Feeding the Social Enterprise Zoo: Variants between Corporate Forms

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INTRODUCTION

The term “social enterprise” has had immense growth in popularity for the last fifteen years (Wolk, 2007); however, the concept still does not have a definition which receives unanimous consent. Though the core tenet of the concept – commercial activity for social betterment – is not in dispute, it is the operationalization and classification of actual entities which cause disagreement. Should nonprofits be considered social enterprise, or should the potential to realize a profit be a prerequisite? Must an organization be a standalone corporate entity to be a social enterprise, or can one qualify as a tandem structure between two or more organizations, or as a department or subsidiary within a larger organization, such as the certification of Ben & Jerry’s (a division of Unilever) as a B Corp? As academics and professionals charged with offering advice based on an understanding of the sector, how can we proceed without an adequate definition of what we are experts on?

There are three definitions which have received attention in the literature that will be addressed here. The first is the definition adopted by Social Enterprise UK. It consists of six principles:

1. Have a clear social and/or environmental mission set out in their governing documents
2. Generate the majority of their income through trade
3. Reinvest the majority of their profits
4. Be autonomous of state
5. Be majority controlled in the interests of the social mission
6. Be accountable and transparent (Social Enterprise UK, 2012)

These are all generally accepted as guiding themes by the sector at large; however, it does not offer any guidance as to the more specific questions we outline regarding corporate form.

The second is the definition offered by Martin and Osberg (2007). Unlike some of the operational terms regarding profits that are offered by Social Enterprise UK, Martin and Osberg (2007) utilize the motivations behind the formation of the social enterprise: the targeting of an unacceptable equilibrium, a founder who uses their unique personal characteristics for change, and the creation of a new equilibrium that is more desirable than the first. Though this emphasizes the motivational aspect of social enterprise formation, I find two difficulties. The first is that the definition is only applicable ex post, relying on the success of the idea as to the degree of impact on a new equilibrium. This means that applying for funding meant specifically for social enterprise becomes problematic, since classification as such cannot occur until after the deployment and assessment of the intervention. Second, it is not necessary that the innovation be society-altering in order to be considered a social enterprise. Mohammed Yunus did not initially begin the method of microfinance and village banking as a world-wide panacea, but rather to address a particular set of needs in a group of women in a nearby village. The idea turned out to be highly scalable, but the Martin and Osberg definition begs the questions of whether microfinance was a social enterprise before it was scaled up. Since I am inclined to believe that it is, we must search for another definition.

Finally, there is the definition of the “zoo school” of social enterprise, which maintains the importance of heterogeneity within the ranks of social enterprise as a feature integral to the sector.

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1 We hold with Alter’s (2004) assessment of social enterprise as the “institutional expression” of the social entrepreneur, allowing a certain degree of interchangeability between the scholarship regarding the two activities.
Young and Lecy (2012) describe the social enterprise sector as one with internal and external boundaries, but without exclusion based on corporate types, missions, eventual efficacy, scope of impact, or funding resources. Instead, these parameters can be used to construct the inner boundaries, depending on what the needs of the classification system are. Similar to Frumkin’s (2002) approach to sectoral diversity, this definition allows us to keep a fluid and thriving ecosystem in place at the forefront of the definition, but still gives a number of potential frameworks for operationalization.

As practitioners and academic researchers involved in the social enterprise sector, we can be thought of as the zoologists responsible for determining the care and feeding of an assortment of corporate species, several of which are what Alter (2004) calls “new institutional animal[s].” Even though the day-to-day care may fall to practitioner zookeepers, what zoologists learn about the structure, behavior, and needs of the forms guide the practice of caring for the diverse range of species. Of the practitioner zookeeper concerns, there are two which are paramount: what does the animal eat, and how do we keep the animals from eating each other? It is the first of these questions that will be answered in this study. By subdividing the social enterprise zoo into funding (“food”) types, we can preserve the ecosystem while continuing to nourish the unique species contained there. First, we will look at the general classifications of social enterprises in the United States context and which funding types they tend to concentrate on; this is followed by a discussion of nine unique types of capital and their appropriateness to each corporate form. Implications for the funding of a diverse social enterprise sector conclude.
1. ORGANIZATIONAL SPECIES

1.1. Nonprofit:

The nonprofit corporate entities are the gentle herbivores of the social enterprise animal kingdom. A nonprofit corporate type is distinguishable from a for-profit in several ways. First, there is no ownership of the company in the form of any stock or equity. Second and related to this, there are no profit distributions – any operating profit that the nonprofit sees is folded back into the nonprofit. Most nonprofits take the additional step of filing for charitable status, which excludes them from having to pay taxes on mission-related activities and allows those that donate to them to write off their donation (in some form) on their own taxes; this applies to both private and corporate donations. Because of this tax treatment and the nondistribution constraints, any assets left after the dissolution of a nonprofit must continue on to another nonprofit entity. Further, the inability to market and sell equity makes financing which traditionally relies on this mechanism, such as venture capital funding or loans, often very difficult to secure.

