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THE ROLE OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS

by

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

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INTRODUCTION

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

Despite these wide-ranging developments, hybrid organizations remain poorly understood. As a result, legal policy in this field has been haphazard and largely ineffective. First, there is some uncertainty about the extent to which business planners have the power to form businesses that combine profit and social missions. A recent Delaware case, *eBay v. Newmark*, has been viewed as casting doubt on the ability of corporations to commit to a social purpose.[4] Partly to address this issue, new legal forms have been introduced for

[1] I redefine the term "hybrid organization" more formally in Part I.

[2] STEPHEN DAVIS ET AL., THE NEW CAPITALISTS 173-201 (Harvard Business School 2006).

[3] See ANTHONY BUGG-LEVINE & JED EMERSON, IMPACT INVESTING: TRANSFORMING HOW WE MAKE MONEY WHILE MAKING A DIFFERENCE (Jossey-Bass 2011); J.P. Morgan & The Rockefeller Foundation, *Impact Investments: An Emerging Asset Class* (November 29, 2010), *available at* http://www.rockefellerfoundation.org/news/publications/impact-investments-emerging-asset (last visited Jan. 4, 2014).

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

incorporating businesses that have a social mission.[5] Two prominent examples in the U.S. are the low-profit LLC ("L3C") and the Benefit Corporation, both of which are legal entities that have a social mission but can nonetheless distribute profits to their owners. However, although these legal forms have been diffusing rapidly among states, most hybrid organizations continue to use the traditional corporate forms. Thus, it is questionable whether or not the new forms are actually necessary, and how such forms should be designed. Second, if hybrid organizations are desirable, they arguably deserve to receive tax or other subsidies. Malani & Posner, for example, propose that all for-profits should be provided with tax benefits for doing good things, such as selling fair trade products.[6] However, trusting profit-driven corporations to employ subsidies towards social missions is highly problematic, mainly because they have an obvious incentive to overstate the social value of their activities in order to enhance their reputations.[7] As a result, tax policy remains very suspicious of for-profit firms that pursue a social mission, and the IRS has so far resisted attempts to facilitate subsidized investments in intermediary legal forms.[8]

The state of legal policy in this area stems from the failure of economic and legal scholarship to identify the structural and functional attributes that make hybrid organizations effective in addressing social problems. Despite the numerous colorful terms that have been attached to hybrids, most of these terms boil down to the simplistic notion of combining for-profit and altruistic missions.[9] This approach is apparent in the definitions of hybrids under the statutes for incorporating new organizational forms. For example, the L3C is a Limited Liability Company that significantly furthers the accomplishment of charitable or educational purposes, and the Benefit Corporation is a corporation

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[5] For reviews of the new legal forms, see Jill R. Horwitz & Rachel Culley, *Profits v. Purpose: Hybrid Companies and the Charitable Dollar*, (U. of Mich. L. & Econ. Res. Paper No. 12-006, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 2055368; Thomas A. Kelley III, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337 (2009); Matthew NC. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291 (2010); Dana B. Reiser, *Blended Enterprise and The Dual Mission Dilemma*, 35 VT. L. REV. 105 (2010); Dana B. Reiser, *Theorizing Social Enterprise*, 62 Emory L.J. 681 (2013); Fabrizio Cafaggi and Paola Iamiceli, *New Frontiers in the Legal Structure and Legislation of Social Enterprises in Europe: A Comparative Analysis* (Eur. U. Inst. L. Working Papers 2008/16), *available at* http://cadmus.eui.eu/handle/1814/8927 (last visited Jan. 4, 2014).

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

[7] Milton Friedman, *The Social Responsibility of Business Is To Increase Its Profits*, N.Y. TIMES, Sep. 13, 1970; Henry G. Manne, *Milton Friedman Was Right*, WALL. ST. J., Nov. 24, 2006.

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

[9] For examples, see Gregory J. Dees, *Enterprising Nonprofits*, HARV. BUS. REV., Jan.-Feb. 1998, at 55; Bugg-Levine & Emerson, *supra* note 3; Jed Emerson, *The Blended Value Map: Tracking the Intersects and Opportunities of Economics, Social and Environmental Value Creation* (2003), *available at* http://www.blendedvalue.org/bv-map-papers/ (last visited Jan. 4, 2014); Kim Alter, *Social Enterprise Models and Their Mission and Money Relationships*, *in* SOCIAL ENTREPRENEURSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE 205 (Alex Nicholls ed., 2006); THE EMERGENCE OF SOCIAL ENTERPRISE (Carlo Borzaga & Jacques Defourny eds., 2001).

whose purpose is to create a material positive impact on society and the environment.[10] The main problem with the notion of mixed mission is that in most cases it is practically impossible to measure and verify the accomplishment of altruistic or social goals. Moreover, these terms appear to confuse many forms of hybrid organizations. In particular, they follow the tendency of many commentators to treat the difference between corporate social responsibility and social enterprise as mainly one of degree, without delineating their different structures or functional roles.[11] In fact, the terms social enterprise and corporate social responsibility are often used interchangeably to denote essentially the same type of business.[12]

In this article, I offer a theory of social enterprise and hybrid organizations that can inform legal policy. The theory focuses on a set of organizations which are commonly referred to as "social enterprises", such as microfinance institutions, firms that sell fair trade products, work integration social enterprises, and low-cost sellers. The main common characteristic of social enterprises is that they have a commitment to transact with their beneficiaries, who are either purchasers of the firm's goods or services or suppliers of input (including labor) to the firm. I will refer to such beneficiaries as "patron-beneficiaries".[13] For example, microfinance institutions make loans to low-income borrowers, and work integration social enterprises employ disadvantaged workers. As will be explained in greater detail below, certain classes of disadvantaged individuals and businesses are unable to transact with standard profit-maximizing firms, either because of information asymmetries that make it costly for commercial firms to evaluate their abilities or because they lack sufficient abilities (e.g., to repay a loan). In these circumstances, such individuals may suffer from lack of access to capital, systematic unemployment and want of essential products and services. Social enterprises are committed to transact with these individuals as patrons.

The essence of the theory is that social enterprises perform a *measurement* role. The financial viability of social enterprises depends in large part on the performance of their patron-beneficiaries. For-example, microfinance institutions are financially dependent on the ability of their borrowers to repay their loans. Thus, social enterprises have incentives to measure or gather information on their patron-beneficiaries' attributes (e.g., workers' skills or

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[10] See *infra* section V.D.

[11] For example, see Dana B. Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2450 (2009) (arguing that "Social enterprises integrate philanthropy into their business models at a more basic level than companies that make corporate contributions or practice CSR [Corporate Social Responsibility]"); see also Kelley *supra* note 5, at 350-352; Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through A Legal Lens*, 81 TEMP. L. REV. 831 (2008), Alter, *supra* note 9; THE ECONOMICS OF SOCIAL RESPONSIBILITY: THE WORLD OF SOCIAL ENTERPRISES (Leonardo Becchetti & Carlo Borzaga eds., 2011).

[12] To take one example, firms that sell fair trade products have been referred to as a social enterprise (Becchetti & Borzaga eds., *id.*), corporate social responsibility initiative (Michael E. Porter & Mark R. Kramer, *Strategy and Society: The Link between Competitive Advantage and Corporate Social Responsibility*, HARV. BUS. REV. 78, Dec. 2006, at 78), and corporate philanthropy (Malani & Posner, *supra* note 6).

[13] I use the term "patron" to refer to those who have a transactional relationship with the firm, i.e., investors, workers, suppliers, etc.

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

The measurement function makes social enterprises relatively efficient vehicles for allocating subsidies to promote development goals, such as increasing access to capital, enhancing productivity and employment opportunities, and enhancing consumer welfare. For example, microfinance institutions have grown substantially in the last few decades and now provide financial services to millions of poor customers in developing countries.[14] The relative success of microfinance contrasts with the limited effectiveness of many forms of donative organization,[15] including governments and aid agencies, in spurring development. Social enterprises also need to be contrasted with other forms of hybrid organizations, especially firms that engage in corporate social responsibility policies. Whereas social enterprises have incentives to utilize subsidies effectively, corporations that pursue socially responsible policies have incentives to exaggerate their social value; the effectiveness of such policies therefore tends to be doubtful.

Understanding the basic structure of social enterprises and the measurement function they perform is essential for informing legal policy. Given the apparent effectiveness of social enterprises and their specific structural and functional attributes, legal policy should primarily foster organizations that share those attributes and avoid facilitating or subsidizing inefficient organizational forms. In future work, I will elaborate on how the transaction with beneficiaries and the measurement role of social enterprises can provide a normative framework for designing a new legal form and corporate subsidies to promote development. This article focuses on laying out the structural and theoretical underpinnings of social enterprises as well as other hybrid organizations.

I. THE ESSENTIAL CHARACTERISTICS OF SOCIAL ENTERPRISES AND HYBRID ORGANIZATIONS

Though hybrid organizations are commonly defined as organizations that combine profit and altruistic or social mission, this definition is misleading. Even profit-maximizing firms pursue social purposes, albeit indirectly. Consider a food chain that improves the nutritional value of its products. Such a firm may

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

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

be maximizing its profits by making its products more attractive to customers. Its activities may well generate positive externalities, for example, better health for society as a whole. However, this firm is not conceptually different from most other for-profit firms. The idea that firms generate positive externalities while pursuing profits dates back to Adam Smith's notion of profit-maximization.[16] A useful definition of hybrid organizations must identify in what way they differ from standard profit-maximizing firms.

Properly defined, a hybrid organization is a commercial enterprise that channels a subsidy to a class of beneficiaries. The simplest example of hybrid organizations is corporate charity, e.g., a for-profit firm that donates a percentage of its profits to charity. The subsidy in this case flows from the owners of the firm who presumably agree to some discount on their returns. The subsidy may also flow from consumers who pay premium prices for products sold by a firm with a reputation for donating money to charity. The subsidy need not be provided by government, and may flow from any source, including patrons of the firm, such as its customers or investors. Thus, I define "subsidy" expansively to include any contribution of value – monetary or other – which is provided for no consideration. It need not be a direct subsidy, a grant or a donation, but can also take other forms, including premiums over market prices paid by consumers or discounts to market returns on investment.[17] The subsidy may also flow from employees who accept lower wages or exert greater efforts.

It is important to note that the term "hybrid organization" can be used to describe a wide array of organizations. On the one hand, a hybrid organization may be profit-maximizing, as long as the subsidy is not provided by the owners who generally make market returns on their equity, e.g., when a firm receives a grant from the government or when its consumers pay premium prices. On the other hand, hybrid organizations may be nonprofits. A commercial enterprise is any enterprise that receives a significant portion of its income from prices charged for its products or services, so that its viability or sustainability is dependent on such income.[18] Commercial enterprises include not only for-profit firms, but also commercial nonprofits, such as hospitals or universities that charge patients and students respectively for their services.[19] Commercial nonprofits receive a subsidy in the form of income tax exemption, and hence qualify as hybrid organizations.

A. What Makes an Organization a Social Enterprise?

The focus of this article is on a particular type of hybrid organization, usually referred to as "social enterprises". Social enterprises are not only subsidized commercial enterprises, but they also possess another critical element, i.e., they

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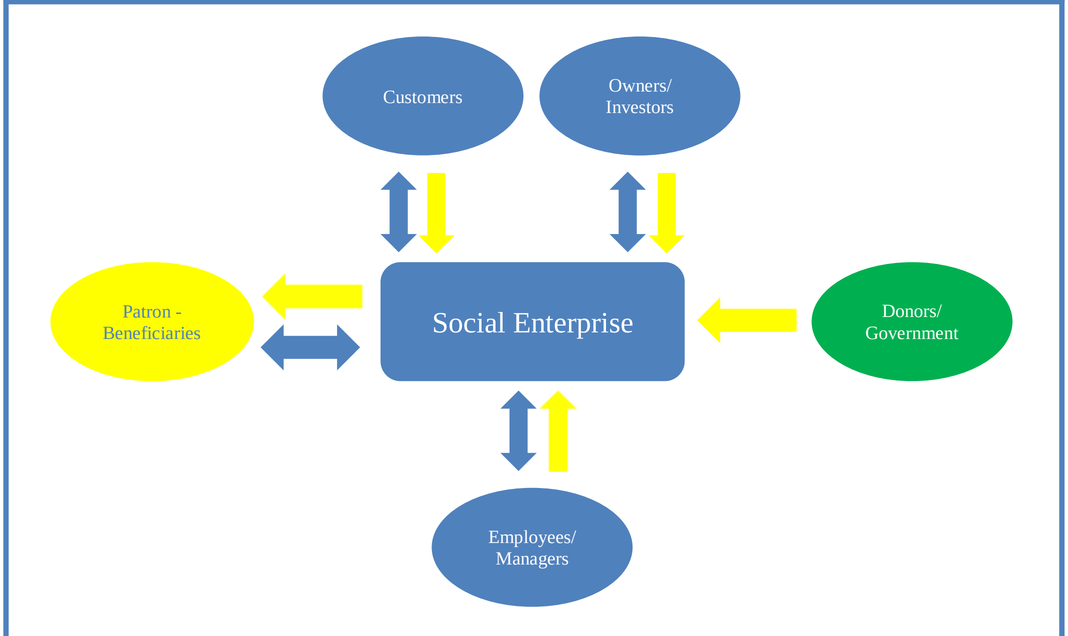
[16] ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS (1776).

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

[18] I emphasize that I make reference to "enterprise" rather than organizations or entities. An enterprise may comprise an entity or several entities, but may also be a segment of an organization that includes various types of enterprise.

[19] See Hansmann, *supra* note 15.

FIGURE 1: SOCIAL ENTERPRISE



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

have a commitment to transact with their beneficiaries as patrons, such as customers or providers of input (see Figure 1). This commitment arises in circumstances where such beneficiaries are unable to transact with commercial firms under standard commercial terms. For example, microfinance institutions lend money to their beneficiaries, disadvantaged individuals or businesses that face difficulties in obtaining capital from commercial lenders. I discuss the economic function of this transactional relationship in Part II. I emphasize that social enterprises do not necessarily transfer subsidies to their patron-beneficiaries (e.g., discounts on loans or products), although many of them do. To count as social enterprises, it suffices that they have a commitment to transact with their beneficiaries, even if no actual transfer of subsidies is made to the beneficiaries.

1. Examples of Social Enterprises

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

***Microfinance Institutions ("MFIs")*:** MFIs provide loans and other financial services to poor customers in developing countries who lack access to capital. MFIs specialize in making small short-term loans, which are unprofitable for commercial banks, but are essential for poor households and small businesses in developing countries. A well-known MFI is Compartamos, which lends mainly to the moderately poor. Compartamos is a for-profit owned by a consortium of NGOs, foundations and social entrepreneurs. Although it underwent an IPO in 2007, the consortium shareholders continue to own 51% of the shares.[20] The NGOs and the International Finance Corporation provided the initial subsidy to the firm in the form of seed capital which was funded by donations. The seed capital may be viewed as an ongoing subsidy. In addition, the owners may be providing a subsidy to the firm to the extent that the firm forgoes opportunities to serve wealthier individuals. Although Compartamos has been very profitable, it could arguably be more profitable if it served more affluent borrowers.[21] Compartamos does not transfer subsidies directly to its customer-beneficiaries like other MFIs, for example in the form of lower rates;[22] rather, the main benefit it confers on them is the opportunity to borrow.

***Credit Development Financial Institutions ("CDFIs")*:** CDFIs provide financial products to low-income customers in the U.S. that are generally not available from mainstream commercial banks, especially depository services, home mortgages and loans to small businesses.[23] An example of a CDFI is the Carver Federal Savings Banks, a New York bank created to serve low-income African-American communities. The bank offers below-market rates to its customers under some of its loan programs.[24] The bank is held by Carver Bancorp, Inc., a holding company whose shares are traded on the NASDAQ. CDFIs are certified as such by a government agency, the CDFI Fund, which provides subsidies to CDFIs in different forms, including subsidized equity investments, guaranties and grants.[25] To be certified, a firm must satisfy certain

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[20] Compartamos, S.A.B. de C.V., Annual Report 2012, *available at* http://www.compartamos.com/wps/portal/Gentera/InvestorRelations/AnnualInformation (last visited Jan. 4, 2014), at 86; Banco Compartmaos S.A., Offering Circular (Apr. 19, 2007), *at* http://www.compartamos.com/wps/portal/Gentera/InvestorRelations/AnnualInformation (last visited Jan. 4, 2014), at 127-128.

