

FOSTERING SOCIAL ENTERPRISE: A HISTORICAL AND INTERNATIONAL ANALYSIS

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INTRODUCTION

Several states in the United States are attempting to nurture the growth of social enterprise by adopting statutes which enable the registration of Low-Profit Limited Liability Companies (“L3Cs”). The L3C is the first American legal form to embrace and facilitate social enterprise. However, Belgium and the United Kingdom created legal forms to achieve similar ends many years prior to the creation of the L3C. The Belgian and U.K. experiences with these legal forms as well as the historical treatment of social enterprise in the United States provide lessons for how the United States should regulate the L3C and social enterprise in general.

This paper tracks the development of social enterprise in the United States and Europe and ultimately proposes that effective government policies need to stimulate capital investment in social enterprise and generate greater public understanding of the sector’s potential benefits. Part I discusses the history and development of social enterprise as a concept and as a sector of the economy in the United States and Europe. Part II discusses the difficulties of adapting the nonprofit and the for-profit corporate forms to entities operating as social enterprises in the United States. Part III discusses social enterprise in Europe and how the governments in Belgium and the United Kingdom have attempted to stimulate growth of social enterprise by creating new business entities which bridge the gap between nonprofit and for-profit forms. Part IV discusses the recent government effort to aid social enterprise in the United States through the creation of the L3C and the difficulties which have slowed the impact of the L3C. Part V discusses lessons from the experiences in Belgium and the United Kingdom which can help guide social-enterprise policy in the United States.

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I. THE CONCEPT OF SOCIAL ENTERPRISE

In this section I discuss how the concept of social enterprise has developed in the United States and in Europe. Both regions have different definitions of social enterprise, in part because the general ideas about social enterprise in the United States and Europe reflect the unique responses to different economic difficulties the regions faced in the past. The definition in the United States generally reflects a focus on generating income for organizations that provide services typically thought of as being provided by the nonprofit sector, such as an organization which offers free eye exams while selling low-cost eyeglasses to low-income populations. In contrast, the concept of social enterprise in Europe has evolved generally to focus on resolving problems of chronic structural unemployment.

Social enterprise as a concept is gaining momentum in business schools across the United States¹ and is an increasingly valuable sector in the global economy.² However, as the concept gains support, its definition continues to expand. One of the major obstacles to the discussion and study of the topic is the lack of a clear and concise definition. In fact, a review of recent scholarly publications yields a crop of over twenty unique definitions of social enterprise,³ not to mention a glut of Venn diagrams attempting to clarify the idea.⁴

Because of the expansive number of definitions of social enterprise, a simple but broad understanding of the term can be helpful when looking at social enterprise across a wide spectrum. The simplest of definitions follows from the individual definitions of “social” and “enterprise.” MERRIAM-WEBSTER defines “social” as “of or relating to human society . . . the interaction of the individual and the group . . . [or] the welfare of human beings as members of society,”⁵ and “enterprise” as “a unit of economic organization or activity . . . [especially]: a business organization.”⁶ Combining these terms leads to an understanding of social enterprise as any business organization which takes into account human society or the welfare of human beings. This definition is vague, but it encompasses many of the broad concepts which have gathered under the

1. See PAUL C. LIGHT, *THE SEARCH FOR SOCIAL ENTREPRENEURSHIP* 1 (2008).

2. See *id.* at vii-viii; Jacques Defournay, *Introduction: From Third Sector to Social Enterprise, in THE EMERGENCE OF SOCIAL ENTERPRISE* 1-28 (Carlo Borzaga & Jacques Defournay eds., 2001).

3. LIGHT, *supra* note 1, at 3.

4. See *infra* Appendix.

5. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2161 (1993).

6. WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 757 (1993).

umbrella of social enterprise. I will use this definition as a starting point from which to form a more concrete understanding of the concept.

This broad definition includes entities or organizations which operate in the commercial sector, but have, at their core, interests which are traditionally associated with the nonprofit sector. One of the best known social enterprises in the United States, Goodwill Industries, has existed since 1902.⁷ Edgar J. Helms, a Methodist minister, started the organization in Boston, Massachusetts to collect goods donated from the wealthy and to hire poorer city residents to repair and sell the goods.⁸ It was a means to fund his community programs and provide job training for people in disadvantaged communities.⁹ Similar organizations existed on a smaller scale in the United States throughout the early- and mid-twentieth century.¹⁰

These types of businesses became more prominent in the United States during the late 1970s and 1980s in response to the economic downturn and major cutbacks in government spending. These developments caused many charities to lose funding while facing increased needs due to the dramatic rise in unemployment.¹¹ Many charities at this time felt the need to increase their revenue from sources other than grants and donations. Several of these charities began to rely increasingly on commercial activities for revenue, greatly expanding this type of American social enterprise. As a result, the portion of income that charities received from commercial activity increased by 20% between 1982 and 2002.¹²

Social enterprises in Europe also gained prominence during the economic downturn in the 1970s, but for slightly different reasons. As was the case in the United States, several European countries experienced

7. Goodwill Industries, Our History, <http://www.goodwill.org/page/guest/about/whatwedo/ourhistory> (last visited Nov. 15, 2009).

8. *Id.*

9. *Id.*

10. See, e.g., Provident Living, Deseret Industries, <http://www.providentliving.org/content/list/0,11664,2022-1,00.html> (last visited Nov. 15, 2009); R.W. Dellinger, *St. Vincent de Paul Thrift Store Has History of Helping*, TIDINGS ONLINE, June 22, 2007, <http://www.the-tidings.com/2007/062207/vincent3.htm>.

11. Janelle A. Kerlin, *Social Enterprise in the United States and Europe: Understanding and Learning from the Differences*, 17 VOLUNTAS 247, 251 (2006). See also Michael A. Urquhart & Marilyn A. Hewson, *Unemployment Continued to Rise in 1982 as Recession Deepened*, 106 MONTHLY LAB. REV. 3, Feb. 1983, at 3 (discussing the high unemployment rates of the early 1980s).

12. These figures are based on a 2002 study of nonprofits with annual revenue of over \$25,000. Commercial activity, defined as income from special events, sales of goods, and dues and payments where members received comparable benefits, grew as percentage of income for these groups from 48.1% in 1982 to 57.6% in 2002. Kerlin, *supra* note 11, at 252.

drastic increases in unemployment, with many countries surpassing 10% unemployment.¹³ However, unlike in the United States, where only 12% of the unemployed were considered “long-term unemployed” (unemployed for more than a year), 40% of Europe’s unemployed fell in this category.¹⁴ The downturn significantly cut government budgets across the continent, reducing states’ ability to provide unemployment assistance and job re-integration, further compounding the unemployment problem.¹⁵ In response to the void left by the reduction in government services, several charities chose to focus their efforts on battling structural unemployment.¹⁶ Many charities started job-training and work-integration programs—programs which often had commercial, or social-enterprise, characteristics.¹⁷

The European charities’ focus on unemployment marked a distinct shift from earlier ideas of charity as being limited to advocacy and the provision of services for the poor.¹⁸ Because this new focus often included commercial activities, it decisively shaped the understanding of social enterprise in Europe and in turn guided the development of social-enterprise policy across the continent.¹⁹ However, despite this common focus and a developed history of social-enterprise legislation, discussion of social enterprise in Europe remains difficult due to the lack of a unified definition of the concept. Several European countries have adopted their own official definitions,²⁰ but the European Union (“EU”) has yet to

13. TACKLING SOCIAL EXCLUSION IN EUROPE: THE CONTRIBUTION OF THE SOCIAL ECONOMY 5 (Roger Spear et al. eds., 2001).

14. *Id.*

15. Defourny, *supra* note 2.

16. Kerlin, *supra* note 11, at 252-53.

17. Defourny, *supra* note 2.

18. Jacques Defourny, *Towards a European Conceptualization of the Third Sector*, in IMAGES AND CONCEPTS OF THE THIRD SECTOR IN EUROPE 3 (Jacques Defourny et al. eds., 2008).

19. *See id.*, at 12; Kerlin, *supra* note 11, at 250.

20. The United Kingdom, Belgium, Latvia, Lithuania and Finland have official definitions of social enterprise. KMU FORSCHUNG AUSTRIA, AUSTRIAN INSTITUTE FOR SME RESEARCH, STUDY ON PRACTICES AND POLICIES IN THE SOCIAL ENTERPRISE SECTOR IN EUROPE 11 (2007) [hereinafter KMU FORSCHUNG AUSTRIA]. The official definition in the United Kingdom is, “a business with primarily social objectives whose surpluses are principally re-invested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners.” KMU FORSCHUNG AUSTRIA, AUSTRIAN INSTITUTE FOR SME RESEARCH, STUDY ON PRACTICES AND POLICIES IN THE SOCIAL ENTERPRISE SECTOR IN EUROPE: COUNTRY FICHE – UNITED KINGDOM 2 (2007). The official definition in Belgium is enterprises that “produce goods and services [that] answer a certain need and target a population of costumers [*sic*]. . . [and the goods] are made available on the market for a certain price. Social economy initiatives and social enterprises strive towards continuity, profitability and sustainable development.” KMU FORSCHUNG AUSTRIA, AUSTRIAN INSTITUTE FOR SME RESEARCH, STUDY ON PRACTICES AND POLICIES IN THE SOCIAL ENTERPRISE SECTOR IN EUROPE: COUNTRY FICHE – BELGIUM 2 (2007) [hereinafter COUNTRY FICHE – BELGIUM]. The official definition

recognize a single overarching definition. The lack of a common or unified understanding hinders trans-national statistical comparisons and makes it difficult to monitor best practices or successful regulatory frameworks across countries.²¹

II. PROBLEMS OF ADAPTING TRADITIONAL U.S. LEGAL FORMS TO SOCIAL ENTERPRISE

Until recently, social enterprises in the United States were stuck firmly between the choice of forming as for-profit entities with some social objectives or as nonprofit entities with some commercial objectives. These traditional forms are each designed for either end of the economic spectrum: nonprofit and for-profit. Social enterprises typically have characteristics of both, yet neither traditional form offers much room for hybrid activity. In the past few years new hybrid options have become available, including the L3C. In order to understand the potential economic and social impacts of these new hybrids, it is important to recognize the advantages and limitations of the traditional options. In this section I discuss the difficulties of using the traditional nonprofit and for-profit forms for social-enterprise organizations in the United States.

A. The Nonprofit Corporation

Tax incentives and the nature of the work done by social enterprises drive many social entrepreneurs to form their enterprises as nonprofit

in Latvia is, “associations and foundations that in their statutes have given their objectives of operating to create social benefit, as well as religious organisation or institutions which also have social objectives, if these associations, foundations, and religious organisations have been given the status of social enterprise and if they do not distribute their physical and financial assets directly or indirectly among the establishers, representatives of board of administration, or members of other administrating institutions.” KMU FORSCHUNG AUSTRIA, AUSTRIAN INSTITUTE FOR SME RESEARCH, STUDY ON PRACTICES AND POLICIES IN THE SOCIAL ENTERPRISE SECTOR IN EUROPE: COUNTRY FICHE – LATVIA 2 (2007). The official definition in Lithuania is, “an independent small or medium-sized enterprise . . . [where] the employees classified as target groups account for at least 40% [of the workforce] and there are at least 4 such employees . . . ; [where] the enterprise is engaged in the development of employees’ working and social skills and social integration; [and] the enterprise’s income from activities [are] not eligible for support account for not more than 20%.” KMU FORSCHUNG AUSTRIA, AUSTRIAN INSTITUTE FOR SME RESEARCH, STUDY ON PRACTICES AND POLICIES IN THE SOCIAL ENTERPRISE SECTOR IN EUROPE: COUNTRY FICHE – LITHUANIA 2 (2007). The official definition in Finland is, “a company . . . producing goods and services on commercial principles and whose purpose is to make profits. . . . The special feature of a social enterprise is that at least 30% of its employees are disadvantaged in the labour market and long-term unemployed.” KMU FORSCHUNG AUSTRIA, AUSTRIAN INSTITUTE FOR SME RESEARCH, STUDY ON PRACTICES AND POLICIES IN THE SOCIAL ENTERPRISE SECTOR IN EUROPE: COUNTRY FICHE – FINLAND 2 (2007).