What does a nonprofit enterprise in our zoo eat? According to the Stanford Social Innovation Review, 40 percent of high growth nonprofits receive most of their funding from the government, followed by service fees (33 percent), corporate giving (19 percent), individuals (6 percent), and foundations (2 percent) (Foster & Fine, 2007). However, if we turn our attention to the nonprofit section of the social enterprise zoo rather than the nonprofit sector at large, service fees should account for a larger percentage; if we are adhering to the notion that market mechanisms should be a significant (or even present) source of revenue for social enterprise, then this will exclude at least some of the more philanthropically-based nonprofits. Social enterprise, when in nonprofit form, often appears as organization-wide or internal commercial ventures; a nonprofit or for-profit subsidiaries of the organization; or a working relationship with a for-profit business in activities such as cause-related marketing (Kerlin, 2006). Even for the nonprofit sector as a whole, Young (1998) finds that commercial revenue growth not only accounts for the largest source of nonprofit revenue for the sector at large (not just the fastest-growing nonprofits), but also was the most rapidly growing source of revenue. Therefore, the nonprofit social enterprise species can and often do include commercial revenues, but they often have a diet with much more variety than for-profit or hybrid forms.

1.2. For-profit:

For-profit corporations can be thought of as the stereotypical carnivore, prowling the market in search of commercial revenues and service fees. Though not precluding any sort of private donations or grants, the lack of a tax incentive to give (not to mention the lack of regulations to keep the owners from absconding with the money) hamstring efforts for socially-minded for-profits to attract this type of funding. However, the ability to offer equity which can both command a dividend and appreciate in value opens the door to the types of equity-based funding that nonprofits have difficulty in utilizing. Even when regulations or definitions such as those in the U.K. prevent the distribution of profits from social enterprises, the ability for equity to appreciate or be sold in cases of liquidation make securing funding of this type much easier.

1.3. Hybrids:

In the last decade, there has been a surge of creativity in response to the rising sense of corporate social responsibility and the blending of lines between the public, private, and nonprofit sectors. Though not as strong as some of the social enterprise movements in Europe, where established legal structures such as co-operatives and community benefit societies have shown that a new alternative to traditional charities can thrive, the social enterprise movement into unique forms of omnivorous
corporate entities is proof that the United States is growing. As it does, the demand for legal structures can attract a greater diversity of funding opportunities.

**Tandems:** Long before the benefit corporations and L3C’s were conceived of, individuals with both charitable and commercial interests had avenues of cooperation to pursue. A great deal of scholastic literature has been devoted to partnerships between the public, private, and nonprofit sectors; however, the majority of this has addressed contractual relationships which are project- or campaign-based, such as the partnership between Yoplait Yogurt and Susan G. Komen for the Cure for breast cancer awareness and research (Andreasen, 1996; Frumkin, 2002; Serban, 2011; Sinclair & Galaskiewicz, 1996). Considerably less study has been made of the more permanent tandem corporate relationships, which allows the long-term pursuit of goals to be achieved through mutual specialization. These, more so than the project-based teams, are both what have inspired the more permanent fusions of non- and for-profit hybrid entities and what can give us an indication of the regulatory problems that any hybrid corporate form is going to face.

The perils of tandem structures are heavily dependent on which forms which they are comprised of. First, there is the parent-child relationship, which can arise in several ways. A nonprofit could have a desire to launch a social enterprise line of activities that it would like to house in a commercial setting: this could be a museum’s gift shop or the micro-financing activity of a large INGO. In either situation, there is a potential need to insulate the parent nonprofit from the liability (whether physical or financial) of the subsidiary activity, in addition to the benefits of separate financials. Less often, a for-profit corporation will be interested in opening a nonprofit subsidiary; though possible, this is generally not advisable since the nonprofit needs to show clear independence and mission, which can be difficult if authority lies with a parent for-profit (Mittermaier & Neugart, 2011).

A second use is the brother-sister relationship, which can occur with or without a controlling “parent” organization. This is the more common form of for-profit-driven partnerships, such as those corporations who wish to have a dedicated foundation with which to direct the company’s charitable giving. Since it is important to keep the boards of the two companies predominantly separate from each other, this relationship can suffer from the opposite problem of the first: the autonomy granted to each organization gives each the ability to drift from the other.