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

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

[23] CDFIs also exist in the U.K., though their number and operations are relatively small; see http://www.cdfa.org.uk/about-cdfis (last visited Jan. 4, 2014).

[24] Carver Bancorp, Inc., Annual Report 2012, *available at* http://www.snl.com/irweblinkx/FinancialDocs.aspx?iid= 112079 (last visited Jan. 4, 2014).

[25] See CDFI Coalition, *CDFI Types*, *available at* http://www.cdfi.org/about-cdfis/cdfi-types/ (last visited Jan. 4, 2014); Lehn Benjamin et al., *Community Development Financial Institutions: Current Issues and Future Prospects*, 26 J. URB. AFF. 177, 177-179 (2004).

requirements to lend to low-income borrowers.[26] The CDFI Fund also enters into an Assistance Agreement with each CDFI that is awarded assistance.[27] The agreement incorporates performance goals to be accomplished by the CDFI, the scale of its activities, and the terms offered to low-income borrowers (e.g., below-market rates).[28] Equity investors in CDFIs are typically also eligible for tax credit incentives under the New Markets Tax Credits ("NMTCs") program.[29]

***Social Investment Firms*:** Social investment firms make investments in businesses, mainly in developing countries,[30] which are perceived as too risky for commercial investors, such as private equity firms and venture capital firms. They also make investments in other social enterprises. Such firms specialize in making relatively small investments, which usually take the form of equity or loans with equity features. While some social investment firms aim at earning near-competitive returns, others expect below-market returns.[31] Triodos Bank N.V., a bank based in the Netherlands, lends to businesses and nonprofits that have some social or ecological benefit, such as MFIs, fair trade social enterprises (discussed below), organic farms, and renewable energy projects. The subsidy in the case of Triodos Bank flows from its equity holders that hold depository receipts and earn only moderate returns on equity.[32] The depository receipts are publicly listed and traded on a matched bargain system.[33] The equity holders do not have voting rights. The shares of Triodos Bank are held by a foundation which makes voting decisions on behalf of the holders of depository

[26] For example, an applicant for CDFI certification must serve a Target Market, which is defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national median family income, or where the unemployment rate is 1.5 times the national average; see 12 C.F.R. §1805.201 (2005).
[27] 12 C.F.R. §1805.802 (2005).
[28] 12 C.F.R. §1805.804 (2005).
[29] To be eligible for tax credit incentives, CDFIs must qualify as Community Development Entities ("CDEs"), but CDFIs virtually always do; see Julia S. Rubin & Gregory M. Stankiewicz, *The New Markets Tax Credit Program: A Midcourse Assessment*, 1 COMMUNITY DEV. INVESTMENT REV. 1 (2005).
[30] Some social investment firms known as Community Development Venture Capital Funds ("CDVCFs") also exist in the U.S. CDVCFs typically invest in small to medium sized businesses in distressed communities which have a potential for rapid growth; see Julia S. Rubin, *Financing Rural Innovation with Community Development Venture Capital: Models, Options and Obstacles*, 2 COMMUNITY DEV. INVESTMENT REV. 15 (2006). Note that CDVCFs are also regarded as a type of CDFI and are eligible for assistance from the CDFI Fund.
[31] J.P. Morgan & The Rockefeller Foundation, *supra* note 3; The Rockefeller Foundation, *Solutions for Impact Investors: From Strategy to Implementation* (Nov. 2009), *available at* http://www.rockefellerfoundation.org/news/publications/solutions-impact-investors-from (last visited Jan. 4, 2014); Monitor Institute, *Investing for Social And Environmental Impact: A Design for Catalyzing An Emerging Industry* (Jan. 2009), *available at* http://www.monitorinstitute.com/impactinvesting (last visited Jan. 4, 2014).
[32] Triodos Bank Annual Report 2010, *available at* http://report.triodos.com/en/2010/servicepages/welcome.html (last visited Jan. 4, 2014). The return on equity from 2008 to 2012 was between 3.4% and 5%; see http://www.triodos.com/en/about-triodos-bank/who-we-are/key-figures/ (last visited Jan. 4, 2014).
[33] A matched bargain system is a system for trading stocks that matches a buy offer directly with a sell offer. Such a system tends to be less liquid than standard stock exchanges where buyers and sellers deal through an intermediary market maker.

receipts, and is required to exercise its voting rights in a manner consistent with its ethical goals and mission, its business interests, and the interests of the depository receipt holders.[34]

***Low-Cost Sellers*:** There are various types of sellers that sell affordable products or services to poor customers in developing markets, for example, bed-nets, eyeglasses, and healthcare services.[35] A to Z Textile Mills of Tanzania is a producer of long-lasting insecticide-treated bed-nets.[36] A to Z is a profit-maximizing firm that entered into a partnership which includes the World Health Organization, NGOs, and other profit-maximizing firms. Pursuant to the partnership, A to Z is committed to selling bed-nets in Tanzania and the other partners provide it with some form of subsidy.[37] The firm uses a new technology invented by Sumitomo Chemical Company and transferred to A to Z for free. Sumitomo also trained A to Z technicians and helped make the company's operations more efficient. With the new technology, A to Z managed to reduce the price of high-quality bed-nets from $7 to $5. Upon its establishment, it received its main capital from the Acumen Fund, a nonprofit social investment firm, through a loan of $325,000 at a 6% interest rate to buy machinery and specialized chemicals. A to Z employs a price differentiation scheme, whereby bed-nets are either sold at market price ($5 each) or through the partnership to vulnerable groups at a discount paid by the partnership or the Tanzanian government.

***Fair Trade Social Enterprises ("FTSEs")*:** FTSEs buy their input from small producers in developing countries.[38] Fair trade products include coffee, cocoa, tea, sugar, bananas, chocolate, and handicrafts. The subsidies to FTSEs flow primarily from their consumers who are willing to pay a premium on fair trade products.[39] Sales of fair trade products have increased dramatically in the last 20 years.[40] With fair trade becoming part of mainstream retail, large corporations, such as Starbucks and Nestle, sell fair trade products. There are also many firms that sell exclusively fair trade products, for example, Cafédirect, one of the largest hot drinks companies in the UK. Cafédirect

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[34] Triodos Bank Annual Report 2010, *supra* note 32, at 119-121. It is noteworthy, though, that the depository receipt holders appoint the members of the foundation.

[35] See generally, Ashish Karamchandani, et al., *Emerging Markets, Emerging Models: Market-Based Solutions to the Challenges of Global Poverty* (Monitor Group, March 2009), *available at* http://www.thegiin.org/cgi-bin/iowa/resources/research/5.html (last visited Jan. 4, 2014); C. K. PRAHALAD, THE FORTUNE AT THE BOTTOM OF THE PYRAMID: ERADICATING POVERTY THROUGH PROFITS (Pearson Education 2010) (2005).

[36] See Winifred Karugu & Triza Mwendwa, *A to Z Textile Mills: A Public Private Partnership Providing Long-Lasting Anti-Malaria Bed Nets to the Poor* (UNDP, Sep. 2007), *available at* http://cases.growinginclusivemarkets.org/documents/120 (last visited Jan. 4, 2014).

[37] Karugu & Mwendwa, *id.*

[38] See generally, ALEX NICHOLLS & CHARLOTTE OPAL, FAIR TRADE: MARKET-DRIVEN ETHICAL CONSUMPTION (Sage 2005).

[39] Daniele Giovannucci & Freek Jan Koekoek, *The State of Sustainable Coffee: A Study of Twelve Major Markets*, (IISD, UNCTD and ICO, 2003) *available* at http://www.iisd.org/publications/pub.aspx?pno= 579 (last visited Jan. 4, 2014), at 40.

[40] Certified fair trade products are now produced by more than 1.2 million farmers and workers and sales amount to several billion dollars annually. See the website of Fair Trade International at http://www.fairtrade.net/facts_and_figures.html (last visited Jan. 4, 2014).

products are certified by the Fair Labeling Organization ("FLO").[41] The Fair Trade mark is attached to products that comply with the Fair Trade standards to signal to consumers that they deserve a premium over other products.[42] The Fair Trade standards certify *inter alia* that the producers are indeed "small producers", broadly defined as those who produce labor-intensive products, but employ a limited number of permanent workers or rely on family labor.[43] Second, the FLO ensures, through audits and inspections, that the importer pays producers the fair trade minimum price, provides them with an additional premium that must be used for developing their community, and, when requested, extends them pre-financing of up to 60% of the orders.[44]

Though many FTSEs rely exclusively on subsidies from consumers, the subsidy in the case of Cafédirect is also provided by the shareholders who accept below-market returns. Cafédirect seems to use such subsidies to pay a higher price and a higher social premium than that mandated by the Fair Trade standards. The shares of Cafédirect are publicly listed and traded on a matched bargain exchange. While shareholders do have voting rights, there is also a guardian share, which is held by two of the founders, a subsidiary of Oxfam International and Cafédirect Producers Ltd., a cooperative of producers that transact with the firm.[45] The guardian share has the right to block any changes to the company's objectives as set out in its articles of association.[46] These objectives include a commitment to selling exclusively fair trade products, as well as reinvesting at least one third of the profits in growers' communities, an amount significantly above the social premium required under the Fair Trade standards.

***Work Integration Social Enterprises ("WISEs")*:** WISEs are businesses that employ disadvantaged employees who suffer from systemic unemployment. Disadvantaged employees include disabled people, ethnic minorities, individuals with a criminal record, and members of low-income communities.[47] WISEs usually sell products or services which require a large number of low-skilled employees in industries such as food, catering, custodial services, recycling, etc. A notable example is the Greyston bakery, a $10 million business as of 2012, which specializes in gourmet cookies and baked ice cream ingredients. The Greyston bakery hires workers in a low-income area in Yonkers, New

[41] Note though that fair trade standards do not exist for all products, including many types of fruits and handicrafts.
[42] Certification for products rather than firms enables the same firm to have and operate both a social enterprise and a profit-maximizing enterprise (e.g., Starbucks selling fair trade products). This is possible because fair trade products can be separated from other products and traced to small producers.
[43] Section 2.1 of the Fairtrade Standard for Small Producer Organizations (May 1, 2011), *available at* http://www.fairtrade.net/our-standards.html (last visited Jan. 4, 2014).
[44] Importers must report to the FLO on orders supplied by certified producers and the price paid on such orders. Section 4.2 and 4.3 of the Fairtrade Standard, *id.*
[45] Cafédirect Annual Report 2012, *available at* http://www.cafedirect.co.uk/smallstory/shareholder-information/ (last visited Jan. 4, 2014).
[46] Cafédirect Annual Report 2012, *id.*
[47] Catherine Davister et al., *Work Integration Social Enterprises in the European Union: An Overview of Existing Models* (EMES Working Paper No. 04/04), *available at* http://www.emes.net/index.php?id= 49; JERR BOSCHEE, SOCIAL ENTERPRISE SOURCE BOOK (Encore! Press 2001).

York who have little or no education and employment record.[48] Unlike other WISEs that pay fair market wages to their worker-beneficiaries, the bakery pays its workers a salary that reflects their average productivity without a subsidy in the form of a wage premium.

The Greyston Foundation, a nonprofit dedicated to promoting community development primarily through employment programs, owns the bakery. The bakery has received subsidies from various sources. The foundation provided the seed capital using donative funds. Although the profits of the bakery are currently equivalent to other commercial bakeries, in the early years after its establishment, it apparently generated only below-market returns for its owner, the foundation. The foundation also provides training, housing assistance and childcare services to the workers. Moreover, the bakery has been receiving favorable trade terms from its well-known customer, the ice cream company, Ben & Jerry's, especially a willingness to adjust the terms of transactions if performance is not adequate or timely. The bakery also markets its social mission to attract premiums from consumers by introducing the "Do-Goodie" brownies.[49] Finally, the managers of the firm invest special effort in training employees and attending to their needs.

2. The Structure of For-profit Social Enterprises

When we examine the structure of for-profit social enterprises, it becomes apparent that they are not only characterized by having a transactional relationship with a class of beneficiaries. In addition, all of them have some contractual relationship with a nonprofit entity. Each of the social enterprises above is either controlled or certified by a nonprofit or has a contract with one. I use the term nonprofit entity loosely to include not only nonprofit corporations, but also government agencies and multilateral organizations, such as the World Bank. All these entities are effectively subject to a constraint on distribution, i.e., those who control the organization cannot distribute earnings to themselves. I also include social entrepreneurs, i.e., individuals with a strong reputation for pursuing altruistic missions who may also be viewed as being subject to some constraint on distribution.[50]

The role of the nonprofit is essentially to ensure that the for-profit social enterprise indeed transacts with its beneficiaries as patrons, and in some cases also allocates a subsidy to them. There are essentially three mechanisms by which the nonprofit monitors the for-profit entity: **(1) *Certification mechanisms*:** firms or products are certified as a form of social enterprise in accordance with certain standards. As shown above, the products of FTSEs, such as Cafédirect, are certified by the Fair Labeling Organization, to ensure that the firm transacts with "small producers" and extends them favorable terms. Likewise, financial institutions, such as Carver, may be certified as

[48] Boschee, *id.*, at 78-83; Michael Barker, et al., *A Case Study on Greyston Bakery: The Do-Goodie Product Launch* (May 15, 2009) (on file with the author; hereinafter, *The Do-Goodie Product*); Michael Barker et al., *Greyston Bakery: The Costs and Benefits of an Open Hiring Policy* (May 15, 2009) (on file with the author; hereinafter, *Open Hiring Policy*).
[49] See Barker, et al., *The Do-Goodie Product*, *id.*
[50] Social entrepreneurs effectively pledge their reputation as a commitment not to pursue excessive profits at the expense of the interests of third-party beneficiaries.

CDFIs if they serve low-income communities. **(2) *Contractual mechanisms*:** a contract between the social enterprise and a nonprofit that requires the social enterprise to transact with disadvantaged individuals and in some cases allocate a subsidy to them. As shown above, A to Z, a manufacturer of affordable bed-nets, entered into an agreement with certain nonprofits to serve low-income consumers. Likewise, CDFIs enter into an assistance agreement that, *inter alia*, dictates the terms extended by CDFIs to their low-income consumers (e.g., discounted interest rates). **(3) *Control mechanisms*:** the for-profit is controlled, through ownership or voting rights, by a nonprofit that ensures that the for-profit transacts with a disadvantaged group and, when applicable, gives it favorable terms. As shown above, this mechanism is used by many forms of social enterprise, including MFIs such as Compartamos, social investment firms such as Triodos Bank, WISEs such as the Greyston bakery, and even FTSEs such as Cafédirect.