21. See KMU FORSCHUNG AUSTRIA, *supra* note 20, at 4.

corporations. However, the business characteristics of these organizations can create obstacles to receiving the full benefits of the nonprofit form. Some of these problems stem from ambiguous and often conflicting ideas as to the nature, purpose, and boundaries of charity.

Initial conceptions of charity in the United States grew from an idea of community self-help in the absence of aid from the government. To a certain extent this reflects how communities initially developed. As settlers came over from Europe, “New World” communities were established before the inception of any strong government. Often, public needs, such as caring for the poor, had to be handled by members of the community if they were to be handled at all.²² This idea of community self-help helped initially shape the charitable sector, as the sector developed in the United States largely without influence from the government.

Before the creation of the federal income tax in 1913 and the accompanying federal definition of “charity,” individual states defined “charity.” However, even within each state, creating a uniform definition proved to be a difficult task. This dilemma is evident in Pennsylvania Supreme Court rulings from the second half of the nineteenth century. The court had difficulty determining whether charity was rooted in the intentions of the donor or in the ultimate use of the donations. In 1857 the court took the position that intent was relevant, holding that “‘whatever is given for the love of God, or for the love of your neighbor, in the catholic and universal sense . . . free from the stain or taint of every consideration that is personal, private, or selfish,’ is a gift of charitable uses.”²³ The court later retreated from this idea in 1888, when it stated that “[i]t would be as vain as it would be unprofitable for a human tribunal to speculate upon the motives of men in such cases The money which is selfishly given to public charity does as much good as that which is contributed from a higher motive, and in a legal sense the donor must have equal credit therefor.”²⁴ This second, more objective, test ultimately proved to be more practical in determining what qualifies as a charitable contribution, rather than relying on the moral undertones of the court’s first test. However, moral elements are still evident in today’s laws relating to what constitutes a charity.

The most defining characteristics of public charities in the United States is exemption from federal income taxes and the ability to receive

22. Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 *FORDHAM L. REV.* 2437, 2451 (2005).

23. *Price v. Maxwell*, 28 Pa. 23, 35 (Pa. 1857) (quoting Attorney Binney’s argument in *Vidal v. The City of Philadelphia*, 43 U.S. 127 (1844)).

24. *Fire Ins. Patrol v. Boyd*, 15 Atl. 553, 554-55 (Pa. 1888).

tax-deductible donations. Because of these common traits, the federal government's definition of charity prevails over other definitions. The exemption from federal income tax is as old as the income tax itself. The Tariff Act of 1894 provided the first glimpse of tax-exempt status when it said "nothing herein contained shall apply to . . . corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes."²⁵ The Tariff Act was later deemed unconstitutional,²⁶ but following the passage of the Sixteenth Amendment, the succeeding Revenue Act of 1913 also granted a tax exemption to "any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes."²⁷ This benefit was significantly enhanced in 1917 when Congress introduced a tax deduction available to donors for their donations to these statutorily-defined nonprofit organizations.²⁸

Nevertheless, the creation of a federal standard of charity did not eliminate the difficulty of determining which organizations should be considered charities. This is often not a problem, as many charities, like soup kitchens and homeless shelters, clearly operate in the nonprofit arena; however, when nonprofits direct some of their operations in the commercial arena, such as through the sale of goods or the provision of moving services,²⁹ the task becomes more difficult. Social enterprises that want to operate as nonprofits and avail themselves of the associated benefits, but also want to pursue commercial activities, must navigate the various tests and regulations devised by Congress and the U.S. Department of the Treasury in order to ensure that they can maintain their tax-exempt status.

The Internal Revenue Service ("IRS") sets out the basic criteria for tax-exempt status in Section 501(c)(3) of the tax code. The criteria can be understood as having five main parts: the organization must be (1) a "Corporation[], . . . community chest, fund, or foundation," (2) "organized and" (3) "operated exclusively for [one of the purposes identified by the

25. Wilson Tariff Act, ch. 349, § 32, 28 Stat. 556 (1894), *invalidated by* Pollock v. Farmer's Loan & Trust Co., 158 U.S. 601 (1895).

26. Pollock v. Farmer's Loan & Trust Co., 158 U.S. 601 (1895).

27. Underwood Tariff Act, ch. 16, § 2, 38 Stat. 114, 172 (1913) (amended 1993).

28. War Revenue Act, ch. 63, § 1201(2), 40 Stat. 300, 330 (1917).

29. See, e.g., TROSA, Trosa Businesses, <http://www.trosainc.org/businesses/index.htm> (last visited Nov. 15, 2009).

IRS, hereinafter referred to generally as an “exempt purpose”],³⁰ (4) “no part of the net earnings of which inures to the benefit of any private shareholder or individual,” and (5) “no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation . . . [or] intervene in . . . any political campaign.”³¹ The most relevant portions of this five-part test to social enterprise are parts three and four: that the nonprofit must be operated exclusively for an exempt purpose, and that there can be no private inurement.

The meaning of “operated exclusively” for determining whether an organization can receive a tax exemption is not as clear as it first appears. At first glance, it appears that the tax code disallows tax-exempt status to nonprofits that engage in any trade or business activity that is not wholly directed towards fulfilling an exempt purpose. However, the regulations specify that the “exclusively test” is not as stringent as it sounds, detailing that “[a]n organization will be regarded as ‘operated exclusively’ . . . if it engages primarily in activities which accomplish one or more exempt purposes.”³² This clarifies that the exclusively requirement can in fact be met by the less exacting requirement of *primarily* operating for an exempt purpose. Furthermore, even if the trade or business is a substantial part of the organization’s activities, the exclusively test can be satisfied if the activity “is in furtherance of the organization’s exempt purpose.”³³ Therefore, insubstantial commercial activity is allowed so long as it does not stand in the way of the organization primarily operating for an exempt purpose, and substantial activity is allowed as long as it furthers the organization’s exempt purpose. These regulations make it clear that there is some room for entrepreneurial and commercial activity while remaining a nonprofit, but it is unclear where the boundaries are. This lack of defined boundaries causes the determination to fall to the courts, and social entrepreneurs are left to guess how courts will rule in their specific situations.

Judicial attempts to define what activity is “substantial” do not offer any certainty to social enterprises attempting to operate as nonprofits. In an attempt to clarify what activity is deemed substantial, courts have

30. The IRS defines “exempt purpose” as “religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals.” I.R.C. § 501(c)(3) (2007).

31. *Id.*

32. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2009).

33. *Id.* § 1.501(c)(3)-1(e) (2009).

developed the “commerciality doctrine.” This doctrine essentially asks whether the business activity in question has a distinctive “commercial hue.”³⁴ The development of this concept, however, has not added a substantial amount of clarity to the issue. Courts have stated that large profits alone are insufficient to prove that a nonprofit’s business activity has become activity of a commercial hue.³⁵ However, courts have also indicated that sizable profits can be *evidence* of activity “of a commercial character.”³⁶ This difficulty is compounded by unclear, if not inconsistent, application of the doctrine by the IRS and the courts. In 1979, the IRS sued a nonprofit, which operated a pharmacy that generally sold discounted drugs to senior citizens.³⁷ Although only 2% of the pharmacy’s sales were made to the public at retail prices, the Tax Court held that the pharmacy was too commercial in character and revoked its tax-exempt status.³⁸ One year later, in 1980, the IRS issued a Private Letter Ruling (“PLR”) informing a nonprofit, which operated a prosthetic center for injured veterans, and which generated 47% of its revenue from the general public, that the nonprofit’s commercial activities did not jeopardize its tax-exempt status.³⁹ The commerciality doctrine does not let social enterprises operating as nonprofits easily predict whether their tax-exempt status is in jeopardy when conducting business activity that does not further their exempt purpose, but which may qualify as insubstantial activity.

When social-enterprise nonprofits operate a substantial amount of commercial activity, they need to qualify this activity as activity which furthers their exempt purposes in order to not risk losing their tax-exempt status.⁴⁰ It is important to note, however, that operating commercial activity simply to fund an exempt purpose will not qualify as furthering the exempt purpose.⁴¹ Instead, the commercial activity must itself further the exempt purpose. A clear example is Goodwill Industries, where the sales of donated goods not only raise funds, but also offer opportunities for job training for members of disadvantaged communities.⁴²

34. *See* *Airlie Found. v. I.R.S.*, 283 F. Supp. 2d 58, 65 (D.D.C. 2003).

35. *See* *Scripture Press Found. v. United States*, 285 F.2d 800, 803 (1961).

36. *Id.*

37. *Fed’n Pharm. Servs., Inc. v. Comm’r*, 72 T.C. 687 (1979).

38. *Id.*

39. I.R.S. Priv. Ltr. Rul. 80-38-004 (May 28, 1980).

40. *See* Treas. Reg. § 1.501(c)(3)-1(e) (2009).

41. *See* *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 (3d Cir. 1951).

42. *See* *Goodwill Industries*, *supra* note 7.

Satisfying the “operated exclusively” test under one of these two prongs is necessary for nonprofits to gain some of the benefits of tax-exempt status. However, even with tax-exempt status, nonprofits are not wholly exempt from income-tax responsibilities. Nonprofits are still responsible for paying taxes on income derived from an “unrelated trade or business.”⁴³ While some amount of commercial activity may not strip the nonprofit of its tax-exempt status, if the activity is not substantially related to the exempt purpose, then income tax will be due on that portion of income, and the tax exemption will be worth far less to the enterprise.

Because the unrelated business income tax (“UBIT”) can limit the value of a nonprofit’s tax exemption, it often serves as a significant restriction on the nonprofit’s activities. In order to appreciate these limitations, it is important to understand the UBIT’s development. Before 1950, the UBIT did not exist and tax-exempt nonprofits could earn tax-free income from any commercial activity that they operated, so long as they maintained their tax-exempt status. Needless to say, this prompted some nonprofits to engage in business activity entirely unrelated to their exempt purposes simply to raise funds. An alumni group from the New York University School of Law gained national attention when it purchased the C.F. Mueller Company, a highly successful pasta manufacturer, solely to direct its profits to the law school.⁴⁴ This purchase raised the ire of the business community which clamored that this offered an unfair competitive advantage to companies owned by nonprofits over other commercial enterprises that have to pay corporate income tax on their profits. Shortly after the C.F. Mueller purchase, Congress responded to the complaints of the business community. In 1950, Representative John Dingell went so far as to report to the House of Representatives that “eventually all the noodles produced in this country will be produced by corporations held or created by universities.”⁴⁵ Later that year Congress passed the Revenue Act of 1950, imposing, for the first time, federal income tax on unrelated business income (“UBI”).⁴⁶

Social-enterprise nonprofits that want to raise tax-exempt funds through commercial activities need to be careful that the income is not categorized as UBI. The Treasury attempts to clarify what activity generates UBI by outlining a three-part test in the regulations. UBI will

43. I.R.C. § 513(a) (2007).

44. *See C.F. Mueller Co.*, 190 F.2d at 120.