Third, in all of these situations, special mention should be made as to the role of limited liability corporations (“LLCs”). With a single-member LLC, this will allow pass-through taxation to the parent organization. Should this parent be a 501c3 nonprofit, this means that the incomes reported by the LLC would pass through directly; provided that the income was considered related to the purpose of the nonprofit, this revenue would be tax-free. The deductibility of the 501c3 charitable status also flows downward through the LLC, allowing those who donated to the LLC to also write such contributions off on their taxes. This attribute in addition to the liability protection afforded to the LLC’s activities makes this a particularly attractive and popular option. However, it is unlikely that the commercial venture would have been encapsulated in an LLC unless the activity was likely unrelated to the nonprofit mission and therefore subject to unrelated business income tax (UBIT); in this case, the contribution of the taxable revenue to the overall financial portfolio of the nonprofit should be monitored to avoid the potential loss of tax-exempt status ("Announcement 99-102, 1999-2 C.B. 545 ", 1999; McCray & Thomas, 2001).

As evidenced, the tandem hybrid form is at best unwieldy, at worst an expedited method of losing nonprofit status due to revenues from commercial activities unrelated to the mission of the nonprofit. However, there are definite synergies to the approach: the tax exemption of the nonprofit and the commercial revenue of the for-profit could produce great societal good so long as there was some form of regulatory protection against those who would use the form for unscrupulous ends. Further, there are forms of funding unique to each type of organization that could be used to further the social mission. Accordingly, in 2008 and 2010, unique corporate forms that attempted to rectify the profit/social dichotomy were first signed into law as low-profit limited liability companies and benefit
corporations, respectively. Each was designed to address the dichotomy using slightly different means, but still stem from the same frustration with established corporate structures.²

L3C: Though most individuals associate the hybrid movement with the expansion of corporate definition, the low-profit limited liability company (L3C) is a corporate form that deliberately restrains the flexible nature of the limited liability company. Whereas in several states LLCs can legally operate with “any lawful purpose” in their Articles of Organization, L3Cs must utilize the wording of Reg. 53.4944-3 Exception for Program-Related Investments (Brewer, 2012). This adaptation means that the ability to qualify for a program-related investment (PRI), a potentially lucrative type of finance discussed later in the paper, is baked into the corporate structure; how advantageous this is will depend on whether the PRI investment vehicle gains additional proponents. However, even without PRIs, L3Cs have the same streamlined managerial and maintenance needs as the LLC, which is an advantage to those entrepreneurs who would like an enterprise smaller in scope. Further, it can attract some types of private investment through offering a limited partnership in the business, but this is often not a popular option for individuals and firms who wish to invest due to the flow-through treatment of taxes to all partners. However, for those who are interested in writing off some of the probable losses from the first few years, this could be a benefit; Mancuso (2008), in his well-known line of Nolo do-it-yourself corporate series, recommends beginning a start-up as an LLC and then converting to a corporation for the “building” phase. Further, as Tyler (2010) suggests, there is a marketing benefit to being an L3C, which means that they could be capable of attracting investment which would normally not have been invested in an LLC.

Benefit Corporations: Benefit corporations, though stemming from the same frustration with established corporate forms as L3Cs, arose in a very different fashion. Rather than restricting an existing form of corporate entity, benefit corporations expand their business purpose from shareholder maximization to the achievement of a “general public benefit” (Munch, 2012; Reiser, 2011). By including this verbiage in the Articles of Incorporation, the owners are seeking protection from potential lawsuits alleging breach of fiduciary duty since the motive of profit maximization was not being held paramount. Such fears stem originally from Dodge v Ford (“Dodge v. Ford Motor Company”, 1919), where the Dodge brothers successfully sued Henry Ford for flaunting his social goals above the financial interests of the shareholders. Though the salience of the threat is hotly debated in the field, the presence of ambiguity means that risk-averse potential founders may be looking for more solid legal protection. As the numbers of formal incorporations increase, the initial legitimacy issues regarding the new organizational form should ebb, allowing a large amount of private capital and financial involvement.

2. SURVEY OF FINANCIAL INSTRUMENTS

Entrepreneurs, whether socially-minded or otherwise, have a wide variety of different funding options in order to realize their goals. None of the options are easy – even tools that are administratively easy to handle, such as asking friends and family, can come with potentially large risks in other ways. However, there is a subset which is particularly popular and helpful, though not all are well-known.

² There are other “hybrid” corporate structures such as the flexible purpose corporation in the U.S., and several others in the UK and Europe. We will concentrate on these two hybrid forms since they are both the most well-known, and because they are significantly differentiated from the standard corporate types and each other.
This section will conduct a brief survey of the more popular and versatile sources of funding for social enterprises of both for-profit, nonprofit, and hybrid species. This list is not exhaustive: creative options such as barter, supplier agreements, strategic alliances, mergers, and several other potential avenues exist. Further, as shown in Figure 2, there are types of funding which are better suited to certain stages in the life cycle of an enterprise. However, the following is a basic guide to the potential social entrepreneur.