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

3. Social Enterprises as Commercial Nonprofits

Social enterprises (as hybrid organizations) may be – and many of them are – formed as nonprofits. Whereas for-profit social enterprises must have a contractual relationship with another nonprofit entity, in this case there is only one entity, the nonprofit social enterprise. For nonprofit social enterprises, the commitment device is simply the non-distribution constraint. Those who control the organization have limited incentives to compromise the mission of the organization, which is to transact with disadvantaged individuals.[51] With respect to all the examples of for-profit social enterprises listed above, there are corresponding examples of well-known nonprofit social enterprises that operate in the same business. Some of the largest and most influential MFIs are nonprofits, for example, BRAC and ASA in Bangladesh. Community loan funds, a form of CDFIs that focus on loans to nonprofits and small businesses, are typically nonprofits.[52] The Acumen Fund is a nonprofit venture fund that makes investments in the form of loans to or equity in businesses in developing countries that promote a social good, such as A to Z discussed above. VisionSpring, a low-cost manufacturer and seller of affordable reading glasses, and The Aravind Eye Care, a provider of low-cost eye care services, including

[51] The function of the non-distribution constraint was laid out in Hansmann's seminal article on nonprofits; Hansmann, *supra* note 15.
[52] CDFI Coalition, *supra* note 25.

screening and surgeries, are nonprofits. Indego Africa is a nonprofit FTSE that buys jewelry, accessories and home décor from women-owned businesses in Rwanda and sells them to major retail stores in the U.S. and Europe. Gulf Coast Enterprises, a WISE that provides custodial services and food services, and employs primarily disabled workers or workers with behavioral disorders, is a nonprofit.[53]

Nonprofit social enterprises fall under the definition of commercial nonprofits, i.e., they receive a substantial part of their income from selling products or services.[54] This raises the question whether many other commercial nonprofits should be viewed as social enterprises, especially those that do not engage directly in development missions like the social enterprises described above. Examples of such commercial nonprofits in the U.S. include nursing homes, hospitals and universities. Not all commercial nonprofits, however, should be viewed as social enterprises. The answer ultimately turns on whether or not such organizations truly facilitate transactions with individuals that cannot transact with profit-maximizing firms. Consider nursing homes. On the one hand, they appear to transact with their customer-beneficiaries, i.e., the patients. However, their beneficiaries can hardly be described as individuals who have no access to care services.[55] In fact, nursing homes are formed as nonprofits to provide high-quality service to affluent customers.[56] They therefore cannot be described as having a commitment to transacting with a class of disadvantaged individuals.[57] In addition, hospitals in the U.S. appear to form as nonprofits mainly for historical reasons, and therefore I will not discuss them in much detail.[58]

On the other hand, universities do seem to have a commitment to transacting with disadvantaged individuals. American universities, for example, transact with students who cannot afford to pay full tuition and bear the costs of living expenses through their studies. Students may receive varying forms of price discounts in the form of grants and loans on favorable terms.[59] This price

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[53] Boschee, *supra* note 47, at 90-96.
[54] Hansmann, *supra* note 15, at 840-841.
[55] To be sure, the patients may be disabled and reliant on their families, but the point is that they are capable of paying for care services.
[56] Hansmann, *supra* note 15, at 863-865; Edward L. Glaeser & Andrei Shleifer, *Not-For-Profit Entrepreneurs*, 81(1) J. OF PUB. ECON. 99 (2001). In this case, the nonprofit form assures the customers that those who control the firm have limited incentives to shirk on quality, in circumstances where the customers (i.e., the patients) have difficulty evaluating the services provided to them.
[57] The same analysis applies to daycare centers described in Hansmann, *id.*, at 865.
[58] See Hansmann, *id.*, at 866-868; Henry Hansmann et al., *Ownership Form and Trapped Capital in the Hospital Industry*, *in* THE GOVERNANCE OF NOT-FOR-PROFIT ORGANIZATIONS 45 (Edward L. Glaeser ed., 2003); Cf. Jill Horwitz, *Does Nonprofit Ownership Matter?*, 24 YALE J. ON REG. 139 (2007). To be sure, hospitals that provide affordable services to low-income individuals may be viewed as social enterprises.
[59] Unlike social enterprises that may be formed as for-profits, elite universities invariably form as nonprofits. This is because universities rely in great part on donative funding, and also engage in allocating large subsidies towards risky projects, such as funding research projects with uncertain outcomes. It may also be due to the risk faced by students that the associative value of their university degrees will depreciate over time. Students expect universities to commit to maintaining their reputation and academic quality even several decades after they no longer study at those institutions. Strong pressure by investors to generate profits may be

differentiation seems similar to that employed by many social enterprises, especially low-cost sellers, such as A to Z, discussed above. Accordingly, there is scope for viewing universities in the U.S. as social enterprises too.[60] However, as I explain below, while universities may be viewed as social enterprises, the social enterprise structure (i.e., a commitment to transacting with beneficiaries as patrons) is *essential* only in the context of development missions.[61] This may be the reason why the social enterprise label is typically associated with organizations that address development missions, and why universities in developed countries are not usually viewed as social enterprises.

B. Social Enterprises versus Donative Organizations

Social enterprises need to be distinguished from donative organizations. Donative organizations have been defined as nonprofits which are funded primarily by donations.[62] Oxfam International, a nonprofit devoted to promoting development and alleviating poverty, is a well-known example. I use the term "donative organization" to refer not only to certain nonprofit corporations but also to government agencies and multilateral organizations that allocate subsidies (e.g., the World Bank). Both government agencies and multilateral organizations may be viewed as nonprofits because they are effectively subject to a non-distribution constraint, i.e., those who control the organization are prohibited from appropriating its funds to themselves. Moreover, although they are not funded by private donations, they are essentially dependent on a form of grant, i.e., an allocation of governmental funds. These organizations are active in numerous programs to promote development both domestically and globally. USAID and the World Bank are two common examples of such organizations.

There are two main distinguishing elements between social enterprises and donative organizations. The first is that the former are funded by earned income, whereas the latter are funded by donations. To be sure, as discussed above, social enterprises, as subsidized commercial enterprises, may receive donations or grants. The critical point, however, is that the financial viability of social enterprises is primarily dependent on earned income, whereas the financial viability of donative organizations depends on donations. The second element has been largely overlooked in the literature on nonprofits, and is central to the theory offered in this article. Unlike social enterprises that transact with their beneficiaries, donative organizations are engaged primarily in allocating subsidies to "external" beneficiaries, i.e., beneficiaries who are not patrons of the enterprise (see Figure 2).[63] A simple example of subsidies to external beneficiaries would be distribution of essential goods (e.g., bed-nets or

inconsistent with a long-term commitment to promoting academic excellence, and could affect the associative value of a university degree. On the other hand, universities that focus on teaching rather than research are increasingly formed as for-profits; see Henry Hansmann, *The Evolving Economic Structure of Higher Education*, 79 U. CHI. L. REV. 161 (2012).

[60] The argument can also be extended to museums and the performing arts.

[61] See *infra* Part II.

[62] Hansmann, *supra* note 15, at 840.

[63] Donative organizations may have a contract with their external beneficiaries. For example, the contract may require the beneficiary to use subsidies they receive for their intended purpose

FIGURE 2: DONATIVE ORGANIZATION

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

water purifiers) to the poor, or subsidies towards the purchase of such goods (e.g., voucher schemes). Other examples may be contribution of capital through credit subsidies or professional training programs. To be sure, as pointed out above, many social enterprises do allocate subsidies to their beneficiaries. For example, MFIs may provide subsidized rates to their investees, low-cost sellers sell products at discounted prices, and FTSEs provide training subsidies to their farmers. However, whereas donative organizations are engaged exclusively in transferring subsidies to beneficiaries, social enterprises require their patron-beneficiaries to provide a nontrivial consideration (e.g., the price of a bed-net, return of a loan with interest, or input provided by farmers) that reflects the utility they derive from transacting with the social enterprise.

The source of funding and the relationship with the beneficiaries are not independent of one another. The ability of social enterprises to earn revenues partly depends on their patron-beneficiaries' performance, whether as customers or providers of input. For example, a low-cost seller depends on its customer-beneficiaries' ability to pay; MFIs depend on borrowers' repayment rates; and WISEs depend on their workers' skills. On the other hand, the financial viability of donative organizations is not materially dependent on their beneficiaries, who are simply recipients of subsidies. Thus, unlike social enterprises, donative organizations engage primarily in the collection and disbursal of capital rather than the employment of capital in the production of goods and services.

The link between the source of funding and the relationship with the beneficiaries is manifested when we examine the experience of state development banks. State development banks have been employed for many years as a tool to increase access to capital through subsidized credit.[64] An example is India's Integrated Rural Development Program, a heavily subsidized

(e.g., using medical supplies to treat patients and not to resell them). But, the critical point is that the beneficiary is not required to provide a nontrivial consideration for the benefit received.

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

government program to fund loans mainly from state owned banks to excluded groups in India. As subsidized organizations with a commitment to making loans to poor borrowers, state development banks seem similar to social enterprises. However, they are better categorized as donative organizations. First, such banks are typically funded by the state, and have the full support and backing of the government in case they fail. Thus, their source of funding is primarily donative in nature, and for all practical purposes their viability does not depend on their borrower-beneficiaries. In fact, many such banks have continued to operate despite extremely high default rates. Accordingly, their credit programs have been viewed as effectively grants rather than loans.[65] Hence, despite transacting with their borrowers, state development banks largely transfer subsidies to their beneficiaries, rather than transact with them as patrons. Accordingly, I treat them as donative organizations.[66]

Finally, it should be emphasized that joint ventures or other contractual arrangements between donative organizations and for-profits may effectively create social enterprises. In fact, these types of arrangements may underlie the contractual and control mechanisms discussed above.[67] First, a donative organization may enter into a contract with a for-profit firm pursuant to which the former provides some form of subsidies, and the latter commits to transacting with certain beneficiaries. The for-profit essentially becomes a social enterprise by dint of this contract. The agreement discussed above between A to Z, a for-profit low-cost seller of bed-nets, and a partnership consisting of donative organizations, such as the World Health Organization, is one example of contractual mechanisms. Similarly, certain donative organizations agree to provide training subsidies and quality control to farmers in developing countries if a for-profit firm – essentially an FTSE – contractually commits to buying its supplies from those producers. Technoserve, a donative organization which provides agricultural training to small businesses in developing countries, typically enters into such agreements with for-profit firms.[68] Second, many of the control mechanisms described above include a donative organization which provides subsidized equity investment to the social enterprise entity. In this case, an organization which for the most part is donative in nature acts as a social investment firm, or more precisely, part of its activities involves social investment.[69] One example is the Greyston Foundation, the owner of the Greyston bakery. Its regular activities concentrate on providing professional training to external beneficiaries, the unemployed, but with respect to the bakery, it operates like a social investment firm.[70]

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[65] Armendáriz & Morduch, *id.*, at 11.

[66] To be sure, if the state support was credibly limited then state development banks would be financially dependent on their borrowers, and could then function as social enterprises.

[67] Note that in the case of certification, the nonprofit certifier may be classified as a commercial nonprofit; see *infra* note 71.

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

[69] As pointed out above, *supra* note 18, an enterprise may be part of an organization.

[70] I.e., the bakery is the patron-beneficiary.

C. Categories of Hybrid Organization

For reasons which I discuss in Part V, it is important to distinguish between social enterprises and other forms of hybrid organization. Hybrid organizations include many forms of subsidized commercial enterprises that do not necessarily qualify as social enterprises. In particular, such hybrid organizations do not have a commitment to transacting with their beneficiaries. Figure 3 details the classes of hybrid organizations. There are three main categories: (1) social enterprises, (2) commercial nonprofits, and (3) a residual category that includes mainly firms that engage in corporate charity and corporate social responsibility ("CSR"). As noted above, commercial nonprofits are one type of hybrid organization, as they constitute subsidized commercial enterprises, where the subsidy may take the form of income tax exemption.[71] As explained above, there is a degree of overlap between commercial nonprofits and social enterprises.

Unlike other commentators, I treat corporations that engage in corporate charity and CSR and social enterprise as distinct categories, on the basis that corporate charity and CSR do not involve a commitment to transacting with beneficiaries. Corporate charity and CSR usually reflect policies intended to boost a firm's goodwill and reputation or respond to pressures to address unfair distributional outcomes.[72] In most cases, similarly to donative organizations, such policies involve a transfer of a subsidy to an external beneficiary.[73] Corporate charity, mentioned above, is simply a disbursal from a for-profit firm to external beneficiaries. For example, Google, Inc. has promised to dedicate 1% of its equity and profits to making donations. Often such donations are made to a donative organization (for example, the Global Fund) that channels them to external beneficiaries (e.g., people with HIV in developing countries). CSR policies are largely identical to corporate charity in economic terms, except that CSR is usually used to refer to a wider set of policies, especially different forms of service. Examples include volunteer work of employees in the community, the provision of technical assistance to small businesses, and pro bono work for clients that cannot afford to pay for services. As explained above, the subsidy in these cases may flow from the investors who possibly give up some returns to fund the policy or from consumers who prefer to buy products from firms with a strong ethical outlook.

Finally, I note that in practice not all firms will fit neatly into a specific category. For example, a FTSE may also be involved in corporate social responsibility initiatives, for example, building schools in farmers communities.

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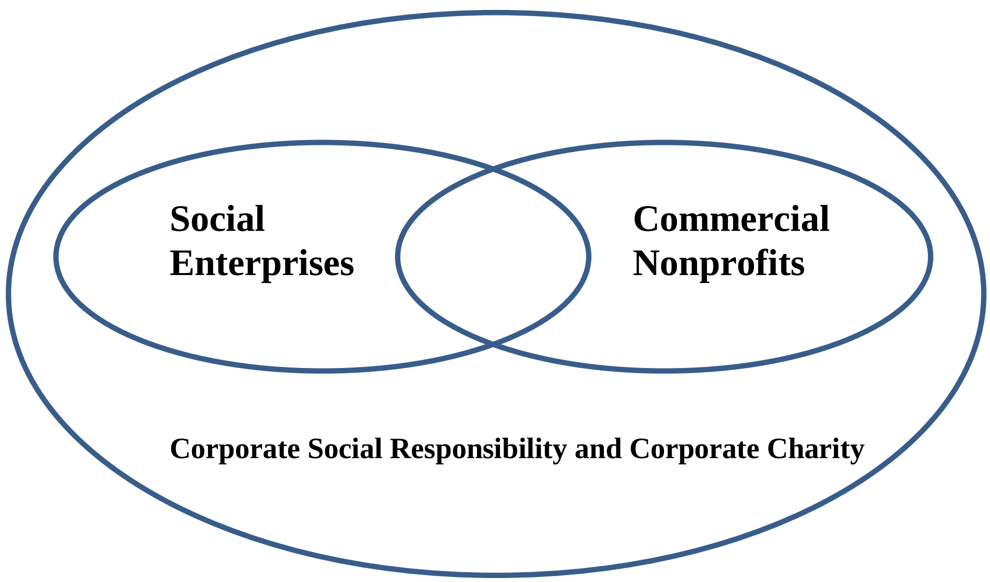
[71] Interestingly, one can classify certifiers of social enterprises, such as the Fair Labeling Organization, as a form of commercial nonprofits that are designed to provide high-quality services to their customers (i.e., certified firms), similarly to nursing homes discussed in section I.A.3. The nonprofit certifier must commit to certified firms that it will make efforts to maintain the integrity of its standards across a wide range of firms. Because certification services may be complicated and hard to evaluate, firms that seek certification prefer to patronize nonprofit firms.

[72] Geoffrey Heal, *Corporate Social Responsibility: An Economic and Financial Framework*, 30 THE GENEVA PAPERS 387 (2005).

[73] More difficult cases of CSR where the subsidy is channeled to a patron yet there is no "true patron-beneficiary" are discussed in section V.A.

FIGURE 3: HYBRID ORGANIZATIONS



The large circle encompasses the full range of hybrid organizations. It includes social enterprises, commercial nonprofits and residual categories of organizations that channel a subsidy to beneficiaries, especially for-profits that engage in corporate social responsibility and corporate charity. Note that the class of social enterprises overlaps with commercial nonprofits.

Similarly, a donative organization that operates training programs for external beneficiaries may also comprise a separate business segment that employs disadvantaged workers (i.e., a WISE) within the same entity. Accordingly, the categories of hybrid organizations identified herewith should be considered as ideal types rather than mutually exclusive and exhaustive categories.[74]

II. A THEORY OF SOCIAL ENTERPRISE

A theory of social enterprise should explain how the structure of social enterprises serves a specific economic role, and why this structure gives them specific advantages over other organizations in fulfilling this role. In particular, the theory set out herewith explains how the transactions with their patron-beneficiaries make social enterprises relatively effective in addressing complex development missions as compared to other forms of organization. To be sure, for the purposes of this Part, I am indifferent as to whether social enterprises are formed as for-profits or nonprofits, as long as they are under a commitment to transacting with a class of disadvantaged patrons.

Standard economic theory is very suspicious of subsidizing corporations. There is a general concern that subsidies fail to achieve their purpose and may

[74] Hansmann, *supra* note 15, at 841, makes a similar observation with respect to the categorization of nonprofit corporations.

be expropriated by those who control the organization. In the case of donative organizations, the non-distribution constraint mitigates the possibility that managers will expropriate the subsidies (i.e., the donations), and thus makes it more likely that they will use them to benefit third parties. The non-distribution constraint on its own is a relatively crude mechanism that works well especially when donative organizations simply transfer subsidies to beneficiaries (e.g., soup kitchens). However, in many cases, the goal of subsidies is to address complex development missions, for example, increasing access to capital and improving employment opportunities. It is unrealistic to expect the non-distribution constraint to assure donors that their subsidies will be used effectively when the mission is highly complex.

While there may be many reasons why subsidies fail, the ineffectiveness of subsidies ultimately stems from information asymmetries. It is useful to contrast a standard contract and a subsidy. The price that each party to a contract pays the other reflects the minimum value he ascribes to that contract. If I pay $100 for a good, this good is worth at least $100 to me, though it may be worth more (e.g., $120), in which case, there is a surplus (i.e., $20). By contrast, subsidies are transactions, in which the provider of the subsidy gives something of value (cash, goods or a service) to a recipient for no consideration. The value of the subsidy to the provider is well known. If I donate $100 to fund a training program for low-income workers, the value to me of helping the worker-beneficiaries is $100. This is based on the assumption that the subsidy will be used to train workers and improve their chances of finding a job. However, there may be uncertainty as to whether the subsidy was used effectively. Whether or not the training is effective depends on the attributes of each beneficiary. The beneficiaries may already have the skills to perform the job, and their unemployment is possibly due to other economic factors. Alternatively, workers may lack very basic skills (e.g., attentiveness), and therefore complicated technical training may be inappropriate and unlikely to improve their capabilities. An ineffective subsidy is not simply a distribution of wealth, but constitutes waste, as the provider of the subsidy presumably intended it to be utilized effectively.