45. *Hearings Before the House Comm. on Ways and Means*, 81st Cong., 579-80 (1950) (statement of Rep. Dingell, Member, House Comm. on Ways and Means).

46. Revenue Act of 1950, Pub. L. No. 81-814, § 301, 64 Stat. 906, 947 (1950).

arise from activity that is (1) “a trade or business,” (2) “regularly carried on,” and (3) that “is not substantially related” to the nonprofit’s exempt purpose.⁴⁷ The IRS adds that any income derived from conduct “not substantially related” to the “exercise or performance” of the organization’s exempt purpose will qualify as UBI.⁴⁸ The regulations explicitly clarify that solely using profits to fund an exempt activity will not meet the level of substantially related conduct, and that there must be a “causal connection” between the business activity and the exempt purpose.⁴⁹

These various tests and definitions still leave significant ambiguity for social-enterprise nonprofits. For example, how strong does the casual connection need to be? Would the sale of recycled goods by a nonprofit focused on increasing access to recycling programs count? What about at-cost sales of art supplies in disadvantaged communities? The case involving the nonprofit prosthetic center operated to aid disabled veterans discussed above offers some clarity.⁵⁰ The IRS concluded that all income derived from sales and services provided for veterans would not be UBI, but that all income derived from sales to the general public would qualify as UBI (though it would not rob the organization of its tax-exemption).⁵¹ For social enterprises that have difficulty delineating which services are offered to the general public and which services further their exempt purpose, these rules create a large possibility of having to pay income taxes on income which is not clearly in line with their exempt purpose.

Moreover, the “operated exclusively” test and the UBIT pose serious impediments to financing charity through activities that have commercial qualities. Generally, it appears that the tax code pushes nonprofits to operate in a manner similar to traditional charities, operating primarily off of grants and donations. However, many scholars believe that the message from Congress and the public to charities is to operate more like a business, with a careful eye on efficiency and sustainability.⁵² The confusion in this area raises the question of whether it is in the best interests of society to prevent charities from embracing the full potential of commercial activity.

Some scholars argue that nonprofits should be encouraged to participate in the market economy as a means to enhance their efficiency

47. Treas. Reg. 1.513-1(a) (2009).

48. I.R.C. § 513(a) (2007).

49. Treas. Reg. 1.513-1(d) (2009).

50. *See supra* text accompanying note 37.

51. I.R.S. Priv. Ltr. Rul. 803-80-04 (May 28, 1980).

52. Kelley, *supra* note 22, at 2437-38.

and increase their overall impact.⁵³ On the macro level, empirical evidence suggests that nonprofits tend to react slower to changes in the demand for the services they offer when compared to for-profit organizations.⁵⁴ The roots of the efficiency-disparity can be seen in two areas. First, the restriction in the tax code denying nonprofits a tax exemption if they generate any private inurement bars nonprofits from using incentive-based pay schemes to compensate their employees.⁵⁵ This type of compensation structure could help incentivize managers of nonprofits to minimize administrative costs⁵⁶—costs which have grown to the point where the average charity spends close to 18% of its income on fundraising and overhead costs.⁵⁷ Compared to the average cost of raising funds to start a small business, typically 2% to 5% of funds raised, and average sales and marketing costs of consumer-oriented companies, typically about 10% of income, the 18% figure for charity overhead costs suggests that some structural inefficiencies exist.⁵⁸

In addition, the allocation of funds to, and within, charities is often not correlated with the charity's success. One study confirming this observation compared the per-client costs of over 300 local affiliates of three large, nationally organized nonprofit youth organizations. The study found that some affiliates spent significantly more per client to achieve comparable results of other affiliates, yet resources were not in turn diverted to the cost-effective affiliates.⁵⁹ Furthermore, foundation grants tend to favor new and innovative, but potentially inefficient and costly projects, rather than tested, reliable, and efficient programs.⁶⁰ This systemic

53. See Bill Drayton, *The Citizen Sector Transformed*, in SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE 45 (Alex Nichols ed., 2006); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017-66 (2007).

54. J. Gregory Dees & Beth Battle Anderson, *For-Profit Social Ventures*, 2 INT'L. J. OF ENTREPRENEURSHIP EDUC. (SPECIAL ISSUE: SOC. ENTREPRENEURSHIP) 6 (2004).

55. I.R.C. § 501(c)(3) (2007).

56. Malani & Posner, *supra* note 53, at 2027.

57. *What We Know about Overhead Costs in the Nonprofit Sector*, NONPROFIT OVERHEAD COST PROJECT (Ctr. on Nonprofits and Philanthropy, Urban Inst. Ctr. on Philanthropy, Ind. Univ.), Feb. 2004, at 1. In some extreme cases this figure can rise to over 90%. See *United Cancer Council, Inc., v. Comm'r*, 165 F.3d 1173, 1175 (7th Cir. 1999) (where a nonprofit organization spent \$26.5 million to raise \$28.8 million).

58. Bill Bradley, Paul Jansen & Les Silverman, *The Nonprofit Sector's \$100 Billion Opportunity*, HARV. BUS. REV. May 2003, at 94, 97.

59. Local agencies in the 25th percentile spent 67% more per client than those in the 75th percentile. *Id.* at 100.

60. See Christine W. Letts, William Ryan & Allen Grossman, *Virtuous Capital: What Foundations Can Learn from Venture Capitalists*, HARV. BUS. REV., Mar.-Apr. 1997, at 36, 37.

lack of accountability along with the incentives to develop new programs can lead charities to develop inefficient practices and focus on developing ideas for the future rather than reviewing past successes.⁶¹ A 2003 study estimated that such inefficiencies cost nonprofits roughly \$100 billion annually.⁶²

Bill Drayton, founder of Ashoka, one of the largest foundations exclusively funding social enterprises, points out that from the time of Ancient Rome until 1700, there was essentially zero per capita income growth in western countries, but at the turn of the eighteenth century businesses began operating in a more modern, competitive fashion which resulted in per capita income growth of 20%, 200%, and 740%, respectively, over the following three centuries.⁶³ However, during this period of expansive business growth, charities developed along an entirely different path, with their own legal forms and methods of operation. Drayton argues that this split was a “historical accident, a giant navigational error,” and that “the inertia of [the initial] division remains strong,” holding back the growth of modern charities.⁶⁴ The apparent lack of efficiency in today’s charitable organizations seems to be in line with Drayton’s argument.

B. For-Profit Entities

In light of the difficulties and obstacles inherent in operating a social enterprise as a nonprofit entity, some social entrepreneurs prefer to operate as a free-standing for-profit entity, or create a for-profit entity that contributes its profits to a corresponding nonprofit. However, these options have their own set of difficulties.

The main obstacle to operating a social enterprise as a for-profit entity is the difficulty of raising capital.⁶⁵ Choosing to operate a business with a social purpose often involves making choices that can lower the potential to generate economic profits. As a result of this diminished profit-potential, the interest rates associated with raising capital through debt markets can be prohibitively high.

Problems also arise when attempting to access equity markets. Once a company issues shares, its board and its officers are obligated to look after

61. *Id.* at 37.

62. Bradley, Jansen & Silverman, *supra* note 58, at 102.

63. Drayton, *supra* note 53, at 46.

64. *Id.* at 51.

65. See Matrix Group Discussion Paper, *Finance for Foundations: Expanding the Toolbox for Impact* (UBS Philanthropy Servs., Discussion Paper No. 2007-06-05).

the interests of the shareholders over all other constituencies. This shareholder primacy model dates back to 1918, when Henry Ford made the mistake of declaring that his ambition was “to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes,” instead of delivering increased profits back to the shareholders.⁶⁶ A court order required the Ford Company to issue a special dividend rather than reinvest the money as Henry Ford wanted.⁶⁷ Henry Ford’s mistake flowed from stating that he wanted to direct the business’s resources to help outside constituencies, instead of reinvesting with an eye toward greater future profits or creating returns for the shareholders. Although courts have yet to require another company to issue special dividends, there still remains the risk of shareholder derivative suits if profits are not reinvested to create economic gains or distributed to the shareholders.⁶⁸

Consequently, the social enterprise’s interest in reinvesting profits toward social purposes could easily be viewed as conflicting with the shareholders’ interest of increasing the economic return on their shares. This suggests a significant potential for derivative suit litigation. Furthermore, directors of the company who are elected by the company’s shareholders may find themselves favoring the economic interests of the shareholders over the social interests for which the enterprise was established.

Social enterprises set up as public for-profit corporations that donate profits to corresponding charities face additional obstacles when attempting to donate large percentages of their profits. The IRS allows corporations to deduct charitable donations of up to 10% of their profits.⁶⁹ However, if more than 10% of profits are given to charity, the donated profits above this level are taxed at the corporate income tax rate. State laws governing corporate law do not restrict donations to this level, but the laws are generally interpreted to authorize only reasonable levels of giving.⁷⁰ Furthermore, courts have used the 10% level from the tax code as a “helpful guide” to determine if a charitable gift amounts to actionable corporate waste.⁷¹ It appears that in most situations, for-profit public

66. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 671 (Mich. 1919).

67. *See id.* at 685.

68. I address the issue of explicitly including the interests of outside constituencies in corporate documents later in this note. *See infra* text accompanying notes 74-81.

69. This level is subject to carry-back provisions, etc. I.R.C. § 170(2)(A) (2007).

70. *See Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969).

71. *See Kahn v. Sullivan*, 594 A.2d 48, 61 (Del. 1991).

corporations donating more than 10% of their profits to a nonprofit would be opening up themselves to liability from a derivative suit, essentially foreclosing this scheme as a viable option for social enterprises.

Therefore, when a social enterprise needs to raise significant amounts of capital to establish itself, the for-profit model offers little help due to the shareholder primacy model and government restrictions on donations to outside charities, whether affiliated or not. However, when social enterprises can raise capital through private seed money and without relying on loans and equity markets, for-profit corporations and social enterprise can be a successful combination. One prominent example is Newman's Own, a for-profit corporation which sells food products at a profit and then donates the entirety of the after-tax profits to charity.⁷² Since its launch in 1982, the company has donated over \$280 million to charity.⁷³ However, this type of opportunity and success is rare; in most situations start-up social enterprises, like other businesses, require more funding than they can provide themselves, and profits are needed to repay loans or entice shareholders to purchase equity.

Recently, there have been attempts to steer more capital to social enterprises organized as for-profit companies through private certification. B Lab, a nonprofit corporation based in Pennsylvania, created the "B-Corporation" designation (the "B" stands for beneficial) for which for-profit social enterprises can apply.⁷⁴ In order to be certified as a B-Corporation, a corporation, partnership, sole proprietorship, or LLC must receive a grade of at least 80 out of a possible 200 points on B Lab's questionnaire focusing on the company's social impact.⁷⁵

Once certified, the company must amend its bylaws or other operating agreement to ensure that managers and directors can consider constituencies other than just shareholders, including its employees, suppliers, consumers, community, and environment.⁷⁶ However, if the company is a corporation, the company's state of incorporation must have a "constituency statute" which allows the directors of corporations to

72. Funding Universe, Newman's Own, Inc., <http://www.fundinguniverse.com/company-histories/Newmans-Own-Inc-Company-History.html> (last visited Nov. 15, 2009).