**Angel Investment**: Angels, as befits their name, are beneficent individuals who wish to invest time and energy into an enterprise of their choosing; they are not philanthropists, instead seeking personal financial return on their investment. Also, unlike venture capital and commercial loans that are distributed through brokers, angel investors are normally individuals who are investing their own wealth; this greater degree of autonomy with their own accounts translates into a greater degree of control expected as an exchange for the capital. There is little academic research on angel investment due to the highly personal nature of the activities, though there have been suggestions regarding an investment-centered approach that appear promising (Mason & Harrison, 2008). Resources to help locate an angel, however, are numerous using online resources.

There are definite advantages to angel funding. First, they will often fund earlier stages of the company than other large single investors, such as venture capitalists or venture philanthropists. Though this doesn’t normally extend to the proof of concept phase, it may. This can lead to complementarities between the angel and venture capital markets since the infant companies receive the initial growth money, then use this to strengthen their capacity in anticipation of sequential funding from venture capitalists (J. Freear & Wetzel, 1990). Further, the time and money that the negotiations require are often less for angels than for venture capital (John Freear, Sohl, & Wetzel, 1995). Since they are a more informal type of financing, however, this means that angel investment can be more difficult to find. This is being ameliorated somewhat by the appearance of angel training programs (such as Pipeline) and the formation of angel groups (such as Angel Lounge). However, as the supply of angel funding becomes more prevalent, so does the competition for funding.

Angels often require (in addition to the debt, equity, or convertible instruments being bought with the cash) a large role in the company’s decision choices; though this is often considered a very attractive aspect for some entrepreneurs who lack experience in starting a company (John Freear et al., 1995),
it may involve a relinquishing of control or slight alteration of course that may not suit all founders. Finally, it is key to remember that most angels are still seeking a monetary return on their investment. There are angels specifically dedicated to nonprofits, such as Echoing Green. Echoing Green is itself a nonprofit, which makes it unlike the typical angel, but it provides seed funding and maintains a high level of involvement through a 5-year fellowship program (Echoing Green, 2012). This is more than just a rule; however, and nonprofits may be better off pursuing other forms of capital. However, for for-profit social enterprises at seed stage, angel investors are a good option, should you find one; enterprises with a strong health care or technological component have higher odds, though this may reflect the fact that Silicon Valley produced 39% of the $7.5 billion angel investment from the second quarter of 2011 (Statistic Brain, 2012).

Banking and Commercial Lending: Banking and commercial lending are available to all types of social enterprise, though there are specialty financial institutions for the nonprofit sector. There are numerous types of financing available: loans, lines of credit, and banking services dedicated to the needs of small business, for example. Many entrepreneurs have experience with such institutions as private individuals through their own banking, which makes traditional banks a familiar and trusted face during a time of high uncertainty. As numerous handbooks about starting a company mention, however, there are serious obstacles to taking advantage of commercial banks without the help of a government program such as the SBA.

As Abrams emphasizes in her mainstream handbook on entrepreneurship (2012), any commercial loan will require some form of collateral. Often, for enterprises (social or otherwise) that are just starting out, there will not be any capital with which to guarantee the loan. Instead, many banks will require the individual to personally guarantee the loan, which means that the bank can pursue personal assets in case the enterprise itself defaults. This is even more difficult for nonprofit enterprises, whose founders will not have direct ownership of the assets held by their start-up. For example, if you were creating a for-profit bakery which would employ at-risk youth, you could offer the ovens and other capital as part of the collateral with which to sign the loan. Even if you needed to personally guarantee it, the enterprise’s monetary and physical assets would revert to you if the organization dissolved, and you would be able to liquidate them to help pay off the debt. If your bakery was a nonprofit, however, you would not be able to liquidate the physical assets — all assets would need to stay in the nonprofit and tax-exempt system. This increases your exposure as a social entrepreneur. As an alternative, such financial options as lines of credit may be of more use, but often the same processes regarding guarantees must also be met.

This is not to say that commercial banking institutions should be avoided or are of little use — quite the contrary. However, their utilization, at least at the beginning, often involves the use of personal credit and assets, which should be given serious consideration prior to their use. Additionally, since these difficulties are relatively well-known, there are resources such as the Small Business Administration (SBA) which can provide both information and forms of financial assistance using these same institutions; prior to engaging a commercial lender, these resources should be investigated fully.

Community Development Financing Institutions (CDFIs): Community Development Financing Institutions are providers of credit and banking services to underprivileged communities. The current industry was built from the Johnson administration’s War on Poverty policy initiative in their creation of community development corporations and credit unions (CDFI Coalition, 2012). The movement accelerated with the revision of the Community Reinvestment Act in 1995 and the establishment of the Community Development Financial Institutions Fund in 1994 (Benjamin, Rubin, & Zielenbach, 2004). Since then, Congress has been authorizing annual appropriations to the CDFI Fund for the distribution to qualifying institutions.

