THE ROLE OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS

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Recent years have brought remarkable growth in hybrid organizations that combine profit-seeking and social missions. Despite popular enthusiasm for such organizations, legal reforms to facilitate their formation and growth—particularly, legal forms for hybrid firms—have largely been ineffective. This shortcoming stems in large part from the lack of a theory that identifies the structural and functional elements that make some types of hybrid organizations more effective than others. In pursuit of such a theory, this Article focuses on a large class of hybrid organizations that has been effective in addressing development problems, such as increasing access to capital and improving employment

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opportunities. These organizations, which are commonly referred to as "social enterprises," include microfinance institutions, firms that sell fair trade products, work integration firms, and low-cost sellers of essential goods and services such as eyeglasses, bed nets, and healthcare. The common characteristic of social enterprises is that they have a transactional relationship with their beneficiaries, who are either purchasers of the firms' goods or services or suppliers of inputs (including labor) to the firm. The essence of this Article's theory is that through these transactions, social enterprises perform a measurement role; that is, they measure or gather information on their patron-beneficiaries' abilities to transact with commercial firms (for example, workers' skills, borrowers' creditworthiness, and consumers' ability to pay). That information permits social enterprises to tailor the form and amount of subsidies to the specific needs of individual beneficiaries. This "measurement" function makes social enterprises relatively effective vehicles for allocating subsidies as compared to traditional donative organizations and other forms of hybrid organization, in particular firms that pursue corporate social responsibility policies. Thus, the measurement function can serve as the basis for designing a legal form for social enterprises.

I. INTRODUCTION

In recent years, there has been a remarkable increase in the number of organizations that combine profit-seeking with an altruistic or social mission. We can broadly term this class of entities "hybrid organizations," though a variety of other terms have been used, including mixed-mission, blended value, triple bottom line, and creative capitalism.[1] In particular, much attention—as well as legislative activity—has focused on a broad but vaguely defined group of hybrid organizations that are commonly referred to as "social enterprises." Common examples of social enterprises include microfinance institutions that provide credit to low-income borrowers, businesses that sell fair trade products, and companies that sell affordable products in developing countries. This pursuit of a mixed commercial and social mission is not exclusively the domain of a small set of specialized firms. Multinational corporations such as Starbucks, Nike, and J.P. Morgan are increasingly engaged in a variety of corporate social responsibility initiatives.[2] Investors are increasingly mindful of social and environmental indicators in their investment decisions, and some focus on investing in firms that purport to generate social impact.[3] Thus, there is a growing popular belief that combining profit and mission is an effective way of producing social wealth.

Despite these wide-ranging developments, hybrid organizations remain poorly understood. As a result, legal

1 The term "hybrid organization" is defined more formally in Part II.

2 *See infra* Sections II.C, VI.A.

3 *See* ANTONY BUGG-LEVINE & JED EMERSON, IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE (2011); J.P. MORGAN GLOB. RESEARCH & THE ROCKEFELLER FOUND., IMPACT INVESTMENTS: AN EMERGING ASSET CLASS (2010), https://www.jpmorganchase.com/corporate/socialfinance/document/impact_investments_nov2010.pdf [https://perma.cc/8762-2NCF].

policy in this field has been haphazard and largely ineffective. First, there is some uncertainty about the extent to which business planners have the power to form businesses that combine profit and social missions. A recent Delaware case, *eBay v. Newmark*, casts doubt on the ability of corporations to espouse a social purpose.[4] Partly to address this issue, new legal forms have been introduced to incorporate businesses that have a social mission.[5] In

4 eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 28 (Del. Ch. 2010) ("The corporate form in which [the corporation] operates, however, is not an appropriate vehicle for purely philanthropic ends . . . Having chosen a for-profit corporate form, the [corporation's] directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders."). The *eBay* case reflects the conventional view, dating back to *Dodge v. Ford Motor Company*, that the directors' duty is to maximize shareholders' profits. 170 N.W. 668 (Mich. 1919); *see also* David A. Wishnick, *Corporate Purposes in a Free Enterprise System: A Comment on* eBay v. Newmark, 121 YALE L.J. 2405 (2012). The *eBay* case involved heightened scrutiny of a poison pill adopted by management in order to entrench a social purpose to which the shareholders had never acquiesced in the company's charter or otherwise. *eBay*, 16 A.3d at 28, 32–33.

5 For reviews of the new legal forms, see Dana Brakman Reiser, *Blended Enterprise and The Dual Mission Dilemma*, 35 VT. L. REV. 105 (2010); Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681 (2013); Matthew F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291 (2010); Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337 (2009); J. Haskell Murray, *The Social Enterprise Law Market*, 75 MD. L. REV. 541 (2016); Alicia E. Plerhoples, *Social Enterprise as Commitment: A Roadmap*, 48 WASH. U. J.L. & POL'Y 89 (2015); Joseph W. Yockey, *Does Social Enterprise Law Matter?* 66 ALA. L. REV. 767 (2015); Fabrizio Cafaggi & Paola Iamiceli, *New Frontiers in the Legal Structure and Legislation of Social Enterprises in Europe: A Comparative Analysis* (Eur. U. Inst. L. Working Papers, Paper No. 2008/16), http://cadmus.eui.eu/handle/1814/8927 [https://perma.cc/RCU5-5SH7]; Rachel Culley & Jill R. Horowitz, *Profits v. Purpose: Hybrid Companies and the Charitable Dollar* (U. of Mich. Program in Law & Econ. Working Paper Series, Paper No. 12-006, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2055368 [https://perma.cc/T7LC-SDE6].

particular, the Benefit Corporation is a legal entity that has a social mission but can nonetheless distribute profits to its owners. Although such legal forms have been diffusing rapidly among states, most hybrid organizations continue to use the traditional corporate forms. Thus, it is questionable whether the new forms are actually necessary and how such forms should be designed. Additionally, if hybrid organizations are desirable, they arguably deserve to receive tax or other subsidies. Malani and Posner, for example, propose that all for-profits should be provided with tax benefits for doing good things, such as selling fair trade products.[6] However, trusting profit-driven corporations to employ subsidies towards social missions is highly problematic, mainly because they have an obvious incentive to overstate the social value of their activities in order to enhance their reputations.[7] As a result, the IRS has so far resisted attempts to facilitate subsidized investments in hybrid legal forms.[8]

The state of legal policy in this area stems from the failure of economic and legal scholarship to identify the structural and functional attributes that make hybrid organizations effective in addressing social problems. Despite the numerous colorful terms that have been attached to hybrids, most of these terms boil down to the idea of

6 Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2064–67 (2007).

7 The well-known exposition of this view is by the economist Milton Friedman, who urged corporations to focus on maximizing profits for the firm's owners while conforming to the basic legal and ethical rules of society. *See* Milton Friedman, *The Social Responsibility of Business Is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970; *see also* Henry G. Manne, *Milton Friedman Was Right*, WALL. ST. J. (Nov. 24, 2006, 12:01 AM), https://www.wsj.com/articles/SB116432800408631539 [https://perma.cc/UY66-HZAS].

8 *See* J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273 (2010).

combining for-profit and altruistic missions.[9] The problem is that, in most cases, it is practically impossible to measure and verify the accomplishment of altruistic goals.[10]

The definitions of hybrids under the statutes for incorporating new organizational forms illustrate this difficulty. For example, the "Benefit Corporation" is a corporation whose purpose is to create a material positive impact on society and the environment.[11] However, it is largely impossible to verify what qualifies as a "material

9 *See, e.g.*, THE EMERGENCE OF SOCIAL ENTERPRISE (Carlo Borzaga & Jacques Defourny eds., 2001); BUGG-LEVINE & EMERSON, *supra* note 3; Sutia Kim Alter, *Social Enterprise Models and Their Mission and Money Relationships*, *in* SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE 205, 205–06 (Alex Nicholls ed., 2006); J. Gregory Dees, *Enterprising Nonprofits*, HARV. BUS. REV., Jan.–Feb. 1998, at 55; Jed Emerson & Sheila Bonini, The Blended Value Map: Tracking the Intersects and Opportunities of Economics, Social and Environmental Value Creation (unpublished manuscript) (October 2003), http://www.blendedvalue.org/wp-content/uploads/2004/02/pdf-bv-map.pdf [https://perma.cc/FVY6-MHBQ].

10 Moreover, there is a tendency to treat the difference between corporate social responsibility and social enterprise as mainly one of degree, without delineating their different structures or functional roles. *See, e.g.,* THE ECONOMICS OF SOCIAL RESPONSIBILITY: THE WORLD OF SOCIAL ENTERPRISES 7 (Leonardo Becchetti & Carlo Borzaga eds., 2011); Alter, *supra* note 9; Kelley, *supra* note 5, at 350–52; Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through A Legal Lens*, 81 TEMP. L. REV. 831 (2008); Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2450 (2009) (arguing that "[s]ocial enterprises integrate philanthropy into their business models at a more basic level than companies that make corporate contributions or practice [Corporate Social Responsibility]"). In fact, the terms are often used interchangeably to denote essentially the same type of business. To take one example, firms that sell fair trade products have been referred to as a social enterprise, THE ECONOMICS OF SOCIAL RESPONSIBILITY, *supra*, corporate social responsibility initiative, Michael E. Porter & Mark R. Kramer, *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV., Dec. 2006, at 78, and corporate philanthropy, Malani & Posner, *supra* note 6.

11 *See infra* Section IX.A.

positive impact," and while the Benefit Corporation is a laudable attempt to encourage corporations to produce such an impact, it is highly doubtful that it has achieved this effect. A recent example is Laureate University, a for-profit network of universities incorporated as a Benefit Corporation. Laureate recently completed its celebrated IPO, the first of any Benefit Corporation.[12] It is difficult, however, to see what makes Laureate different from standard for-profit firms in the same industry. Recent evidence suggests that it employs aggressive promotional tactics, suffers from low graduation and loan repayment rates in some regions, and primarily serves the premium segment of the market.[13] While not incorporated as hybrids, the experiences of other large companies that vowed to serve social and

12 *See* Alex Barinka, *Laureate Education Plans IPO as a Public Benefit Company*, BLOOMBERG (Oct. 2, 2015, 5:37 PM), https://www.bloomberg.com/news/articles/2015-10-02/kkr-backed-laureate-education-files-for-initial-public-offering [https://perma.cc/8GA4-G69A]; Natalie Sherman, *Laureate Becomes Public Company Again, Raising $490 Million*, BALTIMORE SUN (Feb. 1, 2017, 7:52 PM), http://www.baltimoresun.com/business/bs-bz-laureate-ipo-20170201-story.html [https://perma.cc/6KHP-HJA6].

13 *See, e.g.*, Laureate Education Inc. Registration Statement (Form S-1) (Oct. 2, 2015), https://www.sec.gov/Archives/edgar/data/912766/000104746915007679/a2209311zs-1.htm [https://perma.cc/A2F6-FJJL]; John Fritze & Natalie Sherman, *Laureate IPO Still Pending Amid Political Flap, Industry Crackdown*, BALTIMORE SUN, http://www.baltimoresun.com/news/maryland/bs-md-laureate-faces-challenges-20161008-story.html [https://perma.cc/G3NA-UMXW] (Oct. 10, 2016, 7:17 PM); Janet Lorin, *Laureate's U.S. Students Struggling to Repay Loans as IPO Looms*, BLOOMBERG (Nov. 4, 2015, 5:00 AM) https://www.bloomberg.com/politics/articles/2015-11-04/laureate-loan-repayment-rate-shows-u-s-debt-burden-as-ipo-looms [https://perma.cc/2FU5-EQZP]; Michael Smith & Mina Kimes, *Chilean Regulators Say No to Clinton-Backed University*, BLOOMBERG (Feb. 4, 2014, 2:58 PM), https://www.bloomberg.com/news/articles/2014-01-24/chilean-regulators-crack-down-on-university-with-ties-to-clinton [https://perma.cc/P8VG-QXD2].

environmental missions, including Google, Etsy, and even British Petroleum, range from disappointing to egregious.[14]

In order to develop legal policy in this area, there is a need for a theory that identifies a set of organizations that actually have incentives to pursue social missions effectively and explains their functional role. This Article offers a theory of social enterprise and hybrid organizations that can inform legal policy. The theory focuses on a set of organizations that are commonly referred to as "social enterprises," such as microfinance institutions, firms that sell fair trade products, work integration social enterprises, and low-cost sellers. The common characteristic of these organizations is that they have a commitment to transacting with their beneficiaries, who are either purchasers of the firm's goods or services or suppliers of inputs (including labor) to the firm. This Article will refer to such beneficiaries as "patron-beneficiaries."[15] For example, microfinance institutions make loans to low-income borrowers, and work integration social enterprises employ disadvantaged workers. As this Article explains in greater detail below, it may be prohibitively costly for standard commercial firms to transact with disadvantaged individuals. This occurs for two reasons: (1) firms lack information to evaluate the abilities of such individuals, or (2) such individuals lack sufficient abilities (e.g., ability to repay a loan). In these circumstances, disadvantaged individuals may suffer from lack of access to capital, systematic unemployment, and want of essential products and services. Social enterprises

14 As discussed in Section VI.A below, Google's charitable arm has had limited social impact; Etsy, an online marketplace for crafts, is certified by B-Lab, a nonprofit that certifies and ranks firms as producing public benefits, but is also allegedly involved in aggressive tax planning. *See infra* Section VI.C. Finally, British Petroleum, a company that had a strong reputation for adopting environmentally friendly policies, was responsible for a major oil spill in 2010. *See infra* Section VI.D.

15 The term "patron" is used to refer to those who have a transactional relationship with the firm, i.e., investors, workers, suppliers, etc.

address these problems by committing to transacting with disadvantaged individuals as patrons.

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

The measurement function makes social enterprises relatively effective vehicles for allocating subsidies to promote development goals, such as increasing access to capital, enhancing productivity and employment opportunities, and enhancing consumer welfare. For example, microfinance institutions have grown substantially in the last few decades and now provide financial services to millions of poor customers in developing countries.[16]

The relative success of microfinance and other social enterprises in spurring development contrasts with the limited effectiveness of many organizations that engage primarily in giving to beneficiaries (as opposed to transacting with them), such as donative organizations like

[16] BEATRIZ ARMENDÁRIZ & JONATHAN MORDUCH, THE ECONOMICS OF MICROFINANCE 12–15 (2nd ed. 2010); BRIGIT HELMS, ACCESS FOR ALL: BUILDING INCLUSIVE FINANCIAL SYSTEMS 2–5 (2006).

government and aid agencies.[17] Social enterprises also need to be contrasted with other forms of hybrid organizations, especially firms that engage in corporate charity and social responsibility policies. Whereas social enterprises have incentives to utilize subsidies effectively, corporations that pursue socially responsible policies have incentives to exaggerate their social value.

From a theoretical perspective, this Article contributes to understanding the functional role of different forms of organization. The theory proposed is related to the well-known "metering" theory of Alchian and Demsetz, which argues that firms arise as a solution to problems in metering or measuring input productivity and rewards,[18] and that nonprofits are likely to shirk because they have limited incentives to meter productivity.[19] However, unlike Alchian

17 The term "donative organization" was defined by Hansmann to mean nonprofits that receive most or all of their income in the form of grants or donations. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 840 (1980). This Article will argue that donative organizations are also characterized by the fact that they transfer a subsidy to their beneficiaries rather than transacting with them as patrons. *See infra* Part II.

18 As stated by Alchian and Demsetz: "If the economic organization meters poorly, with rewards and productivity only loosely correlated, then productivity will be smaller; but if the economic organization meters well productivity will be greater." Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 779 (1972). More broadly, Alchian and Demsetz seek to explain why firms are an efficient means for organizing economic activity (as opposed to contracts) when individual output is difficult to observe but collective output is observable. *Id*.

19 *Id*. at 789–90. In contrast, as shown by Hansmann, *supra* note 17, nonprofits may actually have stronger incentives to produce higher quality. *See also* Edward L. Glaeser & Andrei Shleifer, *Not-For-Profit Entrepreneurs*, 81 J. OF PUB. ECON. 99 (2001) (developing an economic model of Hansmann's theory); *cf.* Albert H. Choi, *Nonprofit Status and Relational Sanctions: Commitment to Quality through Repeat Interactions and Organizational Choice*, 58 J.L. & ECON. 969 (2015) (offering an economic model where stronger relational sanctions by consumers against

and Demsetz, this Article draws a distinction between transacting and giving organizations, rather than emphasizing the distinction between for-profits and nonprofits.[20] The reason is that social enterprises that engage in market transactions may be formed not only as for-profits, but also as nonprofits, and in either case, they have a financial (as well as altruistic) incentive to measure the output of their beneficiaries and to tailor subsidies to their needs.

From a policy perspective, understanding the basic structure of social enterprises and the measurement function they perform is essential for informing policies to encourage corporations to pursue social missions. Since social enterprises appear to be effective, legal policy should primarily foster organizations that share their structural and functional attributes. Section IX outlines how the transaction with beneficiaries and the measurement role of social enterprises can provide a normative framework for designing a legal hybrid form.[21] This Article focuses on laying out the structural and theoretical underpinnings of social enterprises as well as other hybrid organizations.

This Article is organized as follows: Section II discusses the structure of different forms of hybrid organizations, and in particular social enterprises. Section III describes in detail the measurement theory of social enterprise. Section IV applies the theory to different forms of social enterprises. Section V describes the different devices social enterprises employ to commit to transacting with disadvantaged groups.

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for-profits cause for-profits to produce quality equivalent to that of nonprofits).

20 To be fair, Alchian & Demsetz, *supra* note 18, wrote at a time when nonprofits were less commercialized and hence less likely to engage in market transactions. For discussion of the commercialization of nonprofits, see TO PROFIT OR NOT TO PROFIT: THE COMMERCIAL TRANSFORMATION OF THE NONPROFIT SECTOR (Burton A. Weisbrod ed., 1998).

21 *See infra* Section IX. Details of the policy implications are discussed in Ofer Eldar, *Designing Organizations to Pursue Social Goals: An Economic Analysis of Legal Hybrid Forms* (on file with author).

Section VI contrasts social enterprises with other hybrid organizations that engage primarily in giving to beneficiaries rather than transacting with them. Section VII notes several disadvantages of social enterprises. Section VIII explains why other theories of hybrid organizations fail to explain the structure and role of hybrid organizations. Section IX discusses why legal hybrid forms have been largely ineffective in encouraging firms to address social missions and how the theory put forth in this Article can inform the design of a new legal hybrid form.

II. THE ESSENTIAL CHARACTERISTICS OF SOCIAL ENTERPRISES AND HYBRID ORGANIZATIONS

Although hybrid organizations are commonly defined as organizations that combine profit and altruistic or social missions, this definition is misleading. Even profit-maximizing firms pursue social purposes, albeit indirectly. Consider a food chain that improves the nutritional value of its products. Such a firm may be maximizing its profits by making its products more attractive to customers. Its activities may well generate positive externalities, such as better health for society. This firm, however, is not conceptually different from most other for-profit firms. The idea that firms generate positive externalities while pursuing profits dates back to Adam Smith's notion of profit maximization.[22] A useful definition of hybrid organizations must identify the way they differ from standard profit-maximizing firms.

Properly defined, a hybrid organization is a commercial enterprise that channels a subsidy to a class of beneficiaries. The simplest example is a corporate charity, which is a for-profit firm that donates a percentage of its profits to charity. The subsidy need not be provided by the government and

[22] *See* ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

usually flows from the firm's customers and investors. To fund the charity, the owners of the firm may agree to some discount on their returns or the consumers may pay premium prices for the firm's products. Thus, this Article defines "subsidy" expansively to include any contribution of value—monetary or otherwise—that is provided to the ultimate beneficiary of the subsidy for no consideration. It need not be a direct subsidy, like a grant or a donation, but may also take the form of premiums over market prices paid by consumers or discounts to market returns on investment.[23]

It is important to note that the term "hybrid organization" can be used to describe a wide array of organizations. On one hand, a hybrid organization may be profit-maximizing as long as the owners do not provide the subsidy. For example, a firm may receive a grant from the government or its consumers may pay premium prices. On the other hand, hybrid organizations may be nonprofits. A commercial enterprise is any enterprise that receives a significant portion of its income from prices charged for its products or services so that its viability or sustainability is dependent on such income.[24] Commercial enterprises include not only for-profit firms, but also commercial nonprofits such as hospitals or universities that charge patients and students respectively for their services,[25] despite receiving at least some subsidies in the form of donations and tax exemptions.

23 The difference between premium prices or below-market rates and market prices or rates (as applicable) constitutes the subsidy.

24 This Article refers to "enterprises" rather than organizations or entities. An enterprise may comprise an entity or several entities, but may also be a segment of an organization that includes various types of enterprise.

25 *See* Hansmann, *supra* note 17, at 840–41.