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

This inability of disadvantaged people to transact with commercial firms may derive from two sources. The first is that commercial firms have difficulty in evaluating the abilities of individuals that belong to disadvantaged groups. As a result of such information asymmetries, commercial firms fail to transact with them, even if such individuals have fully competitive ("FC") abilities to carry out their transaction with the firm. A substantial body of research shows that although many members of disadvantaged communities may be too poor or lack technical skills, a significant number of them have ample capabilities to transact with commercial firms, e.g., buy products, repay debt, or work at a factory.[75] In general, any commercial firm has to deal with information asymmetries with respect to the attributes of its patrons, e.g., workers' skills or borrowers' creditworthiness. While this problem exists in many contractual transactions, there are various mechanisms to mitigate these problems, for example, education helps workers signal their abilities, or credit-rating bureaus collect information on borrowers' creditworthiness. Such mechanisms are often absent in developing countries or low-income communities. Moreover, the high proportion of individuals who lack FC abilities in disadvantaged communities makes it harder for commercial firms to identify those who have such abilities. Consequently, in transacting with disadvantaged individuals firms face a higher risk of adverse selection, which is the risk that a firm will transact with individuals with less than FC abilities (e.g., very risky borrowers). In addition, to the extent that firms transact with individuals with less than FC abilities, they face a higher risk of moral hazard, i.e., the risk that those who transact with the firm will not make sufficient efforts to perform at the required level under the contract, because individuals with lower ability face higher costs for exerting effort. The high risk of adverse selection and moral hazard makes it less profitable for commercial firms to transact with disadvantaged groups.[76] Transacting with disadvantaged patrons therefore entails incurring an economic loss and hence opportunity costs.[77] The opportunity costs of transacting with disadvantaged individuals are likely to lead profit-maximizing firms to ignore them altogether.

Second, many disadvantaged individuals fall short of FC abilities. Commercial firms wouldn't transact with them even if they were able to observe their abilities. The traditional approach to dealing with this problem is for a donative organization, a government agency or a nonprofit, to provide some form of assistance – essentially a subsidy – in order to help such individuals transact with commercial firms. Such assistance may take several forms, for example, distribution or subsidization of goods (e.g., fertilizer), credit subsidies or professional training programs. As stated above, however, for such a subsidy to be effective there must be information on the abilities of its beneficiaries. An effective subsidy would only be allocated to those who

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[75] See Part III below.

[76] In general, firms can adjust their contracts to reflect the lower abilities of disadvantaged patrons, for example, by reducing wages or increasing interest rates to borrowers. But as wages fall or interest rates increase, more capable patron-beneficiaries will exit the market, a process which leads to rationing and often a collapse of the market; see Joseph Stiglitz & Andrew Weiss, *Credit Rationing in Markets with Imperfect Information*, 71 AM. ECON. REV., 393 (1981); Chapter 2 in Armendáriz & Morduch, *supra* note 14, at 29-66.

[77] Economic loss in this context means the difference between the revenue earned from the sale of the firm's output when it transacts with disadvantaged patrons and the revenues it would earn if it transacted with patrons who are not disadvantaged. This economic loss is equal to the opportunity costs of transacting with disadvantaged patrons.

have below-competitive ("BC") abilities, but could reach FC abilities if they receive the subsidy. It would be of limited effectiveness if allocated to people who already have FC abilities, or to individuals who have no competitive ("NC") abilities, i.e., individuals who are unable to acquire FC abilities even if they receive assistance.[78] For example, a training subsidy should be administered only to workers who have some basic skills and could perform at a fully competitive level if they received professional training.[79]

If donative organizations had information on beneficiaries' attributes they would be able to allocate the appropriate amount and type of subsidy. Just like commercial firms, however, donative organizations face high costs in evaluating the attributes of their beneficiaries. In these circumstances, there is a risk that they will prescribe wasteful programs with limited effect.[80] A donative organization that cannot observe its beneficiaries' attributes is most likely to allocate a subsidy to all members of a disadvantaged group, say workers, in the hope that it will induce those with BC abilities to obtain FC abilities.[81] The waste in this case includes the costs of the subsidy (e.g., the costs of the training) to those with FC abilities (as they do not need any training) and those with NC abilities (for whom training would be useless).[82] The social costs also include the waste from having trained effectively those with BC abilities, who nonetheless fail to obtain employment with firms that choose to ignore disadvantaged individuals anyway. Accordingly, subsidies will tend to be wasteful when there is a high proportion of individuals with FC or NC abilities, or if commercial firms ignore disadvantaged groups anyway.

The limited effectiveness of donative organizations stems from lack of information on beneficiaries' attributes. This information problem derives from the nature of their relationship with the beneficiaries. By definition, the beneficiaries of donative organizations are external beneficiaries, i.e., they do

[78] Of course, this categorization is somewhat crude, but nonetheless helpful in elucidating the advantages of social enterprises.

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

[80] There is ample literature on the disappointing effectiveness of foreign aid provided by government agencies or international organizations to spur growth and development; see THE INSTITUTIONAL ECONOMICS OF FOREIGN AID (Bertin Martens et al. eds., 2002); William Easterly, *Can the West Save Africa?*, 47 J. OF ECON. LITERATURE 373 (2009); William Easterly, *Was Development Assistance a Mistake?*, 97(2) AM. ECON. REV., 328 (2007); Claudia Williamson, *Exploring the Failure of foreign Aid: The Role of Incentives and Information*, 23 THE REV. OF AUSTRIAN ECON. 17, 27-31 (2010); Eric D. Werker & Faisal Z. Ahmed, *What do Non-Government Organizations Do?,* 22(2) J. OF ECON. PERSP. 73 (Spring 2008).

[81] When donative organizations have no information on beneficiaries' abilities, the rational strategy for them is to provide the same subsidy to all beneficiaries in the same amount that would help those who have BC abilities attain FC abilities, i.e., assume that all beneficiaries have BC abilities. The reason is that disbursals in any other amount and type will always be inefficient, whereas such disbursals will at least be efficient with respect to beneficiaries that have BC abilities.

[82] A similar analysis applies in the context of credit, goods and services. For example, it would be wasteful to provide a person with a good worth $100 for free when that person can afford to pay $50 for it; the excess subsidy of $50 is a waste.

not transact with the organization.[83] A contractual transaction enables commercial enterprises to elicit information about their patrons, especially their patrons' preferences, abilities and efforts. It shows that patrons value the benefit they receive under the contract with the firm. Borrowers value the opportunity to employ loan funds in a business project, and employees value the opportunity to work for a salary. Repayment of a debt or performance as an employee reveals information on one's abilities and efforts. By contrast, as donative organizations do not transact with their beneficiaries as patrons, they need to rely on available information to the extent that such exists.

It can be argued that donative organizations could simply study their beneficiaries' attributes, and monitor how they use the subsidies they receive. However, such studies on the use of subsidies are likely to be very costly.[84] More importantly, donative organizations have only modest incentives to use capital to fund such studies.[85] As they receive their funding from donors, donative organizations are generally designed to serve their donor-customers by disbursing donated funds to beneficiaries on their behalf. Impact studies may reveal that subsidies are being used inefficiently and dissuade donors from making additional contributions. Thus, donative organizations tend to report information on the amount rather than the effectiveness of their disbursals in order to attract donative funding.[86]

The thrust of my theory is that transacting with the beneficiaries gives social enterprises the incentives and tools to utilize subsidies effectively. Social enterprises perform a *measurement* function with respect to the attributes of their beneficiaries. Unlike donative organizations, social enterprises are subject to a commitment to transacting with their beneficiaries as patrons.[87] The commitment device ensures that they cannot transact with other more capable patrons, for example, more productive workers from high-income communities.[88] Because transacting with disadvantaged patrons entails an economic loss, social enterprises must receive some subsidies. However, despite being subsidized, as explained above, social enterprises must still earn revenues to remain financially viable.[89] For social enterprises to earn revenues,

[83] See Figure 2.

[84] Though some impact studies of subsidy programs do exist, these studies take time and are often prohibitively costly. For example, following every worker that undergoes a training program to record their employment and performance is unlikely to be practical in most cases. More importantly, even if it is revealed that training was inadequate, the results of one study will not necessary carry over to other instances.

[85] Bertin Martens, *The Role of Evaluation in Foreign Aid Programs*, *in* Martens et al. eds., *supra* note 80, at 154-177.

[86] Donative organizations are usually evaluated by donors and other external agencies, such as Charity Navigator, primarily on the basis of the quantity of disbursals they make to beneficiaries; see Bertin Martens, *Introduction*, *in* Martens et al. eds., *supra* note 80, at 19-20.

[87] Compare Figures 1 and 2.

[88] The form of commitment device adopted by the social enterprise is of limited relevance for present purposes. For a discussion of choice of commitment devices and organizational form, see Part IV.

[89] An example is a social enterprise that employs disadvantaged workers and makes a 10% annual return on a $1 million investment, while a profit-maximizing firm would make a 30% annual return on the same investment; the subsidy being the 20% annual return that investors are willing to forgo. It is noteworthy that a social enterprise may also make negative returns on invested capital as long as it also receives additional subsidies to ensure that the firm remains

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

Consequently, social enterprises have the incentives and tools to measure their beneficiaries' abilities to make sure that they have at least FC or BC abilities.[90] For example, as discussed below, a WISE will closely monitor the performance of its worker-beneficiaries to evaluate their abilities. It will sever its transactions with those who have NC abilities as they are unable to perform the job even if they receive some form of training. Those with NC abilities may still seek relief from a donative organization whose role is to assist those who cannot acquire the skills and abilities to transact with commercial firms. Social enterprises are best suited to assist those who have FC and BC abilities.

Social enterprises use the information on their patron-beneficiaries to tailor the amount and type of subsidies to their specific needs. If the subsidies transferred to beneficiaries are excessive, the social enterprise will be less profitable. If the subsidy is insufficient or inadequate, the patron-beneficiaries may not perform well, and again the business will suffer. For example, a WISE will employ those with FC abilities, but has no need to allocate them a training subsidy. It will then allocate a subsidy only to those who have BC abilities. In particular, given its contractual relationship with its worker-beneficiaries, it is able to ensure that workers with BC abilities are actually productive and that the training program is indeed adapted to the commercial needs of the firm. Note also that there are welfare gains to patron-beneficiaries with FC or BC abilities who would not otherwise be able to transact with commercial firms.[91] Contrast this with a donative organization which allocates wasteful subsidies to beneficiaries with FC and NC abilities, and has no practical way to ensure that its beneficiaries are actually employed. Accordingly, the use of social enterprises results in more effective utilization of subsidies. The same principles apply to other social enterprises, such as MFIs, FTSEs or low-cost sellers.

In this way, the structure of social enterprise, especially committing the firm to transacting with a disadvantaged group, effectively aligns the profit and social missions.[92] More specifically, it aligns the interests of the subsidy-providers with the profit interest of those who control the social enterprise, i.e.,

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solvent; for example, where the return on investment is -10% and the firm receives a government grant to cover accounting losses. Even in this case, the firm needs to earn substantial revenues to be viable.

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

[91] These welfare gains are equal to the economic surplus they derive from their transactional relationship with the social enterprise. For example, worker-beneficiaries gain the surplus of their salary over the lowest salary they would accept for the same work. Similarly, consumer-beneficiaries of social enterprises gain the consumer surplus, i.e., the surplus of the price they pay (e.g., interest rate on a loan) over the highest price that they would be willing to pay.

[92] Note that this is subject to the risk of mission-drift discussed in section VI.B below.

the owners in the case of for-profit social enterprises[93] or the managers in the case of nonprofit social enterprises who presumably want to maximize spending on perquisites.[94] In order for social enterprises (whether formed as for-profit or nonprofit) to remain financially viable, they must ensure that their patron-beneficiaries perform well and that subsidies are not wasted. Thus, the incentives of social enterprises to allocate subsidies effectively are present even if, and in fact in large part because, the owners and/or managers are motivated by profit. The same incentives exist when the owners and/or managers are altruistic, because even an altruistic owner or manager does not derive utility from wasting subsidies and must make sure that the business is viable for it to achieve its development mission. When the profit and social missions are aligned it matters little if the manager and/or owners are motivated by profit, altruism, or both.

Social enterprises employ three main mechanisms to measure their beneficiaries' attributes: ***(1) Due diligence*****:** Social enterprises study the attributes of their beneficiaries *ex ante* entering into a contract with them. Social enterprises then use such information to decide whether or not to transact with such potential patron-beneficiaries and whether to allocate them a subsidy. ***(2) Intensive monitoring*****:** Social enterprises can transact with their patron-beneficiaries on the basis of imperfect information. In the course of transacting with them, the social enterprise monitors their performance, thereby acquiring information on their abilities. This information is then used to make decisions on whether to continue the contractual relationship and the type of subsidies to be allocated to such beneficiaries. With respect to patron-beneficiaries who turn out to be incapable of performing the contract (i.e., they have NC abilities), the social enterprise terminates their relationship.[95] If the patron-beneficiaries need assistance (i.e., have BC abilities), the social enterprise has an incentive to allocate them appropriate subsidies in order to help them reach FC abilities. ***(3) Incentive mechanisms*****:** Social enterprises may utilize the relationship with the patron-beneficiaries as the basis for developing incentive mechanisms to reveal information on patron-beneficiaries' abilities and efforts. In order to be eligible for a subsidy, beneficiaries with BC abilities must reveal their abilities to perform the contract; if they were to represent themselves as having NC abilities, they would not be able to transact with the social enterprise. While those with FC abilities may have an incentive to pretend they have BC abilities in order to qualify for certain subsidies (e.g., longer grace periods on loans), the contract may provide for various mechanisms to mitigate their incentives to

[93] When a for-profit social enterprise adopts a control mechanism as a commitment device, the owners or some of them may be nonprofits that provide subsidies to the social enterprise. As discussed above, the Greyston Foundation owns the Greyston bakery. Nonetheless, even such nonprofit owners have a profit motive to increase their income, so that they have more funds to apply towards their social missions.

[94] In line with the model of nonprofits offered by Glaeser & Shleifer, *supra* note 56, I assume that even managers of nonprofits want to increase profits because they can extract a proportion of such profits in the form of higher salaries and perks.

[95] J.P. Morgan & The Rockefeller Foundation, *supra* note 3, at 45 (noting that a portion of the population with the lowest income levels will remain reliant on aid, i.e., disbursals from donative enterprises).

understate their abilities (e.g., a promise of a future loan on better terms if they timely repay a loan, thereby revealing their FC abilities).

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

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

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

Another important example is universities in the U.S. As stated above, universities may be viewed as social enterprises because they transact with their patron-beneficiaries, i.e., students who cannot afford to pay full tuition.[96] In this case, however, it is not costly to verify students' financial condition, whether such verification is conducted by the university itself or by another organization. That is, there are no information asymmetries. It is perfectly possible to envisage for-profit universities that charge their students market fees and have no specific commitment to transacting with students who cannot afford tuition. Students may in turn receive financial aid from a donative organization by showing documents verifying their financial status and enrollment.[97] In these circumstances, a university structured as a social enterprise has no particular advantage over donative organizations in measuring students' ability to pay,

[96] See *supra* section I.A.3.
[97] In fact, Hansmann contemplates a greater role for the for-profit sector in higher education; see Hansmann, *supra* note 59.

because information is already available.[98] There is no need to create an organizational structure with incentives to measure students' ability to pay. A donative organization would be just as effective as a social enterprise in allocating subsidies.