What does this mean for the capital-hungry social enterprise? Though many of the mechanisms of commercial banking are shared with CDFI’s, the way that such tools are used and with whom are quite different. The most common financial instruments are business development loan funds,
community development venture capital funds, and micro-loan funds (Benjamin et al., 2004). BDLFs begin as small grants and below-rate loans to the CDFI, which are then re-loaned to CDFI recipients at a market rate; here, the issue being overcome is not a prohibitively high interest rate, but the access to capital which would otherwise be nonexistent. Unfortunately, most of the enterprises which receive BDLFs are existing operations with a history of working capital (Benjamin et al., 2004); this reliance on working capital rather than equity, however, means that there is little objection to modifying these for a nonprofit recipient. CDVCs are also funded by low-interest debt or equity investments into the CDFI from those outside of it, such as banks, foundations, and different levels of government (Rubin, 2001); instead of looking for companies with very high growth rates, however, CDVC’s prefer funding companies who have the potential for very high job creation (Benjamin et al., 2004). Micro-loan funds operate in much the same way that they do in the developing economy context: small loans are made to mostly low-income, female sole proprietorships (Clark, Kays, Zandniapour, Montoya, & Doyle, 1999).

In the U.K., CDFIs have been hailed as the solution to ending the social enterprise sector’s “cultural aversion” to borrowing money, preferring instead to receive grants and donations (Brown, 2006). Whether this is true has yet to be seen. This financial option does, however, have the breadth of commercial lending options, with the additional benefits of being potentially open to nonprofits and specifically designed to fit a social mission. If an enterprise’s primary audience for either employment or benefit is in a traditionally underprivileged area, a CDFI should be included as a potential funding source.

Crowdfunding: Crowdfunding is a versatile source of capital that relies on the surge in popularity of social media platforms in recent years. Called the democratization of funding (Haddad, 2012), crowdfunding allows any individual to contribute money for a particular project that has been listed on one of any number of social crowdfunding platforms. These platforms can be generic or specialized to a particular submarket: Microryza and Petridish support hard science projects, Kickstarter tends toward creative ventures, Crowdriser is dedicated to nonprofits, while Indiegogo is a more general platform where one can find personal pleas for medical donations and requests for invention prototype funding. The mechanism is fairly simple. An individual browses a portal (such as one of those listed above), and can view the projects that have been registered there. Most projects will contain different levels of funding, often associated with different levels of recognition; for example, on Indiegogo, one of the successfully funded projects is for a steampunk transmedia and graphic novel series named Clockwork Watch (Ayeni, 2012). If the donor is interested, they can donate $5 in exchange for a badge and a listing amongst their sponsors; for $15, you would gain the $5 gifts plus a limited edition of the first graphic novel; and if you contribute the highest level out of eleven ($1000), you get inside access to the logistics of the project in addition to dinner at the graphic novel’s location (Ayeni, 2012). Even though this particular type of funding has not been around in this form for very long, this stepwise incentive structure should be familiar to anyone who has donated money to a nonprofit, whether that is an international NGO such as the World Wildlife Fund or a sponsorship for the local Little League team.

However, as the field matures, there has also been growing concern about what the online use of such fundraising tactics may imply for regulatory or investor protection issues. The first is that the offering of incentives such as equity, whether in small pieces or not, constitutes classification as a security under the Securities Act of 1933 and the Howey test (Heminway & Hoffman, 2010; “SEC v. W.J. Howey Co”, 1946). This would require registration with the SEC, in addition to the potential of having such crowdfunding sites listed as brokers – this would require additional registrations and fees (Cohn, 2012). Most of the published literature urges the U.S. government to create a special exemption for the securities, whether it is an exemption from all registrations or if it keeps those regulations which protect consumers from fraud. Crowdfunding did receive such an exemption in the 2012 Jumpstart Our Businesses (JOBS) bill, which is now Section 4(6) of the 1933 Securities Act (“Jumpstart Our Business Startups Act”, 2012). The language of the bill, however, has not received praise from legal scholars, being described by Cohn as “seriously deficient in both purpose and effect” (2012). Registration is not required, but the use of a portal and numerous levels of reporting
requirements have been added; this adds protection for the consumer from bogus fundraising, but also diminishes the easy accessibility for small enterprises who do not have the capacity to comply with the new requirements.

The second concern is briefly mentioned in Hazen (2012), but has largely passed the notice of the literature: why does crowdfunding not trigger the charitable solicitation registration that most states contain? If there is no ownership involved and the possibility of financial or material reward is uncertain and/or token, then the money should (and often is) considered a charitable contribution. There does not appear to be a salient difference between my $40 contribution to the World Wildlife Fund in exchange for a nominal tote bag and a $40 contribution to a budding graphic novel artist in exchange for a signed first edition. Another supporting indicator of this is the recent decision of Indiegogo to partner with the Fractured Atlas organization in order to facilitate the use of nonprofit tax deductions to charitable causes through the site (Zhou, 2012), though details of the purpose and mechanics of this are still forthcoming. The question that remains is how open solicitations for social purposes are managing to avoid donor protections which appear to be even more important in the online forum than in print.

