising, mostly early-stage growth companies, and (3) encouraging access to capital markets in

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69. *Id.* (“Besides, in case PhVCs take a seat in the board of directors of the organizations they back, they retain important rights which allow them to intervene in the company’s operations when necessary.”).

70. Cohen & Sahlman, *supra* note 15.

71. *What is Patient Capital?*, *supra* note 46.

72. “Stimulating a rapid and smooth process of raising, structuring and exiting funds is crucial to start and restart venture capital cycles, but also to develop a sustainable and robust venture capital industry.” Vermeulen & Nunes, *supra* note 26, at 2.

order to improve liquidity and exit opportunities that enable venture capital funds to return capital to their investors.”<sup>73</sup> A number of policymakers and regulatory experts recognize venture capital funds should be exempted from stringent registration and reporting requirements to which alternative investment fund advisers/managers are subject.<sup>74</sup> The notion is that such venture capital exemptions in the Dodd-Frank Act are appropriate because VC funds do not threaten the stability of the financial system,<sup>75</sup> and by avoiding the financially burdensome registration requirements, more money remains with VCs for potential startup investments.

However, reviving the VC market is perhaps a small piece of the puzzle for increasing potential capital available to those for-profit social enterprises even capable of attracting VC investment. Below market rate returns prove unattractive to such investors, particularly when it is difficult to measure social outcomes and “disentangle” the risks presented by blended value enterprises from the financial returns.<sup>76</sup> Informational asymmetries additionally contribute to challenges in establishing investment relationships between investors and social enterprises. A more proactive role assumed by government could help to remedy this type of issue.

[F]inancial institutions are handicapped in local markets where they can’t access information about the level of entrepreneurial activity, outcomes of past investments, and so forth—making them understandably leery of committing funds. . . . [E]ntrepreneurs in emerging venture markets often lack insight into the expectations of top-tier private investors, potential strategic partners, and investment bankers. Government can help bridge these information gaps by publishing data and facilitating conversations. It can also encourage local trade associations to do so, perhaps by providing them with funding.<sup>77</sup>

The government’s role as facilitator could benefit not only the social entrepreneurs who may be given a better chance of connecting with investors, but also the government itself. Social enterprises that ultimately get the funding necessary to scale and successfully deliver public benefit services can help reduce government expenditure on public benefits. That is, the government can realize cost savings as a result of social impact achieved by social enterprises.

The Social Enterprise Ecosystem and Economic Development Commission Act of 2013 (SEED Commission Act), introduced to the House on May 17, 2013, signals a step in the right direction. This bill proposes to

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73. *Id.* at 1.

74. *Id.*

75. *Id.* at 46 (The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) and Europe’s Alternative Investment Funds Managers Directive (AIFMD) include such “venture capital exemptions”).

76. Antony Bugg-Levine et al., *A New Approach to Funding Social Enterprises*, HARV. BUS. REV., Jan.–Feb. 2012, at 123.

77. Josh Lerner & William Sahlman, *Reviving Entrepreneurship*, HARV. BUS. REV. (Mar. 2012), available at <http://hbr.org/2012/03/reviving-entrepreneurship/ar>.

establish the Commission on the Advancement of Social Enterprise, whose purpose is “to examine and make recommendations with respect to ways the Federal Government can support and utilize the transformative power of social enterprises.”<sup>78</sup> The Commission would be required to both establish criteria for identifying social enterprises for purposes of federal programs and identify opportunities for the federal government to engage social enterprises in job creation and strengthening of local economies.<sup>79</sup>

Though it is unlikely that this bill will be passed,<sup>80</sup> it reflects a growing understanding that social enterprise has tremendous potential to both stimulate the economy and save the government money through the enterprises’ work to address social issues often otherwise left to be remedied (or not) by government spending and public benefit programs. Time will tell how Congress responds, but it is crucial that more policymakers turn their focus to this area and develop creative ways to frame the benefits of a more positive regulatory environment for social enterprise, so that Congressional buy-in may be achieved.

As entrepreneurs are, by nature, ambitious and tenacious, they “can be relied on to relentlessly pursue opportunities; the key for government is to ensure the right mix of risks and rewards to elicit a broad-based response.”<sup>81</sup>

### 1. Government-Backed Social Impact Bonds

Short of legislation, the government can engage in other activities to spur investment and capitalize on the fact that investors’ interest in high-growth, socially impactful businesses is increasing.<sup>82</sup> To illustrate, SJF Ventures (SJF), which invests in businesses focused on social impact or sustainability, exceeded its target and raised a \$90 million fund over 15 months in the current economic environment to invest in growth companies having social impact.<sup>83</sup> The fund’s investors are a diverse group composed of both those primarily interested in socially responsible investing and others primarily interested in financial return: large banks, insurance companies, foundations, and individuals.<sup>84</sup> Successful VC firms such as

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78. H.R. 2043, 113th Cong. §2 (2013), *available at* <http://www.govtrack.us/congress/bills/113/hr2043/text>.

79. *Id.*

80. GovTrack.us projects a one percent chance of enactment. GovTrack.us, <https://www.govtrack.us/congress/bills/113/hr2043> (last Apr. 26, 2014).

81. Lerner & Sahlman, *supra* note 77.

82. *See* Tozzi, *supra* note 33. Investors’ Circle, a highly active, national group of socially conscious angel investors, recently ranked in the top ten most active angel groups in the U.S. SILICON VALLEY BANK & ANGEL RES. INST., HALO REPORT: US ANGEL GROUP UPDATE: 2013 YEAR IN REVIEW 4 (2014), *available at* [http://www.svb.com/uploadedFiles/Content/Blogs/Halo\\_Report/halo-report-2013.pdf](http://www.svb.com/uploadedFiles/Content/Blogs/Halo_Report/halo-report-2013.pdf).

83. Tozzi, *supra* note 33.

84. *Id.*

SJF will hopefully set a positive example for VCs and angel investors skeptical of the financial and social rewards of investing in social enterprises.