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

III. APPLICATION OF THE THEORY

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

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

(1) Profit-Maximizing Firms**:** Commercial banks have traditionally avoided transacting with poor individuals in low-income communities in both developing and developed countries. Commercial lenders rely on credit scores to evaluate their borrowers. They also require collateral or other security to mitigate the risk of default. In low-income communities, credit scores are usually not available, as borrowers lack a credit history, employment track record and, in some cases, even proof of identity. In addition, poor borrowers usually lack collateral to pledge as security for a loan.[99] Moreover, the presence of many risky borrowers who have limited earning capacity makes it harder for banks to identify those who can repay their debts. Likewise, investment firms tend to ignore small businesses, especially in developing countries.[100] In developed markets, investment firms, such as private equity firms, rely on audited financial information, the track record and reputation of their investees' management, and general market information. By contrast, in developing markets, the balance sheet of businesses may not be a reliable source of information, as financial standards either do not exist or are not enforced, and,

[98] To be sure, universities that operate in rural communities may need to measure their students' ability to pay and, hence, the social enterprise structure may be advantageous.

[99] See CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY (Margaret J. Miller ed., 2003).

[100] See BRIGIT HELMS, ACCESS FOR ALL: BUILDING INCLUSIVE FINANCIAL SYSTEMS 2-5 (World Bank 2006); Prahalad, *supra* note 35; Benjamin et al., *supra* note 25.

more generally, data on the relevant market may be scarce. Moreover, when a firm considers making an investment in a new small business with no track record, it may have difficulties evaluating the potential of the investee and the skills of its management.

(2) Donative Organizations**:** Many low-income individuals or small businesses cannot pay commercial rates for loans or generate commercial returns (as applicable). Governments of developing countries have for many years subsidized credit in an attempt to increase access to capital, especially for small farmers. These subsidies have taken different forms, in particular, the allocation of cheap loans through state-owned development banks. Although several studies find modest benefits to borrowers, the overwhelming majority of studies find that credit subsidies in whatever form have been grossly inefficient.[101] Repayment rates at such programs have been very low, with default rates ranging from 40 to 95 percent.[102] Impact studies that reviewed these programs have attributed low repayment rates in large part to a variety of information problems, for example, inadequate program design that wrongly assumed that borrowers, mainly farmers, necessarily had good projects, uncertainty regarding the ability of borrowers to meet payment obligations, and failures to monitor borrowers who often diverted loan funds to other purposes, including consumption.[103] Moreover, many farmers lacked knowledge and input (such as fertilizers), and therefore their projects were likely to fail. These subsidized programs collected too little revenue and were not financially viable. They either ran out of money or drained government accounts. The root of the problem was seemingly that the lending banks were simply capitalized by the state, and thus, as explained above, operated largely as donative organizations that transferred subsidies to beneficiaries.[104] Because they had no material financial dependence on their borrowers, they had little financial incentive to gather information on their beneficiaries' abilities and projects.

(3) Social Enterprises**:** MFIs, CDFIs and social investment firms tailor the terms of their investments to the creditworthiness and business potential of their investees. Compartamos charges market rates on its loans to the moderately poor. Thus, it does not directly allocate subsidies to its beneficiaries; rather, it utilizes the subsidies it has received to measure its beneficiaries' creditworthiness using various mechanisms discussed below. As a result of such measurement, default rates tend to be very low, despite the high interest rates charged to borrowers.[105] Simply transferring credit subsidies to borrowers in circumstances when they can afford taking a loan or, even worse, when they have no good projects is clearly an inferior solution. On the other hand, MFIs, CDFIs and social investment firms that transact with less capable individuals provide them with different types of subsidies. For example, MFIs, such as BRAC and ASA, provide a wide range of subsidies to their borrowers, in

[101] See citations *supra* note 64.
[102] Armendáriz & Morduch, *supra* note 14, at 11.
[103] See especially, Buttari, *supra* note 64; Braverman & Guasch, *supra* note 64.
[104] See *supra* section I.B.
[105] Default rates for Compartamos were historically less than 1%, whereas the average default rate on consumer loans by other Mexican banks was 4.4%; see Compartamos Offering Circular, *supra* note 20, at 83.

particular, reduced rates and business training. Similarly, while some social investment funds seek to make near-competitive returns,[106] others, such as Triodos Bank and the Acumen Fund, charge below-market rates and provide business training to their investees. Thus, the prices patron-beneficiaries are charged and the subsidies allocated to them are adjusted to their abilities.

The effectiveness of subsidies channeled through social enterprises is simply evidenced by their ability to sustain themselves. When borrowers of MFIs and CDFIs pay back their loans, and investees of social investment firms generate reasonable returns, this is an indication that the subsidies are effective, as the patron-beneficiaries are performing well. In particular, measurement of borrowers has been particularly successful for MFIs whose loan repayment rates tend to be very high.[107] Moreover, subsidies are probably not excessive (or at least, not too excessive) because otherwise the social enterprise would not be financially viable. Next, I consider how MFIs, CDFIs and social investment firms measure their beneficiaries' attributes. As discussed above, social enterprises use three main mechanisms:

(i) Due diligence: CDFIs use alternative mechanisms to collect information on the creditworthiness of low-income borrowers, such as utility bills, house visits and personal interaction with borrowers.[108] To reduce the costs of information, they also tend to specialize in specific industries, such as housing finance.[109] Social investment firms invest effort and resources in due diligence, including vetting the character and qualifications of the management team and financial analysis of their investees, especially where such investees are located in jurisdictions with weak accounting standards.[110] By contrast, MFIs conduct a less onerous diligence process and rely more extensively on other mechanisms.[111] The reason seems to be that MFIs make very small loans to borrowers, so conducting detailed diligence *ex ante* the loan contract with respect to each loan would be too costly.

(ii) Intensive monitoring: MFIs as well as CDFIs evaluate the performance of their borrowers throughout their loans, and over time they accumulate data

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[106] For example, the IGNIA Fund, discussed in section IV.C.

[107] There is mixed data on delinquency rates of CDFIs' loans, though they generally appear to be comparable to industry averages; see Michael Swack et al., *CDFI Industry Analysis: Summary Report* (Carsey Institute, 2012), *available at* http://www.cdfifund.gov/news_events/CDFI-2012-12-CDFI-Fund-Releases-In-Depth-Examination-of-State-of-the-CDFI-Industry.asp (last visited Jan. 4, 2014).

[108] Katy Jacob, *Reaching Deeper: Using Alternative Data Sources to Increase the Efficacy of Credit Scoring* (The Center for Fin. Services Innovation, March 2006), *available at* http://cfsinnovation.com/node/2510 (last visited Jan. 4, 2014).

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

[110] J.P. Morgan & The Rockefeller Foundation, *supra* note 3, at 70. For a useful illustration of the process, see the following case studies explaining the valuation process by the Acumen Fund of Ziqitza Healthcare Limited ("ZHL"): William Davidson Institute, *Acumen Fund: Valuing a Social Venture* (Michigan Ross School of Business note 1-428-788, May 2009); William Davidson Institute, *Acumen Fund: Valuing a Social Venture (B)* (Michigan Ross School of Business note 1-428-872, Oct. 2009). I discuss ZHL in section IV.C., and note 114.

[111] To be sure, some MFIs do rely on diligence by sending loan officers to the villages and learning about the applicants' character from individuals in the relevant community; see Armendáriz & Morduch, *supra* note 14, at 159-160.

on borrowers' business projects and repayment rates. MFIs use frequent repayment installments of very small amounts, in order to allow their credit officers an early opportunity to assess borrowers' performance.[112] Repayment of the loan on time is a clear indication of a borrower's abilities, and he may then be given additional loans. At some stage, it may become evident that borrowers no longer need a subsidy. They then may indeed obtain loans at commercial rates; for example, the interest rates may be lowered and the loan size increased, not as a disbursal to the borrower, but to reflect the lower risk of lending to a borrower with higher abilities. On the other hand, if borrowers default, they receive no further loans.[113] Through this type of process conducted over many years, MFIs and CDFIs have compiled a sizeable database on the creditworthiness of substantial sections of their target markets. Although social investment firms tend to rely more on diligence, diligence is inevitably imperfect. They therefore also exercise substantial monitoring over their investees. The monitoring may consist of appointing directors to the board of the investee and requiring board consent for certain business decisions, including not only major transactions, such as a merger, but also managerial decisions regarding business strategy.[114]

(iii) Incentive mechanisms: Many MFIs rely on a specialized incentive mechanism known as group lending. The gist of group lending is that loans are made to a group of borrowers rather than to an individual.[115] Each borrower is jointly liable for the debts of all other borrowers in his group. Group lending gives rise to a process of assortative matching whereby safe (i.e., more capable) borrowers form groups with other safe borrowers, and risky (i.e., less capable) borrowers form groups with other risky borrowers. The risky borrowers effectively pay higher rates than the safe ones because their groups default more often, and each of them faces liability for any and all of the group members' defaults. In this way, group lending generates information on borrowers' abilities *ex ante* a loan. Group lending also reduces moral hazard *ex post* a loan contract, as group members monitor each other to make sure they repay their loans. It further creates social pressure on borrowers to repay their loans, as repayments are usually made at group meetings, and failure to pay results in a social stigma.[116] Although the group lending mechanism has proven to be effective in ensuring very high repayment rates, the transaction costs of group

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[112] Armendáriz & Morduch, *id.*, at 145-153.

[113] For example, Shore Bank, a known CDFI, experimented with loans to small businesses that suffered from high default rates before it started focusing on housing finance; see Grzywinski, *supra* note 109.

[114] For example, the term sheet for the issuance of shares to the Acumen Fund by ZHL includes, *inter alia*, the appointment of a director by the Acumen Fund, veto rights to the Acumen Fund with respect to any major transaction, such as issuance of shares or any amendments to articles of association, a specific target date for an IPO, including the right of the Acumen Fund to approve the investment banker for the IPO, and giving the Acumen Fund access to the premises and any corporate records; see William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, *supra* note 110, at 21-24.

[115] For a detailed explanation, see Chap. 4 in Armendáriz & Morduch, *supra* note 14.

[116] Armendáriz & Morduch, *id.*, at 157.

lending, including conducting group meetings to collect payments and sending loan officers to rural communities, are high.[117]

Given these high transaction costs and in light of greater information on borrowers' creditworthiness, many MFIs are gradually shifting away from group lending to using more standard incentive mechanisms. In particular, borrowers are promised an opportunity to borrow more capital on better terms if they repay their existing loans on time.[118] Thus, loans may be made for larger amounts, longer terms, and at better interest rates.[119] This addresses the risk that borrowers will not pay once project returns have been realized. Alternatively, MFIs threaten not to refinance their customers in the future if they do not repay; a powerful threat in the case of borrowers with multiple projects.[120]

B. Improving Productivity: Fair Trade Social Enterprises

***(1) Profit-maximizing firms*:** Multinational corporations buy their input from well-established commercial producers or middlemen and avoid buying input directly from small producers.[121] The major concern of commercial firms is the quality of products supplied by small producers. In a fragmented market of numerous suppliers, and with respect to products the quality of which is not observable by cursory inspection, it is too costly to evaluate each item of input.[122] Coffee beans and bananas are two notable examples.[123] There is great difficulty in distinguishing among producers with different levels of abilities, especially as many small producers in developing countries do not meet the quality standards of export markets.[124] It is also costly to monitor small producers to ensure that they exert a sufficient level of effort without constantly

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[117] Nitin Bhatt & Shui-Yan Tang, *The Problem Of Transaction Costs In Group-Based Microlending: An Institutional Perspective*, 26 WORLD DEV. 623 (1998).

[118] Armendáriz & Morduch, *supra* note 14, at 143-144.

[119] By contrast, group lending is generally associated with poor customers, smaller loans and higher costs relative to loan size.

[120] Armendáriz & Morduch, *supra* note 14, at 140-143.

[121] Small producers in developing countries sell their products to middlemen known as "coyotes" who are often in a position to exploit their monopsonist power. Thus, a common explanation for fair trade is that it is a solution to monopsonist pricing; see Nicholls & Opal, *supra* note 38, at 33-34; Mark Hayes, *On the Efficiency of Fair Trade*, 64 REV. OF SOC. ECON. 447 (2006). While it is true that small producers face monopsonist pricing, this view ignores a more fundamental question, which is why there is no competition in the first place. If multinational corporations traded directly with small producers, competition for the products of small producers would raise prices. The problem is that information asymmetries preclude direct trading between corporations and small producers. This problem is similar to the problem of monopolist moneylenders with respect to lending to poor borrowers (see Armendáriz & Morduch, *supra* note 14, at 31-33). When commercial lenders refrain from lending to the poor because of information problems, monopolist moneylenders may step in and lend at exploitative rates.

[122] BENOIT DAVIRON & STEFANO PONTE, THE COFFEE PARADOX: GLOBAL MARKETS, COMMODITY TRADE AND THE ELUSIVE PROMISE OF DEVELOPMENT 129-131 (Zed Books 2005).

[123] Coffee beans are sold by producers in cherry form, so their taste is hard to evaluate at the time of the sale. Bananas are susceptible to disease and infections; see Nicholls & Opal, *supra* note 38, at 81, 87. Accordingly, both coffee and bananas are usually grown in large plantations owned by or affiliated with the importers.

[124] See Nicholls & Opal, *id.*, at 35-38.

inspecting the quality of each item.[125] Small producers may try to establish a reputation for high quality by using marketing and branding tools, but with few exceptions, they tend to be too segregated or too poor to establish a brand. Accordingly, many producers, especially farmers in developing countries, have difficulties in selling their products to multinational corporations even if they can meet high quality standards.

(2) Donative Organizations**:** Many farmers lack training with respect to quality standards, production methodologies and organizational skills.[126] Donative organization may step in and provide them with assistance in the form of subsidized input, such as fertilizer, professional training and technical assistance. Subsidizing fertilizers to enhance farm productivity has a longstanding history in attempts to jumpstart African agriculture.[127] These programs, however, were found to have high costs and questionable benefits. In particular, programs have suffered from a variety of problems which relate to beneficiaries' skill level and knowledge, including: little actual use of fertilizers by farmers, lack of information on the benefits of fertilizers and how to properly use them, excessive use which may in fact reduce yields, delivery after the optimal fertilization period, and lack of complementary measures (e.g., quality inputs).[128] Although yields do seem to increase following subsidization or distribution,[129] there is a consensus that these programs tend to be inefficient.

The record of training programs, known as agricultural extension, has been even more dismal as a result of information and incentive problems of program sponsors, such as the World Bank. Agricultural training requires dealing with individual farmers, and each farmer's needs are different.[130] Among other problems, training programs have been found to suffer from lack of knowledge as to farmers' abilities and needs, difficulties in attributing impact to training efforts, little effort to learn from experience, and limited incentives to provide quality information to farmers.[131] Moreover, given the difficulty of

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[125] For example, less labor-intensive harvesting may result in lower-quality coffee.

[126] There are multifold reasons for this. Small producers lack knowledge about many issues, including the taste and quality requirements in export markets, swings in commodity prices, cultivation practices, and managerial skills necessary for increasing scale. In addition, they do not have sufficient capital to purchase high-quality raw materials or efficient technology. See DEAN KARLAN, MORE THAN GOOD INTENTIONS: IMPROVING THE WAYS THE WORLD'S POOR BORROW, SAVE, FARM, LEARN, AND STAY HEALTHY 168 (Penguin 2011); Nicholls & Opal, *supra* note 38, at 34-39. Ashish Karamchandani, et al., *supra* note 35, at 5.

[127] Easterly, *Can the West Save Africa*, *supra* note 80, at 416; Michael Morris et al., *Fertilizer Use in African Agriculture: Lessons Learned and Good Practice Guidelines* (The World Bank, 2007), *available at* http://documents.worldbank.org/curated/en/2007/01/7462470/fertilizer-use-african-agriculture-lessons-learned-good-practice-guidelines (last visited Jan. 4, 2014); Zoé Druilhe and Jesús Barreiro-Hurlé, *Fertilizer subsidies in sub-Saharan Africa* (ESA Working paper No. 12-04, United Nations, 2012), *available at* http://www.fao.org/economic/esa/publications/details/en/c/151041/ (last visited Jan. 4, 2014).

[128] Morris et al., *id.*, at 31-44.

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

[130] Easterly, *supra* note 127, at 419.

[131] See Jock R. Anderson & Gershon Feder, *Agricultural Extension: Good Intentions and Hard Realities*, 19(1) WORLD BANK RES. OBSERVER 41 (2004); Jock R. Anderson et al., *The Rise and Fall of Training and Visit Extension: An Asian Mini-drama with an African Epilogue* (World Bank Pol'y Res. Working Paper 3928, May 2006), *available at*

attributing outcomes, program staff tends to focus excessively on reporting input indicators (e.g., visits made) rather than material impact.[132] There is also evidence that the training is only useful to farmers with higher skills,[133] though it is presumably administered to all farmers in a given community.