**Government Social Enterprise and Entrepreneur Funds:** The federal government has a wealth of programs designed for entrepreneurs, with many specifically designed for social enterprise. The first of the generic programs is the Small Business Administration (SBA) of the federal government. Loans themselves are made through traditional lending agencies, but are guaranteed by the SBA – in the Job Recovery and Reinvestment Act, this guarantee rate was at 90% of the loan (Markiewicz, 2011). There are several different types of loan program, from the common Basic 7(a) loan program to those tailored to meet more specific geographical areas (such as the underserved areas in the Community Express program) or needs (such as CAP Lines for short-term capital shortfalls). Additionally, there are seed capital opportunities through Small Business Investment Financing Companies (SBIC), which are privately owned funds that are regulated and partially funded by the SBA (U.S. Small Business Administration, 2012).

For social enterprises specifically, there are several government initiatives that exist in order to cultivate the sector. The Development Innovation Ventures (DIV) project, which is a part of USAID’s Office of Innovation and Development Alliances, provides grants to applicants with innovative solutions to development problems in either the proof of concept, start-up, or scale-up phases. In addition to the capital, DIV provides rigorous outcomes testing to the idea and uses the information to gauge further disbursements (USAID, 2012). The Overseas Private Investment Corporation, which is the development finance institution for the U.S. government, offers a range of financing options to U.S. enterprises of any size that are working in a developing country (OPIC, 2012). For those enterprises with a domestic focus, the Department of Commerce’s Office of Innovation and Entrepreneurship helps coordinate numerous efforts, such as the i6 Challenges, which could be great sources of capital for social enterprises whose prospective contributions are a good match for the programs.

Despite these initiatives, however, there are still drawbacks to relying on government loans and seed grants. The first is that they are simply hard to come by – similar to standard commercial loans, many government programs also require significant capital or personal co-signing in order to qualify for a loan. In the report from Startup America regarding obstacles to entrepreneurship, a panel of experts emphasized this drawback and asked for the government to consider different ways of disbursing capital, such as lending criteria based on cash flow; this same panel also recommended an expansion of SBIC funding and the creation of a small-cap initial public offering (Mills, 2011). The ultimate hope is that the United States will develop an initiative similar to the U.K.’s Big Society Capital, which is a £600 million joint institution between the government and the four top commercial banks; the goal of Big Society is to further develop the capital market around social

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3 As a note, this panel also recommended securities laws exemptions for crowdsourcing and the use of social impact bonds, both of which have become recent policy realities.
enterprises (both nonprofit and for-profit) that can repay investments through income (Cabinet Office Press Office, 2012). Until then, however, SBA and other government-affiliated financing is a viable option for most types of social enterprise, especially those who address a particular political or economic priority of that government program.

**Program-Related Investments (PRIs):** These investments are a way for foundations, which are restricted in their ability to see gains with their disbursements, to fund enterprises where their investment could generate an economic profit; though often considered in the context of for-profit and hybrid social enterprises, these can also be loans to nonprofits that will be repaid either partially or in full. These investments can take the form of debt, equity, or guarantees. For debt, the foundation can provide a loan to any enterprise that furthers its charitable mission. For equity, the foundation could either purchase shares of the company outright (which would require a for-profit or hybrid form, with some corporate forms being preferred over those based on LLCs). Guaranties such as bond back-stops or credit guaranties could also be offered, which do not provide the funding per se, but help diffuse the risk of another institution providing the capital (Bill and Melinda Gates Foundation, 2012). For the foundation, these PRIs will be counted toward the 5% mandatory distribution that must be utilized every year and are not counted as assets when deciding the year’s payout allocation (GPS Capital Partners, 2009). Further, in the case of default, the money can be treated like a grant, which would have been the alternative form of financial support without the PRI alternative.

Also, as mentioned previously, there are traits of hybrids which make them particularly suited to PRIs. The L3C was crafted with specific wording in its statute in order to perfectly mirror the requirements of a PRI: achieving a charitable purpose, forming specifically for that purpose, not focusing on making a profit, and not having a political purpose (Brewer, 2012). Further, PRIs can be viewed as the social enterprise hybrid of the financial tools: able to do good and make money. However, even with L3Cs, very few PRIs are actually in use. Why, despite these benefits, are PRIs underutilized?