A. What Makes an Organization a Social Enterprise?

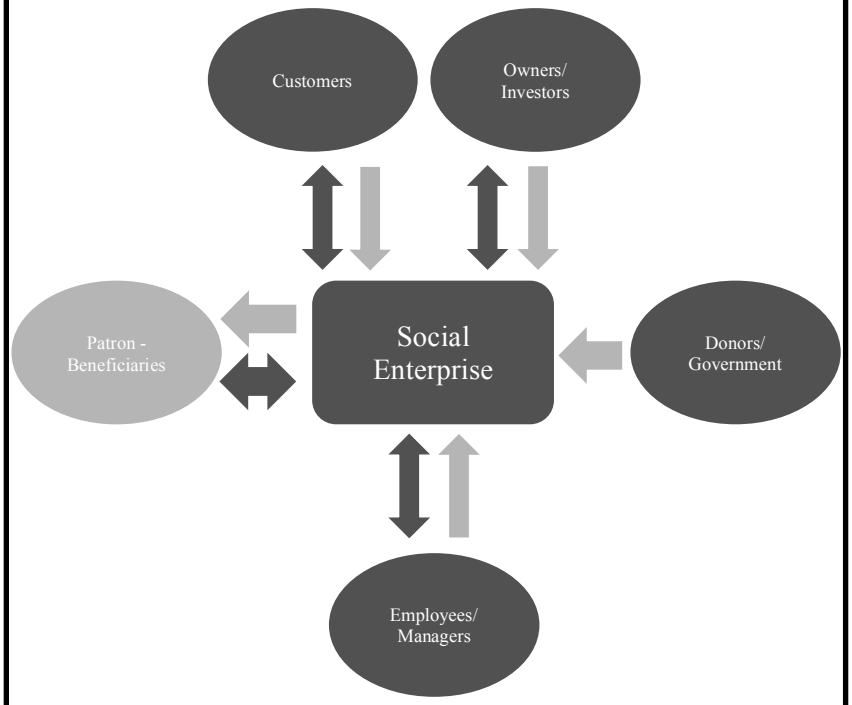
The focus of this Article is on a particular type of hybrid organization, usually referred to as a "social enterprise." Social enterprises are not only subsidized commercial enterprises, but they also possess another critical element: they have a commitment to transact with their beneficiaries as patrons,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

1. Examples of Social Enterprises

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

***Microfinance Institutions ("MFIs")*:** MFIs provide loans and other financial services to poor customers in developing countries who lack access to capital.

FIGURE 1: SOCIAL ENTERPRISE



A social enterprise is a subsidized commercial enterprise (for-profit or nonprofit) with a commitment to transacting with a class of patron-beneficiaries. The patron-beneficiaries may belong to any class of the firm's patrons, including some or all of its customers, employees, or suppliers. The subsidy to the firm may be provided by donors, government or any other class of patrons. A one-sided light grey arrow is used to denote a subsidy. A two-sided dark grey arrow is used to denote a transactional relationship with a patron.

MFIs specialize in making small short-term loans, which are unprofitable for commercial banks but are essential for poor households and small businesses in developing countries. A well-known MFI is Compartamos, which lends mainly to the moderately poor. Compartamos is a for-profit owned by a

consortium of NGOs, foundations and social entrepreneurs. Although it underwent an IPO in 2007, the consortium shareholders continue to own a controlling interest in the company.[26] The NGOs and the International Finance Corporation provided the initial subsidy to the firm in the form of seed capital, which was funded by donations. In addition, the owners may provide a subsidy to the firm to the extent that the firm forgoes opportunities to serve wealthier individuals. Although Compartamos has been very profitable, it could arguably be more profitable if it served more affluent borrowers.[27] Compartamos does not transfer subsidies directly to its customer-beneficiaries like other MFIs, for example in the form of lower rates;[28] rather, the main benefit it confers on them is the opportunity to borrow.

***Credit Development Financial Institutions ("CDFIs")*:** CDFIs provide financial products to low-income customers in the U.S. that are generally not available from mainstream commercial banks, particularly depository

[26] COMPARTAMOS, S.A.B. DE C.V., 2012 ANNUAL AND SUSTAINABLE REPORT 86 (2013), https://www.compartamos.com/wps/themes/html/mango/media/CompartamosInformeWeb2012/compartamos%20ingles/pdfs/informe_anual_y_sustentable_2012_Grupo_Compartamos.pdf. [https://perma.cc/GV5M-KE7B]; BANCO COMPARTAMOS, S.A., OFFERING CIRCULAR 127–28 (2007), https://www.compartamos.com/wps/wcm/connect/?MOD=PDMProxy&TYPE=personalization&ID=NONE&KEY=NONE&LIBRARY=%252FcontentRoot%252Ficm%253Alibraries&FOLDER=%252FRelacion+con+Inversionistas%252FInformacion+Corporativa%252FProspecto+de+Colocacion+En%252F&DOC_NAME=%252FcontentRoot%252Ficm%253Alibraries%252FRelacion+con+Inversionistas%252FInformacion+Corporativa%252FProspecto+de+Colocacion+En%252FProspecto+de+Colocacion+Ingles+(Offerong+circular).pdf&VERSION_NAME=NONE&VERSION_DATE=NONE&IGNORE_CACHE=false&CONVERT=text/html&MUST_CONVERT=false [https://perma.cc/HKT3-6RA7] [hereinafter COMPARTAMOS OFFERING CIRCULAR].

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

[28] In fact, its rates are known to average nearly 90%. *See* Michael Chu, *Commercial Returns at the Base of the Pyramid*, INNOVATIONS, Winter/Spring 2007, at 115, 126.

services, home mortgages, and loans to small businesses. An example of a CDFI is the Carver Federal Savings Bank, a New York bank created to serve low-income African-American communities.[29] The bank is held by Carver Bancorp, Inc., a holding company whose shares are traded on the NASDAQ.[30] CDFIs are certified as such by a government agency, the CDFI Fund, which provides subsidies to CDFIs in different forms, including subsidized equity investments, guaranties, and grants.[31] To be certified, a firm must satisfy certain requirements to lend to low-income borrowers.[32] The CDFI Fund also enters into an Assistance Agreement with each CDFI that is awarded assistance.[33] The agreement incorporates performance goals to be accomplished by the CDFI, the scale of its activities, and the terms offered to low-income borrowers (e.g., below-market rates).[34] Equity investors in CDFIs are typically also eligible for tax credit incentives under the New Markets Tax Credits program.[35]

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29 *See* CARVER BANCORP, INC., ANNUAL REPORT (FORM 10-K), at 3 (June 29, 2015), http://www.snl.com/interactive/lookandfeel/112079/AnnualReport_ 2015_.pdf [https://perma.cc/MX4R-QWZA].

30 *See Corporate Profile*, CARVER FED. SAV. BANK, http://www.snl.com/irweblinkx/corporateprofile.aspx?iid=112079 [https://perma.cc/QTG3-K2ZU] (last visited Mar. 18, 2017).

31 *See* Lehn Benjamin et al., *Community Development Financial Institutions: Current Issues and Future Prospects*, 26 J. URB. AFF. 177, 177–79 (2004); *CDFI Types,* CDFI COALITION, http://www.cdfi.org/about-cdfis/cdfi-types/ [https://perma.cc/3DF4-NFLZ?type=image] (last visited Mar. 18, 2017).

32 For example, an applicant for CDFI certification must serve a Target Market, which is defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national median family income, or where the unemployment rate is 1.5 times the national average. *See* 12 C.F.R. § 1805.201(3) (2016).

33 12 C.F.R. § 1805.801 (2016).

34 *Id.*

35 *See* Julia Sass Rubin & Gregory M. Stankiewicz, *The New Markets Tax Credit Program: A Midcourse Assessment*, 1 COMMUNITY DEV. INVEST. REV. 1, 3 (2005).

***Social Investment Firms*:** Social investment firms make relatively small investments in businesses, including in other social enterprises, which are perceived as too risky for commercial investors, such as private equity and venture capital firms. While some social investment firms aim at earning near-competitive returns, others expect below-market returns.[36] Triodos Bank N.V., a bank based in the Netherlands, lends to businesses and nonprofits that have some social or ecological benefit, such as MFIs, fair trade social enterprises (discussed below), organic farms, and renewable energy projects.[37] The subsidy in the case of Triodos Bank flows from its equity holders that hold depository receipts and earn only moderate returns on equity.[38] The depository receipts are publicly listed and traded on a matched bargain system.[39] The voting rights in Triodos Bank are held by a foundation which makes voting decisions on behalf of the holders of depository receipts, and is required to exercise its voting rights in a manner consistent with its ethical goals and mission, its business

[36] J.P. MORGAN GLOB. RESEARCH & THE ROCKEFELLER FOUND., *supra* note 3, at 6; ROCKEFELLER PHILANTHROPY ADVISORS, SOLUTIONS FOR IMPACT INVESTORS: FROM STRATEGY TO IMPLEMENTATION 11–12 (2010), http://www.rockpa.org/wp-content/uploads/2016/02/MONO-SolutionForImpactInvestors2.pdf [https://perma.cc/W8Y5-T58H]; MONITOR INST., INVESTING FOR SOCIAL AND ENVIRONMENTAL IMPACT: A DESIGN FOR CATALYZING AN EMERGING INDUSTRY 31 (2009), http://monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf [https://perma.cc/3TNY-TME7].

[37] *What We Do*, TRIODOS BANK, https://www.triodos.com/en/about-triodos-bank/what-we-do/ [https://perma.cc/M4QN-AY8G] (last visited Mar. 18, 2017).

[38] TRIODOS BANK, 2015 ANNUAL REPORT 4 (2016), https://www.triodos.com/downloads/about-triodos-bank/annual-reports/triodos-bank-annual-year-report-2015.pdf [https://perma.cc/AP6Q-MKDW] [hereinafter TRIODOS BANK ANNUAL REPORT 2015]. The return on equity in 2015 was 5.5% (up from 4.4% in 2014). *Id.*

[39] A matched bargain system is a system for trading stocks that matches a buy offer directly with a sell offer. Such a system tends to be less liquid than standard stock exchanges.

interests, and the interests of the depository receipt holders.[40]

***Low-Cost Sellers*:** There are various types of organizations that sell affordable products or services to poor customers in developing markets, such as bed nets, eyeglasses, and healthcare services.[41] A to Z Textile Mills of Tanzania is a producer of long-lasting insecticide-treated bed nets.[42] A to Z is a for-profit firm that entered into a partnership that includes the World Health Organization, NGOs, and other large commercial firms. Pursuant to the partnership, A to Z is committed to selling bed nets in Tanzania, and the other partners provide it with various forms of subsidy, such as free use of technology and loans at below-market rates to buy machinery and specialized chemicals.[43] A to Z employs a price differentiation scheme, whereby bed nets are either sold at market price ($5 each) or through the partnership to vulnerable groups at a discount paid by the partnership or the Tanzanian government.[44]

***Fair Trade Social Enterprises ("FTSEs")*:** FTSEs buy their inputs (such as coffee beans) from small producers in developing countries.[45] The subsidies to FTSEs flow primarily from their consumers who are willing to pay a

40 TRIODOS BANK ANNUAL REPORT 2015, *supra* note 38, at 39.

41 *See generally* ASHISH KARAMCHANDANI ET AL., EMERGING MARKETS, EMERGING MODELS: MARKET-BASED SOLUTIONS TO THE CHALLENGES OF GLOBAL POVERTY (2009), http://www.beyondthepioneer.org/wp-content/uploads/2014/04/emergingmarkets_full.pdf [https://perma.cc/6FDG-KS3T]; C. K. PRAHALAD, THE FORTUNE AT THE BOTTOM OF THE PYRAMID: ERADICATING POVERTY THROUGH PROFITS (2010).

42 *See* WINIFRED KARUGU & TRIZA MWENDWA, A TO Z TEXTILE MILLS: A PUBLIC PRIVATE PARTNERSHIP PROVIDING LONG-LASTING ANTI-MALARIA BED NETS TO THE POOR 2 (2007), http://healthmarketinnovations.org/sites/default/files/A%20To%20Z%20Textiles%20Case%20Study.pdf [https://perma.cc/F88L-SHGJ].

43 *Id.* at 9–10.

44 *Id.* at 11.

45 *See generally* ALEX NICHOLLS & CHARLOTTE OPAL, FAIR TRADE: MARKET-DRIVEN ETHICAL CONSUMPTION (2005).

premium on fair trade products.[46] Sales of fair trade products have increased dramatically in the last twenty years.[47] Large corporations, such as Starbucks and Nestle, sell fair trade products. There are also many firms that only sell fair trade products, such as Cafédirect, a prominent hot drinks company in the UK. Cafédirect products are certified by Fairtrade International ("FLO").[48] The Fair Trade mark is attached to products that comply with the Fair Trade standards to signal to consumers that they deserve a premium over other products.[49] The Fair Trade standards certify, *inter alia*, that the producers are "small producers," broadly defined as those who produce labor-intensive products but employ a limited number of permanent workers

46 DANIELE GIOVANNUCCI & FREEK JAN KOEKOEK, THE STATE OF SUSTAINABLE COFFEE: A STUDY OF TWELVE MAJOR MARKETS 40 (2003), http://www.iisd.org/publications/pub.aspx?pno=579 [https://perma.cc/VQ27-KL9H].

47 *See* Rebecca Smithers, *Global Fairtrade Sales Reach £4.4bn Following 15% Growth During 2013*, GUARDIAN (Sept. 3, 2014, 11:23 AM), https://www.theguardian.com/global-development/2014/sep/03/global-fair-trade-sales-reach-4-billion-following-15-per-cent-growth-2013 [https://perma.cc/XZE9-R3MP]; Press Release, Research Reveals Increased Consumer Demand for Fair Trade Certified-Labeled Products, Fair Trade USA (Apr. 25, 2011), https://fairtradeusa.org/press-room/press_release/research-reveals-increased-consumer-demand-fair-trade-certified-labeled-pro [https://perma.cc/2KP5-7ADV]; *cf.* Sarah Butler, *Fairtrade Sales Fall for First Time in Foundation's 20-Year Existence*, GUARDIAN (Feb. 22, 2015, 7:01 PM), https://www.theguardian.com/business/2015/feb/23/fairtrade-sales-fall-first-time-20-year-existence [https://perma.cc/6TLM-JFA6].

48 *See Cafédirect: A Fairtrade Pioneer*, FAIRTRADE INT'L (June 20, 2011), https://www.fairtrade.net/new/latest-news/single-view/article/cafedirect-a-fairtrade-pioneer.html [https://perma.cc/4AK6-NDF2]. Note though that Fair Trade standards do not exist for all products, including many types of fruits and handicrafts. *See Standards for Small Producer Organizations*, FAIRTRADE INT'L (2014), https://www.fairtrade.net/standards/our-standards/small-producer-standards.html [https://perma.cc/C87H-RE5K].

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

or rely on family labor.[50] Moreover, FLO ensures (through audits and inspections) that the importer pays producers the Fair Trade minimum price, provides them with a "social premium" that must be used for developing their community, and, when requested, extends them pre-financing of up to 60% of the orders.[51]

Though many FTSEs rely exclusively on subsidies from consumers, shareholders appear to provide Cafédirect's subsidy by accepting below-market returns.[52] Cafédirect seems to use such subsidies to pay a higher price and a higher social premium than that mandated by the Fair Trade standards.[53] The shares of Cafédirect are publicly listed and traded on a matched bargain exchange.[54] While shareholders do have voting rights, there is also a guardian share, which is held by a subsidiary of Oxfam and a cooperative of producers that transact with the firm.[55] The guardian share has the right to block any changes to the company's objectives to sell exclusively fair trade products and reinvest a third of the profits in growers' communities.[56]

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50 FAIRTRADE INT'L, FAIRTRADE STANDARD FOR SMALL PRODUCER ORGANIZATIONS § 1.2 (2011), https://www.fairtrade.net/fileadmin/user_upload/content/2009/standards/documents/generic-standards/SPO_EN.pdf [https://perma.cc/FMU6-TFME].

51 *Id.* § 4.1; FAIRTRADE INT'L, FAIRTRADE STANDARD FOR COFFEE FOR SMALL PRODUCER ORGANIZATIONS §§ 4.2–4.3 (2011), https://www.fairtrade.net/fileadmin/user_upload/content/2009/standards/documents/2012-04-01_EN_SPO_Coffee.pdf [https://perma.cc/WPY6-EB2V].

52 CAFÉDIRECT, 2014 ANNUAL REPORT (2015), http://www.cafedirect.co.uk/wp-content/uploads/downloads/2015/05/FINAL-Annual-Review-2015.pdf [https://perma.cc/FXD8-BUNU] ("Cafédirect has built over the years a big pool of friends who have continued to support the business despite declining sales. Shareholders have really been very understanding given that no dividends have been declared in successive years.").

53 *Id.* at 3.

54 *Id.* at 10.

55 *Id.* at 28.

56 *Id.*

***Work Integration Social Enterprises ("WISEs")*:** WISEs are businesses that employ disadvantaged workers who suffer from systemic unemployment. Disadvantaged employees include disabled people, ethnic minorities, individuals with a criminal record, and members of low-income communities.[57] WISEs usually sell products or services that require a large number of low-skilled employees in industries such as food, catering, and custodial services. A notable example is the Greyston Bakery, a growing business that specializes in gourmet brownies and baked ice cream ingredients. The Greyston Bakery hires workers in a low-income area in Yonkers, New York who have little or no education or employment records.[58] Unlike other WISEs that pay fair market wages to their worker-beneficiaries, the bakery pays its workers a salary that reflects their average productivity without a wage premium.

The Greyston Foundation, a nonprofit dedicated to promoting community development primarily through employment programs, owns the bakery.[59] The bakery has received subsidies from various sources. The foundation provided capital to the bakery presumably using donative funds. The foundation also provides training, housing assistance, and childcare services to the workers (among

57 JERR BOSCHEE, SOCIAL ENTERPRISE SOURCE BOOK (2001), http://www.socialent.org/pdfs/GREYSTONBAKERY.pdf [https://perma.cc/5B4V-2R27]; Catherine Davister et al., *Work Integration Social Enterprises in the European Union: An Overview of Existing Models* 11–12 (EMES Working Paper No. 04/04, 2004), http://emes.net/publication-categories/working-papers/ [https://perma.cc/WWS2-EDWB].

58 BOSCHEE, *supra* note 57, at 78–83; Michael Barker et al., A Case Study on Greyston Bakery: The Do-Goodie Product Launch 2 (May 15, 2009) (unpublished manuscript) (on file with the author) [hereinafter Barker et al., The Do-Goodie Product]; Michael Barker et al., Greyston Bakery: The Costs and Benefits of an Open Hiring Policy 1 (May 15, 2009) (unpublished manuscript) (on file with the author) [hereinafter Barker et al., Open Hiring Policy].

59 *See* Barker et al., The Do-Goodie Product, *supra* note 58, at 3.

others).[60] Moreover, the bakery has been receiving favorable trade terms from its well-known customer, the ice cream company Ben & Jerry's, including a willingness to adjust the terms of transactions if performance is not adequate or timely.[61] The bakery also markets its social mission to attract premiums from consumers.[62]

2. The Structure of For-Profit Social Enterprises

For-profit social enterprises are not solely characterized by having a transactional relationship with a class of beneficiaries—in addition, they all have some contractual relationship with a nonprofit entity. Each of the social enterprises described above is either controlled or certified by a nonprofit or has a contract with one. This Article uses the term "nonprofit entity" loosely to include not only nonprofit corporations, but also government agencies and multilateral organizations, such as the World Bank. All these entities are effectively subject to a constraint on distribution, i.e., those who control the organization cannot distribute earnings to themselves. Social entrepreneurs, i.e., individuals with a strong reputation for pursuing altruistic missions who may also be viewed as being subject to some constraint on distribution,[63] are also included in this definition of nonprofit entity.

The role of the nonprofit is essentially to ensure that the for-profit social enterprise transacts with its beneficiaries as patrons, and in some cases also allocates a subsidy to them. There are essentially three mechanisms by which the nonprofit monitors the for-profit entity: **(1) *Certification mechanisms*:** firms or products are certified as a form of social enterprise in accordance with certain standards. As

60 BOSCHEE, *supra* note 57, at 83.

61 Barker et al., The Do-Goodie Product, *supra* note 58, at 8.

62 *See id.* at 1–2.