Sir Ronald Cohen, credited with being one of the pioneers of venture capitalism, is now attempting to create a cultural shift toward impact investing in social enterprises, rather than just traditional business startups.<sup>85</sup> His goal is to harness the power of venture capital investment and direct it toward organizations that will create social returns, rather than just quick financial returns, for the ultimate purpose of reducing social inequality.<sup>86</sup> Cohen believes that such social inequality, manifested by a large gap between the rich and poor, has not been effectively reduced by philanthropic efforts—an ineffective model that hampers the social organizations from scaling and achieving their full potential—and also suffers from the government’s inability to “redress the balance.”<sup>87</sup>

To combat this problem, Cohen and other supporters of the field believe that social enterprise strikes the right balance between social return and financial return to enable it to attract capital investment from those that would otherwise look to invest in purely for-profit businesses.<sup>88</sup> Social impact bonds (SIBs) are financial instruments that earn a return for the investor if the cost or incidence of a social issue is reduced with comparable or better results by the work of an investee nonprofit/social enterprise than would be achieved by a government program.<sup>89</sup> SIBs are designed to measure the social impact of the work conducted by investees and translate this impact into a tangible financial metric for investors.

The first SIB was launched in the U.K. in 2010, with the goal of reducing the recidivism rates of convicted criminals.<sup>90</sup> Rather than relying on donations, the Peterborough Bond was backed by the U.K. government to raise £6 million for three charitable organizations to carry out their missions of helping former prisoners successfully reintegrate into society.<sup>91</sup> The bond issuance was successful because of investor confidence in the charities’ abilities to lower the recidivism rates. If a greater than 7.5 percent reduction in recidivism rates was not achieved by the charities’ efforts, the bond’s investors would lose their money.<sup>92</sup> If recidivism were reduced at the rate of 15 to 17.5 percent, the U.K. Ministry of Justice and the Big Lottery Fund would repay the investors their initial investment plus the yield on the bond.<sup>93</sup> This yield could range from 2.5 to 13 percent,

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85. Nigel Roberts, *Sir Ronald Cohen: Venture Capitalist to Social Capitalist*, INSEAD KNOWLEDGE (May 7, 2013), <http://knowledge.insead.edu/csr/social-entrepreneurship/sir-ronald-cohen-venture-capitalist-to-social-capitalist-2468>.

86. *Id.*

87. *Id.*

88. See Roberts, *supra* note 85.

89. Cohen & Sahlman, *supra* note 15.

90. Cohen, *supra* note 1.

91. Roberts, *supra* note 85.

92. *Id.*

93. *Id.*



depending on the specific reduction rate achieved. The initial investors could, therefore, receive a 13 percent return on their initial investment if recidivism were reduced by 15 percent.<sup>94</sup> With decreased repeat offending and subsequent prison stays, the costs to both society and the U.K. government associated with recidivism could be reduced.

SIBs present an innovative means of (1) enticing investors to invest in organizations working to address social or environmental issues, because of the dual potential for social and financial return, and (2) securing a large source of capital (for the duration of the bond) for nonprofits or social enterprises that would otherwise likely be forced to resort to continuous fundraising in order to continue operating. Such investments would permit social enterprises to focus more on carrying out their missions and less on raising capital. And because success in carrying out their missions generates financial return for the bond investors, this can serve to attract greater investment in future bonds.<sup>95</sup> Thus, a positive cycle can be created in which substantial capital investment raised through bonds is allocated to the nonprofits and social enterprises and enables them to scale successfully, which in turn generates financial return for the bondholders and increases the attractiveness of future investment in SIBs. Cohen and others believe that this will revolutionize the way business is done and that SIBs highlight the potential for different business models and financial instruments to facilitate social impact and government cost savings on a more meaningful scale.<sup>96</sup>

## 2. The Role of Legal Entities, Tax Implications, and How Hybrid Forms Can be Better Utilized

Nonprofit and charitable organization entity forms are established under state law.<sup>97</sup> Two major draws for ventures establishing as one of these forms are the positive ethos associated with nonprofits in the public service community and the potential federal tax benefits.<sup>98</sup> Most nonprofits are eligible for 501(c)(3) tax-exempt status; however, this status is contingent on complying with the accompanying non-distribution constraint, which dictates that no part of an organization's net earnings are provided to any private shareholder or individual.<sup>99</sup> If the distribution constraint is violated, tax-exempt status can be revoked or profits can be subjected to income tax.<sup>100</sup> Federal tax law thus incentivizes a charity or nonprofit to engage in business activities that are either related to its charitable pur-

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94. *Id.*

95. *Id.*

96. *Id.*

97. See *Choose Your Business Structure*, U.S. SMALL BUS. ADMIN., <http://www.sba.gov/category/navigation-structure/starting-managing-business/starting-business/choose-your-business-stru> (last visited Apr. 26, 2014).

98. Katz & Page, *supra* note 5, at 70.

99. I.R.C. § 501(c)(3) (2010); Treas. Reg. § 1.501(c)(3)-1(c)(2) (2008).

100. The "commerciality doctrine." Katz & Page, *supra* note 5, at 70.

pose or help to achieve its charitable or tax-exempt purpose. Federal tax law further discourages “unrelated” business activity via the Unrelated Business Income Tax (UBIT), which requires that a tax-exempt organization that engages in unrelated business activities pay corporate income tax on the profits earned by those activities.<sup>101</sup> Tax-exempt status can be similarly revoked if the organization conducts an excessive amount of unrelated business activity.<sup>102</sup> In the face of these limitations, an increasing number of nonprofits have, in recent years, embraced earned income strategies in order to reduce dependence on donations and grants.<sup>103</sup> Earned income strategies are methods nonprofits have adopted to allow them to raise funds through modes that may resemble activities that have traditionally been considered as for-profit, such as the sale of goods and services.<sup>104</sup> Earned income also provides the added benefit of expanding the “controllers’ power over their organization’s resources because earned income—unlike donations—is generally unencumbered by donor-imposed restrictions on its use.”<sup>105</sup> This flexibility is important, as nonprofits deriving a majority of their funding via restricted grants or donations may operate or utilize funds in a manner resulting in unintended violations of tax-exempt status.