The primary drawback to program-related investments, despite their utility, is that they do not seem to be especially popular with foundations. The potential exists for a PRI to produce a profit for the foundation and be ruled by the IRS as a “jeopardizing investment” according to Internal Revenue Code Section 4944; in this situation, the investment and the fund manager can be hit with taxes (“Tax Reform Act of 1969”, 1969). PRIs have an exception to this in the code, but the investment must be monitored, and, even if not jeopardizing, may still be subject to unrelated business income tax (Brewer, 2012). In order to protect against “jeopardizing investment,” some private foundations seek a private letter ruling from the IRS, which protects them against a later ruling of improper investment; the cost of a PLR, however, is $10 thousand in fees to the IRS alone, not including attorney and other preparation fees (Doeringer, 2010). This makes a “safe” PRI prohibitively expensive for small foundations and a less desirable option for larger foundations. Even those foundations who are comfortable making PRIs do not wish to be the primary source of capital – the Bill and Melinda Gates Foundation, which uses PRIs with regularity, prefers a 5:1 PRI to other external capital ratio (Bill and Melinda Gates Foundation, 2012). Until foundations move past their risk aversion through either exposure to PRIs through other institutions or a blanket ruling from the IRS protecting PRIs from being considered jeopardizing investments, their utilization will probably remain minute.

**Social Impact Bonds:** One of the truly new forms of financial instruments designed for social purposes, social impact bonds are ways for third parties to issue guarantees for social investments in order to entice private institutions otherwise uninterested or unable to participate. They are not actually bonds: the guarantees are for a fixed period of time, but do not yield a fixed amount like a traditional bond. Instead, the private issuer of the bond receives repayment only if the program is successful in achieving its outcomes; this saves the taxpayer money and allows the private sector to properly value and diffuse the risk (von Glahn & Whistler, 2011).
Social impact bonds began in the U.K. at the Peterborough prison in 2010 ("Being Good Pays", 2012). The government of the U.K. partnered with a social impact group, Social Finance, Ltd., in an effort to reduce recidivism. Social Finance, Ltd. provided the cash for the program implementation. Following deployment of the program and the measurement of outcomes using evidence-based metrics (rather than financially-based metrics, as was custom), the government will repay Social Finance if the program proves to be successful. If not, Social Finance is out the money the same as it would had it issued a grant. Most private institutions do not make grants of this nature, which is why the success of this movement will depend in large part on the proportion of successes that the pilot programs enjoy; if there is a profit to be made, then this will attract more companies to issue social impact bonds.

In the United States, the most well-known impact bond is the one involving re-incarceration rates among youths at Rikers prison. Goldman Sachs provides 9.6 million dollars to pay a social services nonprofit to deliver the program, designed to reduce recidivism among young men leaving Rikers (Chen, 2012). If the program reduces the re-incarceration rate by 10%, Goldman Sachs will be repaid the entire amount by the government; if the rate drops even farther, then Goldman could see a profit. However, if the program fails to attain its desired effect, Goldman will not be reimbursed by the government (Chen, 2012), which would mean that Goldman would face a potential loss. The New York situation is sweetened for Goldman by the guarantee which Bloomberg Philanthropies has put in place to keep Goldman from facing a total loss; however, the basic mechanism that private companies will accept risk in exchange for potential reward is still present. The potential of social impact bonds is discovery that there is a way to entice private capital into nonprofit financing while relieving some of the fiscal stress of local governments; time will tell whether this type of financing lives up to expectations.

**Venture Capital:** Unlike angel investors, venture capitalists are more interested in the scale-up and exit than in long-term capacity building, putting a great deal of attention into the risk reduction and more formulaic aspects of the investment prior to making the commitment (Van Osnabrugge, 2000). This does not mean, however, that they are uninvolved in governance affairs, and they may also take positions on the board of directors or provide similar counsel in order to safeguard and encourage their financial investment (National Venture Capital Association, 2012).

Venture capital is considered the gold standard in entrepreneurial funding because of the size and timing of the funding. As seen in Figure 2, venture capitalists can enter at proof of concept and stay until the exit event, which is ideally either being acquired by another company and their investment bought out, or the transition of the private company to one publicly held where the capitalist's equity can appreciate and be traded. Further, even before the exit event, it is in the venture capitalists best interests to continue securing further rounds of funding for promising enterprises; once venture capital has been acquired, then the imposing initial hurdle of gaining attention to your project has already been crossed, leaving your odds better of securing further rounds either with the same or an expanded community of investors. Venture capitalists, however, will walk away from an investment that does not thrive since they owe a fiduciary duty to their investors, which provides the incentive to the start-up to continue innovating (National Venture Capital Association, 2012).

There are several drawbacks to venture capital, however, and the approach is not an ideal method for all enterprises. Those who are and intend to stay on a small, local scale are not a good match for venture capital funding; similarly, if only a small sum (less than $500 thousand) is needed, venture capitalists may not be interested (J. Freear & Wetzel, 1990). If the enterprise anticipates achieving medium growth in revenues but a high job creation rate, then a community development VC could be pursued (Benjamin et al., 2004).