***(3) Social Enterprises*:** By comparison to donative organizations, FTSEs have a clear advantage in adjusting their subsidies to the attributes of their producers. Cafédirect's business development programs, which include building capabilities in marketing, quality control, and crop management, are tailored to producers' specific needs.[134] FTSEs have incentives to subsidize fertilizers and high-quality input to the extent that small farmers cannot afford to purchase them as well as to teach farmers how to use them effectively. The effectiveness of their training and fertilizer subsidies is simply evidenced by their financial sustainability. The profitability of Cafédirect is itself an indication that the quality of the product is high, that the subsidies it allocates to its producers are sufficient to enable them to reach fully competitive abilities, and that such subsidies are not excessive; otherwise, the business may fail. FTSEs measure their beneficiaries' attributes in the following ways.

(i) Due diligence: FTSEs invest in studying the capabilities of producers. They send expeditions to developing countries to visit producers in order to sample the quality of their products. This diligence need not be fully carried out by the FTSE itself; often a donative organization, such as Technoserve, may take responsibility for liaising with the farmers and assisting with sampling and training.[135] In addition, where fair trade products are certified, some of the diligence on producers is facilitated through the certifier. The Fair Labelling Organization, for example, assists in creating networks between farmers and importers.

(ii) Intensive monitoring: FTSEs transact with small producers on the basis of imperfect information and gather information on their abilities and efforts in the course of the relationship. FTSEs almost invariably sell high-quality products, mainly to address concerns that the poor cannot produce quality products.[136] Therefore, they naturally need to ensure that the quality of the input they buy from the producers is high. Although the relationship between the importers and producers is generally expected to be long-term,[137] there is no commitment to transacting with producers who turn out to be unable to perform. FTSEs learn which producers are more capable than others, as the quality of the input affects the quality of the end product. If consumers buy the

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http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 917499); IEG, *World Bank Assistance to Agriculture in Sub-Saharan Africa*, (2007), *available at* http://web.worldbank.org/WBSITE/EXTERNAL/EXTOED/EXTASSAGRISUBSAHAFR/0,,menuPK:4422655~ pagePK:64829575~ piPK:64829612~ theSitePK:4422577,00.html (last visited Jan. 4, 2014), at 44, 54-56.

[132] Anderson et al., *id.*, at 6.

[133] *Id.*, at 5.

[134] *Id.*

[135] See Karnani, *supra* note 68. For examples of cooperation by Starbucks with various donative organizations, see James E. Austin & Cate Reavis, *Starbucks and Conservation International* (Harv. Bus. Sch. Case 9-303-055, 2002), at 12; Paul Argenti, *Collaborating with Activists: How Starbucks Works with NGOs*, 47 CAL. MGMT. REV. 91, 108-110 (2004).

[136] Nicholls & Opal, *supra* note 38, at 24.

[137] Section 4 of the Fairtrade Standard, *supra* note 43.

product, this is an indication of its high quality, and vice versa. If a producer supplies input of the required quality in timely fashion, the firm will continue to transact with that producer.

(iii) Incentive mechanisms: First, the Fair Trade standards require small producers to be members of cooperatives, an arrangement under which producer-members have equity ownership proportional to the quantity of product they sell through the cooperative.[138] The function of the cooperative, other than to enable producers to pool resources (e.g., share transportation costs), is to address information asymmetries. The formation of cooperatives leads to assortative matching among producers, like group lending in the case of MFIs. Producers with sufficiently high capabilities will partner with producers with similar capabilities in order to ensure that their cooperative will supply products of sufficient quality, so that FTSEs continue to transact with them. Once the cooperative starts transacting, producers have incentives to monitor each other to ensure that each of them supplies high-quality input in timely fashion.

Second, Fair Trade standards contain requirements which enhance producers' incentives to invest in the quality of their products by insuring producers against risks outside their control. FTSEs are expected to transact with small producers on a long-term basis, even if the opportunity costs of transacting with other producers are lower.[139] Although this requirement is not legally binding, importers that cut-off small producers without good reason are likely to face reputational costs. Moreover, importers must pay either the market price or floor price of a commodity, whichever is higher, and must pre-finance up to 60% of orders.[140] The reason for this is not only to transfer wealth to the producers; rather, the primary reason is that producers, who lack access to credit and insurance products, may have to cut costs at the expense of quality if they are subject to unexpected adverse shocks. Income-smoothing and price insurance assure producers that they will not face short-term capital constraints or severe loss as a result of circumstances outside their control, such as a sharp decline in commodity prices or a drought. Being given a price that reflects their efforts and the promise, albeit informal, of future transactions if they perform well, producers have stronger incentives to invest in quality.

C. Employment Opportunities: Work Integration Social Enterprises

***(1) Profit-maximizing firms*:** Low-income individuals and other disadvantaged groups, such as disabled persons or people with a criminal record, tend to suffer from systemic unemployment.[141] The reason for this appears to be the costs associated with evaluating their abilities. In any hiring decision, commercial firms face asymmetric information with respect to workers' abilities. In developed labor markets, workers typically use their educational and professional qualifications, job referrals and even their social background to

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[138] Nicholls & Opal, *supra* note 38, at 24; Section 4.2 of the Fairtrade Standard, *supra* note 43.
[139] Section 4 of the Fairtrade Standard, *id.*
[140] See *supra* note 44.
[141] TIMOTHY J. BARTIK, JOBS FOR THE POOR: CAN LABOR DEMAND POLICIES HELP? 55-58 (Russell Sage Foundation 2001).

signal their abilities to prospective employers. Such signaling mechanisms are particularly important in the case of low-skill jobs where employers care primarily about soft skills, such as discipline and attentiveness, which are difficult to observe prior to hiring. Poor workers in disadvantaged communities tend to lack access to education and have no employment track record.[142] Moreover, the presence of a large number of workers with low skills makes it even harder for firms to identify those who have sufficient abilities. In these circumstances, firms often assume that all workers who belong to a disadvantaged group are unlikely to be capable workers.

***(2) Donative Organizations*:** When workers lack sufficient capabilities, donative organizations may provide them with training. Government agencies in the U.S. and most European countries have operated training programs with the goal of integrating unemployed and economically disadvantaged workers into the workforce. As in the case of agricultural training discussed in the context of FTSEs, many studies show that the effectiveness of such training programs tends to be partial at best. The benefits to participants in terms of earnings and employment are modest and do not persist over time.[143] Interestingly, many studies suggest that the least able participants among the low-skilled populations benefit the least from them.[144] This indicates that many programs are wasteful in the sense that training is provided to those whose abilities may be too low. In addition, training programs have been criticized for failing to meet the needs of commercial businesses.[145] Thus, although there are cases where training is beneficial, the evidence as a whole suggests that positive effects may be spurious.

***(3) Social Enterprises*:** WISEs have a clear advantage in adjusting training programs to the skill level of their beneficiaries and the particular needs of the business. The Greyston bakery conducts multiple training sessions designed specifically to enhance the performance of its workers. The bakery's profitability is itself an indication that the subsidies are effective in helping its workers reach a competitive level, yet not wasteful as the business would then be financially unsustainable. Again, there are three ways in which WISEs gather information.

(i) Due diligence: Many WISEs, like any business, conduct diligence *ex ante* hiring decisions. WISEs may rely on referrals from training agencies, nonprofits or welfare departments,[146] and some conduct rigorous screening of

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[142] Bartik, *id.*, at 57; Giulia Galera, *Social Enterprises and the Integration of Disadvantaged Workers, in* Becchetti & Borzaga eds., *supra* note 11, at 106-107.

[143] See James Heckman et al., *The Economics and Econometrics of Active Labor Market Programs, in* HANDBOOK OF LABOR ECONOMICS, VOLUME 3B 1865 (Orley Ashenfelter & David Card eds., 1999), at 2050-2054; Bartik, *supra* note 141, at 88-110; IEG, *Using Training to Build Capacity for Development: An Evaluation of the World Bank's Project-Based and WBI Training* (World Bank 2008), at 36-38.

[144] Heckman, *id.*, at 2060-2064.

[145] See Bartik, *supra* note 141; John P. Martin & David Grubb, *What Works and for whom: A Review of OECD Countries' Experiences with Active Labour Market Policies* (OECD Working Paper 2001:14), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 348621; IEG, *supra* note 143, at 36-38.

[146] Note that the training program is essentially a subsidy provided to the WISE, which is expended on diligence on behalf of the WISE.

referrals through interviews and tests.[147] The Greyston bakery on the other hand does not conduct any diligence *ex ante* hiring; rather, it relies on intensive monitoring and incentive mechanisms *ex post* hiring.

(ii) Intensive monitoring: The Greyston bakery hires workers on a "no questions asked" basis (i.e., no *ex ante* diligence). At this stage it has limited information on its newly hired employees, who may have different levels of ability.[148] The management then monitors their performance and gathers information on their abilities, especially with respect to soft skills, i.e., attitude, punctuality and productivity. After one year's apprenticeship, during which they are evaluated on a biweekly basis, they may be hired as fulltime employees. In the course of their employment they receive ongoing professional development training, which includes performance evaluations. The firm has incentives to develop training programs that are effective in enhancing its employees' abilities, and the effectiveness of such training programs is continuously tested on the job. Over time, the firm gathers information on employees. Workers who perform well may be promoted to a better position, or move to working for higher salaries at commercial firms. On the other hand, workers who fail to meet certain minimum standards are laid off. The average turnover rate at Greyston is relatively high and entails high costs for the firm.

(iii) Incentive mechanisms: The Greyston bakery also employs incentive mechanisms embedded in the employment contract to reveal information on employee-beneficiaries' abilities and efforts. Those who perform adequately may be hired as fulltime employees after a year's apprenticeship, and may later be promoted to better positions, including managerial ones.[149] In addition, the bakery provides positive reinforcement to its employees, including a monthly award of distinction. Workers thus have incentives to reveal their true abilities. Workers have little incentive to understate their abilities because they may either lose their jobs or forgo opportunities to gain awards, a promotion, or a better salary. I emphasize again that using such incentive mechanisms entails higher costs than employing equivalent mechanisms in standard commercial bakeries. In order to implement such mechanisms, WISEs must continuously monitor their worker-beneficiaries. The Greyston bakery conducts biweekly evaluations of its employees.[150] By contrast, such intensive monitoring is not necessary in standard commercial firms, because workers tend to have higher abilities.

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

***(1) Profit-maximizing firms*:** Although multinationals are increasingly penetrating emerging markets, many rural markets remain underserved.[151]

[147] Bartik, *supra* note 141, at 219 (describing BMC Enterprises, a business operating grocery stores); interview with Jonathan Harrison of Rubicon National Social Innovations (February 4, 2010) (describing the hiring process at the Rubicon bakery, a for-profit bakery that employs workers with a criminal record, behavioral problems, addiction, or very little employment record).
[148] Barker et al., *Open Hiring Policy*, *supra* note 48.
[149] *Id.*
[150] *Id.*
[151] Prahalad, *supra* note 35.

Consequently, many essential products and services are often lacking in such markets. Examples include eye glasses, health services, water purifiers, bed-nets, etc. Many poor customers in developing markets actually have substantial purchasing power.[152] In mature developed markets, commercial firms may produce affordable products designed specifically for low to moderate income customers at a profit. The growth of low-cost retailers and food chains, such as Walmart and McDonalds, is a pertinent example. In rural markets, however, the problem seems to be the costs of gathering information on consumers' abilities and preferences. Rural communities typically include a large proportion of very low-income consumers.[153] Identifying those consumers who have sufficient abilities to buy existing or hypothetical products may be prohibitively costly. In addition, consumers' preferences are difficult to observe. Traditional distribution channels based on face-to-face interaction, lack of effective means of communication, and language and cultural differences make it costly for firms to observe consumers' spending patterns and tailor their products to consumers' abilities and preferences.[154]

***(2) Donative Organizations*:** Distribution of essential goods and services raises similar concerns to other subsidies, although the evidence is more equivocal. Empirical studies that compared the effect of distribution versus selling products have yielded different results. Many studies concentrate on bed-nets and water purifiers. On the one hand, there is significant evidence that bed-nets donated by NGOs were inappropriately used as fishing nets, not used at all, or even resold to others.[155] Moreover, another study relating to chlorine shows that consumers who pay higher prices are likely to use it in their drinking water more frequently.[156] On the other hand, many other studies suggest that demand for bed-nets and health products is very sensitive to price and usage rates decline sharply even when fees are very low.[157] The reason appears to be limited knowledge about the benefits of bed-nets and health products in preventing disease. These studies arguably support the view that bed-nets and other essential products should be distributed to the poor for free.

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[152] DARYL COLLINS ET AL., PORTFOLIOS OF THE POOR: HOW THE WORLD'S POOR LIVE ON $2 A DAY (Princeton University Press 2009).

[153] SANAL KUMAR VELAYUDHAN, RURAL MARKETING: TARGETING THE NON-URBAN CONSUMER 74-76 (Response 2005) (2007).

[154] See Karamchandani et al., *supra* note 35; Prahalad, *supra* note 35. Moreover, household income of the poor tends to be not only low, but also irregular and unpredictable (Collins, et al., *supra* note 152, at 16-17; Karamchandani et al., *id.*, at 36-39), for example, a willingness to spend on "aspirational goods", such as TVs, but little on products they "need", such as low-energy stoves (Karamchandani et al., *Is the Bottom of the Pyramid Really For You?*, HARV. BUS. REV., March 2011, at 3, 3-5).

[155] Noboru Minakawa, et al., *Unforeseen Misuses of Bed Nets in Fishing Villages along Lake Victoria*, 7 MALARIA J. 165 (2008); *Insecticide-Treated Mosquito Nets: A WHO Position Statement* (World Health Organization, 2007), *available at* http://www.who.int/malaria/publications/atoz/itnspospaperfinal/en/index.html (last visited Jan. 4, 2014).

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

[157] See Easterly, *Can the West Save Africa*, *supra* note 80, at 411.

Nonetheless, the partial evidence that distribution of goods is effective needs to be qualified.[158] First, to the extent that consumers are able to pay for goods or services, as accepted in virtually all studies, subsidies are inherently wasteful. As many poor individuals can afford to pay at least a portion of the market price of a product, clearly the efficient policy would be to use fewer subsidies per beneficiary and produce more bed-nets with the savings. Second, none of these studies compares donative organizations to social enterprises, such as low-cost sellers. The sale of products under these studies is done through a randomized process. Consequently, these studies cannot capture the incentives of social enterprises to create a market for their products, convince low-income consumers to pay for essential products, and educate consumers about the benefits of the products and how to use them. Donative organizations have little incentive to do so; it may not be surprising, therefore, that many of their beneficiaries are not prepared to share the costs of bed-nets and have limited knowledge regarding how to use them.

***(3) Social Enterprises*:** Low-cost sellers have incentives to gather information on consumers' ability to pay for their products, and to create a market for the product by highlighting their products' benefits. Consider A to Z. The investment of the Acumen Fund in A to Z together with the other subsidies has facilitated the creation of a firm that produces millions of bed-nets per year. Without subsidized investment and the free technology it received, the firm would have had difficulty getting on its feet. Although distribution of bed-nets remains essential for very low-income individuals, a social enterprise that differentiates among consumers in accordance with their ability to pay is clearly a preferable approach to channeling subsidies. For a given investment, many more bed-nets will be sold by a social enterprise than delivered by a donative organization that bears the full costs of each bed-net.[159] Tiered price schemes that differentiate among consumers are employed by other low-cost sellers, including both nonprofits such as VisionSpring, a low-cost manufacturer and seller of affordable reading glasses,[160] and The Aravid Eye Care, which provides low-cost eye-care services,[161] and for-profits such as Ziqitza Healthcare Limited ("ZHL"), a private ambulance service provider in areas

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[158] There are also some concerns with the design of these studies. For example, there is a concern that the subjects of these studies refuse to pay for products because they anticipate receiving them for free in the future. See also Dani Rodrik, *The New Development Economics: We Shall Experiment, but How Shall We Learn?*, *in* WHAT WORKS IN DEVELOPMENT? THINKING BIG AND THINKING SMALL 24 (William Easterly & Jessica Cohen eds., 2009).

[159] The Acumen Fund estimated that it would cost it less than $0.02 to protect one individual from malaria for one year by making an investment in A to Z, compared to $0.84 through a donative organization; See *The Best Available Charitable Option* (Acumen Fund, Jan. 2007), *available at* http://acumen.org/idea/the-best-available-charitable-option/ (last visited Jan. 4, 2014).