73. Newman's Own, Our Story, <http://www.newmansown.com/ourstory.aspx> (last visited Nov. 15, 2009).

74. B Corporation, FAQ, <http://www.bcorporation.net/faq> (last visited Nov. 15, 2009).

75. B Corporation, Becoming a B Corporation, <http://www.bcorporation.net/become> (last visited Nov. 15, 2009).

76. B Corporation, Term Sheet for Class of 2009 B Corporations, http://www.bcorporation.net/resources/bcorp/documents/BCorp_TermSheet_Declaration_ConstituencyState_20091.pdf.

consider groups other than shareholders. Currently thirty-one states have constituency statutes,⁷⁷ but Delaware, the state in which more than half of the publicly traded companies in the United States are incorporated,⁷⁸ notably, does not. It appears that the directors' contractual duties to outside constituencies mandated by B Lab are incompatible with Delaware's conception of fiduciary duties.⁷⁹ If a corporation wants to gain the B-Corporation label and it is incorporated in a state without a constituency statute, it has to reincorporate in a state that does have a constituency statute, or risk facing a derivative suit.

As of this point, the B-Corporation has yet to gain much momentum, as only 220 companies have obtained the certification.⁸⁰ Some of the difficulty could be due to the fact that the benefits of B-Corporation status are uncertain, while there are certain definite costs. For instance, certified B-Corporations must agree to provide specified percentages of their income every year to B Lab,⁸¹ but it is not certain that the label will help to raise capital.

III. SOCIAL ENTERPRISE IN EUROPE

For over a decade, European efforts to spur the growth of social enterprise have included policies aimed at the creation of hybrid entities. The policies regarding these entities have generally reflected the European understanding of social enterprise as a tool for decreasing unemployment, an idea which is also evident in the European Union's hopes for the sector.⁸² The European Commission estimates that there are close to 2

77. Alissa Mickels, *Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe*, 32 HASTINGS INT'L & COMP. L. REV. 271, 290 n.273 (2009).

78. Delaware Department of State, Division of Corporations, About Agency, <http://www.corp.delaware.gov/aboutagency.shtml> (last visited Nov. 15, 2009).

79. See Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 795 (2008) (arguing that B-Corporations are currently incompatible with Delaware corporate law).

80. B Corporation, B Community, <http://www.bcorporation.net/community> (last visited Feb. 10, 2010). Seventh Generation, manufacturer of non-toxic cleaners and personal care products, is one notable B corporation. B Corporation, Seventh Generation, <http://www.bcorporation.net/seventhgeneration> (last visited Nov. 15, 2009). King Arthur Flour is another. B Corporation, King Arthur Flour, <http://www.bcorporation.net/kingarthurfLOUR> (last visited Nov. 15, 2009).

81. B Corporation, Make It Official, <http://www.bcorporation.net/index.cfm/nodeID/3C192853-ADFD-4C10-B5F3-3D9654551A98/fuseaction/content.page> (last visited Nov. 15, 2009).

82. The Commission of the European Communities recommends creating policies to facilitate the growth of entrepreneurship, including social entrepreneurship, as a method for strengthening the overall European Economy. Communication from the Commission to the Council, The European Parliament,

million social enterprises currently operating in Europe, which comprises roughly 10% of all European companies.⁸³ The Commission further estimates that these businesses employ 11 million people in Europe,⁸⁴ although the different definitions of social enterprise make it difficult to gather precise numbers.⁸⁵

Recognizing that most social enterprises, at least at their inception, are small or medium sized enterprises (“SMEs”),⁸⁶ the European Commission is attempting to spur the creation of social enterprises as part of its efforts to develop the SME sector as a whole.⁸⁷ The Commission recommends that European Union member-states implement policies that incentivize citizens to create SMEs in hopes of closing the productivity gap between the European Union and the United States.⁸⁸ The Commission suggests that the creation of SMEs leads to increased economic diversity, which in turn promotes greater economic growth potential.⁸⁹ This hypothesis rests, in part, on economist Joseph Schumpeter’s concept of “creative destruction,” the idea that the entry and exit of businesses in the market allows for continuous reallocation of resources to their best use.⁹⁰ The Commission suggests that member states provide business support to entrepreneurs and create policies that allow for the easy creation of businesses.⁹¹ Belgium and the United Kingdom have followed these recommendations and enacted legislation intended to encourage the growth of social enterprise within their borders.

In this section I discuss the policies which Belgium and the United Kingdom have adopted in order to promote the growth of social enterprise.

The European Economic and Social Committee and the Committee of the Regions, *Action Plan: The European Agenda for Entrepreneurship*, COM (2004) 70 final (Feb. 11, 2004) [hereinafter *European Agenda for Entrepreneurship*]. See also Rafael Chaves Ávila & José Luis Monzón Campos, *The Social Economy of the European Union*, 7-8, delivered to the European Economic and Social Committee, CESE/COMM/05/2005 (2005).

83. European Commission, Enterprise and Industry: Social Economy, http://ec.europa.eu/enterprise/entrepreneurship/craft/social_economy/soc-eco_intro_en.htm.

84. *Id.*

85. KMU FORSCHUNG AUSTRIA, *supra* note 20, at 13.

86. An SME is a company with fewer than 250 employees. Commission Recommendation (EC) No.2003/361 of 6 May 2003, Annex, art. 2(1), 2003 O.J. (L124) 36, 39.

87. See *European Agenda for Entrepreneurship*, *supra* note 82, at 3.

88. *Id.*

89. Communication from the Commission, to the Council, The European Parliament, The European Economic and Social Committee and the Committee of the Regions, “*Think Small First: A “Small Business Act” for Europe, Impact Assessment*, at 2, COM (2008) 394 final (June 25, 2008).

90. See *id.* at 7 (advocating member states to ensure fast bankruptcy proceedings).

91. *European Agenda for Entrepreneurship*, *supra* note 82, at 6.

Both countries have created unique business forms that cater to the needs of social-enterprise organizations. However, the policies in the United Kingdom have proven more successful because of their focus on generating greater public understanding of social enterprise and creating new sources of capital for social-enterprise organizations. The policies in Belgium have been more limited in their success mainly because the business form tailored to social-enterprise organizations does not provide new capital streams to the organizations.

A. Belgium

Belgium was one of the first European countries to implement policies aimed at actively supporting social enterprise. However, their policies have had only limited success so far. The Belgian government officially defined social enterprise as a company with “a purpose of serving members of the community rather than seeking profit, an independent management, a democratic decision-making process, and the primacy of people and labor over capital in the distribution of income.”⁹² Despite this national definition, the governments of Belgium’s three regions use their own definitions when gathering statistics on social enterprise.⁹³ This results in imprecise data which has hindered the study and development of the sector.⁹⁴

The global economic downturn in the 1970s led to an increase in structural unemployment in Belgium.⁹⁵ In response, many Belgians started charity organizations focused on job reintegration in Belgium during the 1980s and early 1990s.⁹⁶ These groups were typically organized as nonprofit entities known as Associations sans but Lucratifs (“ASBLs”). ASBLs are similar to American nonprofit corporations, especially in that they can carry out only limited commercial activity and are able to apply for government subsidies. The limitations on commercial activity hinder their effectiveness as vehicles for social enterprise.

In 1995, the Belgian government made its first attempt at encouraging this type of social-enterprise activity when the parliament approved a law creating a new corporate form called the Société à Finalité Sociale

⁹³ Defourney, *supra* note 18, at 11.

⁹³ KMU FORSCHUNG AUSTRIA, *supra* note 21, at 13.

⁹⁴ COUNTRY FICHE - BELGIUM, *supra* note 20, at 2-3.

⁹⁵ Belgian Section of CIRIEC, *The Social Economy of Integration, Analysis of the Complementarities and Efficiency of the Tools of the Social Economy*, at 3-4, N SO/H6/049 (2005).

⁹⁶ *Id.*

(“SFS”).⁹⁷ The purpose of the SFS is to provide a business format for social enterprises that allows for more commercial activity than ASBLs. However, in action, the SFS is more like the certification system of the B-Corporation, acting as a label rather than a new business entity.⁹⁸ To become an SFS, a company must include in its articles that the members of the company are seeking limited or no profit, and that any profit distributions cannot exceed an annual return of 6% on the investor’s principal.⁹⁹ Additionally, when the company is dissolved, any assets remaining after liabilities are repaid and investors’ capital is returned must be reinvested in a company or charity which furthers the SFS’s social purpose.¹⁰⁰ The SFS essentially operates as a for-profit company that has additional restrictions on profit distribution. Despite these restrictions the SFS does not offer any advantages for raising capital, compared to a regular for-profit company, other than the potential branding value of being recognized as a social enterprise.

Due to the lack of clear advantages of the SFS, many social entrepreneurs have chosen to either forgo the full realization of the commercial aspects of their social enterprises and instead form ASBLs or simply to form for-profit companies without the distribution restrictions. As a result, few Belgian entrepreneurs are choosing to use the SFS form. Between its creation in 1995 and 2003, only 400 SFSs registered with the Belgian government,¹⁰¹ and the form has not received much popular support.¹⁰² The disadvantages of the SFS, as compared to the ASBL and for-profit companies, have limited the development of the social-enterprise sector in Belgium, as social enterprises have not embraced the SFS and remain generally confined to the traditional forms.

B. The United Kingdom

While Belgium has struggled to facilitate the development of social enterprise, the United Kingdom has developed the most robust social-enterprise sector in the European Union.¹⁰³ The British government

97. Jacques Defourney & Marthe Nyssen, *Belgium: Social Enterprises in Community Services*, in THE EMERGENCE OF SOCIAL ENTERPRISE, *supra* note 2, at 47.

98. Marthe Nyssens, *Belgium*, in SOCIAL ENTERPRISE IN EUROPE: RECENT TRENDS AND DEVELOPMENT 13, 13 (Jacques Defourney et al. eds., 2008) (arguing that the SFS is really just a label) [hereinafter *Belgium*, SOCIAL ENTERPRISE IN EUROPE].

99. *Id.* at 61 n.3.

100. *Id.*

101. *Id.* at 13.

102. *Id.* at 7.

103. KMU FORSCHUNG AUSTRIA, *supra* note 20, at 12.

endorses the view that social enterprises are a useful tool for closing the productivity gap with the United States¹⁰⁴ and has been creating a network of resources for this purpose. The government established the Social Enterprise Unit with its own junior minister in 2001 to identify barriers to the growth of the social-enterprise sector in the United Kingdom and to develop strategies to overcome these obstacles.¹⁰⁵ The Unit officially defined “social enterprise” for the U.K. government in its first report one year later as “a business with primarily social objectives whose surpluses are principally reinvested for that purpose in the business or in the community, rather than being driven by the need to maximise profit for shareholders and owners.”¹⁰⁶

This report also identified four primary areas where the government can help to develop the social-enterprise sector: (1) foster a culture where there is full information about the potential of social enterprise, (2) ensure advice and information is available for those running social enterprises, (3) ensure there is access to finance for social enterprise, and (4) ensure that social enterprises can do business with the public sector and work with the government to achieve shared objectives.¹⁰⁷ These findings not only reflected the belief that there was a profound lack of information available to the public about social enterprise,¹⁰⁸ but also that the government was transitioning from providing wholly government-sponsored public services to forming public-private partnerships to achieve the same goals.¹⁰⁹

The government quickly moved to implement policies in the four target areas. To help the flow of information and support for social enterprise, the Social Enterprise Unit created a website dedicated to social enterprise and opened regional social-enterprise development centers. The Unit then selected 35 social-enterprise ambassadors to help spread

104. CABINET OFFICE, OFFICE OF THE THIRD SECTOR, SOCIAL ENTERPRISE ACTION PLAN: SCALING NEW HEIGHTS 17 (2006) [hereinafter SCALING NEW HEIGHTS], available at http://www.cabinetoffice.gov.uk/media/cabinetoffice/third_sector/assets/se_action_plan_2006.pdf.