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

discussed above, the products of FTSEs are certified by FLO, to ensure that the firm transacts with "small producers" and extends them favorable terms. Likewise, CDFIs are certified as financial institutions that serve low-income communities. **(2) *Contractual mechanisms*:** a contract between the social enterprise and a nonprofit can require the social enterprise to transact with disadvantaged individuals. As discussed above, A to Z entered into an agreement with certain nonprofits to sell affordable bed nets to low-income consumers. Likewise, CDFIs enter into an assistance agreement with the CDFI Fund that dictates the terms extended by CDFIs to their consumers (e.g., discounted interest rates). **(3) *Control mechanisms*:** the for-profit is controlled, through ownership or voting rights, by a nonprofit that ensures that the for-profit transacts with a disadvantaged group. This mechanism is used by many forms of social enterprise, including MFIs such as Compartamos, social investment firms such as Triodos Bank, WISEs such as the Greyston Bakery, and even FTSEs such as Cafédirect.

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

3. Social Enterprises as Commercial Nonprofits

Social enterprises (as hybrid organizations) may be—and many are—formed as nonprofits. Nonprofit social enterprises fall under the definition of commercial nonprofits, which receive a substantial part of their income from selling products or services.[64] They are also hybrid organizations as they all receive some form of subsidy, whether from income tax exemptions or donations. In this case there is only one entity, the nonprofit social enterprise. For nonprofit social enterprises, the commitment device is simply the non-distribution constraint and the nonprofit form. Those who control the organization have limited incentives to compromise the mission of the organization, which is to transact with disadvantaged individuals.[65] There are many examples of nonprofit social enterprises. Some of the largest and most influential MFIs are nonprofits, including BRAC and ASA in Bangladesh. Community loan funds, a form of CDFI that focuses on loans to nonprofits and small businesses, are typically nonprofits.[66] The Acumen Fund is a nonprofit venture fund that makes investments in businesses in developing countries that promote social goods,

64 Hansmann, *supra* note 17, at 840–41. This raises the question whether many other commercial nonprofits, such as nursing homes and hospitals, should be viewed as social enterprises, especially those that do not engage in development missions. The answer turns on whether or not such organizations facilitate transactions with individuals that cannot transact with commercial firms. For example, nursing homes and day care centers that provide high quality services to affluent customers would not count as social enterprises. However, hospitals and universities that provide affordable services to low-income individuals would count.

65 The function of the non-distribution constraint was laid out in *id.*, at 838. In addition, for a commercial firm, such as a bank or a bakery, to qualify as a tax-exempt organization under I.R.C. § 501(c)(3), it must serve a charitable purpose, presumably by transacting with disadvantaged or poor individuals.

66 CDFI COALITION, *supra* note 31.

such as A to Z discussed above.[67] VisionSpring, a low-cost manufacturer and seller of affordable reading glasses,[68] and Aravind Eye Care System, a provider of low-cost eye care services,[69] are nonprofits.

B. Social Enterprises Versus Donative Organizations

Social enterprises need to be distinguished from donative organizations. Donative organizations have been defined as nonprofits that are funded primarily by donations.[70] Oxfam International, a nonprofit devoted to promoting development and alleviating poverty, is a well-known example. This Article uses the term "donative organization" to refer not only to certain nonprofit corporations but also to government agencies and multilateral organizations that allocate subsidies to promote development. These organizations may be viewed as nonprofits because they are effectively subject to a non-distribution constraint; those who control the organization are prohibited from appropriating its funds for themselves. Moreover, they are essentially dependent on a form of grant, i.e., an allocation of governmental funds. USAID and the World Bank are two common examples of such organizations.

There are two main elements that distinguish between social enterprises and donative organizations. The first is that the former are funded by earned income, whereas the latter are funded by donations. As discussed above, social enterprises, as subsidized commercial enterprises, may receive donations or grants. The critical point, however, is that the financial viability of social enterprises is primarily

67 *See* ACUMEN, http://acumen.org/ [https://perma.cc/L732-PDKM] (last visited Mar. 17, 2017).

68 *See* VISIONSPRING, http://visionspring.org/ [https://perma.cc/7RW3-JCVB] (last visited Mar. 17, 2017).

69 *See About Us*, ARAVIND EYE CARE SYSTEM, http://www.aravind.org/Default/aboutuscontent/genesis [https://perma.cc/373T-WAGQ] (last visited Mar. 17, 2017).

70 Hansmann, *supra* note 17, at 840.

dependent on earned income rather than donations. The second often overlooked element, which is central to the theory in this Article, is that donative organizations are engaged primarily in allocating subsidies to "external" beneficiaries, i.e., beneficiaries who are not patrons of the enterprise.[71] Examples of subsidies to external beneficiaries include distribution of goods (e.g., bed nets), subsidies towards the purchase of goods or services (e.g., voucher schemes or contribution of capital through credit subsidies), and professional training programs. To be sure, many social enterprises do allocate subsidies to their beneficiaries. MFIs may provide subsidized rates to their borrowers, and FTSEs may provide training subsidies to their farmers. However, whereas donative organizations are engaged exclusively in transferring subsidies to beneficiaries, social enterprises require their patron-beneficiaries to provide a nontrivial consideration (e.g., return of a loan with interest, or input provided by farmers) that reflects their capital and resources (e.g., ability to pay or productivity).

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

71 *See infra* Figure 2. Donative organizations may have a contract with their beneficiaries that requires them to use subsidies for their intended purpose (e.g., using medical supplies to treat patients). But, the critical point is that the beneficiaries are not required to provide a nontrivial consideration for the benefit received.

example.[72] Similarly, donative organizations often agree to provide training subsidies and quality control to farmers in developing countries if a for-profit firm—essentially an FTSE—contractually commits to buying its supplies from those producers.[73]

Second, control mechanisms often include a donative organization that provides subsidized equity investment to the social enterprise entity. One example is the Greyston Foundation, the owner of the Greyston bakery. Its regular activities concentrate on providing professional training to external beneficiaries, i.e., the unemployed, but with respect to the bakery, it operates like a social investment firm.[74]

FIGURE 2: DONATIVE ORGANIZATION

A donative organization is funded by subsidies in the form of donations or grants, and it distributes those subsidies to its beneficiaries. A one-sided light grey arrow is used to denote a subsidy.

72 *See supra* text accompanying notes 41–44.

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

74 For instance, the bakery is the patron-beneficiary. *See supra* note 62 and accompanying text.

C. Social Enterprises Versus Other Hybrid Organizations

As stated above, a common form of hybrid organization consists of corporations that engage in corporate charity and corporate social responsibility ("CSR"). The major difference between these organizations and social enterprises is that they do not involve a commitment to transacting with beneficiaries. In most cases, like donative organizations, CSR policies involve the transfer of a subsidy to an external beneficiary.[75] Many corporations donate a portion of their profits to charity. Often such donations are made to a donative organization (for example, the Global Fund) that channels them to external beneficiaries (e.g., people with HIV in developing countries). CSR policies are largely identical to corporate charity in economic terms, except that CSR usually refers to a wider range of methods for passing on subsidies. Google has vowed to use one percent of its profits and its employees' time to create solutions to global problems, such as climate change and poverty alleviation.[76]

TABLE 1: GIVING VERSUS TRANSACTING

	Giving	**Transacting**
For-profit	**Corporate Charity**	**For-profit Social Enterprise**
Nonprofit	**Donative Organizations**	**Nonprofit Social Enterprise**

75 More difficult cases of CSR, where the subsidy is channeled to a patron but there is no "true patron-beneficiary," are discussed *infra* Section VI.A.

76 *See* Reiser, *supra* note 10, at 2439.

Accordingly, the key distinction drawn in this paper is between organizations that provide charity through giving subsidies and social enterprises that commit to transacting with disadvantaged groups. The distinction between giving and transacting transcends the traditional distinction between for-profits and nonprofits. As shown in Table 1, "giving" organizations include both donative organizations and for-profit corporations that engage in charity, and as shown above, social enterprises may be formed as for-profit or nonprofits. The focus of this Article is to highlight the advantages of social enterprises in utilizing subsidies to promote development, although other forms of hybrid organizations are discussed in more detail in Section VI.

Finally, not all firms fit neatly into a specific category. Many social enterprises adopt corporate social responsibility initiatives. Similarly, a donative organization may comprise a social enterprise.[77] Accordingly, the categories identified herein should be considered as ideal types rather than mutually exclusive and exhaustive categories.

III. A THEORY OF SOCIAL ENTERPRISE

The theory of social enterprise set out here explains how the transactions with their patron-beneficiaries make social enterprises relatively effective in addressing complex development missions as compared to other forms of organization. For this purpose, there is no need to draw distinctions between social enterprises formed as for-profits and those formed as nonprofits, as long as they are under a commitment to transact with a class of disadvantaged patrons. This Section will first consider the problems posed by the use of subsidies and then will explain how the measurement function of social enterprises can mitigate these problems.

77 For example, donative organizations that operate training programs may also employ disadvantaged workers.

A. The Limits of Subsidies

Standard economic theory is suspicious of subsidizing corporations. There is a general concern that subsidies fail to achieve their purpose and may be expropriated by those who control the organization. In the case of donative organizations, the non-distribution constraint mitigates the possibility that managers will expropriate the subsidies (i.e., the donations). The non-distribution constraint on its own is a relatively crude mechanism that works well especially when donative organizations simply transfer subsidies to beneficiaries (e.g., soup kitchens). However, in many cases, the goal of subsidies is to address complex development missions, such as increasing access to capital and improving employment opportunities. It is unrealistic to expect the non-distribution constraint to assure donors that their subsidies will be used effectively when the mission is highly complex.

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

Social enterprises are designed to deal with the uncertainty of subsidies' effectiveness when subsidies are intended to address complex development missions, such as increasing access to capital and enhancing productivity.

Employing subsidies effectively to address such problems requires differentiating among beneficiaries based on their attributes, including creditworthiness, productivity, and ability to pay. Such complex problems merit specific attention. Consider a worker from a disadvantaged community that suffers from systemic unemployment. Rephrasing the issue, the problem is that such a worker cannot find employment at a standard commercial firm. Likewise, poor individuals cannot get loans from commercial banks, small producers have difficulty selling their products to multinational corporations, and individuals in rural communities cannot buy essential products and services.

This inability of disadvantaged people to transact with commercial firms may derive from two sources. The first is that commercial firms have difficulty evaluating the abilities of individuals that belong to disadvantaged groups. As a result of such information asymmetries, commercial firms fail to transact with them, even if such individuals have fully competitive ("FC") abilities to carry out their transactions with the firm. A substantial body of research shows that although many members of disadvantaged communities may be too poor or lack technical skills, a significant number of them have sufficient capabilities to transact with commercial firms, for example, by buying products, repaying debt, or working at a factory.[78] While any commercial firm has to deal with information asymmetries with respect to the attributes of its patrons, e.g., workers' skills or borrowers' creditworthiness, there are various mechanisms to mitigate these problems. For example, education helps workers signal their abilities, and credit-rating bureaus collect information on borrowers' creditworthiness. Such mechanisms are often absent in developing countries or low-income communities. Moreover, the high proportion of individuals who lack FC abilities in disadvantaged communities makes it harder for commercial firms to identify those who have such abilities. Consequently, when transacting with disadvantaged

78 See *infra* Part IV.

individuals, firms may face a higher risk of transacting with individuals with less than FC abilities.[79] Transacting with disadvantaged patrons therefore entails opportunity costs (reflecting the opportunity to transact with patrons with higher abilities), and hence leads commercial firms to ignore them altogether.

Second, many disadvantaged individuals fall short of FC abilities. Commercial firms would not transact with them even if they could observe their abilities. The traditional approach to dealing with this problem is for a donative organization, a government agency, or a nonprofit to provide them with some form of assistance—essentially a subsidy. Such assistance may take several forms, for example, distribution or subsidization of goods, credit subsidies, or professional training programs. However, for such a subsidy to be effective there must be information on the abilities of its beneficiaries. An effective subsidy would only be allocated to those who have below-competitive ("BC") abilities, but who could reach FC abilities if they received the subsidy. A subsidy would be of limited effectiveness if it were allocated to people who already have FC abilities or to individuals who have no competitive ("NC") abilities, i.e., individuals who are unable to acquire FC abilities even if they received assistance.[80] For example, a training subsidy should be administered only to workers who have some basic skills and

79 In general, firms can adjust their contracts to reflect the lower abilities of disadvantaged patrons, for example, by reducing wages or increasing interest rates to borrowers. But as wages fall or interest rates increase, more capable patron-beneficiaries will exit the market, a process that leads to rationing and often a collapse of the market. *See* Joseph E. Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV. 393, 393 (1981); *see also* ARMENDÁRIZ & MORDUCH, *supra* note 16, at 29–56.

80 Of course, this categorization is somewhat crude, but it is nonetheless helpful in elucidating the advantages of social enterprises.

could perform at a fully competitive level if they received professional training.[81]

The problem with donative organizations, however, is that they have limited means for gathering information on their beneficiaries' attributes. By definition, there is no transactional relationship between the organization and the beneficiaries.[82] A contractual transaction enables commercial enterprises to elicit information about their patrons, especially their abilities and preferences. It shows that patrons have at least some capabilities to perform the contract. For example, repayment of a debt or performance as an employee reveals information on one's abilities. By contrast, because donative organizations do not transact with their beneficiaries, they lack this information.[83]

If donative organizations had information on beneficiaries' attributes, they would be able to allocate the appropriate amount and type of subsidy. But, without such information, there is a risk that they will prescribe wasteful programs with limited effect[84] that do not address the needs

81 To be sure, charitable transfers (e.g., cash or food stamps) to those with NC abilities is desirable; the point is that at a very low ability level, professional training would be a wasteful way of allocating subsidies to such individuals.

82 *See supra* Figure 2.

83 Donative organizations could conduct impact studies of their programs to address this problem. However, these studies are often prohibitively costly. For example, following every worker that undergoes a training program to record employment and performance requires paying numerous staffers to both gather and interpret the information. Moreover, it has been argued that donative organizations have only modest incentives to carry out such studies because they may highlight to donors the ineffectiveness of the organization's programs. *See* Bertin Martens, *The Role of Evaluation in Foreign Aid Programmes*, *in* THE INSTITUTIONAL ECONOMICS OF FOREIGN AID 154, 170 (Bertin Martens et al. eds., 2002).

84 There is ample literature on the disappointing effectiveness of aid provided by government agencies or international organizations. *See id.*, at 155; William Easterly, *Can the West Save Africa?*, 47 J. ECON. LITERATURE 373, 438–39 (2009); William Easterly, *Was Development Assistance a Mistake?*, 97 AM. ECON. REV., 328, 330 (2007); Claudia R.

and attributes of their beneficiaries. The waste in this case includes the costs of the subsidy (e.g., the cost of the training) given to those with FC abilities (as they do not need any training) and to those with NC abilities (for whom training would be useless).[85] The additional social costs include the waste from training those with BC abilities effectively who nonetheless fail to obtain employment with firms that choose to ignore disadvantaged individuals anyway. Accordingly, subsidies tend to be wasteful when there is a high proportion of individuals with FC or NC abilities or if commercial firms ignore disadvantaged groups anyway.

B. The Measurement Role of Social Enterprises

The thrust of the theory described in this Article is that transacting with their beneficiaries gives social enterprises the tools and incentives to utilize subsidies effectively. Social enterprises perform a *measurement* function with respect to the attributes of their beneficiaries. Unlike donative organizations, social enterprises are committed to transacting with their beneficiaries as patrons.[86] The commitment device ensures that they cannot transact with other more capable patrons, for example, more productive workers from high-income communities.[87] Because transacting with disadvantaged patrons entails opportunity costs, social enterprises must receive some subsidies.

Williamson, *Exploring the Failure of Foreign Aid: The Role of Incentives and Information*, 23 REV. AUSTRIAN ECON. 17, 27–31 (2010).

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

86 *Compare supra* Figure 1 *with supra* Figure 2.

87 The form of commitment device adopted by the social enterprise is of limited relevance for present purposes. For a discussion of choice of commitment devices and organizational form, see *infra* Part V.

However, as explained above, social enterprises must still earn revenues to remain financially viable.[88] For social enterprises to earn revenues, the patron-beneficiaries must be able to perform their tasks and duties under their transactions with the social enterprise firm at a reasonable level: a WISE would suffer financially if its workers were not competent; an MFI must ensure that its borrowers are sufficiently creditworthy; if the quality of input is low, FTSEs will not be able to sell their products; and for a low-cost seller to be commercially viable, its consumers must be able to purchase the products or services it offers.

Consequently, social enterprises have the tools and the incentives to measure their beneficiaries' abilities to make sure that they have at least FC or BC abilities.[89] For example, as discussed below, WISEs closely evaluate the productivity and performance of their worker-beneficiaries. Social enterprises use the information on their patron-beneficiaries to tailor the amount and type of subsidies to their specific needs. If the subsidies transferred to beneficiaries are excessive, the social enterprise will be less profitable. If the subsidy is insufficient or inadequate, the patron-beneficiaries may not perform well, and again the business will suffer. For example, a WISE will employ those with FC abilities, but has no need to allocate them a training subsidy. It will then allocate a subsidy only to those who have BC abilities. In particular, given its contractual

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

89 Depending on the business model, some social enterprises transact only with individuals who have FC abilities, whereas others transact also with those who have BC abilities.

relationship with its worker-beneficiaries, a WISE is able to ensure that workers with BC abilities are actually productive and that the training program is indeed adapted to the commercial needs of the firm.[90] Note also that there are welfare gains to patron-beneficiaries with FC or BC abilities who would not otherwise be able to transact with commercial firms.[91] Contrast this with a donative organization that allocates wasteful subsidies to beneficiaries with FC and NC abilities, and has no practical way to ensure that its beneficiaries are actually employed. Accordingly, the use of social enterprises results in more effective deployment of subsidies.

In this way, the commitment to transacting with a disadvantaged group effectively aligns the profit and social missions of social enterprises.[92] More specifically, it aligns the interests of the subsidy providers with the profit interest of those who control the social enterprise, i.e., the owners in the case of for-profit social enterprises[93] or the managers in the case of nonprofit social enterprises who presumably want to maximize spending on perquisites.[94] In order for social

90 A social enterprise will sever its transactions with those who have NC abilities as they are unable to perform the job, but these individuals may still seek relief from a donative organization. *See* J.P. MORGAN GLOB. RESEARCH & THE ROCKEFELLER FOUND., *supra* note 3, at 45 (noting that a portion of the population with the lowest income levels will remain reliant on aid).

91 These welfare gains are equal to the economic surplus they derive from their transactional relationship with the social enterprise.

92 Note that this is subject to the risk of mission-drift discussed *infra* Section VII.A.

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

94 In line with the model of nonprofits offered by Glaeser & Shleifer, *supra* note 19, managers of nonprofits want to increase profits because they can extract a proportion of such profits in the form of higher salaries and perks.

enterprises (for-profits or nonprofits) to remain financially viable, they must ensure that their patron-beneficiaries perform well and that subsidies are not wasted. Thus, the incentives of social enterprises to allocate subsidies effectively are present even if, and in fact in large part because, the owners and/or managers are motivated by profit. The same incentives exist when the owners and/or managers are altruistic, because even an altruistic owner or manager does not derive utility from wasting subsidies and must make sure that the business is viable for it to achieve its development mission.

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

To be sure, these mechanisms are not conceptually different from those used in contracts between standard commercial firms and their patrons. The main difference is

that employing these mechanisms with respect to disadvantaged persons is more costly than with respect to non-disadvantaged ones and may require social enterprises to develop specialized techniques to measure the attributes of disadvantaged individuals; hence, the need for a subsidy. For example, doing diligence in rural markets on the creditworthiness or ability to pay of low-income people may be extremely costly; intensive monitoring of workers with different ability levels requires a great deal of effort on the part of managers. Additionally, as shown below, incentive mechanisms used by social enterprises can be highly specialized and entail high transaction costs.

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

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

pay or skill level, donative organizations could simply tailor subsidies to their needs.

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

IV. APPLICATION OF THE THEORY

This Section applies the theory to various forms of social enterprise. The discussion is divided into different types of development goals. With respect to such goals, this Section describes how information problems preclude standard commercial firms from transacting with disadvantaged groups, explains why donative organizations fail to assist them, and shows how social enterprises use their measurement role to address the problem.

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

***(1) Commercial Firms*:** Commercial banks have traditionally avoided transacting with poor individuals in low-income communities in both developing and developed countries. Commercial lenders rely on credit scores to evaluate their borrowers. They also require collateral or other security to mitigate the risk of default. In low-income communities, credit scores are usually not available, as borrowers lack credit history, employment track record, and, in some cases, even proof of identity. In addition, poor borrowers usually lack collateral to pledge as security for a

loan.[95] Moreover, the presence of many risky borrowers who have limited earning capacity makes it harder for banks to identify those who can repay their debts. Likewise, investment firms tend to ignore small businesses, especially in developing countries.[96] In developed markets, investment firms, such as private equity firms, rely on audited financial information, the track record and reputation of their investees' management, and general market information. By contrast, in developing markets, the balance sheet of businesses may not be a reliable source of information, as financial standards either do not exist or are not enforced, and, more generally, data on the relevant market may be scarce. Moreover, evaluating the potential of a small business with no track record can be difficult.