**Venture Philanthropy:** Venture philanthropy is traditionally the nonprofit answer to venture capital, describing more the approach to philanthropy rather than a particular typology. Blodget offers an entertaining narrative of the emergence of venture philanthropy as a reflection of the “new”
technology personalities versus the “Establishment” philanthropists, with the former being typified as Bill Gates and Larry Ellison (Blodget, 2006). As Blodget notes, however, the adoption of both the new and Establishment schools of such vernacular as “investee” (rather than client) and the notion of social returns on investment imply a level of legitimacy to this genre of venture funding.

Similar to government programs, the ability to utilize any particular venture philanthropist will be determined greatly by what that particular institution or person has expressed interest in. For example, there are firms of venture philanthropy dedicated specifically to for-profit social enterprises (such as NYC Venture Philanthropy) and nonprofit social enterprises (Venture Philanthropy Partners). The common thread is that, unlike traditional grants and some sources of capital, the venture philanthropist is not interested in funding programming costs. Unlike the ratings produced by charity watchdog groups such as GuideStar, venture philanthropists are interested in building the organizational capacity of the enterprise rather than addressing the underlying social need. This is a welcome respite in the nonprofit world, where the struggle to find unrestricted funds with which to keep the organization running, especially if the organization is small or new, can be a struggle (Chambré & Fatt, 2002).

There are difficulties with venture philanthropy on both practical and theoretical grounds. On the practical side, the largest impediment to the utilization of venture philanthropy is its availability. On the theoretical side, Sievers (2001) mentions four issues: the lack of a bottom line for creating metrics, the questionable need for large scalability, the lack of control, and the lack of the important venture capitalist notion of an exit strategy. Of these, the first and last are of the most concern. As a substitute for more straightforward financial analysis, venture philanthropists want to measure their social return on investment: how, exactly, is this to be measured? For some foundations, such as the Gates Foundation, having staff qualified to conduct randomized control trials is not an issue. For most, however, the problem that the nonprofit field has always had with providing measurable proof of their efficacy continues to exist, albeit with more zeros. As to the Sievers’ fourth concern, one of the distinctive traits of venture capitalism is the rapid build-up of a company with strong growth in order for the capitalist to reap financial reward from either an IPO or an acquisition large enough to offset the extreme risk he or she took at the initial investment. What is the exit strategy for a venture philanthropist, who may have invested a large sum in an entity that will not be able to grant equity? In this sense, Frumkin (2003) emphasizes that, in many ways, venture philanthropy is simply a fancy new name for grant-making that has been happening for decades. If the new moniker and large sums helps move capital to social enterprises, however, then this change in vernacular is most welcome to the sector.

3. IMPLICATIONS AND CONCLUSIONS

The beauty of social enterprise corporate hybrids is the intended synergy of for-profit tools with nonprofit motives. This movement is a natural outgrowth of two trends, the commercial revenue trend in nonprofits and the corporate social responsibility trend in for-profits. Therefore, the ideal financial environment would be one where the hybrids were able to derive funding sources from both fields, in addition to new financial instruments. As evidenced, this has been met with limited success, but the law continues to evolve.

We also must recognize the possibility that the law itself may evolve to accommodate the spirit of social enterprise without the need for new corporate forms. First, as has been mentioned by several legal scholars (Brewer, 2012; Kerr, 2007; Page & Katz, 2010), there is no per se exclusion of a social purpose to a standard corporation or LLC, especially if said purpose can be construed to be in the long-term interest of the company’s success. Even if not, the business judgment rule can often be used to incorporate business mission (Kerr, 2007). Several large corporations, such as Home Depot and Nike, have either in-house philanthropy divisions or have created a tandem foundation. Second, the continued emphasis on sustainability and “lean” nonprofits has caused many to develop commercial revenue paths of income within their organization, whether it is in- or out-of-mission (Kerlin & Pollak, 2011). Until 2008, those individuals who had a fantastic idea to cure a social ill
would probably have become a small nonprofit; if nonprofits continue to be asked to behave like businesses (which, in an unfortunate catch-22, may result in the loss of the tax exemption), there is also no reason to have new hybrid corporate forms.

Despite these trends, however, there is convincing evidence that these new corporate forms offer different and novel advantages to problems which are unique to social enterprise, such as tax treatment and legitimacy. There is also not a convincing argument that only one hybrid form should dominate, especially if the largest ecological hurdle (legitimacy) is overcome. Each novel form brings its own advantages, in its own way, to leverage the growing amount of human and monetary assets toward solving social ills. In this final way, as well, we should think of social enterprise as a zoo: if the park only contains a single type of animal, it would be extremely efficient to feed. However, the complexity of several species and their unique attributes ensures not only myriad diets, but that additional people and resources will continue to flow in and make the social enterprise zoo, regardless of whom it contains, successful.
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