105. KMU FORSCHUNG AUSTRIA, *supra* note 20, at 43.

106. SCALING NEW HEIGHTS, *supra* note 104, at 10.

107. *Id.* at 19-20.

108. See CABINET OFFICE, OFFICE OF THE THIRD SECTOR, PRIVATE ACTION, PUBLIC BENEFIT: A REVIEW OF CHARITIES AND THE WIDER NOT-FOR-PROFIT SECTOR 57 (2002), available at <http://www.cabinetoffice.gov.uk/media/cabinetoffice/strategy/assets/strat%20data.pdf> [hereinafter PRIVATE ACTION, PUBLIC BENEFIT].

109. ALEX NICHOLLS & CATHY PHAROAH, THE LANDSCAPE OF SOCIAL INVESTMENT: A HOLISTIC TOPOLOGY OF OPPORTUNITIES AND CHALLENGES 21 (2008), available at <http://www.microfinancegateway.org/gm/document-1.9.31110/08.pdf>. For an example of public-private partnership opportunities in the United Kingdom, see DEP'T OF TRADE AND INDUS., PUBLIC PROCUREMENT: A TOOLKIT FOR SOCIAL ENTERPRISES 13 (2003).

information within local communities.¹¹⁰ The government also established a £10 million fund for investment in social enterprises¹¹¹ and started a program to develop better metrics for measuring the social impact of these enterprises.¹¹²

Additionally, the government investigated the adequacy of the legal entities available to social enterprises in the United Kingdom. Before 2004, the options in the United Kingdom were similar to those available in the United States: limited companies and charities. The U.K. government supports charities with a system similar to the charitable income tax deduction in the United States, although there are some subtle differences. In the United Kingdom, individuals give money to charities with after-tax dollars, and the charity receives from the government an amount equal to the bottom-tax-bracket tax paid on the donation by the individual and an additional three pence per pound credit. The bottom tax rate is currently 20%, so for a £100 after-tax donation paid by the individual, the charity gets an extra £28 from the government.¹¹³ Individuals who are in the higher 40% bracket are able to reclaim the difference between the tax they paid on the income used for the donation and the amount the charity received from the government.¹¹⁴

Charities are also able to engage in a limited amount of commercial activity, but only if it directly furthers the charity's charitable purpose beyond simply raising funds for the charity.¹¹⁵ If a charity wants to have more than an insubstantial amount of commercial activity, it is required to set up a separate limited company called a "trading company," which can then donate money from its profits to the charity.¹¹⁶ The trading company can donate pre-tax money from its profits, but cannot give beyond its surplus and the distribution cannot be in the form of a dividend.¹¹⁷ This requirement of a separate entity insulates the charity from losses sustained

110. CABINET OFFICE, OFFICE OF THE THIRD SECTOR, SOCIAL ENTERPRISE ACTION PLAN: ONE YEAR ON 2 (2007), available at http://www.cabinetoffice.gov.uk/media/cabinetoffice/third_sector/assets/social_enterprise_action_plan_one_year_on.pdf [hereinafter ONE YEAR ON].

111. SCALING NEW HEIGHTS, *supra* note 104, at 5.

112. *Id.* at 42.

113. Directgov, Information for Giving, http://www.direct.gov.uk/en/MoneyTaxAndBenefits/ManagingMoney/GivingMoneyToCharity/DG_10015097 (last visited Nov. 15, 2009).

114. *Id.*

115. PRIVATE ACTION, PUBLIC BENEFIT, *supra* note 108, at 44.

116. *Id.*

117. HM Revenue and Customs, Gifts to Charity Made by Companies, <http://www.hmrc.gov.uk/businesses/giving/companies.htm> (last visited Nov. 15, 2009). In other words, this restriction protects charities from the potential losses that regular shareholders might be exposed to.

by the trading company, but also adds a significant amount of administrative cost and difficulty for social enterprises as they need to adhere to the regulatory requirements of two distinct enterprises.¹¹⁸

Despite the added difficulty, one-third of charities in the United Kingdom received income from commercial activities in 2002.¹¹⁹ Recognizing this trend, as well as the limitations on hybrid activity inherent in the for-profit and charity forms, the Social Enterprise Unit recommended to Parliament that the government create a new business entity geared towards the needs of social enterprise.¹²⁰ In 2004, the government followed through and established the Community Interest Company (“CIC”) as part of the 2004 Companies Act.¹²¹

The CIC is similar to a limited company, but has restrictions guaranteeing that the company will serve a social interest. A CIC may be a company limited by guarantee, where all profits are reinvested in the enterprise, or a company limited by shares, where the company can raise equity and issue limited dividends to its shareholders.¹²² The dividends are restricted by a per share return cap of “5% above the Bank of England base lending rate” as well as an aggregate limit of 35% of total company profits,¹²³ generally the aggregate cap is the more limiting of the two restrictions.¹²⁴

The government created two mechanisms to ensure that the CIC succeeds. First, as part of the 2004 Companies Act, the government created the CIC Regulator to register and monitor compliance with CIC regulations. The CIC Regulator’s role is only to be that of a “light-touch regulator” that monitors but does not engage in proactive scrutiny of

118. Costs arise from having to follow two distinct regulatory schemes. Additionally, there is the incentive for charity trustees to heavily invest in regulatory compliance costs, because trustees can be personally liable for any harm to the charity resulting from an improperly administered relationship between the charity and a trading company. See Charity Commission, How Charities May Lawfully Trade, <http://www.charity-commission.gov.uk/publications/cc35.asp> (last visited Nov. 15, 2009).

119. PRIVATE ACTION, PUBLIC BENEFIT, *supra* note 108, at 43.

120. *Id.* at 53.

121. The Companies (Audit, Investigations and Community Enterprise) Act, 2004, c.27.

122. THE REGULATOR OF CMTY. INTEREST COS., INCORPORATING A NEW COMMUNITY INTEREST COMPANY 21 (2008), available at <http://www.cicregulator.gov.uk/guidanceindex.shtml> (last visited Nov. 15, 2009) [hereinafter INCORPORATING A NEW CIC].

123. REGULATOR OF CMTY. INTEREST COS., COMMUNITY INTEREST COMPANIES: FREQUENTLY ASKED QUESTION 11 (2009), available at <http://www.cicregulator.gov.uk/CICleaflets/FAQ%20-%20October%202009%20V5.00%20Final.pdf> [hereinafter FREQUENTLY ASKED QUESTION].

124. FRASER VALLEY CENTRE FOR SOC. ENTER., ANALYSIS OF L3C AND CIC SOCIAL ENTERPRISE MODELS 5 (2008), available at http://www.centreforsocialenterprise.com/f/L3C_and_CIC_social_enterprise_models_Oct_2008.doc.

CICs.¹²⁵ However, if the Regulator discovers a major problem, he or she has the authority to appoint or remove directors and managers and also take steps to protect the CIC's property.¹²⁶ In addition, each CIC must pass the "Community Benefit Test,"¹²⁷ and annually submit a public report confirming that the Test is being met.¹²⁸ The basic test is whether "a reasonable person might consider that [the CIC's] activities are being carried on for the benefit of the community."¹²⁹ This test is generally not satisfied if the CIC aims to benefit a small number of people or if it intends to support a particular political party.¹³⁰ It is important to note that the community receiving the benefit need not be located within the United Kingdom, opening the possibility that the CIC could be a tool for social enterprise worldwide.¹³¹ To ensure that money invested in a CIC reaches the community if the CIC is dissolved, there is an "asset-lock." The asset-lock mandates that after liabilities have been repaid and investors have received their principal, investments, all remaining assets must be transferred to another CIC, a charity, or a foreign equivalent to a charity upon dissolution.¹³²

The primary benefit of the CIC is that it allows enterprises, which otherwise may have operated as charities, to engage in an unrestricted amount of commercial activity, so long as the enterprise provides a community benefit. However, at this point CICs do not receive the tax advantages which charities receive; instead, they are subject to income and value-added taxes like other companies in the United Kingdom.¹³³ To accommodate for this loss of a potential revenue stream, CICs can seek funding from the government's social enterprise investment fund¹³⁴ and

125. INCORPORATING A NEW CIC, *supra* note 122, at 28.

126. FREQUENTLY ASKED QUESTION, *supra* note 123, at 4.

127. INCORPORATING A NEW CIC, *supra* note 122, at 26.

128. REGULATOR OF CMTY. INTEREST COS., INFORMATION PACK: COMMUNITY INTEREST COMPANIES, 37, available at <http://www.cicregulator.gov.uk/CICleaflets/CIC%20INFORMATION%20PACK%20V00.02D.pdf> [hereinafter INFORMATION PACK].

129. *Id.*

130. *Id.*

131. Robert Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233, 244 (2006).

132. INCORPORATING A NEW CIC, *supra* note 123, at 26.

133. INFORMATION PACK, *supra* note 128, at 27.

134. The U.K. government is still determining how best to distribute these funds. CABINET OFFICE, OFFICE OF THE THIRD SECTOR, SOCIAL ENTERPRISE ACTION PLAN: TWO YEARS ON 5 (2008), available at http://www.cabinetoffice.gov.uk/media/84387/seap_two_years_on.pdf [hereinafter TWO YEARS ON].

from the national lottery fund.¹³⁵ There is no explicit wording in U.K. charity laws allowing foundations to support CICs, but foundations can request permission to do so from the U.K. Charity Commission. At least one private foundation in the United Kingdom has applied for, and received, permission to fund CICs.¹³⁶ Additionally, the Social Enterprise Unit is considering a proposal to use money recovered from dormant bank accounts to help fund CICs¹³⁷ and social-enterprise groups are lobbying for special tax advantages for CICs to further facilitate raising capital for social enterprise.¹³⁸

The CIC has played a key role in the United Kingdom's development of its social-enterprise sector, proving more popular than initial government projections had anticipated. There were 360 CICs registered in the form's first year of existence,¹³⁹ over 1,000 in the first two years,¹⁴⁰ and now, nearly five years after the CIC form was created, there are over 3,000 CICs.¹⁴¹ The increase in CICs has occurred alongside a dramatic increase in the general awareness of the social-enterprise sector in the United Kingdom. Two years after the creation of the first CIC, 12% more people in the United Kingdom were aware of the concept of social enterprise as compared to the number of people who were aware of the concept before CICs existed.¹⁴² Additionally, many people believe that the full potential of CICs to expand the social economy has yet to be realized. Some financial analysts believe that the transparency required by the CIC regulations provides a great opportunity for the development of viable secondary markets for shares of the companies.¹⁴³ The government's investment in developing better metrics for social valuation only enhances this possibility.