Tax law and policy hold significant implications for the work of entrepreneurs and can heavily influence their decision making. For example, capital gains taxation reduces the amount of profit retained by an entity and thus influences the supply of risk capital available; investment may be depressed by limitations on the deduction of investment losses, particularly because most startups fail and experience such losses; and individuals might be deterred from working for startups because of tax policies that tax income earned from exercising stock options at the same high taxation rates as ordinary income.<sup>106</sup>

Cash flows can be increased and investment can be encouraged by tax policies that tax at the corporate level and allow tax credits during years of loss; however, tax policy does not create much of a safety net for startup businesses. Startups often generate losses for their first few years as fixed costs exceed income, and accumulate any deductions and credits they qualify for as net operating losses (NOL).<sup>107</sup> NOLs must be carried forward and can be used to offset taxable income once the entity becomes

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101. *Id.* at 79.

102. *Id.*

103. *Id.* at 60.

104. *Earned Income 101 for Nonprofits*, 4GOOD (Jan. 18, 2012), [http://nonprofitwebinars.com/past\\_webinars/1182012-earned-income-101-for-nonprofit/](http://nonprofitwebinars.com/past_webinars/1182012-earned-income-101-for-nonprofit/) (70 percent of funds raised by non-profits in 2008 came from earned income strategies).

105. Katz & Page, *supra* note 5, at 61.

106. *See* Lerner & Sahlman, *supra* note 77.

107. *See* GRANT THORNTON LLP, TIP ON TAX: MANAGING AN IMPORTANT ASSET—YOUR NET OPERATING LOSSES 1 (2012), [http://www.grantthornton.com/staticfiles/GTCom/Technology/TIP%20on%20Tax/TIPonTAX\\_Final.pdf](http://www.grantthornton.com/staticfiles/GTCom/Technology/TIP%20on%20Tax/TIPonTAX_Final.pdf) (“Many technology companies generate operating losses when developing new products. These losses can result in significant tax

profitable,<sup>108</sup> but many startups fail before becoming profitable and having the opportunity to reap such tax advantages.<sup>109</sup> This possibility may be even higher for hybrid entities that choose not to prioritize the financial bottom-line over social returns. In light of the tax drawbacks to investment and involvement in entrepreneurial ventures (which inevitably carry this risk of failure), in order to “promote entrepreneurial action, policy needs to change the after-tax payoff structure for both human and financial capital, making gains more attractive and losses less painful.”<sup>110</sup> This is particularly important for social enterprises, which are perceived to be even riskier and prone to losses than non-social impact startups as a result of their focus on social returns in addition to, rather than solely on, profits.

Increasing tax incentives amenable to investment in entrepreneurial ventures could make a world of difference for social investment. Central to this is creating tax incentives for hybrid/for-profit entities, based on their socially beneficial activities, and amending existing tax policy that disadvantages nonprofit social enterprises’ access to certain tax incentives (compared to those available to traditional for-profit entities) by virtue of their legal structures, which, for example, may prevent them from issuing shares.<sup>111</sup> As is currently being discussed in the U.K., the U.S. should consider undertaking a longer-term, strategic evaluation of tax policy to encourage the promotion and growth of investment in social ventures.<sup>112</sup>

#### a. *Hybrid Forms*

Meanwhile, for-profit social enterprises strive to achieve a “double bottom line” or even “triple bottom line” (financial, social, and environmental returns). Such an entity aims to “use business means to address social problems. . . . [U]nlike a nonprofit social enterprise, it is owned (in whole or in part) by equity investors, and one of its core goals (alongside its social purposes) is to generate returns for those investor-owners,” including founders entitled to a portion of the proceeds from the organization’s sale or initial public offering (IPO).<sup>113</sup> A critical difference between nonprofits and for-profits in the social enterprise space is the “ability of the enterprise’s founders, controllers and investors to lawfully appropriate

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savings benefits that can be used to offset future taxable income. For U.S. federal tax purposes, NOLs can be carried forward for up to 20 years.”).

108. *Id.*

109. See Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start Ups-Fail*, Wall St. J. (Sept. 20, 2012, 12:01 AM), <http://online.wsj.com/news/articles/SB10000872396390443720204578004980476429190>.

110. Lerner & Sahlman, *supra* note 76.

111. NATIONAL COUNCIL FOR VOLUNTARY ORGANISATIONS, NCVO COMMISSION ON TAX INCENTIVES FOR SOCIAL INVESTMENT 3 (2012), available at [http://www.ncvo-vol.org.uk/sites/default/files/ncvo\\_commission\\_on\\_tax\\_incentives\\_for\\_social\\_investment.pdf](http://www.ncvo-vol.org.uk/sites/default/files/ncvo_commission_on_tax_incentives_for_social_investment.pdf).

112. *Id.*

113. Katz & Page, *supra* note 5, at 62.

its surpluses for their private benefit.”<sup>114</sup> As a result, social enterprises are increasingly adopting new hybrid entity forms, which seem to allow them to present a more lucrative image to investors, as well as a socially conscious image that appeals to the public.

Social enterprises and new hybrid entities exhibiting the aforementioned double or triple bottom line business plans often no longer fall into the traditional three organizational categories—nonprofit, for-profit, or government. Even so, social enterprises have been expected to establish ways to gain access to traditional sources of capital in order to survive and scale up.<sup>115</sup> For such reasons, it is increasingly apparent that “outmoded law and inappropriate old-style legal entities hamstringing their socially transformative plans.”<sup>116</sup> In response, social entrepreneurs have expressed the desire for state corporate law and federal tax regulations to be more amenable to their dual purposes,<sup>117</sup> one example of which might be greater freedom from the perceived constraints of profit maximization,<sup>118</sup> which is typically expected by shareholders (and accommodated by board decision making) of traditional businesses.<sup>119</sup> Social entrepreneurs need both the law and lawyers to adapt to their growing needs.<sup>120</sup>

To help address their challenges, multiple states have either enacted or plan to enact various legal forms intended to promote for-profit social enterprise creation and the activities of social entrepreneurs in search of equity investment.<sup>121</sup> Among these newer legal forms are the low-profit limited liability company (L3C)<sup>122</sup> and the benefit corporation.<sup>123</sup> The L3C is an exclusively for-profit variation of the limited liability company. L3C legislation has been enacted on a state-by-state basis via amendments

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114. *Id.*

115. Kelley, *supra* note 14, at 6.

116. *Id.*

117. Steven Munch, *Improving the Benefit Corporation: How Traditional Governance Mechanisms Can Enhance the Innovative New Business Form*, 7 NW. J. L. & SOC. POL'Y. 170, 171 (2012).

118. Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board's Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 635 (2007).

119. Katz & Page, *supra* note 5, at 89.

120. THOMAS J. BILLITTERI, *MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH?* (2007), [http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New\\_Legal\\_Forms\\_Report\\_FINAL.pdf](http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf).

121. Katz & Page, *supra* note 5, at 89.

122. While the L3C was first established in Vermont in 2008, *see* VT. STAT. ANN. tit. 11, § 3001(27) (2008), eight other states have since enacted similar legislation. *See* LAWS, AMS. FOR CMTY. DEV., <http://americansforcommunitydevelopment.org/laws.html> (last visited Apr. 26, 2014).

123. The benefit corporation was first established in Maryland in 2010. *See* MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01 (West 2011). Benefit corporation legislation has since been enacted in 19 states and the District of Columbia, and introduced in 14 other states. *State by State Legislative Status*, BENEFIT CORPORATION INFORMATION CENTER, <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Oct. 11, 2013).

to each state's LLC Act, enabling established L3Cs to enjoy the flexibility and legal governance characteristics of the LLC form.<sup>124</sup> The L3C was designed as an improvement upon the LLC to benefit social ventures through positive "low profit" branding and subsequently increased funding opportunities.<sup>125</sup> Though an L3C does not qualify for tax-exempt status, it must specify a charitable purpose<sup>126</sup> to which its operations are dedicated.<sup>127</sup> This charitable purpose, combined with "low profit" branding, puts "the world on notice that the organization's central purpose is not maximizing profit" for owners,<sup>128</sup> which can reduce entrepreneurs' previously-discussed concerns regarding shareholder claims arising from failure to maximize profits.<sup>129</sup> Such branding can also garner positive attention from the public and socially-minded investors, enabling L3Cs to secure funding from foundations in the form of program-related investments (PRIs), for example.<sup>130</sup> The L3C is designed to "combin[e] the key features of the LLC with the IRS' PRI requirements,"<sup>131</sup> so as to make L3Cs appealing and overcome foundations' perceived risks or transaction costs associated with making PRIs.<sup>132</sup> L3Cs represent a symbolic step forward in the field of social enterprise, though the long-term benefit of this seemingly new means of obtaining capital will remain to be seen: the IRS still has not classified L3Cs as qualifying PRIs<sup>133</sup> and the ABA has expressed disapproval due to lack of clarity of the legal form.<sup>134</sup>

The benefit corporation, a for-profit entity structure, is also an appropriate model for companies with social and financial goals, both of which may be considered in board decision-making.<sup>135</sup> State benefit corporation statutes require that a benefit corporation express its "purpose of creating

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124. See *Laws, AMS. FOR CMTY. DEV.*, <http://americansforcommunitydevelopment.org/laws.html> (last visited Apr. 26, 2014).

125. Kelley, *supra* note 14, at 371-72.

126. This must be one of the enumerated charitable purposes laid out in the Internal Revenue Code. See VT. STAT. ANN. tit. 11, § 3001(27)(A)(i).

127. See Raz, *supra* note 42, at 297.

128. Kelley, *supra* note 14, at 372.

129. *Id.*

130. *Id.* at 371-72; Raz, *supra* note 42, at 297 ("PRIs are loans to or equity investments in either non-profits or for-profits for a charitable purpose, through which the lender or investor foundation can earn a return as long as the pursuit of the return is incidental to the charitable purpose.").

131. Kelley, *supra* note 14, at 372-73.

132. *Id.* at 372-73.

133. Raz, *supra* note 42, at 299.

134. Kelly Kleiman, *L3Cs: A Cure in Search of a Disease*, STAN. SOC. INNOVATION REV. (Mar. 5, 2013), available at [http://www.ssireview.org/blog/entry/l3cs\\_a\\_cure\\_in\\_search\\_of\\_a\\_disease](http://www.ssireview.org/blog/entry/l3cs_a_cure_in_search_of_a_disease).

135. Robert T. Esposito, *The Social Enterprise Revolution in Corporate Law: A Primer on Emerging Corporate Entities in Europe and the United States and the Case for the Benefit Corporation*, 4 WM. & MARY BUS. L. REV. 639, 695 (2013).

a general public benefit,”<sup>136</sup> defined as the “material positive impact on society and the environment” arising from the corporation’s business and operations,<sup>137</sup> in its articles of incorporation. A benefit corporation may also identify a “specific public benefit” that it aims to generate, including:

- (1) Providing low-income or underserved individuals or communities with beneficial products or services;
- (2) Promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;
- (3) Preserving or improving the environment;
- (4) Improving human health;
- (5) Promoting the arts, sciences, or advancement of knowledge;
- (6) Increasing the flow of capital to entities with a public benefit purpose; and
- (7) Conferring any other particular benefit on society or the environment.<sup>138</sup>

These specific public benefits need not be stated in the articles of incorporation, however, so the entity is not bound to achieve any *particular* social or environmental benefits. Because state benefit corporation statutes require a commitment to achieving general public benefit but not specific public benefits, they enable a benefit corporation to pursue any underlying mission, so long as it is also working toward general public benefit.<sup>139</sup> Benefit corporations, therefore, have substantial flexibility in prioritizing their activities, so long as some general benefit to society or the environment can be seen as a consequence of the business’ operations. That said, the requirement imposed on directors to create a material, positive impact (a general public benefit, and any additionally desired specific public benefits) guards against the corporation’s pursuing a very specific public benefit without regard to the other (potentially undesirable) effects that doing so might have on the public.<sup>140</sup>

Because benefit corporations need not commit to particular public benefits, such entities are potentially less accountable to their initial underlying social missions, though statutes address such issues of insufficient accountability through provisions requiring benefit corporations to maintain their corporate purpose.<sup>141</sup> The extent to which benefit corporations can prioritize fidelity to their mission over the interests of shareholders is controversial and ultimately remains to be decided by the courts; however, despite shareholder primacy and wealth maximization norms in public, for-profit companies, no state corporate statute affirmatively imposes a

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136. *Id.* at 697.