***(2) Donative Organizations*:** Many low-income individuals or small businesses cannot pay commercial rates for loans or generate commercial returns. Governments of developing countries have for many years subsidized credit in an attempt to increase access to capital, especially for small farmers. These subsidies have taken different forms, in particular, the allocation of cheap loans through credit subsidies. However, credit subsidies in whatever form have been grossly inefficient.[97] Repayment rates in such programs have been very low, with default rates ranging from forty to ninety-five percent.[98] Impact studies have attributed low repayment rates in large part to information problems.

95 *See* CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY (Margaret J. Miller ed., 2003).

96 *See* HELMS, *supra* note 16, at 2–5; PRAHALAD, *supra* note 41, at 32; Benjamin et al., *supra* note 31, at 177–79.

97 ARMENDÁRIZ & MORDUCH, *supra* note 16, at 9–12; *see generally* UNDERMINING RURAL DEVELOPMENT WITH CHEAP CREDIT (Dale W. Adams et al. eds., 1984); Avishay Braverman & J. Luis Guasch, *Rural Credit Markets and Institutions in Developing Countries: Lessons for Policy Analysis from Practice and Modern Theory*, 14 WORLD DEV. 1253 (1986); Juan J. Buttari, *Subsidized Credit Programs: The Theory, the Record, the Alternatives* (USAID Evaluation Special Study No. 75, 1995).

98 ARMENDÁRIZ & MORDUCH, *supra* note 16, at 9–10.

Examples include inadequate program design that wrongly assumed that borrowers, mainly farmers, necessarily had good projects, uncertainty regarding the ability of borrowers to meet payment obligations, and failures to monitor borrowers who often diverted loan funds to other purposes, including consumption.[99] Moreover, many borrowers lacked knowledge and inputs, and therefore their projects were likely to fail. Accordingly, these subsidized programs were often wasteful and their costs swamped the modest benefits that they generated.

***(3) Social Enterprises*:** MFIs, CDFIs, and social investment firms tailor the terms of their investments to the creditworthiness and business potential of their investees. Compartamos charges market rates on its loans to the moderately poor. Thus, it does not directly allocate subsidies to its beneficiaries; rather, it utilizes the subsidies it has received to measure its beneficiaries' creditworthiness. As a result of such measurement, default rates tend to be very low, despite the high interest rates charged to borrowers.[100] Simply transferring credit subsidies to borrowers in circumstances when they can afford to take out a commercial loan or, even worse, when they have no viable projects is clearly an inferior solution. On the other hand, MFIs, CDFIs and social investment firms that transact with less capable individuals provide them with different types of subsidies. For example, MFIs, such as ASA, BRAC and Grameen Bank, provide their borrowers with reduced rates and business training.[101] Similarly, while some social investment funds

99 *See* Braverman & Guasch, *supra* note 97, at 1257; Buttari, *supra* note 97.

100 Default rates for Compartamos were historically less than 1%, whereas the average default rate on consumer loans by other Mexican banks was 4.4%. *See* COMPARTAMOS OFFERING CIRCULAR, *supra* note 26, at 83.

101 *See* ARMENDÁRIZ & MORDUCH, *supra* note 16, at 325–39; BRAC, 2015 ANNUAL REPORT 22 (2016), http://www.brac.net/images/reports/BRAC-Bangladesh-Report-2015.pdf [https://perma.cc/CD53-2M27]; Ruhul Amin & Rashidul Islam Sheikh, *The*

seek to make near-competitive returns,[102] others, such as Triodos Bank and the Acumen Fund, charge below-market rates and provide business training to their investees.[103] Thus, the prices and subsidies are adjusted to the beneficiaries' abilities.

The effectiveness of subsidies channeled through social enterprises is evidenced by their self-sustainability. When borrowers of MFIs and CDFIs pay back their loans, and investees of social investment firms generate reasonable returns, this indicates that the subsidies are effective, as the patron-beneficiaries are performing well. In particular, measurement of borrowers has been particularly successful for MFIs whose loan repayment rates tend to be very high.[104] As discussed above, social enterprises use three primary mechanisms to measure their beneficiaries:

(i) Due diligence: CDFIs use alternative mechanisms to collect information on the creditworthiness of low-income borrowers, such as utility bills, house visits, and personal interaction with borrowers.[105] To reduce the costs of

Impact of Micro-Finance Program on the Poor: A Comparative Study of Grameen Bank, BRAC and ASA in Some Selected Areas in Bangladesh, 3 EUR. J. BUS. & MGMT. 346 (2011). Note that the rates charged by microfinance institutions are higher than average commercial rates because of the risk associated with lending to the poor; the key point however is that their lending rates are lower than those that commercial firms would require if they made loans to disadvantaged individuals.

102 For example, the IGNIA Fund, discussed *infra* Section V.C.

103 *See* MOSES LEE, ACUMEN FUND: HOW TO MAKE THE GREATEST IMPACT (2007), http://acumen.org/wp-content/uploads/2009/01/1428592-acumen-fund-donotcopy.pdf [https://perma.cc/L8X5-X9JB]; TRIODOS BANK ANNUAL REPORT 2015, *supra* note 38.

104 There is mixed data on delinquency rates of CDFIs' loans, though they generally appear to be comparable to industry averages. *See* MICHAEL SWACK ET AL., CARSEY INSTITUTE, CDFI INDUSTRY ANALYSIS: SUMMARY REPORT (2012).

105 Lindsey Appleyard, *Community Development Finance Institution (CDFIs): Geographies of Financial Inclusion in the US and UK*, 42 GEOFORUM 250, 255 (2011); KATY JACOB, THE CTR. FOR FIN. SERVS. INNOVATION, REACHING DEEPER: USING ALTERNATIVE DATA SOURCES TO INCREASE THE EFFICACY OF CREDIT SCORING, https://s3.amazonaws.com/cfsi-

information, they also tend to specialize in specific industries, such as housing finance.[106] Social investment firms invest effort and resources in due diligence, including vetting the character and qualifications of the management team and financial analysis of their investees.[107] By contrast, MFIs that make very small loans to borrowers tend to conduct a less onerous diligence process and rely more extensively on other mechanisms.

(ii) Intensive monitoring: MFIs as well as CDFIs evaluate the performance of their borrowers for the duration of their loans, and over time they accumulate data on borrowers' business projects and repayment rates. MFIs use frequent repayment installments of very small amounts in order to allow their credit officers an early opportunity to assess borrowers' performance.[108] Repayment of the loan on time is a clear indication of a borrower's abilities, and she may then be given additional loans. At some stage, it may become evident that borrowers no longer need a subsidy. They then may obtain loans at commercial rates; for example, the interest rates may be lowered and the loan size increased, not as a disbursal to the borrower, but to reflect the lower risk of lending to a borrower with higher abilities. On the other hand, if borrowers default, they receive no additional loans.[109] Through this process, MFIs and CDFIs have

innovation-files/wp-content/uploads/2017/02/14031138/2006-03-Reaching-Deeper-Using-Alternative-Data-Sources-to-Increase-the-Efficacy-of-Credit-Scoring.pdf [https://perma.cc/X279-MK2P] (last visited Mar. 18, 2017).

106 *See* Ronald Grzywinski, *The New Old-Fashioned Banking*, HARV. BUS. REV., May–June 1991, at 87, 93; Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. PA. L. REV. 1561, 1578–79 (1995).

107 *See* J.P. MORGAN GLOB. RESEARCH & THE ROCKEFELLER FOUND., *supra* note 3, at 70. For a useful illustration of the process, see WILLIAM DAVIDSON INSTITUTE, ACUMEN FUND: VALUING A SOCIAL VENTURE (A) (2009); WILLIAM DAVIDSON INSTITUTE, ACUMEN FUND: VALUING A SOCIAL VENTURE (B) (2009).

108 *See* ARMENDÁRIZ & MORDUCH, *supra* note 16, at 145–53.

109 For example, South Shore Bank, a known CDFI, experimented with loans to small businesses that suffered from high default rates before

compiled a sizeable database on the creditworthiness of their target markets. Although social investment firms tend to rely more on diligence, they also exercise substantial monitoring over their investees. The monitoring may consist of appointing directors to the board of the investee and requiring board consent for certain business decisions, including not only major transactions, such as mergers, but also managerial decisions regarding business strategy.[110]

(iii) Incentive mechanisms: Many MFIs rely on a specialized incentive mechanism known as group lending. The gist of it is that loans are made to a group of borrowers who are jointly liable for the debts of each other borrower in the group.[111] Group lending gives rise to a process of assortative matching whereby safe (risky) borrowers form groups with other safe (risky) borrowers. The risky borrowers are effectively charged higher rates than the safe ones because their groups default more often. In this way, group lending generates information on borrowers' abilities before a loan is made. Group lending also reduces moral hazard *ex post* a loan contract, as group members monitor each other to make sure they repay their loans, and failure to pay results in social stigma.[112] Group lending has been often associated with very high repayment rates of over 90%. Despite its apparent effectiveness, many MFIs are gradually shifting away from group lending to more standard mechanisms, mainly because conducting group meetings involves high transaction and social costs.[113] In particular,

it started focusing on housing finance. *See* Grzywinski, *supra* note 106, at 93.

110 *See, e.g.*, WILLIAM DAVIDSON INSTITUTE, ACUMEN FUND: VALUING A SOCIAL VENTURE (A), *supra* note 107, at 21 –24.

111 For a detailed explanation, see ARMENDÁRIZ & MORDUCH, *supra* note 16, at 97–98.

112 *Id.* at 157.

113 Nitin Bhatt & Shui-Yan Tang, *The Problem of Transaction Costs in Group-Based Microlending: An Institutional Perspective*, 26 WORLD DEV. 623 (1998).

MFIs promise borrowers an opportunity to borrow more capital on better terms if they repay their existing loans on time.[114] Thus, loans may be made for larger amounts, longer terms, and at better interest rates. This addresses the risk that borrowers will not pay once project returns have been realized.

B. Improving Productivity: Fair Trade Social Enterprises

***(1) Commercial firms*:** Multinational corporations buy their inputs from well-established commercial producers or middlemen and avoid buying inputs directly from small producers.[115] The major concern of commercial firms is the quality of products supplied by small producers. In a fragmented market of numerous suppliers, and with respect to products the quality of which is not observable by cursory inspection, it is too costly to evaluate each item of input. Coffee beans and bananas are two notable examples.[116] There is great difficulty in distinguishing among producers with different ability levels, especially as many small producers in developing countries do not meet the quality

114 ARMENDÁRIZ & MORDUCH, *supra* note 16, at 140, 143.

115 Small producers sell their products to middlemen known as "coyotes" who are often in a position to exploit their monopsonist power. Thus, a common explanation for fair trade is that it is a solution to monopsonist pricing. *See* NICHOLLS & OPAL, *supra* note 45, at 33–34; Mark Hayes, *On the Efficiency of Fair Trade*, 64 REV. SOC. ECON. 447 (2006). This view ignores a more fundamental question, which is why there is no competition in the first place. If multinational corporations traded directly with small producers, competition for the products of small producers would raise prices. The problem is that information asymmetries preclude direct trading between corporations and small producers. This problem is similar to the problem of monopolist moneylenders with respect to lending to poor borrowers. When commercial lenders refrain from lending to the poor because of information problems, monopolist moneylenders may step in and lend at exploitative rates. *See* ARMENDÁRIZ & MORDUCH, *supra* note 16, at 31–33.

116 *See* NICHOLLS & OPAL, *supra* note 45, at 81, 87.

standards of export markets.[117] It is also costly to monitor small producers to ensure that they exert a sufficient level of effort. Small producers may try to establish a reputation for high quality by using marketing tools, but with few exceptions, they tend to be too segregated or too poor to establish a brand. Accordingly, many producers, especially farmers, in developing countries have difficulties selling their products to multinational corporations even if they can meet high quality standards.

***(2) Donative Organizations*:** Many farmers lack training with respect to quality standards, production methodologies, and organizational skills.[118] Donative organizations may provide them with assistance in the form of subsidized input, such as fertilizer, professional training, and technical assistance. Subsidizing fertilizers to enhance farm productivity has a longstanding history in attempts to jumpstart African agriculture.[119] These programs, however, were found to have high costs and questionable benefits. In particular, programs have suffered from a variety of problems, including little actual use of fertilizers by farmers, lack of information on the benefits of fertilizers and how to properly use them, excessive use that may in fact reduce yields, delivery after the optimal fertilization period, and lack of complementary measures (e.g., quality inputs).[120] Although yields do seem to increase following subsidization

117 *See id.* at 35–36.

118 *See* DEAN KARLAN & JACOB APPEL, MORE THAN GOOD INTENTIONS: HOW A NEW ECONOMICS IS HELPING TO SOLVE GLOBAL POVERTY 168 (2011); NICHOLLS & OPAL, *supra* note 45, at 34–39.

119 Easterly, *Can the West Save Africa?*, *supra* note 84, at 416; MICHAEL MORRIS ET AL., THE WORLD BANK, FERTILIZER USE IN AFRICAN AGRICULTURE: LESSONS LEARNED AND GOOD PRACTICE GUIDELINES (2007), http://documents.worldbank.org/curated/en/498591468204546593/pdf/390370AFR0Fert101OFFICIAL0USE0ONLY1.pdf [https://perma.cc/7VJG-CC55].

120 MORRIS ET AL., *supra* note 119, at 31–44.

or distribution,[121] there is a consensus that these programs tend to be inefficient. The record of training programs, known as agricultural extension, has been even more dismal. Agricultural training requires dealing with individual farmers, and each farmer's needs are different.[122] Among other problems, training programs have been found to suffer from lack of information as to farmers' abilities and needs, difficulties in attributing impact to training efforts, little effort to learn from experience, and limited incentives to provide quality information to farmers.[123] Moreover, given the difficulty of attributing outcomes, program staff tends to focus excessively on reporting input indicators, such as visits made, rather than material impact.[124] There is also evidence that the training is only useful to farmers with higher skills,[125] though it is presumably administered to all farmers in a given community.

***(3) Social Enterprises*:** FTSEs have a clear advantage in adjusting their subsidies to the attributes of their producers. Cafédirect's business development programs, which include building capabilities in marketing, quality control, and crop management, are tailored to producers' specific needs.[126] FTSEs have incentives to subsidize

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

122 Easterly, *Can the West Save Africa?*, *supra* note 84, at 419.

123 *See* Jock R. Anderson & Gershon Feder, *Agricultural Extension: Good Intentions and Hard Realities*, 19 WORLD BANK RES. OBSERVER 41, 55 (2004); Jock R. Anderson et al., *The Rise and Fall of Training and Visit Extension: An Asian Mini-drama with an African Epilogue* (World Bank Pol'y Res. Working Paper 3928, 2006), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=917499 [https://perma.cc/ DQ4Q-UEJ5]; WORLD BANK INDEP. EVALUATION GRP., WORLD BANK ASSISTANCE TO AGRICULTURE IN SUB-SAHARAN AFRICA 44, 54–56 (2007), http://siteresources.worldbank.org/EXTASSAGRISUBSAHAFR/Resources/ag_africa_eval.pdf [https://perma.cc/F5K4-5VF7].

124 Anderson et al., *supra* note 123 at 6.

125 *Id.* at 5.

126 CAFÉDIRECT, *supra* note 52, at 3.

fertilizers and high-quality input to the extent that small farmers cannot afford to purchase them, as well as to teach farmers how to use them effectively. The effectiveness of their training and fertilizer subsidies is simply evidenced by their financial sustainability. The profitability of Cafédirect is itself an indication that the quality of the product is high and that the subsidies it allocates to its producers are sufficient to enable them to reach fully competitive abilities. FTSEs measure their beneficiaries' attributes in the following ways:

(i) Due diligence: FTSEs invest in studying the capabilities of producers. They send expeditions to developing countries to visit producers in order to sample the quality of their products. Often a donative organization will partner with a FTSE and assist with sampling and training.[127]

(ii) Intensive monitoring: FTSEs typically sell high-quality products, mainly to address concerns that the poor cannot produce quality products.[128] Therefore, they naturally need to monitor the quality of the input they buy from producers. Although their relationship with their producer-beneficiaries is generally expected to be long-term (as discussed below), there is no commitment to transacting with producers who turn out to be unable to perform. FTSEs learn which producers are more capable than others, as the quality of the input affects the quality of the end product. If consumers buy the product, this is an indication of its high quality, and vice versa.

(iii) Incentive mechanisms: First, the Fair Trade standards require small producers to be members of cooperatives, an arrangement under which producer-

127 *See* Karnani, *supra* note 73. For examples of cooperation by Starbucks with various donative organizations, see JAMES E. AUSTIN & CATE REAVIS, STARBUCKS AND CONSERVATION INTERNATIONAL 12 (2004) (Harv. Bus. Sch. Case 9-303-055); Paul A. Argenti, *Collaborating with Activists: How Starbucks Works with NGOs*, 47 CAL. MGMT. REV. 91, 108–10 (2004).

128 NICHOLLS & OPAL, *supra* note 45, at 24.

members have equity ownership proportional to the quantity of product they sell through the cooperative.[129] The function of the cooperative, other than to enable producers to pool resources and capital, is to address information asymmetries. The formation of cooperatives leads to assortative matching among producers, like group lending in the case of MFIs. Producers with sufficiently high capabilities will partner with producers with similar capabilities in order to ensure that their cooperative will supply products of sufficient quality, so that FTSEs continue to transact with them. Once the cooperative starts transacting, producers have incentives to monitor each other to ensure that each of them supplies high-quality input in a timely fashion.

Second, Fair Trade standards contain requirements that enhance producers' incentives to invest in the quality of their products by insuring producers against risks outside their control. FTSEs are expected to transact with small producers on a long-term basis,[130] and importers that cut off small producers without good reason are likely to face reputational costs. Moreover, importers must pay either the market price or floor price of a commodity, whichever is higher, and must pre-finance up to 60% of orders.[131] The reason for this is not only to transfer wealth to the producers; rather, the primary reason is that producers, who lack access to credit and insurance products, may have to cut costs at the expense of quality if they are subject to unexpected adverse shocks. Income smoothing and price insurance assure producers that they will not face short-term capital constraints or severe loss as a result of a sharp decline in commodity prices or a drought. When given a price that reflects their efforts and the promise, albeit informal, of future transactions if they

129 *See* FAIRTRADE STANDARD FOR SMALL PRODUCER ORGANIZATIONS, *supra* note 50, § 4.2.

130 *See id.* § 4.

131 FAIRTRADE STANDARD FOR COFFEE FOR SMALL PRODUCER ORGANIZATIONS, *supra* note 51, § 4.2.

perform well, producers have stronger incentives to invest in quality.

C. Employment Opportunities: Work Integration Social Enterprises

***(1) Commercial firms*:** Low-income individuals and other disadvantaged groups, such as disabled persons or people with a criminal record, tend to suffer from systemic unemployment.[132] The reason for this appears to be the costs associated with evaluating their abilities. In any hiring decision, commercial firms face asymmetric information with respect to workers' abilities. In developed labor markets, workers typically use their educational and professional qualifications, job referrals, and even their social backgrounds to signal their abilities to prospective employers. Such signaling mechanisms are particularly important in the case of low-skill jobs where employers care primarily about soft skills, such as discipline and attentiveness, which are difficult to observe prior to hiring. Poor workers in disadvantaged communities tend to lack access to education and have little or no employment track record.[133] Moreover, the presence of a large number of workers with low skills makes it even harder for firms to identify those who have sufficient abilities. In these circumstances, firms often assume that all workers who belong to a disadvantaged group are unlikely to be capable workers.

***(2) Donative Organizations*:** When workers lack sufficient capabilities, donative organizations may provide them with training with the goal of integrating unemployed and economically disadvantaged workers into the workforce.

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132 *See* TIMOTHY J. BARTIK, JOBS FOR THE POOR: CAN LABOR DEMAND POLICIES HELP?, 55–58 (2001).

133 *Id.* at 57; Giulia Galera, *Social Enterprises and the Integration of Disadvantaged Workers*, *in* THE ECONOMICS OF SOCIAL RESPONSIBILITY: THE WORLD OF SOCIAL ENTERPRISES, 105, 106–07 (Leonardo Becchetti & Carlo Borzaga eds., 2011).

Many studies, however, show that the effectiveness of training programs tends to be partial at best. The benefits to participants in terms of earnings and employment are modest and do not persist over time.[134] Interestingly, many studies suggest that the least able participants among the low-skilled populations benefit the least from them.[135] This indicates that many programs are wasteful in the sense that training is provided to those whose abilities may be too low. In addition, training programs have been criticized for failing to meet the needs of commercial businesses.[136] Thus, the evidence as a whole suggests that training programs have limited effectiveness.