135. Malcolm Lynch, *For and Against the Community Interest Company*, INVESTMENT MATTERS, Jan. 2004, at 1, 4.

136. FREQUENTLY ASKED QUESTION, *supra* note 123, at 7.

137. ONE YEAR ON, *supra* note 110, at 4.

138. Social Enterprise Coalition, Policy: Tax, <http://www.socialenterprise.org.uk/pages/tax.html> (last visited Nov. 15, 2009).

139. FRASER VALLEY CENTRE FOR SOC. ENTER., *supra* note 124, at 4.

140. Jacques Defourny & Marthe Nyssens, *Social Enterprise in Europe: Introduction to an Update*, in SOCIAL ENTERPRISE IN EUROPE: RECENT TRENDS AND DEVELOPMENT 4, 6 (Jacques Defourny et al. eds., 2008).

141. As of January 8, 2010, there are 3322 registered CICs. The Regulator of Community Interest Companies, List of Community Interest Companies, <http://www.cicregulator.gov.uk/coSearch/companyList.shtml> (last visited Jan. 8, 2010).

142. See TWO YEARS ON, *supra* note 134, at 2.

143. Matrix Group Discussion Paper, *supra* note 65, at 21.

The prospects for the CIC seem bright, but some entrepreneurs believe that the form is too restrictive. As a case in point, the ECT Group was one of the early CIC success stories. The company, which provided a panoply of services to local communities, including street cleaning, recycling, and local public transportation,¹⁴⁴ grew to be the country's largest CIC and was featured prominently in the Social Enterprise Unit's first two annual reports in 2006 and 2007.¹⁴⁵ However, the dividend restrictions imposed on CICs made it difficult for the company to raise capital through equity markets. As a result, the ECT Group took on significant debt as it grew; by 2008 its credit lines had run dry and the company was forced to sell off nearly all its lines of business to companies in the private sector.¹⁴⁶ The sales raised concerns in the social-enterprise community that these types of forced sales could stifle the sector's development. Needless to say, the ECT Group was not included in the Social Enterprise Unit's third annual report.¹⁴⁷

It remains to be seen whether the dividend restrictions will prohibitively limit CICs' access to capital, or whether creative social valuation metrics can nurture an active social-equity market. However, the rapid pace at which entrepreneurs continue to register CICs shows hope, at least, for the latter. Creating laws explicitly allowing private foundations to support CICs and initiating tax advantages for CICs would certainly increase this likelihood, but these developments will largely rest on the political climate within the United Kingdom. Regardless, the CIC appears to be fostering enthusiasm in social enterprise and is helping to provide much needed revenue streams for social services in the United Kingdom.

IV. THE U.S. RESPONSE TO SOCIAL ENTERPRISE

Many of the obstacles to social enterprise in the United States stem from the same problems that existed in the United Kingdom prior to the creation of the CIC and that still exist in Belgium: difficulty raising capital and the lack of an appropriate legal form. The for-profit form and the nonprofit form have their advantages and their disadvantages, but neither are a good fit for the needs of social enterprise. Recognizing the growing interest in social enterprise, several U.S. states have created a hybrid entity, the L3C, in an attempt to create a workable solution for social enterprise.

144. SCALING NEW HEIGHTS, *supra* note 106, at 22.

145. *Id.*; ONE YEAR ON, *supra* note 110, at cover.

146. Helen Warrell, *News Analysis: What's the Price of Social Enterprise?*, THIRD SECTOR, July 2, 2008, available at <http://www.thirdsector.co.uk/News/Article/828078/News-analysis-Whats-price-social-enterprise/>.

147. TWO YEARS ON, *supra* note 134.

The L3C is a specific type of Limited Liability Company (“LLC”). Like other LLCs, it generally limits owners’ liability to their investment and can operate much like a partnership or corporation through the use of contracts. Importantly, the L3C, like the LLC, allows the company to issue equity to raise capital. The crucial difference between the L3C and the LLC (and for-profit corporations) is that the format is designed to make it easy for L3Cs to receive Program Related Investments (“PRIs”) from foundations. This creates the possibility of raising a significant amount of capital for social enterprises.

In this section I discuss the potential value of PRIs to social-enterprise organizations and the obstacles currently limiting their use. I then discuss how the L3C form was designed to resolve these obstacles, but how this potential has yet to be realized due to continued ambiguities from the IRS.

A. Program Related Investments

There are more than 75,000 grant-making foundations in the United States.¹⁴⁸ The Bill and Melinda Gates Foundation is by far the largest, with nearly \$40 billion in assets, while the second largest, the Ford Foundation, has assets of nearly \$14 billion.¹⁴⁹ Foundations provide a significant amount of funding to charitable causes and represent a significant opportunity for social enterprise to gain access to investment capital. Tax law requires charitable foundations in the United States to distribute at least 5% of their assets each year.¹⁵⁰ However, foundations generally treat this minimum level as a target level for giving.¹⁵¹ In 2003, this resulted in distributions of nearly \$30 billion, roughly 12% of the overall charitable donations in the United States;¹⁵² distributions increased to an estimated \$45 billion in 2008.¹⁵³

148. FOUND. CTR., FOUNDATION GROWTH AND GIVING ESTIMATES: CURRENT OUTLOOK 1, 1 (2009).

149. *Id.* at 11.

150. If a foundation does not fulfill the 5% distribution requirement, the foundation can be liable for a 100% tax on the undistributed amount. 26 U.S.C. § 4942 (2007).

151. A survey conducted in 2001 by the Foundation Center of 55,120 private foundations found that the private foundations gave out an average of 5.8% of their assets. Jed Emerson, *Where Money Meets Mission*, STAN. SOC. INNOVATION REV. 38, 40-41 (2003).

152. Sally Osberg, *Wayfinding Without a Compass: Philanthropy’s Changing Landscape and Its Implications for Social Entrepreneurs*, in SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE 309, 310 (Alex Nichols ed., 2006).

153. FOUND. CTR., *supra* note 148, at 4.

Foundation distributions are primarily in the form of grants or donations;¹⁵⁴ however the IRS also allows foundations to make PRIs which count towards the 5% requirement.¹⁵⁵ PRIs let foundations make investments to accomplish an exempt purpose.¹⁵⁶ Production of income cannot be a significant purpose of the investment,¹⁵⁷ but under certain circumstances, investments in for-profit businesses can count as PRIs.¹⁵⁸ Any income received from the investment in PRIs is essentially “off the books”—in other words, not counted as profit—for the foundation, but it must be reinvested within the same year the foundation receives the investment income.¹⁵⁹

The concept of investments to achieve social, rather than income-generating, goals has existed in the United States for centuries. Perhaps the earliest “PRI” was when Ben Franklin left £2000 in his will to be used as a revolving loan base for young artists.¹⁶⁰ PRIs, however, were not institutionalized until the 1960s. The Ford Foundation pioneered the use of PRIs in 1968 when it committed \$10 million for investments in socially beneficial companies rather than simply the traditional grants to charities.¹⁶¹ Congress quickly followed by adding PRIs to the list of acceptable disbursements of foundation assets in the Tax Reform Act of 1969.¹⁶² Since that point, the Ford Foundation has committed \$400 million in PRIs.¹⁶³

Unfortunately, it can be difficult for foundations to determine when they can make acceptable PRIs with companies achieving an exempt purpose and producing a profit. The treasury regulations offer some examples of acceptable PRIs, but many are outdated and unhelpful.¹⁶⁴

154. Julia Vail, *Program-Related Investments Provide Needed Relief*, PHILANTHROPY J., Mar. 2009, (2009), available at <http://www.philanthropyjournal.org/resources/special-reports/finance-accounting/program-related-investments-provide-needed-relief>.

155. I.R.C. § 4944 (2007).

156. *Id.*

157. *Id.*

158. I.R.S. Priv. Ltr. Rul. 199-943-044 (1999).

159. Matrix Group Discussion Paper, *supra* note 65, at 20.

160. FORD FOUND., *INVESTING FOR SOCIAL GAIN: REFLECTIONS ON TWO DECADES OF PROGRAM-RELATED INVESTMENTS* 12 (1991).

161. *Id.* at 5.

162. Tax Reform Act of 1969, Pub. L. No. 91-172, § 4942(g)(2), 83 Stat. 487, 505 (1969).

163. Ford Foundation, *About Our Support*, <http://www.fordfound.org/grants/supporttypes> (last visited Nov. 15, 2009).

164. *See* Treas. Reg. § 53.4944-1 (2009) (stating, among other examples, that loans to or investment in a “a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group” can qualify as a PRIs).

Historically, foundations that want to make a PRI have had two options for evaluating whether their proposed investment qualifies. One option is to request a Private Letter Ruling (“PLR”) from the IRS. Under this option, the foundation carefully describes the proposed investment and its potential uses and the IRS responds with a decision on whether the investment qualifies.¹⁶⁵ Acceptable PRIs have included investment in an LLC which facilitated economic development in disadvantaged communities¹⁶⁶ and investment in a private company developing low-cost solutions to eradicating diseases affecting the developing world.¹⁶⁷ The IRS’s decision is binding only as to the foundation which submits the PLR request and may not be used as precedent by other foundations.¹⁶⁸ Obtaining a PLR gives the foundation a certain degree of security; however, it is a lengthy and expensive process. The IRS charges \$8,700 for a PLR¹⁶⁹ and the accompanying attorney fees can range from \$25,000 to \$50,000.¹⁷⁰ Furthermore, the foundation may be required to ensure that the investment is used by the company to further the exempt purpose and the IRS can require annual reports confirming this.¹⁷¹

Alternatively, foundations can choose to make PRIs without obtaining a PLR, but the foundations run the risk of the investments not qualifying as a PRIs and being labeled as a “jeopardizing investments.” A jeopardizing investment is an investment which does not further an exempt purpose and is also not a prudent economic investment, such as if it is expected to produce below-market returns.¹⁷² If the IRS determines that an investment is a jeopardizing investment and not a qualifying PRI, the foundation and its managers can be liable for punitive excise taxes on the value of the investment.¹⁷³ If it is determined that the investment does not further an

165. See, e.g., I.R.S. Priv. Ltr. Rul. 200-610-020 (Dec. 13, 2005); I.R.S. Priv. Ltr. Rul. 200-603-031 (Oct. 25, 2005); I.R.S. Priv. Ltr. Rul. 81-41-025 (July 20, 1981).

166. See I.R.S. Priv. Ltr. Rul. 200-610-020 (Dec. 13, 2005).

167. See I.R.S. Priv. Ltr. Rul. 200-603-031 (Oct. 25, 2005).

168. I.R.S., Understanding IRS Guidance - A Brief Primer, <http://www.irs.gov/irs/article/0,,id=101102,00.html> (last visited Nov. 15, 2009).

169. ROBERT M. LANG, AMERICANS FOR COMMUNITY DEVELOPMENT, OVERVIEW OF THE L3C 2-3.

170. THE MARY ELIZABETH & GORDON B. MANNWEILER FOUND., INC., PRESENTATION, WORKSHOP 3-C, UBS PHILANTHROPY FORUM – JULY 5-7, 2007, LISBON, PORTUGAL 2 (2007), available at <http://www.americansforcommunitydevelopment.org/supportingdownloads/L3CUBSPresentation.pdf>.