137. N.Y. BUS. CORP. LAW § 1702(b) (McKinney 2012).

138. Esposito, *supra* note 135, at 698.

139. William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 838-42 (2012).

140. Briana Cummings, *Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest*, 112 COLUM. L. REV. 578, 592-93 (2012).

141. Esposito, *supra* note 135, at 698.

requirement that directors maximize shareholder wealth.<sup>142</sup> Further, constituency statutes allow directors of corporations to consider the interests of non-shareholders in their decision making, regardless of directors' (perceived) duty to maximize shareholder value.<sup>143</sup> Thus, in satisfying their fiduciary duties, corporate directors have the flexibility to look beyond shareholders' financial interests in their decision making, and benefit corporation directors have an additional duty, derived from their required commitment to their broad social purpose, to consider various stakeholder groups, such as employees, subsidiaries, suppliers, customer beneficiaries of the benefit corporation's general or specific public benefit purposes, the community, the environment, and society at large.<sup>144</sup> No group is specifically designated to take precedence over another, so the board can prioritize decision making in regards to impact on different stakeholders as it deems appropriate.<sup>145</sup>

Like the L3C, benefit corporation statutes also offer positive branding to socially-minded businesses. This branding can garner positive consumer and investor attention, as well as eligibility to issue equity, secure debt financing, and obtain PRIs.<sup>146</sup> However, because benefit corporations are not required to specify a *particular* social mission and are annually required to self-report only whether they are promoting general public benefit, not all benefit corporations are true social enterprises.<sup>147</sup> Ultimately, while benefit corporations can benefit from the "feel good" label associated with the entity status, there is little guaranteed *external* oversight or protection of the social element of the business to comfort its socially-minded shareholders or investors. Though shareholders of benefit corporations have litigation rights, "they face substantial obstacles in challenging the directorial action—including the formidable business judgment rule, demand requirements, and other procedural hurdles"<sup>148</sup> of derivative litigation. Even though directors are insulated from shareholder deriva-

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142. Though state statutory law does not require corporations to maximize shareholder value, some case law does, in fact, impose a duty on directors to prioritize the interests of shareholder wealth over the interests of non-shareholders in certain circumstances. See *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 43-44 (Del. 1993) (when there is a change of control in a company); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) (when a company is for sale).

143. Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 460-61 (2002).

144. MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1) (LexisNexis 2011); N.J. STAT. ANN. § 14A:18-6(a) (West 2011); VT. STAT. ANN. tit. 11A, § 21.09(a)(1)(C) (2011); VA. CODE ANN. § 13.1-788(A)(1) (2011).

145. Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591 (2011); Cummings, *supra* 140, at 606.

146. *Id.* at 302 (explaining that a benefit corporation must show its activity is in furtherance of a charitable purpose in order to qualify for foundation PRIs).

147. Raz, *supra* note 42, at 302.

148. Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 641 (2010) [hereinafter Brakman Reiser, *Blended Enterprise*].

tive liability for making social or environmentally-related business decisions to the detriment of profit maximization,<sup>149</sup> it is still in the hands of shareholders to enforce the achievement of general public benefit<sup>150</sup> by voicing any concerns and holding directors accountable for relevant decision making. The issue here is that shareholders may lack or lose interest in the public benefit mission and demand that officers and directors prioritize profit maximization,<sup>151</sup> as in a traditional corporate entity. Directors who fear the threat of shareholder claims for making business decisions that favor mission over profit may be less willing to risk such activity.

Though not a legal form, the B Corporation (B Corp) is an interesting, related innovation. B Lab, a nonprofit that initially lobbied for the creation of the benefit corporation form, created a third-party accreditation scheme certifying companies as B Corps if they meet standards of social and environmental performance, transparency, and accountability.<sup>152</sup> Certification for a company (which does not have to be a benefit corporation) is contingent on fulfilling compliance standards for its business operations and fidelity to social mission.<sup>153</sup> Essentially, the B Corp “stamp” is a branding tool for companies that wish to be perceived by investors and the public as genuinely socially-minded businesses.<sup>154</sup> However, B Corp certification does not entitle companies to any special tax treatment, because it is self-imposed and privately regulated by B Lab.<sup>155</sup> Ultimately, while B Corp certification provides another form of feel-good branding for a company, it does not seem to offer much in the way of meaningful legal protections or assurances to non-shareholder constituencies.<sup>156</sup> For example, the certification does not provide stakeholders with a right of action against the B Corp if they believe that directors are not considering stakeholder interests in their business decisions, unlike the rights provided by the articles of incorporation of a registered benefit corporation.<sup>157</sup> As far as balancing protection for social mission, directorial discretion, and socially- vs. non-socially-minded shareholder interests, both the benefit corporation and B Corp certification leave something to be desired for long-term sustainability of social enterprises.

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149. Raz, *supra* note 42, at 304.

150. *E.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(b) (West 2011) (a benefit corporation's directors have no duties to the beneficiaries of the public benefit created by the entity).

151. Raz, *supra* note 42, at 305.

152. *What are B Corps?*, CERTIFIED. B. CORP., <http://www.bcorporation.net/what-are-b-corps> (last visited Oct. 10, 2013).