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

(i) Due diligence: Many WISEs, like any business, conduct diligence *ex ante* hiring decisions. WISEs may rely on

134 *See* James J. Heckman et al., *The Economics and Econometrics of Active Labor Market Programs*, *in* 3A HANDBOOK OF LABOR ECONOMICS 1865, 2050–54 (Orley C. Ashenfelter & David Card eds., 1999); BARTIK, *supra* note 132, at 88–110; WORLD BANK INDEP. EVALUATION GRP., USING TRAINING TO BUILD CAPACITY FOR DEVELOPMENT: AN EVALUATION OF THE WORLD BANK'S PROJECT-BASED AND WBI TRAINING 36–38 (2008), http://siteresources.worldbank.org/EXTTRABUICAPDEV/Resources/full_doc.pdf [https://perma.cc/WN8W-UJLU] [hereinafter IEG, USING TRAINING TO BUILD CAPACITY].

135 Heckman et al., *supra* note 134, at 2060–64.

136 *See* BARTIK, *supra* note 132; IEG, USING TRAINING TO BUILD CAPACITY, *supra* note 134, at 36–38; John P. Martin & David Grubb, *What Works and for Whom: A Review of OECD Countries' Experiences with Active Labour Market Policies* 15 (OECD Working Paper 2001:14), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=348621 [https://perma.cc/8EWZ-NJTJ].

referrals from training agencies, nonprofits, or welfare departments, and some conduct rigorous screening of referrals through interviews and tests.[137] The Greyston Bakery, on the other hand, does not conduct any diligence *ex ante* hiring; rather, it relies on intensive monitoring and incentive mechanisms *ex post* hiring.

(ii) Intensive monitoring: The Greyston Bakery hires workers on a "no questions asked" basis. At this stage it has limited information on its newly hired employees, who may have different levels of ability.[138] The management then monitors their performance and gathers information on their abilities, especially their attitude, punctuality, and productivity. After one year's apprenticeship, during which they are evaluated on a biweekly basis, they may be hired as full-time employees. In the course of their employment they receive ongoing professional development training, which includes intensive bi-weekly performance evaluations. By contrast, such intensive monitoring is not necessary in standard commercial bakeries, because workers tend to have higher abilities. Over time, the firm gathers information on employees. Workers who perform well may be promoted to better positions or move to working for higher salaries at commercial firms. On the other hand, workers who fail to meet certain minimum standards are laid off. The average turnover rate at Greyston is relatively high and entails high costs for the firm.

(iii) Incentive mechanisms: As mentioned above, the workers of the Greyston Bakery who perform adequately may be hired as full-time employees after a year's apprenticeship and may later be promoted to better positions, including managerial ones.[139] In addition, the bakery provides positive reinforcement to its employees, including a monthly award of distinction.[140] Workers thus

137 BARTIK, *supra* note 132, at 219.

138 Barker et al., Open Hiring Policy, *supra* note 58, at 1.

139 *Id.*

140 Barker et al., The Do-Goodie Product, *supra* note 58, at 6.

have incentives to reveal their true abilities. Workers have little incentive to understate their abilities because they may either lose their jobs or forgo opportunities to gain awards, promotions, or better salaries.

D. Enhancing Consumer Welfare: Low-Cost Retailers and Service Providers

***(1) Commercial firms*:** Although multinationals are increasingly penetrating emerging markets, many rural markets remain underserved.[141] Consequently, many essential products and services are often lacking in such markets. Examples include eyeglasses, health services, water purifiers, and bed nets. Many poor customers in developing markets actually have substantial purchasing power.[142] In mature developed markets, commercial firms may produce affordable products designed specifically for low to moderate-income customers at a profit. The growth of low-cost retailers and food chains, such as Walmart and McDonalds, is a pertinent example. In rural markets, however, the problem seems to be the costs of gathering information on consumers' abilities and preferences. Rural communities typically include a large proportion of very low-income consumers.[143] Identifying those consumers who have sufficient abilities to buy existing or hypothetical products may be prohibitively costly. In addition, consumers' preferences are difficult to observe. Traditional distribution channels, an absence of effective means of communication, and linguistic and cultural differences make it costly for firms to observe consumers' spending patterns and tailor their products to consumers' needs and preferences.[144]

141 PRAHALAD, *supra* note 41, at 37.

142 *See* DARYL COLLINS ET AL., PORTFOLIOS OF THE POOR: HOW THE WORLD'S POOR LIVE ON $2 A DAY (2009).

143 SANAL KUMAR VELAYUDHAN, RURAL MARKETING: TARGETING THE NON-URBAN CONSUMER 74–76 (2d ed. 2007).

144 *See* KARAMCHANDANI ET AL., *supra* note 41, at 36–37, 113; PRAHALAD, *supra* note 41, at 37–38. Moreover, household income of the

***(2) Donative Organizations*:** The distribution of essential goods and services raises concerns similar to those of other subsidies, although the evidence is more equivocal. Empirical studies that have compared the effect of distributing versus selling products have yielded different results. Many studies concentrate on bed nets and water purifiers. On the one hand, there is significant evidence that bed nets donated by NGOs have been inappropriately used as fishing nets, not used at all, or even resold to others.[145] Moreover, another study relating to chlorine shows that consumers who pay higher prices are more likely to use it in their drinking water.[146] On the other hand, many other studies suggest that demand for bed nets and health products is very sensitive to price, and usage rates decline sharply even when fees are very low.[147] The reason appears to be limited knowledge about the benefits of bed nets and health products in preventing disease. These studies arguably support the view that bed nets and other essential products should be distributed to the poor for free.

Nonetheless, this evidence needs to be qualified. First, to the extent that consumers are able to pay for goods or services, as accepted in virtually all studies, subsidies are inherently wasteful. As many poor individuals can afford to pay at least a portion of the market price of a product, clearly the efficient policy would be to use fewer subsidies per

poor tends to be not only low, but also irregular and unpredictable. COLLINS ET AL., *supra* note 142, at 16–17; Ashish Karamchandani et al., *Is the Bottom of the Pyramid Really for You?*, HARV. BUS. REV., March 2011, at 107, 108.

145 Noboru Minakawa et al., *Unforeseen Misuses of Bed Nets in Fishing Villages Along Lake Victoria*, 7 MALARIA J. 165, 165 (2008); WORLD HEALTH ORGANIZATION, INSECTICIDE-TREATED MOSQUITO NETS: A WHO POSITION STATEMENT 5 (2007), http://files.givewell.org/files/DWDA%202009/Interventions/Nets/itnspospaperfinal.pdf [https://perma.cc/M3MY-AT7V].

146 Nava Ashraf et al., *Can Higher Prices Stimulate Product Use? Evidence from a Field Experiment in Zambia*, 100 AM. ECON. REV. 2383, 2385 (2010).

147 *See* Easterly, *Can the West Save Africa?*, *supra* note 84, at 411.

beneficiary and produce more bed nets with the savings. Second, none of these studies compares donative organizations to social enterprises, such as low-cost sellers. The sale of products under these studies is done through a randomized process. Consequently, these studies cannot capture the incentives of social enterprises to create a market for their products and educate consumers about the benefits of the products and how to use them. Therefore, these studies do not prove that giving subsidies for free is necessarily a good policy.[148]

***(3) Social Enterprises*:** Low-cost sellers have incentives to gather information on consumers' ability to pay for their products and to create a market for the product. Consider A to Z. The Acumen Fund's investment in A to Z, together with other subsidies, has facilitated the production of millions of bed nets per year. Although distribution of bed nets remains essential for very low-income individuals, a social enterprise that differentiates among consumers in accordance with their ability to pay is a preferable approach to channeling subsidies. For a given investment, many more bed nets will be sold by a social enterprise than delivered by a donative organization that bears the full costs of each bed net.[149] Tiered price schemes that differentiate among consumers are employed by other low-cost sellers, including both nonprofits such as VisionSpring, a low-cost manufacturer and seller of

148 For other criticisms of these studies, *see* Dani Rodrik, *The New Development Economics: We Shall Experiment, but How Shall We Learn?*, *in* WHAT WORKS IN DEVELOPMENT? THINKING BIG AND THINKING SMALL 24, 28 (William Easterly & Jessica Cohen eds., 2010). There is also a concern that the subjects of these studies refuse to pay for products because they anticipate receiving them for free in the future.

149 The Acumen Fund estimated that it would cost less than $0.02 to protect one individual from malaria for one year by making an investment in A to Z, compared to $0.84 through a donative organization. *See* ACUMEN FUND, THE BEST AVAILABLE CHARITABLE OPTION 3 (2007), http://acumen.org/wp-content/uploads/2013/03/BACO-Concept-Paper-final.pdf [https://perma.cc/G79N-ZDU7].

affordable reading glasses,[150] and Aravind Eye Care System, which provides low-cost eye-care services,[151] as well as for-profits such as Ziqitza Healthcare Limited ("ZHL"), a private ambulance service provider in areas lacking high-quality emergency services.[152] The output of each of these firms (e.g., glasses sold or eye surgeries performed) and their financial sustainability serve as indicators of the effectiveness of their subsidy allocation policies.

Low-cost sellers measure their beneficiaries' attributes mainly by using due diligence, given that their transactions with the consumer-beneficiaries are discrete rather than ongoing as in the case of loans or employment. Low-cost sellers invest more capital than commercial enterprises would in research on the relevant market to learn about consumers' spending patterns and preferences, as well as distribution channels in these markets. In addition, they invest in marketing and in educating consumers on the benefits of certain products, such as bed nets and eye-care products. A to Z, together with its nonprofit partners, developed a marketing, retail, and pricing system to publicize and create demand for bed nets among the poor.[153] Moreover, low-cost sellers design business models tailored to the needs and preferences of low-income households,

150 *See* MOLLY CHRISTIANSEN & TED LONDON, SCOJO FOUNDATION: A VISION FOR GROWTH AT THE BASE OF THE PYRAMID (2008), https://oikos-international.org/wp-content/uploads/2013/10/oikos_Cases_2008_Scojo_Foundation.pdf [https://perma.cc/G6YB-4ELW]; NICO CLEMMINCK & SACHIN KADAKIA, WHAT WORKS: SCOJO INDIA FOUNDATION 20–21 (2007), http://siteresources.worldbank.org/DEVMARKETPLACE/Resources/What-Works-Scojo-India.pdf [https://perma.cc/9T24-LFCA].

151 Aravind Eye Care System provides free surgeries to its poorest customers. *See* KARAMCHANDANI ET AL., *supra* note 41, at 30.

152 ZHL charges patients who request to be taken to full-service hospitals a standard fee and offers a discounted rate to those taken to government hospitals. *See* GITA JOHAR & JOANNA HARRIES, DIAL 1298 FOR AMBULANCE MARKETING EMS IN MUMBAI 3–4 (2010), http://acumen.org/wp-content/uploads/2013/03/1298-Ambulance-Columbia-B-School.pdf [https://perma.cc/LW6L-6S49].

153 *See* KARUGU & MWENDWA, *supra* note 42, at 10–11.

including not only tiered pricing, but also innovative cost-cutting methods and specialized distribution channels. The Aravind Eye Care service reduces the demand on doctors' time by training skilled paramedics to undertake standardized clinical tasks, so that doctors' time is spent on surgeries.[154] VisionSpring has created an innovative distribution system that relies on a web of local entrepreneurs with good reputations and connections in rural communities. Finally, after they start offering new products, low-cost sellers further continue to evaluate consumers' preferences, adjust pricing, and design new products.[155]

V. COMMITMENT DEVICES AND CHOICE OF LEGAL FORM

The foregoing Section assumed that social enterprises have a commitment to transacting with disadvantaged individuals. As explained above, for-profit social enterprises may use one of three commitment devices—certification, contract, and control mechanisms[156]—while nonprofit social enterprises rely on the non-distribution constraint.[157] The purpose of this Section is to examine in greater detail the structure and function of different commitment devices.

Social enterprises invariably receive subsidies. In theory, it would be ideal if social enterprises could provide detailed information on the use of subsidies and their effects on beneficiaries' welfare. However, monitoring the use of subsidies and evaluating their benefits is very costly. Hence, the solution is simply to create organizations that have incentives to use subsidies effectively. Transacting with patron-beneficiaries is the mechanism that gives social

154 KARAMCHANDANI ET AL., *supra* note 41, at 62.

155 *See, e.g.*, CHRISTIANSEN & LONDON, *supra* note 150, at 6 (describing how VisionSpring adjusts its strategy and pricing to market demand).

156 *See supra* Section II.A.2.

157 *See supra* Section II.A.3.

enterprises incentives and tools to use subsidies effectively. The essence of commitment devices is that a nonprofit is responsible for identifying a class of patron-beneficiaries, such as borrowers or workers, and verifying the transactions with them. While it is very costly to evaluate the effectiveness of subsidies in achieving development missions, it is relatively simple for nonprofits to verify transactions with patron-beneficiaries. Thus, transacting with the beneficiaries not only underlies the measurement role of social enterprises, but also facilitates the formation of social enterprises as for-profits.

To be sure, commitment devices may go beyond verifying the transaction with beneficiaries. Where the subsidy providers expect a social enterprise to transact with beneficiaries with below-competitive abilities who need some form of subsidy (e.g., a better price or training), the commitment devices also verify that such subsidies are indeed distributed to beneficiaries.[158] Otherwise, there is a risk that social enterprises will transact exclusively with patron-beneficiaries with fully competitive abilities (who do not need subsidies) and those who control the organization will appropriate that part of the subsidies.[159] A good example is the Fair Trade standards, which require producers to provide a floor price and a social premium.

Before embarking on the analysis of different devices, it is worth mentioning that the ability of social enterprises to form as both for-profits and nonprofits gives some credence to the claim that the distinction between the for-profit and nonprofit forms has been gradually eroding.[160] Nonetheless,

158 In fact, the same commitment devices can be used to commit to any form of hybrid organization, for example, corporate charity. *See infra* Part VI.

159 This risk is often referred to as "mission-drift." *See infra* Section VII.A.

160 *See* THE ASPEN INST., ENTERPRISING ORGANIZATIONS: NEW ASSET-BASED AND OTHER INNOVATIVE APPROACHES TO SOLVING SOCIAL AND ECONOMIC PROBLEMS 1, 2 (2005), https://assets.aspeninstitute.org/content/uploads/files/content/docs/pubs/E

it is important to emphasize that all the commitment devices of for-profit social enterprises rely on organizations that are subject to the non-distribution constraint to monitor the for-profit entity. Accordingly, contrary to some recent claims that the non-distribution constraint has lost its usefulness as a commitment device,[161] it remains a key component of the commitment devices associated with for-profit social enterprises. The rationale is that organizations that are subject to a non-distribution constraint can be trusted to monitor for-profits.

A. Certification Mechanisms

Certification mechanisms consist of a nonprofit or government agency that evaluates whether or not firms satisfy certain standards. Certification is feasible only when it is possible to create uniform standards with respect to both the class of beneficiaries and the type of subsidies that should be allocated to them. The best-known example is Fair Trade certification described above. FLO certifies the class of patron-beneficiaries as "small producers," and it ensures through audits and inspections that the producers are allocated subsidies in the form of the Fair Trade minimum price, a social premium, and pre-financing of up to 60% of the orders.[162] Because coffee and other agricultural products, such as bananas, are traded on global commodity exchanges, it is possible to identify commodity prices and prescribe standards for financing and premiums. Small producers can

nterprisingOrgs%20(for%20web).pdf [https://perma.cc/L9CF-TPF2]; Joseph J. Cordes & C. Eugene Steuerle, *Nonprofits and Business: A New World of Innovation and Adaptation*, *in* NONPROFITS AND BUSINESS 1 (Joseph J. Cordes & C. Eugene Steuerle eds., 2008); Alter, *supra* note 9, at 205; Jonathan Conning & Jonathan Morduch, *Microfinance and Social Investment*, 3 ANN. REV. FIN. ECON. 407, 414 (2011).

161 *See* DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 116–19 (2008); Malani & Posner, *supra* note 6, at 2021–22; Clara Miller, *The Equity Capital Gap*, STAN. SOC. INNOVATION REV., Summer 2008, at 41–42.

162 *See supra* note 51.

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

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

When the subsidies flow from other sources, such as the government, a common approach is to use certification of the firm as a whole. An example discussed above is certification by the CDFI Fund, which provides below-market rate investments and guarantees to eligible CDFIs.[163] The class of beneficiaries is defined by reference to aggregate wealth measures of the relevant market, defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national average, or where the unemployment rate is 1.5 times the national average.[164] Another example is incorporation under certain European hybrid legal forms (e.g., the Italian social cooperative), which require that at least a certain percentage of the workers of the incorporating firm belong to a class of disadvantaged individuals.[165] Incorporation as a hybrid essentially constitutes a certification of the firm as a WISE and makes the firm eligible for certain government subsidies.

163 CDFI COALITION, *supra* note 31.

164 12 C.F.R. § 1805.201(b)(3)(ii)(C) (2016).

165 *See* Cafaggi & Iamiceli, *supra* note 5, at 7–14; *see also* Francine J. Lipman, *Enabling Work for People with Disabilities: A Post-Integrationist Revision of Underutilized Tax Incentives*, 53 AM. U. L. REV. 393, 429–30 (2003) (defining disadvantaged individuals to include disabled people, ex-offenders, welfare recipients or recipients of unemployment insurance).

B. Contractual Mechanisms

An alternative commitment device is a contract with a nonprofit organization stipulating that the subsidies will be used for their intended purpose.[166] Contractual mechanisms are typically used when the subsidy to the social enterprise is provided by a donative organization. Contractual mechanisms allow greater flexibility than certification and individual tailoring in defining the class of beneficiaries and the type of disbursals allocated to them. Low-cost sellers may need flexibility in adjusting their prices and discounts to different customers who have different levels of wealth. As discussed above, as part of its partnership with various nonprofit organizations, including the World Health Organization and NGOs, A to Z is committed to marketing and selling bed nets at different discounts funded by the partnership or the local government. With respect to CDFIs, as mentioned above, the CDFI Fund is required to enter into an Assistance Agreement with certified CDFIs that are awarded a subsidy.[167] The agreement must specify, *inter alia*, the CDFI's performance goals and the terms offered to low-income borrowers.[168] While certification is used to define the class of beneficiaries, greater flexibility is necessary to tailor the terms provided to the beneficiaries' economic and social conditions.

C. Control Mechanisms

The most flexible commitment device is control by a nonprofit. The controlling nonprofit typically provides subsidies to the social enterprise, for example subsidized capital. Control allows the nonprofit owner to determine the class of beneficiaries and the type of disbursals (if any). The Greyston Bakery is owned by a single owner, the Greyston

166 *See* Allen R. Bromberger, *A New Type of Hybrid*, STAN. SOC. INNOVATION REV., Spring 2011, at 49.

167 12 C.F.R. § 1805.801 (2016).

168 *Id.*; 12 C.F.R. § 1805.803 (2016).

Foundation.[169] Complete ownership of the social enterprise, however, is not necessary. As discussed above, a controlling stake in Compartamos, whose shares are publicly listed, is held by nonprofits, such as NGOs and foundations. This mechanism provides the nonprofit owners reasonable assurance that the firm will not change its mission if lending to low-income persons entails opportunity costs.

An example of a social investment firm is the IGNIA Fund, which invests in businesses in developing countries in various fields, such as healthcare services and organic farming. The fund is structured as a limited partnership (i.e., a for-profit entity), but is owned by the International Finance Corporation, foundations, and social entrepreneurs.[170] Many low-cost sellers also use control mechanisms. ZHL, described above,[171] is owned by the Acumen Fund (a nonprofit social investment firm) and social entrepreneurs.

Another way to implement a control mechanism is to place the voting rights, at least on fundamental issues, in the hands of a nonprofit. For example, the shares of the social investment firm, Triodos Bank, are held by a foundation that makes voting decisions on behalf of the holders of depository receipts.[172] Similarly, as described above, the guardian share of Cafédirect is held by a subsidiary of Oxfam International and a cooperative of producers that transact with the firm.

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

170 Author's conversation with Alonso Bustamante Guerra, Senior Analyst, IGNIA Fund, (Oct. 19, 2009); *see also Investors,* IGNIA, http://www.ignia.com.mx/bop/investors.php [https://perma.cc/R8XY-HGB3] (last visited Mar. 18, 2017).

171 *See supra* note 152 and accompanying text.