[160] See William Davidson Institute, *Scojo Foundation: A Vision for Growth at the Base of the Pyramid* (Michigan Ross School of Business note 1-428-610, Apr. 2008); Nico Clemminck & Sachin Kadakia, *What Works: Scojo India Foundation* (Columbia Business School, June 2007). VisionSpring, for example, offers fours lines of glasses at varying costs. Note that in practice, it may turn out (as it did in the case of VisionSpring) that most consumers actually prefer to buy the more expensive glasses; see William Davidson Institute, *Id.*

[161] The Aravind Eye Care provides free surgeries to its poorest customers; see Karamchandani et al., *supra* note 35, at 30, 62-63.

lacking high-quality emergency services.[162] The output of each of these firms (e.g., glasses sold or eye-surgeries performed) and their financial sustainability serve as an indication of the effectiveness of their subsidy allocation policies.

Low-cost sellers measure their beneficiaries' attributes mainly by using due diligence, given that their transactions with the consumer-beneficiaries are discrete rather than ongoing as in the case of loans or employment. Low-cost sellers invest more capital than a commercial enterprise would in research on the relevant market in order to learn about consumers' spending patterns and preferences as well as distribution channels in these markets. In addition, they invest in marketing and educating consumers on the benefits of certain products, such as bed-nets and eye-care products. A to Z with its nonprofit partners developed a marketing, retail and pricing system to publicize and create demand for bed-nets among the poor.[163] Moreover, low-cost sellers design business models tailored to the needs and preferences of low-income households, including not only tiered pricing discussed above, but also innovative cost-cutting methods and specialized distribution channels. A to Z reduced the costs of bed-nets from $7 to $5, and sells the bed-nets at a further discount to poor customers through its nonprofit partners. The Aravind Eye Care service is reducing the demand on doctors' time by training paraskilled paramedics to undertake standardized clinical tasks, so that doctors' time is spent on surgeries.[164] VisionSpring has created an innovative distribution system that relies on a web of local entrepreneurs with good reputations and connections in rural communities. Finally, after they start offering new products, low-cost sellers further continue to evaluate consumers' preferences, adjust pricing, and design new products.[165]

IV. COMMITMENT DEVICES AND CHOICE OF LEGAL FORM

In the foregoing part, I assumed that social enterprises have a commitment to transacting with disadvantaged individuals. As explained above, for-profit social enterprises may use one of three commitment devices: certification, contract, and control mechanisms,[166] while nonprofit social enterprises rely on the non-distribution constraint.[167] The purpose of this Part is to examine in greater detail the structure and function of different commitment devices and the circumstances in which social enterprises are likely to adopt each of them.

Social enterprises are invariably recipients of subsidies. In theory, it would be ideal if social enterprises could provide detailed information on the use of subsidies and their effects on beneficiaries' welfare. However, monitoring the

[162] ZHL charges patients who request to be taken to full-service hospitals a standard fee and offers a discounted rate to those taken to government hospitals; see Gita Johar & Joanna Harries, *Dial 1298 for Ambulance Marketing EMS in Mumbai* (Columbia Business School CaseWorks ID#100507, June 28 2010).
[163] This includes social marketing, recruiting retailers in rural communities and distributing free bed-nets to gauge interest in the product.
[164] Karamchandani et al., *supra* note 35, at 62-63.
[165] See, for example, William Davidson Institute, *supra* note 160 (describing how VisionSpring adjusts its strategy and pricing to market demand).
[166] See *supra* section I.A.2.
[167] See *supra* section I.A.3.

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

To be sure, commitment devices may go beyond verifying the transaction with beneficiaries. Where the subsidy-providers expect a social enterprise to transact with beneficiaries with below-competitive abilities who need some form of subsidy (e.g., a better price or training), the commitment devices also verify that such subsidies are indeed distributed to beneficiaries.[168] Otherwise, there is a risk that social enterprises will transact exclusively with patron-beneficiaries with fully competitive abilities (who do not need subsidies), and that part of the subsidies will be appropriated by those who control the organization.[169] A good example is the Fair Trade standards which require producers to provide a floor price and a social premium. Accordingly, depending on the business model and the attributes of patron-beneficiaries, commitment devices may need to verify also the type and amount of subsidies allocated to patron-beneficiaries.

Before embarking on the analysis, I note that the ability of social enterprises to form as both for-profits and nonprofits gives some credence to the claim that the distinction between the for-profit and nonprofit forms has been gradually eroding, and at least in the context of social enterprises both for-profits and nonprofits can be used to pursue "social missions".[170] Given the availability of the new commitment devices, the choice of form is largely a function of capital structure and tax treatment. When an organization needs equity capital it will form as a for-profit, whereas when it relies on donative funds and/or income tax exemption it will form as a nonprofit. Nonetheless, it is important to emphasize that all the commitment devices of for-profit social enterprises rely on organizations that are subject to the non-distribution

[168] In fact, the same commitment devices can be used to commit to any form of hybrid form of organization, for example, corporate charity; see *infra* Part V.

[169] To be sure, social enterprises may in principle commit only to transacting with those who have fully competitive abilities. In that case, a subsidy is still needed to fund the information costs. At any rate, I discuss this risk, which is often referred to as "mission-drift," in section VI.B.

[170] See *Enterprising Organizations, New Asset-based and Other Innovative Approaches to Solving Social and Economic Problems* (The Aspen Institute, 2005), at http://www.aspeninstitute.org/publications/enterprising-organizations-new-asset-based-other-innovative-approaches-solving-social-e (last visited Jan. 4, 2014); Joseph J. Cordes & C. Eugene Steuerle, *Nonprofits and Business: a New World of Innovation and Adaptation*, *in* NONPROFITS AND BUSINESS (J. Cordes & C. Steuerle eds., 2008); Nicholls ed., *supra* note 9; Jonathan Conning & Jonathan Morduch, *Microfinance and Social Investment*, 3 ANN. REV. FIN. ECON. 407, 413-414 (2011). Note that while commentators point out that the distinction between for-profits and nonprofits is gradually eroding, they fail to explain how for-profits can commit to pursuing a social mission.

constraint to monitor the for-profit entity. Accordingly, contrary to some recent claims that the non-distribution constraint has lost its force as a commitment device because for-profits are increasingly engaged in the pursuit of social goals,[171] it remains a key component of the commitment devices associated with for-profit social enterprises. The assumption is that organizations which are subject to a non-distribution constraint can be trusted to monitor for-profits.

In the discussion that follows, I will describe the use of the commitment devices in specific cases and explain what factors affect the choice of commitment device.

A. Certification Mechanisms

Certification mechanisms consist of a nonprofit or government that evaluates whether or not firms satisfy certain standards. Certification is a feasible commitment device only when it is possible to create uniform standards with respect to both the class of beneficiaries and the type of subsidies that should be allocated to them. Perhaps the best known example of a certification mechanism is Fair Trade certification described above in the context of Cafédirect. The certification has two main elements: the Fair Labeling Organization ("FLO") certifies the class of patron-beneficiaries as "small producers", and it ensures through audits and inspections that the producers are allocated subsidies in the form of the fair trade minimum price, a social premium, and pre-financing of up to 60% of the orders.[172] Certification is possible in the case of coffee and other agricultural products, such as bananas, because such products are traded on global commodity exchanges. Therefore, it is possible to identify commodity prices and prescribe other standards relating to financing and premiums. Small producers can also be identified relatively easily, albeit imperfectly, by simply referring to those farmers who rely on family labor. By contrast, in industries such as banking and investment, where industry structure and business practice vary from one firm to another, it is harder to create such a uniform standard.

A unique feature of fair trade certification is that the certification is per each unit of product. Most conspicuously, the Fair Trade label is attached to coffee products that comply with the fair trade standards. Product certification is possible because fair trade products can be segregated and traced to small producers. The certification signals to consumers that products are deserving of a subsidy. Certification per product rather than certification of firms enables firms to have both a social enterprise and a profit-maximizing enterprise operated by the same organization (e.g., Starbucks selling fair trade products). Standard commercial firms may therefore sell certified fair trade products at one point in time, but later abandon this line of business.

When the subsidies flow from other sources, such as the government, a common approach is to use certification of the firm as a whole. An example discussed above is certification by the CDFI Fund, which provides a variety of

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[171] See Malani & Posner, *supra* note 6; DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL 116-125 (Tuft University Press 2008); Clara Miller, *The Equity Capital Gap*, STAN. SOC. INNOVATION REV., Summer 2008, at 41.

[172] See *supra* note 44. An alternative fair trade certification mechanism named UTZ CERTIFIED does not include such pricing or financing requirements, and to that extent it seems to apply to FTSEs that transact only with small producers who have FC abilities.

below-market rate investment and guarantees to eligible CDFIs. The class of beneficiaries is defined by reference to aggregate wealth measures of the relevant market, defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national average, or where the unemployment rate is 1.5 times the national average.[173] Another example is incorporation under certain European hybrid legal forms (e.g., the Italian social cooperative), which require that at least a certain percentage of the workers of the incorporating firm belong to a class of disadvantaged individuals.[174] Disadvantaged workers are typically defined as possessing attributes which are relatively easy to verify, including disabled people, ex-offenders, welfare recipients or recipients of unemployment insurance.[175] Thus, incorporation as a hybrid essentially constitutes a certification of the firm as a WISE. Certification in this case may entitle the firm to some government subsidy which is usually proportional to the number of disadvantaged workers employed at a given time.[176]

B. Contractual Mechanisms

An alternative commitment device is a contract with a nonprofit organization stipulating that the subsidies will be used for their intended purpose.[177] Contractual mechanisms are typically used when the subsidy to the social enterprise is provided by a donative organization (as defined above), such as a nonprofit or a government agency. Contractual mechanisms allow greater flexibility than certification and individual tailoring in defining the class of beneficiaries and the type of disbursals allocated to them. Low-cost sellers may need flexibility in adjusting their prices and discounts to different customers who have different levels of wealth. As discussed above, as part of its partnership with various nonprofit organizations, including the World Health Organization and NGOs, A to Z is committed to marketing and selling the bed-nets at different discounts funded by the partnership or the Tanzanian government. With respect to CDFIs, as mentioned above, the CDFI Fund is required to enter into an Assistance Agreement with certified CDFIs that are awarded a subsidy.[178] The agreement must specify, *inter alia*, the CDFI's

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[173] 12 C.F.R. §1805.201 (2005).

[174] For a discussion of the Italian Type-B social cooperative under Italian law (Law 381/1991), see Carlos Borzaga & Monica Loss, *Work Integration Social Enterprises in Italy* (EMES Working Paper No. 02/02), *available at* http://www.emes.net/what-we-do/publications/working-papers/work-integration-social-enterprises-in-italy/; Cafaggi & Iamiceli, *supra* note 5, at 7-15. For a discussion of Finish WISEs formed under the Finish Act on Social Enterprises (1351/2003), see Cafaggi & Iamiceli, *id.*, at 22-24; Jacques Defourney & Marthe Nyssens eds., *Social Enterprise in Europe: Recent Trends and Developments* (EMES Working Paper No. 08/01), *available at* http://www.emes.net/what-we-do/publications/working-papers/social-enterprise-in-europe-recent-trends-and-developments/, at 17-19.

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

[176] See Borzaga & Loss, *supra* note 174, at 9; Defourny & Nyssens eds., *supra* note 9, at 18.

[177] See Allen Bromberger, *A New Type of Hybrid*, STAN. SOC. INNOVATION REV., Summer 2011, at 49.

[178] 12 C.F.R. §1805.802 (2005).

performance goals and the terms offered to low-income borrowers.[179] While certification is used to define the class of beneficiaries, greater flexibility is necessary to determine the terms provided to them. The details of each agreement with the CDFI Fund are tailored to the economic and social conditions in the area where the relevant CDFI operates.

C. Control Mechanisms

The most flexible commitment device is control by a nonprofit. The controlling nonprofit typically provides subsidies to the social enterprise, for example seed capital and subsidized investment. Control essentially allows the nonprofit owner to determine the class of beneficiaries and the type of disbursals (if any) without being constrained by some uniform standard or rule. In this way, the nonprofit controls how the subsidy it provides to the for-profit social enterprise is used. The Greyston bakery described above has adopted the simplest form of control mechanism, as it is owned by a sole owner, the Greyston Foundation.[180] The foundation is clearly in a position to make sure that the bakery does not compromise its mission by ceasing to employ workers from poor communities. Complete ownership of the social enterprise is not necessary. As shown above, 51% of the shares of Compartamos, whose shares are publicly listed, are owned by nonprofits, such as NGOs and foundations. This mechanism provides the nonprofit owners reasonable assurance that the firm will not change the firm's mission if lending to low-income persons entails opportunity costs.

An example of a social investment firm is the IGNIA Fund, which invests in businesses in developing countries, in various fields, such as healthcare services and organic farming. The fund, which seeks to generate returns which are equivalent to those of private equity firms, is structured as a limited partnership (i.e., a for-profit entity), but is owned by the International Finance Corporation, foundations and social entrepreneurs.[181] Many low-cost sellers also use control mechanisms. Ziqitza Healthcare Limited ("ZHL") is a low-cost private ambulance service provider, operating 100 ambulances in India in areas lacking high-quality emergency services.[182] ZHL is owned by the Acumen Fund, a nonprofit social investment firm, and social entrepreneurs.

Another way to implement a control mechanism is to place the voting rights in the hands of a nonprofit. There are several firms where the equity interest is held by public investors, but voting power at least on fundamental issues is held by a nonprofit. For example, the shares of the social investment

[179] 12 C.F.R. §1805.804 (2005).
[180] As the Greyston bakery is wholly owned by a nonprofit, it may be argued that it should simply form as a nonprofit. However, as pointed out in section I.A.1, the bakery pays below-market wages to its workers, and therefore it is arguably not operating exclusively for an exempt purpose under I.R.C. § 501(c)(3). Second, the Greyston Foundation may possibly be contemplating the sale of a stake in the bakery to private investors. In fact, seemingly for this reason, the Greyston bakery recently reincorporated as a New York Benefit Corporation; see *infra* section V.D.
[181] Interview with Alonso Bustamante Guerra of the IGNIA Fund, October 19, 2009; see also http://www.ignia.com.mx/bop/investors.php (last visited Jan. 4, 2014).
[182] See William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, *supra* note 110, at 2.

firm, Triodos Bank, are held by a foundation which makes voting decisions on behalf of the holders of depository receipts.[183] Likewise, social enterprises may use a guardian share mechanism. As described above, the guardian share of Cafédirect is held by a subsidiary of Oxfam International and Cafédirect Producers Ltd., a cooperative of producers that transact with the firm. The guardian share has the right to block any proposal, including a takeover that might compromise the firm's social mission.[184]

As compared to other commitment devices, control mechanisms allow social enterprises much greater flexibility in deciding which beneficiaries merit assistance and what kind of subsidies should be given to them. Certification mechanisms, contrarily, determine a specific standard to be followed by all firms subject to the certification, while contractual mechanisms allow tailoring of some standards. This appears to be the reason why MFIs and social investment firms use control mechanisms. Creating a uniform standard for developing countries in the fields of banking, investment, retail and services is largely impossible, and thus there is greater need for flexibility. For example, Compartamos lends mainly to the moderately poor and the vulnerable non-poor.[185] Other for-profit MFIs that have adopted control mechanisms, such as Basix, transact with customers who need greater assistance. Basix provides its borrowers with below-market rate loans and a wider range of services, including insurance and comprehensive technical assistance.[186] Similarly, whereas the IGNIA Fund seeks to generate near-competitive returns, Triodos Bank earns moderate returns on equity.[187]

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

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

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[183] For a detailed description, see section I.A.1.

[184] See section I.A.1.

[185] Compartamos Offering Circular, *supra* note 20, at 77.

[186] Thomas Dichter, *Basix (India): The Challenges of Permanently Pioneering* (Dev. Fin. F. Case Series, Jan. 20, 2009) (on file with author).

[187] Triodos Bank Annual Report 2010, *supra* note 32.

In addition, control mechanisms usually serve as a commitment by the firm to the owners who provide the subsidy to the firm. Certification and contractual mechanisms provide assurance mainly to external subsidy-providers, such as customers or government agencies that have no direct control over the firm. The subsidy to MFIs and social investment firms is usually provided by their nonprofit owners in the form of seed capital and below-market returns. The nonprofit owners of Compartamos or Basix can ensure that their firm will not change its business and cease to serve low-income customers. In the case of FTSEs, certification per product is insufficient to assure nonprofit owners that their ongoing subsidies (e.g., seed capital) will be committed to the long-term mission of the firm. The main role of certification is to provide commitment to consumers that pay premium prices. Firms that use product certification, such as Starbucks, may abandon their fair trade business without expropriating any subsidies, because the subsidies, i.e., the premiums over market prices, are per product. But owners may want to ensure that the firm will remain committed to transacting with disadvantaged individuals, at least for as long as they continue to own it. This is another reason why Cafédirect uses a control mechanism in addition to certification.