171. See I.R.S. Priv. Ltr. Rul. 81-41-025 (July 20, 1981).

172. See Treas. Reg. § 53.4944-1 (2007).

173. The foundation faces an initial 10% tax on the value of a jeopardizing investment. Any foundation manager who knowingly makes a jeopardizing investment must also pay a 10% tax on the value of the investment. Additionally, foundations and knowing foundation managers are liable for 25%

exempt purpose but is not a jeopardizing investment, the foundation will not be responsible for any taxes, but the investment will not count towards the foundation's 5% required disbursements.¹⁷⁴

B. The L3C: A Tool to Remove the Uncertainty of PRIs

Due to the difficulty in determining what qualifies as a PRI, foundations have not made use of PRIs on a large scale. PRIs have yet to represent even 1% of the total amount of disbursements from foundations.¹⁷⁵ The primary purpose of the L3C is to make it easier and less costly for foundations to determine where they can safely invest with PRIs, thereby increasing the amount of capital available for social enterprise. By statute, each L3C must create an operating agreement which contractually binds the company to operate primarily for an exempt purpose.¹⁷⁶ If a company ceases to operate primarily for an exempt purpose, it will statutorily cease to be an L3C and foundations will know not to invest PRIs with the company.¹⁷⁷

The potential value of PRIs to L3Cs is much larger than just the PRIs themselves. The hope is that the PRIs will allow L3Cs the opportunity to access funds through traditional capital markets through a process called "layered investing."¹⁷⁸ The idea behind layered investing is that foundation will use PRIs to invest in the L3C at a below-market rate of return; because the investments cannot be made with the primary purpose of generating income, this is not a problem. This low-return investment will allow the L3C to contribute a larger share of profits towards market-oriented investors, thereby raising their potential economic return.¹⁷⁹ This scheme allows L3Cs that have lower than market-rate profit potential, due to the

and 5% excise taxes, respectively, on the value of the jeopardizing investment in each subsequent year in which the investment remains in effect. I.R.C. § 4944 (2009).

174. See I.R.S. Priv. Ltr. Rul. 200-213-038 (Apr. 23, 2001).

175. In 2001, there was a total of \$232.9 million in PRIs and total charitable giving was \$30.5 billion. Michael D. Gottesman, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL'Y REV. 345, 350 (citing JEFFREY A. FALKENSTEIN, THE FOUNDATION CENTER, THE PRI DIRECTORY: CHARITABLE LOANS AND OTHER PROGRAM-RELATED INVESTMENTS BY FOUNDATIONS (2003)). In 2006, there was a total of \$310.5 million in PRIs. Vail, *supra* note 154. In 2008 total charitable giving was \$45.6 billion. FOUND. CTR., *supra* note 148.

176. See, e.g., H.B. 775, 2007-2008 Vt. Adjourned Sess. (Vt. 2008).

177. See *id.*

178. See AMERICANS FOR CMTY. DEV., THE L3C: INTRODUCING THE NEW SOCIALLY RESPONSIBLE LIMITED LIABILITY COMPANY 11 (2008), http://americansforcommunitydevelopment.org/supportingdownloads/Introducing_the_L3C.ppt (last visited Nov. 15, 2009).

179. *Id.* at 14.

costs of serving the enterprise's exempt purpose, to pad their expected rates of return and raise money through traditional capital markets.

In April 2008, Vermont became the first state to adopt an L3C statute.¹⁸⁰ An L3C is not required to do business in the state where it is registered. It is a recognized entity able to do business in any state or abroad as well. Since Vermont passed the L3C bill, five other states have adopted L3C statutes¹⁸¹ and seven additional states have bills at various stages in the legislature.¹⁸² The creation of the L3C has been well-received by foundations. After the passing of the L3C bill in Michigan, Rob Collier, president of the Council of Michigan Foundations, said that "a number of foundations have said that they felt this was a good tool for [them] to add to the toolbox,"¹⁸³ and the president of Michigan foundation Husdon-Webber simply said, "This is big."¹⁸⁴

The L3C can be a vehicle for spurring the growth of new entrepreneurial social enterprises, but may also help some traditional industries which serve the community. Robert Lang, CEO of the Mannweiler Foundation and one of the initial proponents of the L3C,¹⁸⁵ envisions that the L3C form could be a way to save the struggling newspaper industry.¹⁸⁶ So far the idea has been discussed by at least two newspapers, but it is yet to be seen if the L3C will be adopted by either.¹⁸⁷ Additionally, for-profit companies are playing an increasing role in the

180. H.B. 775, 2007-2008 Vt. Adjourned Sess. (Vt. 2008).

181. S.B. 239, 96th Gen. Assem. (Ill. 2009); S.B. 1445, 84th Leg., Reg. Sess. (Mich. 2009); H.B. 1545, 61st Leg. Assem., Reg. Sess. (N.D. 2009); S.B.148 (Utah 2009); H.B. 182, 60th Leg., Gen. Sess. (Wyo. 2009).

182. H.B. 2102, 87th Gen. Assem., Reg. Sess. (Ark. 2009); L.D. 1265, 124th Leg. (Me. 2009); H.B. 817, 95th Gen. Assem., Reg. Sess. (Mo. 2009); H.B. 235, Leg., 61st Sess. (Mont. 2009); S.B. 308, 2009 Gen. Assem., Sess. (N.C. 2009); H.B. 2886, 75th Leg. Assem., Reg. Sess. (Or. 2009); S.B. 472, 106th Gen. Assem. (Tenn. 2009).

183. Sherri Begin Welch, *Foundation for Investment; Nonprofits Can Fund Business Efforts*, CRAIN'S DETROIT BUS., Feb. 23, 2009, at 3.

184. *Id.* at 2.

185. HEATHER PEELER, CMTY. WEALTH VANGUARD, THE L3C: A NEW TOOL FOR SOCIAL ENTERPRISE, <http://www.communitywealth.com/Newsletter/August%202007/L3C.html> (2007).

186. Mark Fitzgerald, *Prophet Motives: What Can Be Done?*, EDITOR AND PUBLISHER, Apr. 2009, at 28.

187. The L3C was discussed as an option for the SAN FRANCISCO CHRONICLE. James Temple, *Plans for Chronicle Floated*, S.F. CHRON., Mar. 28, 2009, at C1. The L3C was also discussed as an option for the PEORIA JOURNAL STAR. Bill Richards, *The Peoria Plan for Saving Local Dailies*, CROSSCUT, Jan. 27, 2009, <http://crosscut.com/2009/01/27/seattle-newspapers/18808/> (last visited Dec. 3, 2009).

healthcare¹⁸⁸ and education¹⁸⁹ industries, and the L3C could be a viable option in both of these fields as well.

Despite the fact that L3C statutes require that L3Cs operate in accordance with IRS standards for organizations that can receive PRIs,¹⁹⁰ the IRS has not issued an official statement that it will automatically allow investments in L3Cs to count as PRIs. Without this assurance many foundations are still hesitant to use PRIs with L3Cs because of the potential of having the investments labeled as jeopardizing investments. Furthermore, without additional programs in place to publicize and support the development of social enterprise, the branding-value of the L3C as a social-enterprise label will not reach its full potential.

V. LESSONS FROM BELGIUM AND THE UNITED KINGDOM

If the United States is committed to developing its domestic social-enterprise sector, policy-makers need to learn from the divergent experiences of Belgium and the United Kingdom. It is also necessary for the United States to take a renewed and pragmatic look at its approach to charity and the provision of social services. Social enterprise represents an opportunity to leverage significantly more private money into the provision of social services, a sector which has traditionally relied on charity and government funding, and also to increase efficiency in order to make this money go further than before.

Looking at Europe, the two primary areas where government can be most effective in stimulating social enterprise are (1) increasing access to capital and (2) creating an environment where the public is aware of and receptive to the benefits of social enterprise. Increasing access to capital can come from making new pools of funding available to social-enterprise organizations such as the United Kingdom's social-enterprise fund, or by fortifying current capital streams by providing government subsidies in the form of tax incentives, as has been suggested in the United Kingdom. Creating a fertile landscape for social enterprise can be achieved through policies such as embracing a uniform definition of social enterprise and investing in programs to quantify social returns.

188. Lisa M. Fairfax, *Achieving the Double Bottom Line: A Framework for Corporations Seeking to Deliver Profits and Public Services*, 9 STAN. J.L. BUS. & FIN. 199, 207 (2004).

189. William C. Symonds, *Education: A New Push to Privatize*, BUS. WK. ONLINE, Jan. 14, 2002, http://www.businessweek.com/magazine/content/02_02/b3765689.htm (last visited Dec. 3, 2009).

190. See, e.g., H.B. 775, 2007-2008 Vt. Adjourned Sess. (Vt. 2008).

From the experiences in Belgium and the United Kingdom, it is clear that if a new entity for social enterprise is going to be successful in increasing access to capital, it needs to offer social entrepreneurs financial benefits which outweigh any added restrictions. The SFS's minute impact in Belgium suggests that a mere social label will not likely generate these needed benefits on its own. In the United Kingdom however, the social enterprise fund, among other things, succeeded in increasing access to capital. In the United States, the opportunity for L3Cs to receive foundation PRIs has the potential to generate the necessary benefits for social entrepreneurs. The PRIs operate like the United Kingdom's social investment fund and lottery fund, making the L3C an excellent vehicle to increase access to capital for social enterprise. However, to ensure that these benefits are realized, steps need to be taken so that foundations are comfortable making PRIs to L3Cs. A blanket statement from the IRS would remove the often prohibitive costs of obtaining a PLR, but could create apprehension over the potential for abuse. In light of this, the Council of Foundations is currently advocating for federal legislation to create a streamlined system of fast-tracked reviews by the IRS where L3Cs could apply for certification to receive PRIs.¹⁹¹

Another option to increase access to capital is to buttress existing capital streams through the creation of tax incentives for L3Cs. A proposal to this end was suggested in the Congressional debate over the recent stimulus bill.¹⁹² Ultimately the tax incentives were not included in the final bill and there would likely be significant political opposition to what could be seen as simply shifting funds to private businesses. However, this argument has two main flaws: (1) it discounts the potential of L3Cs to relieve some of the burden on the government to provide social services, and (2) it ignores the fact that the government often gives subsidies to private businesses with socially beneficial ends such as alternative energy producers, ethanol-producing farmers, and manufacturers of hybrid cars.¹⁹³

It is also essential that the government provide the necessary support for social enterprise to gain solid footing in society. One element of this support is helping to generate a broad, unified understanding of what social enterprise is. The lack of a universal definition of social enterprise stymied Belgium's attempts to gather accurate data on the sector, while an official

191. COUNCIL OF FOUNDS., ISSUE PAPER: ALLOW FOUNDATIONS TO MAKE PROGRAM-RELATED INVESTMENTS TO L3CS (2009).

192. See Senator Chuck Grassley, Prepared Remarks on Charities and Governance, in SENATE COMM. NEWS RELEASE, (Mar. 10, 2009).

193. See Malani & Posner, *supra* note 53, at 2031.

and accepted definition has helped the United Kingdom build public acceptance and support.