172 For a detailed description, see *supra* Section II.A.1.

The guardian share has the right to block any proposal, including a takeover that might compromise the firm's social mission.[173]

As compared to other commitment devices, control mechanisms allow social enterprises flexibility in deciding which beneficiaries merit assistance and what kind of subsidies they should receive. This appears to be the reason why MFIs and social investment firms use control mechanisms. Creating a uniform standard for developing countries in the fields of banking, investment, retail, and services may be difficult. For example, Compartamos lends mainly to the moderately poor and the vulnerable non-poor.[174] Other for-profit MFIs that have adopted control mechanisms transact with customers who need greater assistance and discounted interest rates.[175] Similarly, whereas the IGNIA Fund seeks to generate returns equivalent to those of private equity firms, Triodos Bank earns moderate returns on equity.[176]

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

The flexibility of control mechanisms is also reinforced by their use by FTSEs, such as Cafédirect. Unlike other FTSEs, such as Starbucks, Cafédirect sells exclusively fair trade

173 *See supra* Section II.A.1.

174 COMPARTAMOS OFFERING CIRCULAR, *supra* note 26, at 77.

175 *See* Thomas Dichter, Basix (India): The Challenges of Permanently Pioneering (Jan. 20, 2009) (unpublished manuscript) (on file with author).

176 TRIODOS BANK ANNUAL REPORT 2015, *supra* note 38, at 25 (noting a return on equity of 5.5% in 2015).

products. The control mechanism allows the firm to commit to more demanding standards than those prescribed by FLO. Thus, Cafédirect buys inputs from producers who are less capable than other small producers that qualify as such for the purpose of certification, pays larger premiums to its producers than those required by FLO, and provides more training to them. Thus, control mechanisms enable firms to tailor the Fair Trade standards to their own business model.

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

D. The Nonprofit Form

Many social enterprises continue to form as commercial nonprofits.[177] A key reason for choosing the nonprofit form is its tax advantages in sourcing donations and income tax

177 *See supra* Section II.A.3.

exemptions.[178] When social enterprises are likely to have low profitability, they are more likely to rely on donations and income tax exemptions. Low profitability can arise either because such firms transact with beneficiaries with relatively low abilities who need substantial disbursals, or because there is a high variance in beneficiaries' abilities that requires the firm to invest substantial resources in measurement and tailoring subsidies to their needs.

As discussed above, Compartamos makes loans primarily to moderately poor borrowers in markets where there is relatively better information on borrowers' creditworthiness, and it charges high interest rates. By contrast, nonprofit MFIs, such as ASA and BRAC, provide very small loans to poorer borrowers, mainly women, in rural markets where information is scarce. Therefore, they charge relatively low interest rates and provide a range of services to their borrowers, including schooling, training, and help with business and marketing plans.[179] In fact, Compartamos itself started out as a nonprofit firm and converted into a for-profit as its borrowers developed stronger business acumen and credit history, and the firm acquired better information on its target market.[180]

VI. OTHER FORMS OF HYBRID ORGANIZATION

Most accounts of hybrid organizations do not distinguish between social enterprise and all other types of hybrid

178 Nonprofit social enterprises also have stronger incentives to transact with beneficiaries with lower abilities. *See infra* Section VII.A.

179 ARMENDÁRIZ & MORDUCH, *supra* note 16, at 22.

180 *See Compartamos Banco*, ACCION, https://www.accion.org/our-impact/compartamos-banco [https://perma.cc/J7H7-DPGN] (last visited Mar. 18, 2017). An additional example is the Acumen Fund, a nonprofit that targets investments that may not generate market returns, and therefore the Acumen Fund partly relies on donative funding. *See* LEE, *supra* note 103. The IGNIA Fund, by contrast, is a for-profit limited partnership that seeks to make commercial returns on its investments. *See Our Story*, IGNIA, http://www.ignia.mx/about-us/ [https://perma.cc/2NPF-CKJ4] (last visited Mar. 18, 2017).

organization. From a policy perspective, equating social enterprises to other hybrid organizations may yield ill-advised policy recommendations because many hybrid organizations, especially corporations that engage in corporate social responsibility and corporate charity, do not perform the measurement role of social enterprises. In fact, as shown below, most of them engage in transferring or giving subsidies to beneficiaries, and therefore, are less likely to be effective in addressing complex development missions. Thus, policy recommendations to extend tax benefits to organizations with a mixed mission are likely to be misguided.[181]

A. Corporate Social Responsibility and Corporate Charity

In its most standard form, corporate social responsibility ("CSR") policies and corporate charity involve the allocation of a subsidy from a for-profit firm to external beneficiaries, whether as a monetary donation to a donative organization (e.g., Oxfam) or a training subsidy to the poor.[182] In either of these cases, the firm has no commitment to transacting with beneficiaries as patrons. As a result, the effectiveness of CSR and corporate charity are subject to the same problems as subsidies allocated by donative organizations. In the absence of information on external beneficiaries, subsidies are unlikely to be effective. Moreover, most for-profit corporations that engage in CSR or corporate charity do not usually adopt a commitment device. Accordingly, there is a clear risk that for-profit corporations will exaggerate the magnitude and effectiveness of their CSR policies in order to enhance their reputations among consumers.[183] Drawing goodwill and additional revenues from consumers by

181 One example is Malani & Posner's proposal to extend tax benefits to for-profits for their charitable or socially responsible activities. *See* Malani & Posner, *supra* note 6.

182 *See supra* Section II.C.

183 *See supra* note 7 and accompanying text.

exaggerating the effect and extent of CSR policies may be viewed as an expropriation of subsidies from consumers.[184] An example of the limited effectiveness of CSR is in fact Google's celebrated charitable arm described above. Although Google continues to donate generously to charitable causes, Google.org has so far failed to live up to its ambitious goal of creating novel solutions to poverty alleviation and climate change.[185]

Some corporations do actually adopt commitment devices that implement CSR policies or corporate charity, and to this extent, there is a lesser risk of expropriation. RedF is an example of a certification mechanism. RedF is an LLC that licenses the Red trademark to commercial firms, including Apple, Starbucks and Gap;[186] these firms attach the Red label to certain products. When customers buy Red products, the firm is committed under its contract with RedF to making a certain donation, for example to the Global Fund, a donative organization dedicated to fighting AIDS.[187] Thus the firm adjusts the amount of its donations in accordance with the volume of purchases of Red products by customers. However, while this may be a novel mechanism for firms to

184 In fact, CSR policies and corporate charity may even be used by inefficient managers to entrench themselves by gaining stakeholders' and media support or to support charities affiliated with CEOs at the expense of shareholder value. *See* Giovanni Cespa & Giacinta Cestone, *Corporate Social Responsibility and Managerial Entrenchment*, 16 J. ECON. & MGMT. Strategy 741 (2007); Ronald W. Masulis and Syed Walid Reza, *Agency Problems of Corporate Philanthropy*, 28 REV. FIN. STUD. 592 (2015).

185 *See* Brian Galle, *Social Enterprise: Who Needs It?* 54 B.C. L. REV. 2025, 2034–35 (2014); Stephanie Strom & Miguel Helft, *Google Finds It Hard to Reinvent Philanthropy*, N.Y. TIMES, (Jan. 29, 2011), http://www.nytimes.com/2011/01/30/business/30charity.html [https://perma.cc/A9S2-ARJF].

186 Sarah Dadush, *Profiting in (Red): The Need for Enhanced Transparency in Cause-Related Marketing*, 42 N.Y.U. J. INT'L L. & POL. 1269, 1270 (2010).

187 *Id.* The exact amount of the donations is not actually transparent, and to this extent there is in fact a risk of expropriation. *See id*. at 1272–73.

market their charitable activities and receive feedback from customers concerning their desired volume, it is essentially a form of corporate charity rather than a social enterprise.

An example of a control mechanism used as a commitment to charity is Better World Books, a firm that sells used books and is committed to supporting literacy groups.[188] Many of the books sold by the firm are donated to it to support its social mission. Literacy nonprofits have options in Better World Books that are vested on two metrics, performance measures of their social mission and how many donated books they bring in. The vested options ensure that upon sale of the firm, the nonprofits will receive a proportion of the sale amount.[189] Performance, which is related to students' progress, is relatively easy to measure, and the disbursals to the literacy nonprofits appear to be effective. Again, the basic structure of Better World Books, albeit highly innovative, is identical to corporate charity, i.e., a for-profit making a donation to a nonprofit. In this case, though, there seems to be measurable information on the effectiveness of subsidies.

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

188 *See* Kevin Jones, *Mission Insurance: How to Structure a Social Enterprise So Its Social and Environmental Goals Survive into the Future*, 5 COMMUNITY DEV. INV. REV. 1 (2009).

189 *Id.* at 5–6.

countries,[190] even though in economic terms, wages and working conditions are both efficient and higher than those offered by local firms.

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

To be sure, this type of subsidy may be desirable where governments fail to regulate workers' rights and minimum working conditions, especially in developing countries. However, such CSR policies are typically implemented only as a response to blatant governmental failures and where commercial firms face high reputational costs. Additionally, firms that make these subsidies do not usually adopt a commitment device. Therefore, without appropriate government regulation or at least NGO supervision, working conditions at standard commercial firms are likely to suffer.[191]

190 *See* Geoffrey Heal, *Corporate Social Responsibility: An Economic and Financial Framework*, 30 GENEVA PAPERS ON RISK & INS., 387, 389, 392–93 (2005).

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

B. Socially Responsible Investing

In recent decades, institutional investors, such as pension funds and mutual funds, have become increasingly engaged in socially responsible investing ("SRI"). As of 2014, $6.57 trillion in total assets under professional management in the United States used at least one SRI strategy.[192] SRI refers to investment strategies that consider both financial return and some social good, especially environmental, social, and governance ("ESG") issues. ESG issues range from environmental efficiency, through human rights and diversity, to corporate governance. The most common manifestations of SRI are negative screening of companies that engage in providing goods or services like alcohol, tobacco, or gambling, and shareholder advocacy on ESG issues. Some forms of social enterprise referred to as "community investing" are also commonly included under SRI, such as CDFIs and social investment firms. Though community investing is growing at a rapid rate as an asset class, its assets are only a marginal fraction of SRI.

At any rate, to view SRI and social enterprise as synonymous is misguided. First, it is not clear whether SRI (other than community investing) is a subsidized form of organization. In fact, some studies find that returns on SRI funds are better than on other funds.[193] Additionally, the recent trend to treat corporate governance as an ESG issue appears to be motivated by a desire to enhance shareholder value rather than transfer subsidies to third parties.

192 THE FORUM FOR SUSTAINABLE AND RESPONSIBLE INV., REPORT ON US SUSTAINABLE AND RESPONSIBLE INVESTING TRENDS 12 (2014), http://www.ussif.org/store_category.asp?id=4 [https://perma.cc/BAE3-9T5J].

193 *See, e.g.*, Michael L. Barnett & Robert M. Salomon, *Beyond Dichotomy: The Curvilinear Relationship between Social Responsibility and Financial Performance*, 27 STRATEGY MGMT. J. 1101, 1103 (2006); Christopher C. Geczy et al., Investing in Socially Responsible Mutual Funds (Oct. 2005), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=416380 [https://perma.cc/B2A4-8JCX].

Therefore, SRI funds are not necessarily a type of hybrid organization. Second, even if SRI in its most common form qualifies as a subsidized commercial enterprise (i.e., a hybrid organization), SRI funds do not transact with their beneficiaries. As a result, measuring the social impact of SRI as compared to a standard form of investing is inherently imprecise. In addition, it is noteworthy that commitment devices may be weak in some SRI funds. While some funds can change their social criteria only with a shareholder vote, other funds can alter investing policy without consulting the shareholders.[194] Hence, there is some risk that capital raised under one set of ESG issues will be applied to advance a weaker or stronger set of issues.

C. Social Ratings

Partly to address the measurement problem inherent in social missions, many organizations are developing new social rating mechanisms for evaluating the social impact of for-profit firms. One prominent example is B-Lab, a nonprofit that certifies companies as "B-Corps" and rates them in accordance with certain criteria relating to governance, workers, community, and the environment.[195]

194 Geczy et al., *supra* note 193, at 12.

195 Other rating mechanisms include the following: (1) the Global Reporting Initiative ("GRI"), a nonprofit that certifies companies' sustainability reports in accordance with certain standards, see *About GRI*, GRI, https://www.globalreporting.org/Information/about-gri/Pages/default.aspx [https://perma.cc/PS9Y-FYEL] (last visited Mar. 18, 2017); (2) the Global Impact Rating System ("GIIRS"), a nonprofit that rates companies' social and environmental impact using a different set of standards, the Impact Reporting and Investment Standards ("IRIS"), see *What GIIRLS Does*, GIIRLS, http://giirs.nonprofitsoapbox.com/about-giirs/about [https://perma.cc/54FJ-E7D2] (last visited Mar. 18, 2017) and *About IRIS*, IRIS, https://iris.thegiin.org/about-iris [https://perma.cc/2RRK-PJ7N] (last visited Mar. 18, 2017); (3) the Social Return on Investment ("SROI") Network, which trains practitioners to quantify in monetary terms the social and environmental impact of companies in accordance with the SROI principles, see *Practitioner Training*, SOCIAL VALUE, http://www.socialvalueuk.org/sroi-practitioner-

There is, however, uncertainty regarding which factors should be included in such standards. For example, the first public corporation certified as a B-Corp, Etsy Inc., a company that operates an online marketplace for crafts, was praised for its commitment to social and environmental goals.[196] However, it is hard to see how Etsy is materially different from standard commercial firms, as it doesn't seem to channel material subsidies to third parties. Moreover, there has been substantial pressure from tax activists to deny Etsy's re-certification as a B-Corp because of its aggressive tax planning that involved using an Irish subsidiary to minimize tax liability.[197] This arguably casts doubt on Etsy's commitment to produce public benefits.

To be sure, some of the criteria embedded in B-Lab's standards correspond to the elements that characterize social enterprises, such as the percentage of disadvantaged employees, or whether the firm provides services to poor customers. For example, B-Lab's rating does reward companies for employing disadvantaged workers. However, B-Lab's standards go far beyond these elements to include a host of measures whose value is debatable.[198] First, these

training/ [https://perma.cc/MA2Q-DACH] (last visited Mar. 18, 2017) and *The SROI Network*, IRIS, https://iris.thegiin.org/users/profile/the-sroi-network [https://perma.cc/5VX2-Z7K5] (last visited Mar. 18, 2017).

196 *See* Jena McGregor, *What Etsy, Patagonia and Warby Parker Have in Common,* WASH. POST (Apr. 20, 2015), https://www.washingtonpost.com/news/on-leadership/wp/2015/04/20/what-etsy-patagonia-and-warby-parker-have-in-common/ [https://perma.cc/KNN9-NRRS].

197 *See* Alex Barinka & Jesse Drucker, *Etsy Taps Secret Irish Tax Haven and Brags About Transparency at Home*, BLOOMBERG (Aug. 14, 2015, 12:01 AM), https://www.bloomberg.com/news/articles/2015-08-14/etsy-taps-secret-irish-tax-haven-and-touts-transparency-at-home [https://perma.cc/FJ3R-FARJ].

198 Recently, the Greyston Bakery has obtained B-Corp certification. Interestingly, Greyston ranks high on measures of "community" but below the median on measures of "workers" which evaluate how the firm treats its workers through compensation, employment opportunities, health and safety, etc. *See Greyston Bakery, Inc.*, B CORP.,

metrics include activities whose benefits flow to external beneficiaries, such as corporate charity or environmentally friendly policies. But, as argued throughout this Article, the benefits to external beneficiaries are hard to measure and subject to uncertainty. There is little evidence that B-Lab or any other social rating organization has created a credible way to track and quantify such benefits. Second, the utility of many of the policies advocated by these standards, such as employee ownership or involving stakeholders in decision-making, is either questionable or context-dependent. Third, certain policies, such as strong corporate governance provisions, are potentially profit-maximizing, and it is not clear why they should be mixed up with standards that measure social impact. Finally, some of these standards and their implementation tend to be opaque and depend on subjective assessment of impacts.[199] There is a concern that subsidies provided by trusting consumers may be expropriated by managers of firms that obtain social ratings that exceed their true contributions to altruistic causes.

D. Environmentally Friendly Firms

Firms that adopt environmentally friendly policies may be viewed as hybrid organizations mainly because their consumers pay subsidies in the form of price premiums, which the firms use to produce public goods.[200] There are two main types of environmentally friendly firms. The first type includes firms such as Walmart and IBM that have adopted

https://www.bcorporation.net/community/greyston-bakery-inc [https://perma.cc/9HRJ-Q76X] (last visited Mar. 18, 2017).

199 *See* BUGG-LEVINE & EMERSON, *supra* note 3, at 163–186; Alnoor Ebrahim & V. Kasturi Rangan, *The Limits of Nonprofit Impact: A Contingency Framework for Measuring Social Performance* 9–13 (Harvard Bus. Sch., Working Paper No. 10-099, 2010), http://www.hbs.edu/faculty/Publication%20Files/10-099.pdf [https://perma.cc/8K3U-TUP4].

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

environmentally friendly policies as part of their CSR agenda to boost reputation and goodwill.[201] Many of these firms have not adopted a commitment device, and therefore there is a risk that they will draw goodwill and subsidies from consumers while overstating the extent of their contribution to the environment, a practice known as green-washing. To take one stark example, British Petroleum, an oil company that was commended for its environmental initiatives, turned out to have a troubling record of violating safety regulations, culminating in the oil spill in the Gulf of Mexico in 2010. [202]

The second type involves firms that have adopted a commitment device. An example is Patagonia, a firm that produces outdoor clothing using materials that are less harmful to the environment, such as organic cotton, and environmentally friendly production processes, including reduction of its carbon emissions and the use of recycled materials.[203] Patagonia's consumers appear to pay a premium for the environmental quality of its products,[204] and its sole owner seems willing to accept lower rates to fund the firm's environmental mission.[205] Patagonia has adopted

201 *See* DANIEL C. ESTY & ANDREW S. WINSTON, GREEN TO GOLD: HOW SMART COMPANIES USE ENVIRONMENTAL STRATEGY TO INNOVATE, CREATE VALUE, AND BUILD COMPETITIVE ADVANTAGE 7–8, 106 (2006).

202 The company was in fact ranked first among international firms for its environmental impact. *Id*., at 25; NAT'L COMM'N ON THE BP DEEPWATER HORIZON OIL SPILL & OFFSHORE DRILLING, DEEP WATER: THE GULF OIL DISASTER AND THE FUTURE OF OFFSHORE DRILLING (2011), https://www.gpo.gov/fdsys/pkg/GPO-OILCOMMISSION/pdf/GPO-OILCOMMISSION.pdf [https://perma.cc/BMT2-M4X7].

203 *See* FOREST REINHARDT ET AL., PATAGONIA (2004) (Harv. Bus. Sch. Case 9-703-035) [hereinafter PATAGONIA 1]; FOREST REINHARDT ET AL., PATAGONIA (2010) (Harv. Bus. Sch. Case 9-711-020) [hereinafter PATAGONIA 2].

204 *See* PATAGONIA 1, *supra* note 203, at 10 (Patagonia's products sell for 15% to 50% or more above other similar brands, although this premium may be due to product quality).

205 *See* PATAGONIA 2, *supra* note 203, at 4, 27 (noting that Patagonia's margins decreased following the shift to organic cotton).

several commitment devices. First, the firm is owned by a social entrepreneur who has a reputation for his commitment to the environment. Second, some of its products are certified by the bluesign® system, a certification awarded to textile products that comply with standards relating to energy use, water consumption and use of hazardous chemicals.[206] Moreover, the firm has obtained certification as a B-Corp, which includes environmental performance.[207]

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

To be sure, environmentally friendly firms perform an important function. Given their commitment to adopting environmentally friendly processes, these firms have a profit incentive to reduce the costs of such processes. The subsidies in these firms are used to fund the costs of creating an efficient business model that generates public goods. In some cases, such business models may fail. For example, there have been several unsuccessful attempts to make shoes from

206 *See* BLUESIGN, https://www.bluesign.com/ [https://perma.cc/42ZP-CAM9] (last visited Mar. 18, 2017).

207 *See Patagonia, Inc.*, B CORP., https://www.bcorporation.net/community/patagonia-inc [https://perma.cc/EVG3-Q3J7] (last visited Mar. 18, 2017).

recyclable materials.[208] On the other hand, Patagonia has successfully developed innovative processes for making clothes from organic cotton.[209] Reducing the production costs of environmentally friendly products is important for the sake of leading other firms to adopt similar policies or making a case for environmental regulation.

E. Using Hybrid Organizations to Increase Donative Capital

While social enterprises may involve collaborations between nonprofits and for-profits, not all such collaborations necessarily create a social enterprise. Sometimes a donative organization will simply set up a for-profit in order to make investments that increase the size of its assets. It then invests donative capital in the for-profit entity, and the returns on that investment are distributed to external beneficiaries of the donative organization. One notable example that has existed for many years in the U.S. is museum shops that sell books and artwork to museum visitors. The shop is typically a for-profit entity owned by the nonprofit museum. The shop qualifies as a hybrid organization because it receives subsidized capital, but it has no commitment to transacting with disadvantaged individuals. Another more recent example is Housing Works, an organization dedicated to combating AIDS and homelessness.[210] It is composed of several businesses, including a coffee shop, a secondhand bookstore, and a secondhand clothing store. The profits made by the shops are distributed to the owner, i.e., the donative organization, and used to allocate subsidies to external beneficiaries, especially through housing assistance.