153. Katz & Page, *supra* note 5, at 89.

154. Kelley, *supra* note 14, at 377.

155. Brakman Reiser, *Blended Enterprise*, *supra* note 148, at 637.

156. Though socially or environmentally motivated shareholders who invest in a B Corporation could serve as a proxy for other stakeholder constituencies, such non-shareholders have no standing to litigate against the entity. *Id.* at 641-42.

157. *Id.* at 640-41.



The flexible purpose corporation (FPC), established by the California Corporate Flexibility Act of 2011, is the newest hybrid form and is designed to enable a company to pursue both a business purpose and special purpose(s).<sup>158</sup> Dana Brakman Reiser states that the FPC falls between the L3C and the benefit corporation on a “spectrum of flexibility.”<sup>159</sup> Like an L3C, the FPC provides “significant flexibility and discretion for founders and directors,” as well as the “expansive rights, power and protections for shareholder investors” characteristic of the benefit corporation.<sup>160</sup> The California legislation establishes more extensive reporting requirements<sup>161</sup> than those required for traditional corporations, does not require any specific prioritization of the business purpose and special purpose(s), and grants FPC directors additional discretion<sup>162</sup> to pursue decision making based on interests beyond those of shareholders,<sup>163</sup> similar to the provisions of constituency statutes. However, the directorial protection codified in the California statute does not translate to unbounded directorial discretion; rather, it just provides the FPC “permission to consider the special purpose or purposes stated in an FPC’s articles of incorporation.”<sup>164</sup> This is in direct contrast to the benefit corporation *requirement* that directors consider non-shareholder interests in their business decisions.<sup>165</sup> Additionally, while benefit corporation directors must consider a wide range of non-shareholder interests and are not required to prioritize these interests in a particular manner or to disclose plans for prioritization, FPC directors may only choose to consider non-shareholder interests that are related to the special purpose(s) laid out in the FPC’s articles of incorporation.<sup>166</sup>

The comparatively more limited, specific requirements for FPC governance suggest better guidance and perhaps more manageable duties for FPC directors engaging in business decision-making.<sup>167</sup> Further, if the FPC’s business purpose and special purpose(s) are ever at odds, directors and officers can make business decisions that they deem appropriate with-

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158. S.B. 201, 2011-2012 Legis. Sess. (Cal. 2011).

159. Dana Brakman Reiser, *The Next Big Thing: Flexible Purpose Corporations* 4 (Brooklyn Law Sch. Legal Studies Research Paper No. 311) [hereinafter Brakman Reiser, *The Next Big Thing*], available at <http://ssrn.com/abstract=2166474>.

160. *Id.*

161. CAL. CORP. CODE § 3500 (2012).

162. *See id.* § 2700(c) (“In discharging his or her duties, a director may consider those factors, and give weight to those factors, as the director deems relevant, including the short-term and long-term prospects of the flexible purpose corporation, the best interests of the flexible purpose corporation and its shareholders, and the purposes of the flexible purpose corporation as set forth in its articles”).

163. Brakman Reiser, *The Next Big Thing*, *supra* note 159, at 10.

164. *Id.* at 11.

165. *Benefit Corp vs. Certified B Corp*, BENEFIT CORP. INFO. CTR., <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Oct. 11, 2013).

166. Brakman Reiser, *The Next Big Thing*, *supra* note 159, at 12.

167. *See id.* at 11.

out the threat of being easily challenged by shareholders.<sup>168</sup> Thus, this flexibility might ultimately make it difficult for shareholders to bring duty of care claims against the directors for ordinary business decisions, since the directors are likely to be protected by the business judgment rule.<sup>169</sup> Though monitoring and enforcement of FPC directors' duties rests solely on shareholders, Brakman Reiser argues that they have weak legal tools to enforce the blended mission mandate against "ordinary hazards."<sup>170</sup> Fortunately, shareholders do hold much greater legal power in situations where the FPC abandons its dedication to its special purpose(s) or its blended mission; a two-thirds majority vote is required to consent to such decisions.<sup>171</sup> Ultimately, Brakman Reiser questions whether there are sufficient incentives for shareholders to thoroughly consider the information from FPC disclosures and proactively police an FPC's blended mission,<sup>172</sup> so as to promote accountability.

While these new legal forms have helped some social enterprises to secure the investment and consumer support necessary to thrive, investors may still remain skeptical of the value such entities can offer. Endeavor, an organization that helps entrepreneurs access global capital markets to fuel growth in employment and social impact, has found that the manner in which social entrepreneurs leading social enterprises "make tradeoffs between social and financial goals is a critical factor in determining the degree to which their companies will grow."<sup>173</sup> Endeavor advocates for social entrepreneurs to design business models that closely align desired financial and social goals in order to minimize tradeoffs and friction arising from the competing objectives. It recommends dealing with these tradeoffs by prioritizing financial goals to maximize long-term sustainability and found that enterprises that do so are more likely to grow and achieve greater social impact.<sup>174</sup> While the new hybrid forms are a step in the right direction toward managing such tradeoffs, corporate governance clearly remains an open issue, and these legal forms' long-term contributions to the growth and sustainability of social enterprise are yet to be seen. Certainly, more lawyers must learn about and grasp the benefits of utilizing legal entities creatively so as to manage such competing priorities and help their social enterprise clients position themselves for successful investment and scaling.

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168. *See id.* at 12.

169. Assuming directors can argue that good faith decision-making favoring the business purpose over specific purpose (or vice versa) does not preclude achieving the other type of purpose, it would seem fairly simple for directors to satisfy the business judgment rule and show informed judgment and decision making in the best interest of the company. *Id.* at 17.

170. *Id.* at 19.

171. *Id.* at 15.