Another element of support the government can use to bolster the development of social enterprise is to aid in the branding and valuation of social enterprise. In the United Kingdom, the CIC's Community Benefit Test and the distribution limits help to achieve this end by assuring the public that CICs are serving the community. The United States could put in place similar "light-touch" regulation either at the federal level, through IRS regulations and monitoring, or on a state-by-state basis, by transitioning the role of secretaries of state from registering L3Cs to also lightly monitoring their activities, or by creating state monitoring agencies. The idea of a "light-touch" regulator balances the need for some assurance of public benefit with the potentially high reporting and observing costs associated with in-depth monitoring. The increased regulation would necessarily create the need for additional government spending. However, the U.K. government envisions that CIC registration fees, although set at only £35,¹⁹⁴ may eventually cover the costs of regulation;¹⁹⁵ if the L3C becomes the dominant vehicle for social enterprise, it is possible its regulation could become self-sustainable, or at least partially subsidized.

In addition, the government can aid the development of social enterprise by investing in the research and development of valuation metrics which more accurately account for the social impact of social enterprises. Currently, there are no universally accepted standards for measuring social return, nor is there much known about what type of social returns are important to investors.¹⁹⁶ Better methods of valuing social return could help nurture the market for social investment, as people interested in investing and doing business with companies with a social purpose would have better guidance. Social-return value could also help social enterprises maintain higher prices for their services; a recent study found that nearly 80% of U.S. consumers are willing to pay 10% more for a product produced in a "socially and environmentally responsible way."¹⁹⁷

194. INFORMATION PACK, *supra* note 128, at 35.

195. DEP'T. OF TRADE & INDUS., COMPANIES (AUDIT, INVESTIGATIONS AND COMMUNITY ENTERPRISE) BILL: REGULATORY IMPACT ASSESSMENTS 91 (2004), <http://www.berr.gov.uk/files/file23027.pdf>.

196. NICHOLLS & PHAROAH, *supra* note 109, at 16.

197. The actual figure is 79.2%. James E. Austin et al., *Social Entrepreneurship: It Is for Corporations Too*, in SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE CHANGE 169, 174 (Alex Nichols ed., 2006).

CONCLUSION

It is clear from the experiences in Belgium and the United Kingdom that if governments want to facilitate the growth of social enterprise, it is essential that they provide support and benefits for companies entering the sector. Prior to the creation of the L3C, social-enterprise organizations in the United States were constrained by the rigidities of the traditional nonprofit and for-profit forms which do not allow much room for hybrid activity. In Belgium, government attempts to spur the development of social enterprise has had only limited success because the SFS imposes added costs while only providing a minimal branding benefit. Conversely, government efforts to increase social-enterprise activity in the United Kingdom have been more successful. The CIC allows social-enterprise organizations to tap new sources of capital; and the government's investment in publicizing the potential positive impact of the social-enterprise sector has enhanced the CIC's branding value. In the United States, the L3C could be an important piece of social-enterprise reform. However, the L3C's value will only be realized if government policies stimulate capital flows to these organizations and build increased public awareness of the benefits the social-enterprise sector can provide. If the U.S. government learns from its European counterparts and develops these two pillars of social-enterprise policy, capital support and public awareness, the social-enterprise sector has the potential to leverage billions of dollars for community investment, and in the process, revitalize the provision of social services in the United States.

APPENDIX

The Social Entrepreneurship Collaboratory (SE Lab)

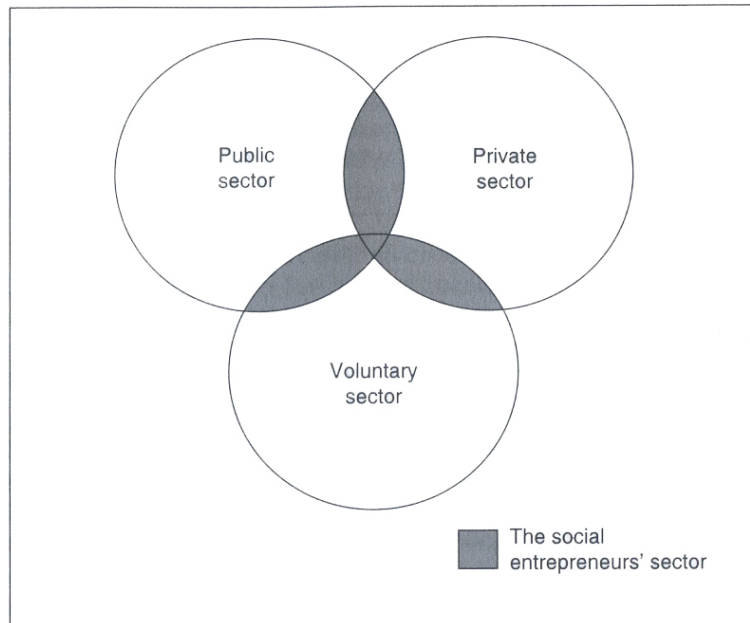


Figure 13.3 Sources of social entrepreneurship (Source: Leadbeater 1997)

Gordon M. Bloom, *The Social Entrepreneurship Collaboratory (SE Lab)*, in *SOCIAL ENTREPRENEURSHIP* 270, 280 (Alex Nichols ed., 2006).

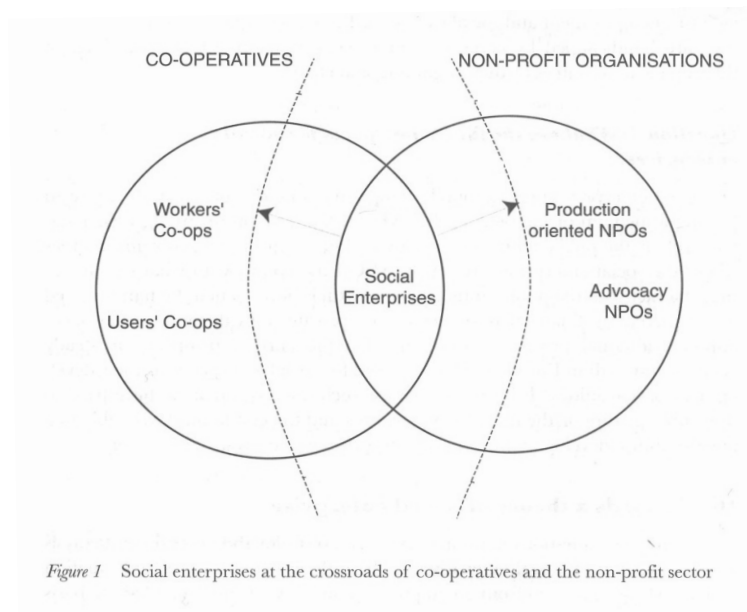
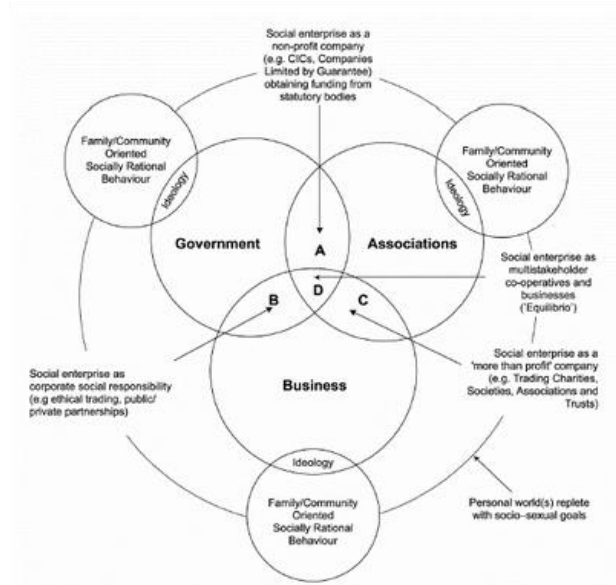
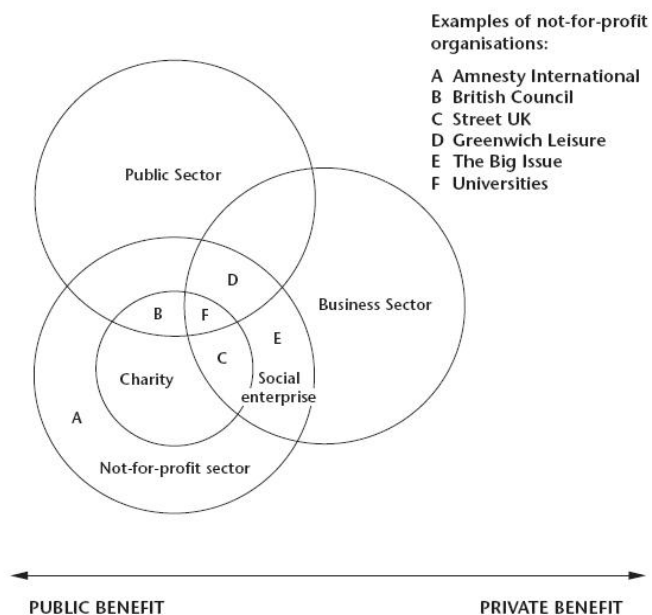


Figure 1 Social enterprises at the crossroads of co-operatives and the non-profit sector

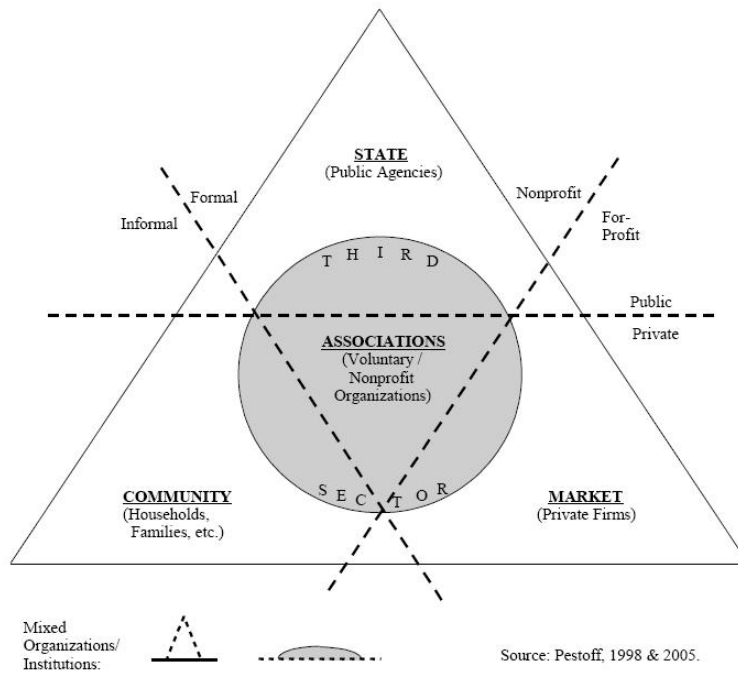
Jacques Defourny, *From the Third Sector to Social Enterprise*, in *THE EMERGENCE OF SOCIAL ENTERPRISE* 1, 22 (Carlos Borzaga & Jacques Defourny eds., 2001).



Rory Ridley-Duff, *Social Enterprise as a Socially Rational Business*,
 14 INT'L J. ENTREPRENEURIAL BEHAV. & RES. 291, 304 (2007).



CABINET OFFICE, OFFICE OF THE THIRD SECTOR, PRIVATE ACTION,
PUBLIC BENEFIT: A REVIEW OF CHARITIES AND THE WIDER NOT-FOR-
PROFIT SECTOR 15 (2002).



Jacques Defourny & Victor Pestoff, *Towards a European Conception of the Third Sector*, in *IMAGES AND CONCEPTS OF THE THIRD SECTOR IN EUROPE 3*, 7 (Jacques Defourny et al. eds., 2008).