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208 *See, e.g.*, PAUL W. HARDY, DEJA SHOE (A): CREATING THE ENVIRONMENTAL FOOTWEAR COMPANY (1996) (University of Michigan CEPM Case Study).

209 Reinhardt et al., PATAGONIA 1, *supra* note 203, at 26, 27.

210 *See* HOUSING WORKS, http://www.housingworks.org/ [https://perma.cc/8PSZ-RL2V] (last visited Mar. 18, 2017).

VII. DISADVANTAGES OF SOCIAL ENTERPRISE

A. Mission-Drift

A common criticism of for-profit social enterprises is that they have incentives to seek profits at the expense of their social missions.[211] This criticism may broadly be divided into two claims. First, social enterprises have an incentive to transact only with patron-beneficiaries with fully competitive abilities and avoid those who have below-competitive abilities. However, this is only a problem where the subsidies provided to the social enterprise are also intended to be used as disbursals to patron-beneficiaries with below-competitive abilities. Such subsidies may be distributed to the owners as profits or simply wasted. In this situation, the commitment device should identify the beneficiaries as including those with below-competitive abilities and specify the disbursals afforded to them. In practice, though, there do not seem to be many known cases of such problems.[212] Organizations that focus on patron-beneficiaries with higher abilities are usually committed to serving only such patrons. For example, Compartamos, which is often criticized for neglecting the destitute, is admittedly committed only to serving the vulnerable non-

211 *See, e.g.*, *Nobel Laureate Muhammed Yunus Speaks Out Against For-Profit Microfinance from Asia-Pacific Microcred*, MICROFINANCE TRANSPARENCY (Aug. 12, 2008), http://www.mftransparency.org/nobel-laureate-muhammad-yunus-speaks-out-against-for-profit-microfinance-from-asia-pacific-microcred/ [https://perma.cc/8MQ9-JKFG].

212 One situation when this may be possible is where the definition of patron-beneficiary is inadequate. Arguably, under the Fair Trade standards, small producers may not always be disadvantaged, such as where small producers' cooperatives have sufficient capital and resources. *See* MARC SIDWELL, UNFAIR TRADE (2008). There have also been concerns that some WISEs only employ workers with higher abilities. *See* Carlo Borzaga & Monica Loss, *Profiles and Trajectories of Participants in European Work Integration Social Enterprises, in* SOCIAL ENTERPRISE AT THE CROSSROADS OF MARKET, PUBLIC POLICIES AND CIVIL SOCIETY 169 (Marthe Nyseens ed., 2006).

poor and the moderately poor.[213] There presumably is scope both for organizations that serve only patrons with fully competitive abilities and for those that also serve patron-beneficiaries with lower abilities. Thus, nonprofit MFIs tend to focus more on small loans to poorer borrowers and women, while for-profit MFIs tend to make larger loans to less-poor borrowers.[214]

Second, the profit motive may induce for-profit social enterprises to exploit their patron-beneficiaries by offering them unfavorable terms. The most conspicuous example is the recent criticism of predatory lending practices employed by MFIs in some regions, including exorbitant rates, misleading advertising, excessive penalties, and aggressive or illegal collection methods.[215] Compartamos, for example, has been criticized for its loan rates, which average almost 90%.[216]

The problem, however, seems to lie in the lack of effective regulatory frameworks to protect consumers and employees in many developing countries.[217] In general, there are two

213 COMPARTAMOS OFFERING CIRCULAR, *supra* note 26, at 77.

214 Conning & Morduch, *supra* note 160, at 413–14.

215 *See id.* at 411–12; Eric Bellman & Arlen Chang, *India's Major Crisis in Microlending*, WALL. ST. J. (Oct. 28, 2010, 12:01 AM), https://www.wsj.com/articles/SB10001424052702304316404575580663294846100 [https://perma.cc/Z2EH-69WQ]; Keith Epstein & Geri Smith, *The Ugly Side of Microlending,* BLOOMBERG (Dec. 13, 2007, 12:00 AM), https://www.bloomberg.com/news/articles/2007-12-12/the-ugly-side-of-microlending [https://perma.cc/44L8-PBJ5].

216 This figure includes a 15% government tax. *See* Elisabeth Malkin, *Microfinance's Success Sets off a Debate in Mexico*, N.Y. TIMES (Apr. 5, 2008), http://www.nytimes.com/2008/04/05/business/worldbusiness/05micro.html [https://perma.cc/MP85-ARW7].

217 PATRICK MEAGHER, MICROFINANCE REGULATION IN DEVELOPING COUNTRIES: A COMPARATIVE REVIEW OF CURRENT PRACTICE 41 (2002), https://www.microfinancegateway.org/library/microfinance-regulation-developing-countries-comparative-review-current-practice [https://perma.cc/8328-PJGX]. The high rates that Compartamos charges its borrowers are also partly due to the lack of competition in the Mexican banking industry. *See* Chu, *supra* note 28, at 127.

main strategies to address this problem. The first strategy is to adopt industry standards and private monitoring in areas such as labor standards and consumer protection. In the context of MFIs, for example, there have been initiatives to introduce consumer protection standards to address the risk of predatory lending.[218] The second strategy is to adopt the nonprofit form or to allocate ownership rights to the beneficiaries. The rationale for this approach is that these mechanisms mitigate the incentives of social enterprise firms to pursue profit, and therefore they are less likely to exploit the beneficiaries.[219] Of course, as is well known, the downside of eliminating investor ownership is that it may inhibit the firm's ability to raise capital and lower incentives for socially valuable innovation.

B. Difficulties in Attracting Capital

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

218 *See* Brigit Helms & David Porteous, *Protecting Microfinance Borrowers*, CGAP FOCUS NOTE, May 2005, at 1 http://www.cgap.org/publications/protecting-microfinance-borrowers [https://perma.cc/KDP4-ZPYF].

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

systems that lack the liquidity afforded by large stock exchanges.[220]

Social enterprises are better able to attract capital primarily in two situations. The first is where the costs of gathering information are low and the subsidies made to patron-beneficiaries are relatively small. Firms like Compartamos, which primarily serves the moderate and marginally poor, but not the destitute, face few information asymmetries and therefore do not need a significant subsidy to begin with. Moreover, over time, Compartamos has reduced the costs of lending to low-income borrowers. Thus, the subsidy it needs from its investors is minimal (if any), and the firm can generate substantial profits.[221] The second is where consumers, donors, or the government, rather than the investors, pay the subsidies. Fair trade products are one prominent example. Usually subsidized by the consumers, fair trade products have become profitable businesses for large corporations.

Nonetheless, there is a growing trend among institutional investors to invest in socially responsible businesses, resulting in the gradual expansion of the social investment sector.[222] Recent reports suggest that there is a great deal of untapped capital from socially responsible funds, foundations, high net worth individuals, and even public investors.[223] However, altruistic investors presumably want

220 *See* the *supra* Section II.A.1 (discussing Triodos Bank and Cafédirect); Jamie Hartzell, *Creating an Ethical Stock Exchange* (Aug. 2007) (Oxford Said Bus. Sch., Skoll Ctr. for Soc. Entrepreneurship Working Paper), http://www.sbs.ox.ac.uk/ideas-impact/skoll/research/social-finance-reports-resources/creating-ethical-stock-exchange [https://perma.cc/28CH-EDTQ].

221 It is fair to claim that, at this stage, Compartamos has become a standard profit-maximizing firm, because it no longer receives substantial subsidies and it does not have a material commitment to lend to disadvantaged groups that lack access to capital.

222 *See supra* Section VI.B.

223 J.P. MORGAN GLOB. RESEARCH & THE ROCKEFELLER FOUND., *supra* note 3; KARIM HARJI & EDWARD T. JACKSON, E.T. JACKSON & ASSOCS. LTD., ACCELERATING IMPACT: ACHIEVEMENTS, CHALLENGES AND WHAT'S NEXT IN

assurance that their funds are well used. Such investors may in principle use control or contractual mechanisms to monitor the social enterprise, but for many investors such monitoring may be too costly. Consequently, passive investors tend to resist investing in social enterprises whose efficacy they cannot oversee. Currently, with some exceptions, no institutional mechanisms exist to signal a credible commitment to such passive investors. One possible solution may be a certification mechanism. The Fair Trade certification, albeit imperfect, has proven to serve as a reasonably effective commitment to many dispersed consumers. Section IX.B below considers a broader certification mechanism for a wider class of social enterprises which would be partly directed towards altruistic investors as well as consumers who have limited means to control or directly contract with the firm.

VIII. OTHER ACCOUNTS OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS

There are several other theories that have been proposed to explain social enterprises and hybrid organizations. As demonstrated below, these theories have failed to provide a convincing account of social enterprise and hybrid organizations.

A. Stakeholder Theories and the Costs of Decision-Making

The upshot of stakeholder theories is that managers should maximize the interests of all stakeholders of the firm, including employees, customers, and even the public at large.[224] Some commentators have advanced a view of social

BUILDING THE IMPACT INVESTING INDUSTRY (2012), https://www.rockefellerfoundation.org/app/uploads/Accelerating-Impact-Full-Summary.pdf [https://perma.cc/VJ4X-9HSX].

224 There are numerous articles on the topic. *See, e.g.*, Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85

enterprise and hybrid organizations as a form of for-profit entity that maximizes the interests of its stakeholders.[225] The major problem with these theories is that they fail to explain how managers should balance competing claims. Without providing clear criteria as to how the stakeholders' interests should be considered in corporate decision-making, broad managerial discretion enables managers to pursue their own interests.[226] Hybrid organizations with broad social and environmental missions are particularly vulnerable to this risk because of the difficulty of defining and verifying what kind of action maximizes the social mission.

Stakeholder theories also advocate allocating voting rights and decision-making power to specific stakeholders.[227] In fact, in some social enterprises, such as FTSEs, there may be board members that represent a class of beneficiaries[228] or

VA. L. REV. 247 (1999); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005). To be sure, most proponents of shareholder primacy agree that a corporation can and should act in the interests of its stakeholders and society as a whole to the extent that doing so indirectly promotes the shareholders' interest. *See* Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); Michael C. Jensen et al., *Value Maximization, Stakeholder Theory, and the Corporate Objective Function* (Harvard Bus. Sch. Working Paper No. 00-058, 2000), https://papers.ssrn.com/sol3/papers.cfm?cfid=768189&cftoken=41041396&abstract_id=220671## [https://perma.cc/L32L-R4LK].

225 *See generally* THE EMERGENCE OF SOCIAL ENTERPRISE, *supra* note 9; THE ECONOMICS OF SOCIAL RESPONSIBILITY: THE WORLD OF SOCIAL ENTERPRISES, *supra* note 10; SOCIAL ENTERPRISE AT THE CROSSROADS OF MARKET, PUBLIC POLICIES AND CIVIL SOCIETY, *supra* note 212.

226 Hansmann & Kraakman, *supra* note 224, at 447–49; Jensen et al., *supra* note 224.

227 *See* Jacques Defourny, *Introduction: From Third Sector to Social Enterprise*, *in* THE EMERGENCE OF SOCIAL ENTERPRISE, *supra* note 9; Jeffrey Moriarty, *The Connection Between Stakeholder Theory and Stakeholder Democracy: An Excavation and Defense*, 53 BUS. & SOC'Y 820 (2012).

228 For example, the producers of Cafédirect, an FTSE that sells hot drinks, have the right to appoint two directors to its board. CAFÉDIRECT, *supra* note 52, at 8–9.

a class of beneficiaries that owns some shares in the firm.[229] Only rarely, however, do beneficiaries truly take an active part in decision-making, mainly because such a decision-making process could be highly cumbersome due to potential conflicts among different stakeholders.

By contrast, decision-making in social enterprises seems to be relatively efficient in resolving conflicts among stakeholders. The reason is that the commitment device not only serves as a credible commitment to utilizing subsidies effectively, but it also mitigates the costs of decision-making by defining how managers should utilize the subsidies. Certification and contractual mechanisms define the class of beneficiaries and the terms of their transactions with the enterprise. Control mechanisms may potentially be susceptible to tension between investors who want to maximize profits and the nonprofit controllers who are satisfied with below-market returns. However, as long as the nonprofit maintains clear control of the social enterprise firm, there seems to be relatively little scope for conflict. Accordingly, managers are left with the task of pursuing profits, subject to the commitment to transact with a class of beneficiaries. In this way, the commitment device effectively defines how to balance the profit and nonprofit missions against each other, so that the margin of discretion left to managers is relatively limited.

Finally, it is important to emphasize that the measurement theory of social enterprises is not necessarily inconsistent with stakeholder theories whose ultimate objective is to create organizations that benefit non-shareholder groups. Instead, it asserts that in order to do this effectively, the organization must have an actual *stake* in the development of the beneficiaries, rather than rely on

229 For example, the borrowers of Grameen Bank, a prominent MFI in Bangladesh, hold approximately 76% of its shares as of 2015. GRAMEEN BANK, ANNUAL REPORT 2015 59 (2016), http://www.grameen.com/wp-content/uploads/bsk-pdf-manager/GB-2015_33.pdf [https://perma.cc/HP6P-XRV4].

broad managerial discretion. Thus, social enterprises may be viewed as a practical mechanism for operationalizing the stakeholder model.

B. Economies of Scope

Malani & Posner ("MP")[230] and Henderson & Malani ("HM," and together "MPH")[231] argue that for-profits are more efficient than nonprofits in pursuing social goals because they benefit from economies of scope.[232] A car company may have more ample resources and knowledge than nonprofits to invest in research on hybrid engines than government or nonprofits. However, other examples provided by MPH have questionable theoretical and empirical support. For example, they suggest that multinational coffee companies are more efficient in disbursing charity to poor farmers. As discussed above, however, multinational companies have generally avoided transacting with poor disaggregated farmers primarily because the costs of transacting with those farmers tend to be high. In fact, the contacts between most large firms and small farmers are initiated and fostered by nonprofits.[233] To take another example, MPH argue that clothing and footwear manufacturers, such as Nike, are better positioned than nonprofits to monitor the working conditions in factories in developing countries. Surely, every organization that is contravening certain standards is best positioned to ensure that such standards are held in compliance. But clearly, such manufacturers have an obvious incentive to shirk on the

230 Malani & Posner, *supra* note 6.

231 M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571 (2009).

232 For elaborate criticisms, see Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213 (2010); James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010).

233 For examples, see AUSTIN & REAVIS, *supra* note 127; Argenti, *supra* note 127.

quality of working conditions to save costs. In fact, the pressure on such manufacturers comes from various nonprofits. Accordingly, the efficiency claim is not convincing.

MPH also claim that for-profits are just as trustworthy or committed as nonprofits.[234] Donors or subsidy providers do not need to patronize a nonprofit to use their funds for charitable purposes; rather, they can simply channel their donation or subsidy through a for-profit firm. The non-distribution constraint is not essential as a commitment device. For-profits can simply commit by contract not to distribute profits and a private auditor can monitor this commitment.[235] However, the feasibility of this contract depends on the availability of measurable standards.[236] Moreover, even if firms could enter into such a contract, in practice virtually none of the examples of for-profit charities discussed by MPH involve such a contract. These examples include: Google's charitable arm; fair trade coffee sold by Starbucks; and Nike's abstinence from purchasing supplies from sweatshops. None of these firms have contracted to not distribute profits to their owners. Accordingly, MPH fail to describe what substitutes for the non-distribution constraint for-profits have adopted as commitment devices.

C. Public Good Theories

The above discussion assumes that social enterprises are designed for the benefit of a specified class of patrons, such as consumers or employees. In practice, the role of social enterprises may be viewed as one of generating public goods. For example, MFIs and CDFIs are widely regarded as tools for alleviating poverty. Social enterprises, on this view, are supposed to benefit external beneficiaries who are affiliated with the patron-beneficiaries. A borrower that receives a

234 Malani & Posner, *supra* note 6, at 2035–36.

235 *Id*.

236 For a detailed criticism of private monitoring of the non-distribution constraint, see Galle, *supra* note 232, at 1218–21.

loan from an MFI or works at a WISE may be able to send his or her children to school and obtain better healthcare services. Likewise, the availability of healthcare services, medicines, or products such as eyeglasses, enhances productivity and reduces the costs of illness.

However, the evidence on the effects of social enterprises as providers of public goods is largely equivocal. MFIs are a case in point. Empirical studies show no clear evidence that MFIs uniformly alleviate poverty and improve the standard of living in a given community in areas such as healthcare and education.[237] On the other hand, there is strong evidence that access to credit has improved the lives of the borrowers themselves.[238] It seems to be the case, then, that the patron-beneficiaries of MFIs have substantially benefited from the ability to transact with MFIs, while the benefits to the community at large are inconclusive.

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237 *See, e.g.*, Abhijit Banerjee et al., *The Miracle of Microfinance? Evidence from a Randomized Evaluation* (Mass. Inst. of Tech. Dep't. of Econ. Working Paper No. 13-09, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2250500 [https://perma.cc/Y766-8LCH]; Dean Karlan & Jonathan Zinman, *Expanding Microenterprise Credit Access: Using Randomized Supply Decision to Estimate the Impacts in Manila* (Yale Econ. Dep't Working Paper No. 68, 2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1444990 [https://perma.cc/SV2W-6WKM]; David Roodman & Jonathan Morduch, *The Impact of Microcredit on the Poor in Bangladesh: Revisiting the Evidence* (Ctr. for Glob. Dev., Working Paper No. 174, 2013), http://www.cgdev.org/content/publications/detail/1422302 [https://perma.cc/J5DY-XL9N].

238 Banerjee et al., *supra* note 237 (finding that microcredit supports household borrowing and investments and the creation and expansion of small businesses, but has no impact on health, education and women's decision-making); COLLINS ET AL., *supra* note 142 (claiming that microfinance may be most effective at smoothing out borrowers' cash flows, so that poor borrowers are less vulnerable to fluctuations in their income); Karlan & Zinman, *supra* note 237 (finding that the introduction of micro-lending to new populations leads to an increase in business profits for male borrowers, but no overall effects on income or poverty).

The distinction between patron-beneficiaries and external beneficiaries may be the reason for these results. The positive externalities which arguably flow to external beneficiaries of MFIs are somewhat uncertain and may depend on numerous factors. For example, the availability of credit may improve a family's financial situation, but without educational opportunities or the availability of healthcare services, it will do little to improve education or health. There is similar empirical data with respect to fair trade and its effect on communities of small farmers.[239] The ability to transact with FTSEs has increased the income of individual farmers and their households, but though there is some evidence of modest positive effects on education and health, it is inconclusive and falls short of showing clear results.[240]

In fact, consistent with the claim of this Article, most social enterprises simply evaluate their impact by measuring the extent to which they transact with patron-beneficiaries, for example, the total output sold to low-income consumers (e.g., bed nets sold), the number of disadvantaged workers employed, or the number of loans made.[241] Note that by definition these transactions would not have taken place without social enterprises. Accordingly, it appears to be

239 For a review of impact studies, see NICHOLLS & OPAL, *supra* note 45, at 201–28; Ann Le Mare, *The Impact of Fair Trade on Social and Economic Development: A Review of the Literature*, 2/6 GEOGRAPHY COMPASS 1922 (2008).

240 NICHOLLS & OPAL, *supra* note 45, at 208–09; Le Mare, *supra* note 239.

241 *See* ALNOOR EBRAHIM & V. KASTURI RANGAN, ACUMEN FUND: MEASUREMENT IN VENTURE PHILANTHROPY (A) (2009), http://acumen.org/wp-content/uploads/2013/03/Case-Study-HBS-Ecotact-Meridian.pdf [https://perma.cc/J9LJ-BWMF]; GREYSTON, ANNUAL REPORT 2015 6 (2016), http://greyston.com/wp-content/uploads/2013/09/greyston_report_2015_02_online_pk_sm.pdf [https://perma.cc/VD47-DRZB] (144 disadvantaged workers employed); CARVER FED. SAV. BANK, WE ARE THE COMMUNITY 2 (2016), https://www.carverbank.com/brochure#page/4 [https://perma.cc/QT4N-SRDP] (152 commercial loans originated).

relatively easier to measure the effects of social enterprises on their patron-beneficiaries.[242] Vis-à-vis their external beneficiaries, social enterprises are in a similar position to donative organizations; unless the benefits to external beneficiaries are measurable at reasonable cost, they remain uncertain.