172. Brakman Reiser, *The Next Big Thing*, *supra* note 159, at 20.

173. Rottenberg & Morris, *supra* note 60.

174. *See id.*

### 3. Securities Regulations

In addition to differing tax treatments and governance duties for the various legal entity choices, there are also varying securities implications for the investment in, and consequent survival of, social enterprises. “[T]he federal securities regulation status of interests in for-profit social enterprise ventures is important for choice-of-entity reasons . . . [,]for capital-structuring reasons within individual forms of entity, and for risk-management reasons at the entity level.”<sup>175</sup> Just as federal securities regulation plays into entity choice, the increasing presence of hybrid legal forms and the differences amongst them additionally complicate securities regulation, where “[t]he current financial regulatory system depends on labeling interests and instruments by their specific type as a means of determining the form and manner of regulation.”<sup>176</sup> The variety of state statutes under which entities can be established creates further inconsistency. It has been suggested that adoption of standardized entity forms for social enterprises across states could potentially lead to greater clarity as to how to treat the securities issued by various entity forms (i.e., as for nonprofits vs. for profits).<sup>177</sup>

Financial instruments generating financial return to the instrument holder are typically treated as securities under federal law (the Securities Act of 1933 and the Securities Exchange Act of 1934);<sup>178</sup> for-profit social enterprises fall under this category, even if they do not end up generating financial return. However, in the interest of not unduly burdening organizations with charitable purposes, nonprofits issuing financial instruments are generally granted privileges and registration exemptions. As for-profit social enterprises have a social benefit purpose and may issue securities with little profit potential, similar disclosure exemptions under the aforementioned Acts could eliminate some of the time-intensive and financially burdensome disclosures that could otherwise discourage social entrepreneurs from establishing as for-profits.<sup>179</sup> Thus, similar exemptions as those provided to nonprofits could encourage social enterprises “by decreasing the cost of raising capital from the public.”<sup>180</sup> Additional securities-related limitations on social venture startups trace back to the early 2000s. An increase in securities regulations introduced in the Sarbanes-Oxley Act of 2002<sup>181</sup> stifled venture capital investment in startups perceived to have potential difficulty meeting the then-newly-mandated compliance require-

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175. Joan M. Heminway, *To Be or Not to Be (A Security): Funding For-Profit Social Enterprises*, 25 *Regent U. L. Rev.* 299, 305 (2013).

176. *Id.* at 326-27.

177. *See id.* at 327.

178. *See id.*; 15 U.S.C. §§ 77a-77aa (2006 & Supp. V 2011); 15 U.S.C. §§ 78a-78pp (2006 & Supp. V 2011).

179. Heminway, *supra* note 175, at 325.

180. *Id.*

181. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

ments,<sup>182</sup> such as § 404(b),<sup>183</sup> within a short period of time. Such startups necessarily became less attractive for investment, and social enterprises fell squarely within that category of organizations. Fortunately, the Jumpstart Our Business Startups Act (JOBS Act)<sup>184</sup> now exempts emerging growth companies from the aforementioned compliance requirement for a few years.<sup>185</sup> One of the underlying purposes of the JOBS Act is to increase entrepreneurs' access to capital and investment funding by reducing such securities regulations faced by small businesses like social enterprises. Despite the goals of the JOBS Act, the various fees that still must be paid by such enterprises might still not be low enough to benefit them. The potential benefits of the JOBS Act may similarly be threatened by the implications of a particular provision in the 2010 Dodd-Frank Act.<sup>186</sup> Section 415 required Congress to study whether the existing criteria for accredited investor status should be amended.<sup>187</sup> The purpose of the accredited investor standard is "to protect investors by allowing only those who can withstand financial losses access to unregistered securities offerings" and to "streamline capital formation for small business."<sup>188</sup> Regarding amendment, there was speculation that the North American Securities Administrators Association (NASAA) would push for a General Accounting Office (GAO) recommendation that Congress raise the net income and net worth thresholds qualifying individuals as accredited investors.<sup>189</sup>

Fortunately, in July 2013, the GAO released its findings and recognized that the aforementioned changes in the accredited investor standard could significantly reduce the existing pool of qualified angel investors,<sup>190</sup> thereby reducing entrepreneurs' access to a significant source of early-stage capital. The GAO recommended that the SEC consider additional criteria for satisfying the accredited investor standard (beyond net worth),

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182. This requires costly and time-consuming external audits of internal controls—especially burdensome for small businesses.

183. Sarbanes-Oxley Act of 2002 § 404(b), 15 U.S.C. § 7262(b) (2012).

184. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

185. *Id.* § 103.

186. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

187. *Id.* § 415.

188. U.S. GOV'T ACCOUNTABILITY OFFICE, REP. NO. GAO-13-640, ALTERNATIVE CRITERIA FOR QUALIFYING AS AN ACCREDITED INVESTOR SHOULD BE CONSIDERED (2013) [hereinafter GAO REP.], <http://gao.gov/assets/660/655963.pdf>.

189. Catherine Mott, *Dodd-Frank Rears its Ugly Head*, ANGEL CAP. ASS'N (Jun. 17, 2013), <http://www.angelcapitalassociation.org/blog/dodd-frank-rears-its-ugly-head>. Such proposed changes arose in response to concerns that an increasing and perhaps inflated number of individuals have qualified as accredited investors based on their net worth, due to the fact that the standard had not been updated since the 1980s (save excluding the value of an individual's primary residence from his net worth). GAO REP., *supra* note 188.

190. GAO REP., *supra* note 188, at 18.

such as identified liquid investments and the use of a registered advisor.<sup>191</sup> The SEC agreed with the GAO's recommendations, though it remains to be seen whether more stringent thresholds in the name of investor protection may arise in the future. Though social enterprise startups are not traditional or public companies, they are still as highly interconnected with and affected by the state of securities regulation as the corporate law and tax regimes.