D. Sustainability and Scale

Several commentators have suggested that social enterprises have emerged as a solution to capital constraints faced by donative organizations. According to this view, social enterprises are more financially sustainable than donative organizations because they can generate revenues. Donative organizations are ineffective in pursuing their missions due to limited funding from donors.[243] Greater sources of revenue enable social enterprises to scale the firm's operations.[244] Without scaling, firms cannot reach a large number of beneficiaries and have a substantial social impact. For example, an MFI with a small number of borrowers arguably has only a modest social impact, whereas one with numerous branches and borrowers has a larger social impact. Some go further by arguing that the ability to distribute profits and tap equity capital is critical to

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

243 MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM (2008); PALLOTTA, *supra* note 161; Dees, *supra* note 9, 55–56; Jerr Boschee & Jim McClurg, Towards a Better Understanding of Social Entrepreneurship (2003) (unpublished manuscript), https://www.law.berkeley.edu/php-programs/courses/fileDL.php?fID=7289 [https://perma.cc/7UUV-BHW5];.

244 YUNUS, *supra* note 243; J.P. MORGAN GLOB. RESEARCH & THE ROCKEFELLER FOUND., *supra* note 3, at 13.

obtaining the capital necessary to scale the firms' operations, and hence their social impact; for example, a for-profit MFI can reach more borrowers than a nonprofit MFI.[245]

These views, however, suffer from several weaknesses. First, there is no systematic evidence that earned income is more sustainable than donative income.[246] Donative organizations, such as large foundations and aid agencies, have very substantial funds. The real problem is that the utilization of these funds, particularly towards development goals, has often been ineffective.[247] In fact, there is little reason to believe that simply increasing the amounts of donations would generate different results. Second, evidence suggests that nonprofits with no access to equity capital can achieve a substantial scale similar to that of for-profits. Nonprofit MFIs, such as ASA and BRAC, serve millions of borrowers and have as wide a reach as for-profit MFIs.[248] In some cases, attracting equity capital may be necessary for scaling. As explained above, however, when social enterprises transact with beneficiaries with lower abilities, equity capital is less likely to be available, and subsidies in the form of donations and income tax exemptions remain essential.[249]

To be sure, social enterprises are better than donative organizations at scaling their social impact. But the reason for this is that social enterprises allocate subsidies more

245 *See* Chu, *supra* note 28.

246 Beth Battle Anderson & J. Gregory Dees, *Rhetoric, Reality, and Research: Building a Solid Foundation for the Practice of Social Entrepreneurship*, in SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE, *supra* note 9, at 144, 148–50.

247 *See supra* note 84.

248 In Bangladesh, ASA and BRAC served around 6 million and 5 million respectively in 2015. *See ASA*, THE MIX, https://www.themix.org/mixmarket/profiles/asa [https://perma.cc/C9AK-8HAN] (last visited Mar. 18, 2017); *BRAC*, THE MIX, https://www.themix.org/mixmarket/profiles/brac [https://perma.cc/J9KN-598R] (last visited Mar. 18, 2017).

249 *See supra* Section VII.B.

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

IX. LEGAL HYBRID FORMS AND HOW TO REFORM THEM

Many U.S. states and different countries have introduced new legal hybrid forms in recent years. The main purpose of such legal forms is to facilitate the flow of subsidized capital to for-profit social enterprises from a growing class of altruistic investors, ethically conscious consumers, private foundations, and even government. As pointed out above, a great deal of untapped capital is potentially available for investments in firms that promote social purposes at below-market returns,[250] and there is evidence that ethically-conscious consumers are increasingly willing to pay significant premiums over market prices for products of firms that do good.[251]

Gaining access to this capital is a particular problem for for-profit social enterprises because they lack a standardized commitment device (such as the non-distribution constraint) to assure their investors, customers, and the government

250 *Id.*

251 The mean premium for socially responsible products was recently estimated to be about 17% over market prices of equivalent products. Stephanie M. Tully & Russell S. Winer, *The Role of the Beneficiary in Willingness to Pay for Socially Responsible Products: A Meta-analysis*, 90 J. RETAILING 255 (2014).

that they utilize subsidies effectively, and there is an obvious risk that those who control an organization will expropriate the subsidies it receives.[252] Most investors and consumers do not have resources to monitor closely the social purpose of the firm they invest in or buy products from, especially when measuring social impact is uncertain. The costs of control and contractual commitment devices are high and require substantial monitoring. Moreover, foundations face substantial regulatory hurdles in making investments in social enterprises, also known as "program related investments" ("PRIs"), and may be subject to tax penalties or even lose their exempt status if they fail to monitor the social purpose of such investments.[253] To reassure providers of subsidized capital and income, legal hybrid forms must identify a particular structure that gives hybrid organizations incentives to utilize subsidies effectively. In this way, such forms can verify that certain for-profits firms can be trusted to employ subsidies to benefit third parties.

252 As explained above, this is essentially the role of the non-distribution constraint in the case of nonprofit corporations. *See supra* Section III.A.

253 A detailed analysis of PRIs is outside the scope of this Article. In summary, PRIs are subsidized investments by private foundations in firms that promote one of the well known exempt purposes, such as educational, scientific, literary or charitable purpose. 26 U.S.C § 4944(c) (2016). The main advantage of PRIs is that they count towards foundations' minimum annual distribution requirements. 26 C.F.R. § 53.4942(a)–3(a)(2) (2016). The main problem with PRIs is that for investments to qualify as PRIs, foundations need to follow detailed and costly procedures which are set out in the expenditure responsibility rules, including monitoring the investees and making reports to the IRS. 26 U.S.C. § 4945(h) (2016); 26 C.F.R. § 53.4945–5 (2016). Failure to follow these rules could result in the foundation's paying significant tax penalties or even losing its tax-exempt status. *See* Callison & Vestal, *supra* note 8. Consequently, few foundations make any PRIs. *See* LILLY FAMILY SCH. OF PHILANTHROPY, LEVERAGING THE POWER OF FOUNDATIONS: AN ANALYSIS OF PROGRAM-RELATED INVESTING 2 (2013), https://philanthropy.iupui.edu/files/research/complete_report_final_51713.pdf [https://perma.cc/6UP5-WE6Z].

As argued below, existing legal hybrids fail to do this, mainly because they rely on a vague notion of combining profit and social mission. Consequently, most social enterprises continue to use the existing legal forms. Although an increasing number of small businesses are using these forms mainly for marketing purposes,[254] few of them seem to have a particularly important social impact, and those that do usually retain the same structure and social mission that they had before they converted from the for-profit form.[255] Moreover, despite the recent IPO of Laureate Education Inc.—the first IPO by a Benefit Corporation—it is unlikely that legal hybrid forms will facilitate liquid public markets for true social enterprises.[256] Finally, despite lobbying attempts to allow some form of tax subsidy for businesses that incorporate as legal hybrids, no such subsidy has been introduced.[257] Perhaps more importantly, investments in legal hybrid forms have not been recognized as PRIs, and therefore few foundations have made investments in such firms.[258]

The following discussion first describes the legal hybrid forms, and in particular the Benefit Corporation. It then outlines a potential reform that can address the deficiencies in such forms. In particular, this Section argues that in order to serve as a credible commitment device, the design of legal

254 *See* Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 607 (2011); Jen Friedman, *The Benefit Corporation: A Tool for Building a Sustainable Brand*, CMO (Apr. 22, 2015), http://www.cmo.com/opinion/articles/2015/4/20/the-benefit-corporation-a-tool-for-building-a-sustainable-brand.html#gs.wDIcMVk [https://perma.cc/S4JE-QBX3].

255 The Greyston Bakery discussed *infra* is one example. *See infra* note 270 and accompanying text.

256 For discussion of Laureate Education, see *supra* text accompanying notes 12–13.

257 *See* Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387, 390–91 (2014).

258 Callison & Vestal, *supra* note 8, at 279.

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

A. Legal Hybrid Forms

Two prominent examples of hybrid forms are the Low-Profit Limited Liability Company ("L3C") and the Benefit Corporation. The L3C is a Limited Liability Company ("LLC") that significantly furthers the accomplishment of one or more charitable or educational purposes, and no significant purpose of the company is the production of income or the appreciation of property.[259] Realizing profit and enhancing value can be purposes of the enterprise as long as they are not significant purposes. This definition reflects the notion of mixed mission that underlies the common definition of hybrid organizations. Merely stating that a firm has a mixed mission, however, is unlikely to give subsidy providers reasonable assurance that their subsidy is being used effectively, especially given the difficulty of measuring social impact. Moreover, it is hard to see what the L3C adds over and above the standard LLC form, since members of an LLC can simply add a provision to the LLC agreement that contractually commits all of them to a particular social purpose.

Benefit Corporations are defined as corporations whose purpose is to create a "general public benefit." General public benefit in most states' statutes means "a material positive impact on society and the environment."[260] Specific benefits include some activities associated with social enterprises as defined here, for example, providing beneficial services and products to low-income communities. However, they go further to include largely any social purpose, including for

259 For the Vermont L3C Act (the first L3C statute), see 11 VT. STAT. ANN. § 3001(27) (2008) (repealed 2016).

260 MODEL BENEFIT CORP. LEGIS. § 102 (2014), http://benefitcorp.net/sites/default/files/documents/Model_Benefit_Corp_Legislation.pdf [https://perma.cc/S7DY-3XAG] [hereinafter MODEL LEGISLATION].

example "conferring any other particular benefit on society or the environment."[261] Accordingly, just like the L3C, the Benefit Corporation is based on the concept of mixed mission. Partly to address the uncertainty inherent in this concept, the Benefit Corporation statutes of most states require that impact on society and the environment be measured by a third-party standard,[262] i.e., a social rating certifier.[263] As discussed above, however, social ratings themselves are subject to many imperfections, and may provide poor information to consumers or other subsidy providers on the social value of hybrid organizations.

In addition, Benefit Corporation statutes include strong constituency provisions that require directors and officers to consider the interests of different stakeholders, including customers, employees, the community in which the firm operates, the local and global environment, and any other group that the directors deem appropriate.[264] The major risk of such provisions is that directors may use them mainly to entrench themselves at the expense of shareholders and potentially other stakeholders. Although shareholders with more than two percent holdings could sue the directors for failure to pursue public or specific benefits,[265] the directors have ample discretion as to the weight they choose to give to the interests of different groups, and they need not give

261 MODEL LEGISLATION § 102. Under the Delaware Code, "Public benefit" means "a positive effect (or reduction of negative effects) on 1 or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature." DEL. CODE ANN. tit. 8, § 362(b) (2014).

262 Third-party standard is defined as "a recognized standard for defining, reporting, and assessing corporate social and environmental performance." MODEL LEGISLATION § 102. Note that under Delaware law, certification by a third-party standard is only optional. *See* DEL. CODE ANN. tit. 8, § 366(b) (2014).

263 The certifier is often B-Lab, although other certifiers may be used.

264 MODEL LEGISLATION §§ 301(a), 303(a).

265 *Id*. § 305.

priority to any particular consideration or factors.[266] Moreover, as in standard business corporations, directors and officers have the protection of the business judgment rule, which largely means that if they were informed and acted in good faith, they are considered to have fulfilled their duties.[267] The ability of directors of Benefit Corporations to entrench themselves, coupled with the weakness of many social rating standards, makes the Benefit Corporation a questionable vehicle for attracting subsidies from consumers, investors, and the government.[268]

To be sure, the Benefit Corporation form does include helpful provisions for owners that want to commit to some social purpose. In particular, termination of Benefit Corporation status must be approved by a qualified majority—typically two-thirds—of the shareholders.[269] This provision effectively gives one-third of the shareholders control over the mission. In fact, the Greyston Bakery

266 *Id.* § 301(a)(3). For example, the Delaware Benefit Corporation statute states that directors need to balance "the pecuniary interests of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or public benefits identified in its certificate of incorporation." *See* DEL. CODE ANN. tit. 8, § 365(a).

267 MODEL LEGISLATION §§ 301(e), 303(e).

268 In fact, the early evidence on Benefit Corporations shows that a significant portion of them choose to incorporate in Nevada. *See* Ellen Berrey, How Many Benefit Corporations Are There? (May 5, 2015) (unpublished manuscript), http://ssrn.com/abstract=2602781 [https://perma.cc/KX6Q-FKKC]. Nevada is a state known for its managerialist corporate laws that exempt managers from fiduciary duties by default. *See* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935 (2012). While pro-managerial laws may not necessarily harm the value of small firms that typically self-select into Nevada, they raise particular concerns when managers are given untrammeled discretion to pursue vague and largely undefined public benefits. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Nevada and the Market for Corporate Law*, 35 SEATTLE U. L. REV. 1165 (2012); Ofer Eldar, *Can Lax Corporate Law Increase Shareholder Value? Evidence from Nevada* (on file with author).

269 VT. STAT. ANN. tit. 11a § 21.07 (2016).

recently converted into a New York Benefit Corporation, probably in anticipation of the Greyston Foundation's selling a stake to for-profit investors but maintaining control of the firm.[270] However, while this provision is helpful in creating a form of control mechanism, the same commitment device can be created with existing legal forms, for example, by adding a charter provision that gives a nonprofit control over the firm's mission.[271] Moreover, this type of control mechanism on its own may have limited utility as a commitment device to a large class of consumers, who may not know which owners control the social mission and would therefore need to rely on the third party rating.

B. Outline for Reform

The core of the following reform proposal is to shift the focus of legal hybrid forms from organizations with mixed missions to firms that commit to transacting with disadvantaged groups as investees, workers, producers, consumers, etc. This reform may be achieved by simply modifying the Benefit Corporation and certification system.

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270 *See Benefit Corporation*, GREYSTON BAKERY, http://greyston.com/the-bakery-open-hiring/benefit-corporation/ [https://perma.cc/8UFY-W8RT] (last visited Mar. 18, 2017); New York law actually requires a three-fourths majority for terminating the Benefit Corporation status. *See* 17 N.Y. BUS. CORP. LAW §§ 1702, 1705 (McKinney 2012). Similarly, Patagonia, an environmentally friendly firm reincorporated as a California Benefit Corporation to benefit from a similar provision. *See* CAL. CORP. CODE § 14604 (West 2012); *supra* Section VI.D.

271 *See supra* Section V.C. As discussed above, though, some statements by Chancellor Chandler in *Ebay v. Newark* suggest that it is not possible to commit a Delaware corporation to a social purpose. *See supra* note 4. But, as pointed out in *supra* note 4, the *eBay* case did not involve a specific charter provision that required the firm to pursue a social mission. Rather, the court reviewed the legality of a poison pill mechanism adopted by management against minority shareholders' will. *See id.*

Details of this reform will be discussed in future work;[272] for present purposes, its main features are outlined below.

First, this requires a new form of certification for social enterprise. Certification would be awarded if a certain percentage of the business of the firm, including its affiliates, is based on transactions with a set of carefully defined classes of beneficiaries. The beneficiaries would be defined by reference to certain criteria of need (for example, levels of income, disability, or location). Certification may be conducted by a private organization, similar to Fair Trade certification. It may also be conducted by a newly formed government agency, similar to the CDFI Fund. The main innovation is that the certification would apply to a wider class of beneficiaries, including, for example, low-income workers. To keep the certification sufficiently flexible, different types of beneficiaries (e.g., borrowers) may be divided into subclasses in accordance with some measures of need.[273] Most states' Benefit Corporation statutes do recognize the need for certifying social impact. However, they are misguided in requiring firms to certify a comprehensive social impact standard that is inherently uncertain. If B-Corp or another certification, private or governmental, focused primarily on verifying the transactional relationship with disadvantaged groups, it could serve as a credible commitment device.

Second, Benefit Corporations would be required to obtain this certification. Whereas under the current version of the Model Benefit Corporation Legislation, firms have freedom to choose a third party standard to measure their social purpose, firms would be limited to one type of certification. Certification would also require Benefit Corporations to

272 Eldar, *supra* note 21.

273 Creating standards for different classes of beneficiaries would be particularly challenging if these criteria extend to developing countries. However, collaboration among a federal agency, multilateral organizations such as the World Bank, and NGOs should be able to address this challenge. *See* Eldar, *supra* note 21.

include an explicit commitment in the firm's certificate of incorporation (or other equivalent constitutional document) to transact with one or more classes of disadvantaged groups. Moreover, the name of Benefit Corporation would be changed to include "BC" (for "Benefit Corporation") or "SE" (for "Social Enterprise") as a suffix. This way, when investors buy their shares or when consumers buy their products, they would have notice that the firm transacts with a class of beneficiaries, and hence it is likely to use subsidies effectively.

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

This proposal may not be as provocative as it may first appear. As discussed above, CDFIs already operate well under a federal certification regime that verifies that they serve specified target markets, and Fair Trade certification has become part of mainstream retail. Moreover, in several European jurisdictions there are hybrid legal forms, which are exclusively designed for firms certified as WISEs if a percentage of their workers belong to disadvantaged groups.[274] A centralized federal agency focused on development missions could be established to certify a wider range of social enterprises. In fact, even the nonprofit form may be viewed as a system whereby there is a government

274 One prominent example is the Type B Italian social cooperative. *See* Cafaggi & Iamiceli, *supra* note 5, at 7–15.

certifier, i.e., the Internal Revenue Service, that primarily ensures that nonprofits are precluded from distributing profits (and hence, are more likely to distribute them to their beneficiaries), and state corporation law governs the internal affairs of the firm.

This reform has the potential for unlocking much-needed capital for social entrepreneurs. It would enable dispersed investors and consumers to donate more funds to social enterprises. To this extent, it may also enable social enterprises to issue public shares. Moreover, it could potentially serve as the basis for allocating tax benefits to social enterprises. Investments in the reformed Benefit Corporations could qualify automatically as PRIs by foundations. The social enterprise certification proposed above could, in this respect, replace the complicated and cumbersome process for making and approving PRIs; the reason is that certified Benefit Corporations would be structured such that they have incentives to pursue development missions effectively. In fact, most PRIs are actually made in businesses that have transactional relationships with their beneficiaries, such as businesses that employ low-income individuals.[275] By streamlining the PRI process and relieving foundations of potential liabilities for making PRIs, this proposal could facilitate the flow of substantial capital to social enterprises.

X. CONCLUSION

Social enterprise and other hybrid organizations are often discussed as an alternative to the traditional form of capitalism, which is based on the norms of profit-maximization and shareholder primacy. These accounts tend to define social enterprises and hybrids simply as

[275] 26 C.F.R. § 53.4944–3 (2016). These examples include businesses owned by members of economically disadvantaged or minority groups, businesses that sell agricultural products sourced from low-income farmers in depressed rural areas, and a variety of low-cost providers of essential goods and services, such as vaccines sold in developing countries.

organizations that mix profit-seeking with social missions or firms with duties towards multiple stakeholders. The theory offered here effectively dispels such claims because the role it ascribes to social enterprises is not intrinsically inconsistent with the traditional role of corporations. Social enterprises can be profit-maximizing if the subsidies they receive flow from government or consumers rather than from owners. Even if the owners do provide the subsidies, social enterprises may still act under a shareholder primacy norm as long as the owners agree to provide such subsidies. Accordingly, the theoretical underpinning of social enterprise is not, as some have argued, its apparent divergence from profit-maximization or shareholder primacy. At the same time, the theory is not necessarily inconsistent with the objective of stakeholder models either, since social enterprises are clearly structured to benefit non-shareholder groups. Rather, the theory may be viewed as an effective way to implement such models by giving firms a financial *stake* in the development of their beneficiaries.

The main contribution of the theory advanced here is to identify the measurement role of social enterprises, and to distinguish them from other hybrid organizations that mainly engage in transferring subsidies to third party beneficiaries. Organizations that give or transfer subsidies, such as donative organizations or firms that engage in corporate charity, work well mainly when the purpose of the subsidies is relatively simple and hence there are no information problems regarding their impact. Social enterprises are designed to use subsidies to promote complex missions, such as increasing employment opportunities or facilitating access to credit. The commitment of social enterprises to transacting with their beneficiaries is the key element in assuring subsidy providers that their subsidies will be used effectively. This commitment essentially aligns the interests of the firm with those of the subsidy providers. Given their dependence on the performance of their beneficiaries, social enterprises have an interest in ensuring that the subsidies are not wasted and that beneficiaries are provided with the optimal amount and type of disbursal. In

this way, the interests of social enterprises are aligned with the interests of subsidy providers who presumably want their subsidy to be used effectively.

The theory advanced in this Article may also inform legal policy. It suggests that legal policy and, particularly, legal hybrid forms should focus on a specific set of enterprises that serve a measurement function. The limited usefulness of new legal hybrid forms, such as the L3C or the Benefit Corporation, is to a large extent due to their questionable theoretical underpinnings. Legal forms for incorporating firms with mixed missions inevitably fail to identify the essential elements that make firms effective in utilizing subsidies or to prescribe adequate commitment devices. It is therefore not surprising that such forms have generally failed to attract subsidies from tax authorities,[276] which tend to view them with suspicion.

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

276 Callison & Vestal, *supra* note 8.