#### B. *Is Crowdsourcing Capital/Crowdfunding Part of the Solution?*

The financial crisis in the past decade has increased pressure for social entrepreneurs to obtain creative sources of financing, given the need for reduced public sector spending to avoid amplifying high governmental debt.<sup>192</sup> This has raised the stakes for social entrepreneurs and made it necessary for them to look to alternative funding sources. Crowdfunding is the concept of targeting a large, disperse population of individuals from whom to raise small amounts of money for the ultimate purpose of raising a large aggregate sum to support a particular venture.<sup>193</sup> It is yet a controversial practice that is believed by some to unlock great potential for funding social entrepreneurial endeavors. Despite the sparse academic literature on the implications of crowdfunding for the benefit of social enterprises,<sup>194</sup> crowdfunding does seem to provide a valuable alternative to the investment methods described herein, as it relies on the small funding decisions of individual crowd investors who look more to the core values of a social enterprise and its mission, rather than exhaustively analyzing its business plan, assets, etc.<sup>195</sup>

Since the JOBS Act was signed into law in 2012 and lifted the ban on startups seeking investment from non-accredited investor individuals (i.e., individuals of the general public), the use of crowdfunding platforms like Kickstarter, Indiegogo, and others has increased as a means of funding small businesses and nonprofits.<sup>196</sup> Fundable, which was launched in conjunction with the JOBS Act, is the first equity crowdfunding platform, and others are anticipated to arise. However, though the Act required their release by December 2012,<sup>197</sup> the SEC has yet to promulgate its final regulations of Title II and Title III, which will address the protection of investors and encouragement of startup investment, particularly via the use of crowdfunding platforms. Currently, however, only high income, high net worth investors can legally invest via crowdfunding sites, though the afore-

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191. *Id.* at 29. The GAO proposed that such alternative criteria could effectively balance the accredited investor standard's dual purposes of investor protection and capital formation.

192. Lehner, *supra* note 35, at 2.

193. *Id.*

194. *Id.*

195. *Id.*

196. Farrell, *supra* note 59.

197. Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012).

mentioned regulations are expected to open crowdfunding to all potential investors.<sup>198</sup> A critical purpose of the SEC regulations is to safeguard investors through various strategies, including restricting the amount individuals can annually invest through crowdfunding (thereby limiting foreseeable financial losses arising from high-risk startup investments), engaging crowdfunding intermediaries in preventing fraud by startups, and generally protecting the unsophisticated investor.<sup>199</sup> The currently proposed regulations<sup>200</sup> remain inadequate for achieving their protective purpose.<sup>201</sup>

The Investor Advisory Committee<sup>202</sup> recommends amendment of the proposed regulations to better protect unsophisticated, low net worth investors from the inherent risks associated with allowing “early stage startup companies to sell securities [to such investors] based on limited information[.]”<sup>203</sup> Changes the Committee believes necessary to help ensure investors better “understand the risks of crowdfunding and avoid unaffordable financial losses” include: setting tighter investment limits for investors; strengthening the enforcement mechanisms for investment limits; requiring investors to agree to electronic delivery of disclosures, and clarifying and strengthening the obligations of intermediaries to prevent fraudulent offerings and to help ensure startups’ compliance with crowdfunding title and regulations.<sup>204</sup>

Ultimately, if the regulations create greater formal allowances of equity crowdfunding platforms, there must also be adequate protection for the community of non-accredited, lower net worth, and inevitably less sophisticated investors that will have access to such platforms. It remains to be seen whether the regulations will be successfully designed and implemented to provide “reasonable investor protections, and the fair and cost-effective marketplace, necessary to ensure [crowdfunding’s] viability as a small company capital formation tool.”<sup>205</sup> Ideally, they will succeed in

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198. *How to Harm Investors*, N.Y. TIMES (Mar. 29, 2014), <http://www.nytimes.com/2014/03/30/opinion/sunday/how-to-harm-investors.html>.

199. *Id.*

200. Crowdfunding, Securities Act Release No. 33-9470, Exchange Act Release No. 34-70741, 78 Fed. Reg. 66,428 (proposed Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200 et seq.).

201. *How to Harm Investors*, N.Y. TIMES (Mar. 29, 2014), <http://www.nytimes.com/2014/03/30/opinion/sunday/how-to-harm-investors.html>; *see also* U.S. SEC. EXCH. COMM’N INVESTOR ADVISORY COMMITTEE, RECOMMENDATION OF THE INVESTOR ADVISORY COMMITTEE: CROWDFUNDING REGULATIONS (2014) [hereinafter CROWDFUNDING RECOMMENDATIONS], available at <http://www.sec.gov/spotlight/investor-advisory-committee-2012/investment-adviser-crowdfunding-recommendation.pdf>.

202. Established by the Dodd-Frank Act to advise the SEC on regulatory priorities and the protection of investor interests. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 911, 124 Stat. 1376, 1822 (2010).

203. CROWDFUNDING RECOMMENDATIONS, *supra* note 201.

204. *Id.*

205. *Id.*

achieving such objectives and promoting investor confidence in crowdfunding, thereby increasing the diversity of funding available to small businesses and social entrepreneurs in the market. This could unlock a significantly larger pool of capital for social enterprises to access in the long-term, regardless of entity structure.

## V. CONCLUSION

It is an exciting time for the world of social enterprise and the role the law and legal professionals can play in helping shape the space. Building upon positives steps forward in terms of the evolution of hybrid legal forms, relaxed securities regulations, and crowdsourcing, greater attention must be dedicated toward creating an enabling ecosystem for investment in social enterprise. As stated by Cohen and Sahlman, “[i]f investors can find the same courage the early institutional backers of the venture capital industry found, we will see talented social entrepreneurs build large, effective organizations that move the needle on a social issue and deliver acceptable financial returns at the same time.”<sup>206</sup> Further, just as the venture capital industry incited a new approach to investing in innovation via the funding of private sector startups, impact investment is increasingly providing opportunities for driving innovation for social benefit through entrepreneurial engagement and capital markets.<sup>207</sup>

Ultimately, academics, practitioners, and entrepreneurs alike must share lessons learned and successful outcomes achieved by social ventures and initiatives such as low-risk social impact bonds that generate returns. This will facilitate the continued development of a more well-defined space and rich interprofessional community around social enterprise. Meanwhile, as the field grows and more successes are achieved through innovative structuring and financing mechanisms, private investor confidence will grow and so too will the capital accessible to social enterprise.

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206. Cohen & Sahlman, *supra* note 15.

207. *Id.*