D. The Non-Distribution Constraint

Many social enterprises continue to form as commercial nonprofits.[188] The main rationale for choosing the nonprofit form is its tax advantages in sourcing donations and income tax exemptions. When social enterprises are likely to have low profitability they are more likely to be reliant on donations and income tax exemptions. The lower the abilities of beneficiaries, the more difficult it is for social enterprises to identify those beneficiaries who have fully competitive abilities, and thus the costs of measurement are likely to be higher. Moreover, when beneficiaries' abilities are lower, their performance negatively affects the firm's profitability, and the amounts of subsidies needed to help them enhance their abilities are naturally higher. Consequently, social enterprises that transact with a greater proportion of beneficiaries with lower abilities are likely to form as nonprofits, while those that transact principally with beneficiaries with higher abilities will form as for-profits.

Several examples illustrate this point: at the Greyston bakery, most employees are required to display a competitive level of productivity and the bakery does not receive donations on a regular basis.[189] On the other hand, Gulf Coastal Enterprise ("GCE"), a firm that provides custodial and food services, is a nonprofit. GCE employs workers with substantial developmental or physical disabilities and different types of behavioral disorders.[190] GCE presumably needs to source more subsidies in the form of donations or tax exemptions, and it is less likely to attract equity capital. Similarly, as mentioned above, Compartamos makes loans primarily to moderately poor borrowers and charges

[188] See *supra* section I.A.3.

[189] Note also that given the commercial nature of its business, it is not clear whether the Greyston bakery would qualify as operating exclusively for an exempt purpose; see discussion *supra* note 180.

[190] Boschee, *supra* note 47, at 90-96.

high interest rates. By contrast, nonprofit MFIs, such as ASA and BRAC, provide very small loans to poorer borrowers, mainly women, charge relatively low interest rates, and provide a range of services to their borrowers, including schooling, training and help with business and marketing plans.[191] Lastly, while the Acumen Fund, a nonprofit, targets investments such as bed-nets or ambulance services, which are unlikely to generate substantial returns, and partly relies on donative funding, the IGNIA Fund, a for-profit limited partnership, seeks to make commercial returns on its investments and does not raise donations.

V. OTHER FORMS OF HYBRID ORGANIZATION

Most accounts of hybrid organizations do not distinguish between social enterprise and all other types of hybrid organization. Treating social enterprises like all other hybrid organizations stems from a failure to identify the distinctive structural and functional elements of social enterprise that make it relatively efficient. Most forms of hybrid organization, especially corporations that engage in corporate social responsibility and corporate charity, do not perform the measurement role of social enterprise and tend to be less effective in utilizing subsidies. From a policy perspective, equating social enterprises to all other forms of hybrid organization may yield policy recommendations that encourage inefficient allocation of resources. In particular, legal policies that advocate subsidizing organizations with a mixed mission are likely to be misguided. One recent example is Posner & Malani's proposal to extend tax benefits to for-profits for their charitable or socially responsible activities.[192] Identifying the distinctive structural and functional elements of social enterprise – especially its measurement role – is essential for designing legal policy. In the following sections I distinguish different forms of hybrid organization from social enterprises.

A. Corporate Social Responsibility and Corporate Charity

In its most standard form, corporate social responsibility ("CSR") policies and corporate charity involve the allocation of a subsidy from a for-profit firm to external beneficiaries, whether it's a monetary donation to a donative organization (e.g., Oxfam) or a training subsidy to the poor.[193] At any rate, in either of these cases, the firm has no commitment to transacting with beneficiaries as patrons. As a result, the effectiveness of CSR and corporate charity are subject to the same problems as subsidies allocated by donative organizations. As in the case of donative organizations, in the absence of information on external beneficiaries, subsidies are unlikely to be effective. Moreover, most for-profit corporations that engage in CSR or corporate charity do not usually adopt a commitment device. Accordingly, there is a clear risk that for-profit corporations will exaggerate the magnitude and effectiveness of

[191] Armendáriz & Morduch, *supra* note 14, at 22.
[192] Posner & Malani, *supra* note 6.
[193] See *supra* section I.C.

their CSR policies in order to enhance their reputation among consumers.[194] Drawing goodwill and additional revenues from consumers by exaggerating the effect and extent of CSR policies may be viewed as an expropriation of subsidies from consumers.

Some corporations do actually adopt commitment devices that implement CSR policies or corporate charity. In these cases, while there is a lesser risk that the subsidy will be expropriated, the subsidy is ultimately allocated to an external beneficiary. RedF is an example of a certification mechanism. RedF is an LLC that licenses the Red trademark to commercial firms, including, Apple, Starbucks and Gap.[195] These firms attach the Red label to certain products. When customers buy Red products the firm is committed under its contract with RedF to making a certain donation, for example to the Global Fund, a donative organization dedicated to fighting AIDS.[196] Thus the firm adjusts the amount of its donations in accordance with the volume of purchases of Red products by customers. While this may be a novel mechanism for firms to market their charitable activities, receive feedback from their customers concerning their desired volume, and perhaps also reduce the transaction costs of raising donations, it is essentially a form of corporate charity rather than a social enterprise.

An example of a control mechanism used as a commitment to charity is Better World Books, a firm that sells used books and is committed to supporting literacy groups.[197] Many of the books sold by the firm are donated to it to support its social mission. Literacy nonprofits have options in Better World Books that are vested on two metrics, performance measures of their social mission and how many donated books they bring in. The vested options ensure that upon sale of the firm, the nonprofits will receive a proportion of the sale amount. Performance, which is related to students' progress, is relatively easy to measure, and the disbursals to the literacy nonprofits appear to be effective. Again, the basic structure of Better World Books, albeit highly innovative, is identical to corporate charity, i.e., a for-profit making a donation to a nonprofit. In this case, though, there seems to be measurable information on the effectiveness of subsidies.

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

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[194] See references *supra* note 7.

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

[196] The exact amount of the donations is not actually transparent, and to this extent there is in fact a risk of expropriation; see Dadush, *id.*

[197] Kevin Jones, *Mission Insurance: How to Structure a Social Enterprise So Its Social and Environmental Goals Survive Into the Future*, 5(2) COMMUNITY DEV. INVESTMENT REV. 1 (2009).

conditions as compared to equivalent standards in developed countries,[198] even though in economic terms, wages and working conditions are both efficient and higher than those offered by local firms.

These policies are different from WISEs with regard to the type of problems they are designed to address, especially the inability of capable workers from disadvantaged backgrounds to obtain employment. In this case, the workers are already employed and receive an efficient wage. Accordingly, it does not make sense in this context to view Nike or Levi's as having a commitment to transacting with their workers, as it is already profit-maximizing to transact with them even without a subsidy. There are therefore no "true patron-beneficiaries" in the sense described above, i.e., disadvantaged individuals that suffer from systemic unemployment. In this case, transacting with workers does not address the type of information gathering or measurement performed by social enterprises. Premium wages and better working conditions are simply a disbursal of a subsidy to the existing patrons of the firm.

To be sure, this type of subsidy may be desirable where governments fail to regulate workers' rights and minimum working conditions, especially in developing countries. However, such CSR policies are typically implemented only as a response to blatant governmental failures and where profit-maximizing firms face high reputational costs. Additionally, firms that make these subsidies do not usually adopt a commitment device. Therefore, without appropriate government regulation or at least NGO supervision, working conditions at profit-maximizing firms are likely to suffer.[199]

B. Socially Responsible Investing

In recent decades, institutional investors, such as pension funds and mutual funds, have become increasingly engaged in socially responsible investing ("SRI"). As of 2012, $3.31 trillion in total assets under professional management in the United States used at least one SRI strategy.[200] SRI, also known as sustainable, socially ethical investing, refers to investment strategies that consider both financial return and some social good, especially environmental social governance ("ESG") issues. ESG issues range from environmental efficiency, through human rights and diversity, to corporate governance. The most common manifestations of SRI are negative screening of companies that engage in alcohol, tobacco, gambling, etc., and shareholder advocacy on ESG issues. Under SRI some forms of social enterprise are also commonly included, usually referred to in this context as "community investing", such as CDFIs and social investment firms. Though community

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[198] See Heal, *Supra* note 72, at 389, 392-393.

[199] To be sure, WISEs like any other firm may engage in CSR and corporate charity by providing premium wages essentially to transfer wealth to their beneficiaries; the key point, however, is that this is not a role that WISEs necessarily have to perform to qualify as social enterprises.

[200] The Forum for Sustainable and Responsible Investment, *Report on Sustainable and Responsible Investing Trends in the United States* (2012), *available at* http://www.ussif.org/store_product.asp?prodid= 5 (last visited Jan. 4, 2014).

investing is growing at a rapid rate as an asset class, its assets are only a marginal fraction of SRI.

At any rate, to view SRI and some forms of social enterprise as synonymous is misguided. First, it is not clear whether SRI (other than community investing) is a subsidized form of organization. In fact, some studies find that SRI funds perform just as well as other funds;[201] hence it is questionable whether there is any subsidy flowing from the investors. Additionally, the recent trend to treat corporate governance as an ESG issue appears to be motivated by a desire to enhance shareholder value rather than transfer subsidies to third parties. Therefore, SRI funds are not necessarily a type of hybrid organization. Second, even if SRI in its most common form qualifies as a subsidized commercial enterprise (i.e., a hybrid organization), it is fundamentally distinct from social enterprise and akin to corporate social responsibility. Again, the critical difference is that SRI funds do not transact with their beneficiaries. As a result, measuring the social impact of SRI as compared to a standard form of investing is inherently imprecise. In particular, quantifying the positive externalities of various environmental and social policies is subject to uncertainty. Finally, it is noteworthy that commitment devices may be weak in some SRI funds. While some funds define screens in their prospectuses and can change them only with a shareholder vote, other funds can alter investing policy without consulting the shareholders.[202] Hence, there is some risk that capital raised under one set of ESG issues will be applied to advance a weaker or stronger set of issues.

C. Social Ratings

Partly to address the measurement problem inherent in social missions, new social rating mechanisms for evaluating the social impact of for-profit firms are being developed by different groups and organizations. There is, however, a great deal of uncertainty regarding which factors should be included in such standards. The large number of such standards and certifiers reflects the lack of consensus as to what generates social impact.[203] The Global Reporting Initiative ("GRI") is a nonprofit that certifies companies' sustainability reports in accordance with certain standards. The Global Impact Rating System ("GIIRS") is a nonprofit that rates companies' social and environmental impact using a different set of standards, the Impact Reporting and Investment Standards ("IRIS"). The Social Return on Investment ("SROI") Network trains practitioners to measure and quantify in monetary terms the social and environmental impact of companies in accordance with the SROI principles. B-

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

[202] Geczy, et al., *id.*, at 12.

[203] One recent report lists more than 100 raters; See *Rate the Raters, Phase Two: Taking Inventory of the Ratings Universe* (Sustainability, Oct 5 2010), *available at* http://www.sustainability.com/library/rate-the-raters-phase-two#.UiP_Tz8R4w8 (last visited Jan. 4, 2014).

Lab is a nonprofit that certifies companies as "B-Corps" and rates them in accordance with certain criteria relating to governance, workers, community and the environment.

To a certain extent, the criteria embedded in these standards correspond to the elements that characterize social enterprises, such as the percentage of disadvantaged employees, or whether the firm provides services to poor customers. For example, B-Lab's rating does reward companies for employing disadvantaged workers. However, these standards go far beyond these elements to include a host of standards whose social and economic value is debatable, and it is largely impossible to know if they are desirable or not.[204] First, these metrics include many activities whose benefits flow to external beneficiaries, such as corporate charity or environmentally-friendly policies. But, as I argue throughout this article, the benefits to external beneficiaries are hard to measure and subject to uncertainty. Moreover, most social rating mechanisms lack transparency, so it is difficult to evaluate their efficacy in measuring social impact. Second, the utility of many of the policies advocated by these standards, such as employee ownership or involving stakeholders in decision-making, is either questionable or context-dependent. Third, certain policies, such as strong corporate governance provisions, are potentially profit-maximizing, and it is not clear why they should be mixed up with standards that measure social impact. Finally, some of these standards and their implementation tend to be opaque and depend on subjective assessment of impacts.[205] There is a concern that subsidies provided by trusting consumers may be expropriated by managers of firms that obtain a social rating that exceeds their true contribution to altruistic causes.

D. Legal Hybrid Forms

New legal hybrid forms have been introduced in recent years in many U.S. states and different countries to facilitate the formation of firms that combine for-profit and social missions. These forms, however, appear to have had only a modest impact on the evolution of hybrid organizations and, with some exceptions, most social enterprises continue to use the traditional forms. Moreover, despite lobbying attempts to allow some form of tax subsidy for businesses that incorporate as a legal hybrid entity, no such subsidy has been introduced,[206] mainly because these forms fail to credibly identify a particular

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[204] Recently, the Greyston bakery has obtained a B-Corp certification. Interestingly, Greyston ranks high on measures of "community" but below the median on measures of "workers" which evaluate how the firm treats its workers through compensations, employment opportunities, health and safety, corporate culture, etc.

[205] See Alnoor Ebrahim & Kasturi V. Rangan, *The Limits of Nonprofit Impact: A Contingency Framework for Measuring Social Performance* (HBS Working Paper Number: 10-099, 2010), *available at* http://hbswk.hbs.edu/item/6439.html, at 9-13; Melinda T. Tuan, *Measuring and/or Estimating Social Value Creation* (Bill & Melinda Gates Foundation, 2008); Bugg-Levine & Emerson, *supra* note 3, at 163-186; Ross Kerber, *Analysis: Sustainability Indexes Lack Own Transparency*, REUTERS, Sep. 16, 2010, *available at* http://www.reuters.com/article/2010/09/16/us-indexes-transparency-analysis-idUSTRE68F56420100916**.**

[206] Most of these efforts have concentrated on allowing foundations to make a form of subsidized investment called "program related investment" in L3Cs; see Callison & Vestal, *supra* note 8.

organizational structure that performs a valuable function. As a result, they are unlikely to provide subsidy-providers – the government, owners or customers – sufficient assurance that their subsidies will be used effectively.

As stated above, two prominent examples are the Low-Profit Limited Liability Company ("L3C") and the Benefit Corporation. The L3C is a Limited Liability Company ("LLC") that significantly furthers the accomplishment of one or more charitable or educational purposes, and no significant purpose of the company is the production of income or the appreciation of property.[207] Realizing profit and enhancing value can be purposes of the enterprise as long as they are not significant purposes. This definition reflects the notion of mixed mission that underlies the definition of hybrid organizations. Merely stating that a firm has a mixed mission, however, is unlikely to give subsidy-providers reasonable assurance that their subsidy is being used effectively, given the difficulty of measuring social impact. Moreover, it is hard to see what the L3C adds over and above the standard LLC form, as members of an LLC can simply add to the LLC agreement a provision that contractually commits all of them to a particular social purpose.

Benefit Corporations are defined as corporations whose purpose is to create a "general public benefit". General public benefit in most states' statutes means "a material positive impact on society and the environment… through activities that promote some combination of specific public benefits."[208] Specific benefits include some activities associated with social enterprises as defined herewith, for example, providing beneficial services and products to low-income communities. However, they go further to include largely any social purpose, including for example "…the accomplishment of any other identifiable benefit for society or the environment."[209] Accordingly, just like the L3C, the Benefit Corporation is based on the concept of mixed mission. Partly to address the uncertainty inherent in this concept, the Benefit Corporation statute of most states requires that impact on society and the environment be measured by a third-party standard,[210] i.e., a social rating certifier.[211] As discussed above, however, social ratings themselves are subject to many imperfections, and may provide poor information to customers or other subsidy-providers on the social value of hybrid organizations.

To be sure, the Benefit Corporation form does include helpful provisions for firms that want to commit to some social purpose. In particular, termination of a Benefit Corporation status must be approved by a qualified majority – typically two-thirds – of the shareholders.[212] This provision effectively gives one

[207] See 11 V.S.A. § 3001(27) for the Vermont L3C Act.
[208] 11A V.S.A. §21.03(4).
[209] 11A V.S.A. §21.03(6). Under the Delaware Code, "Public benefit" means "a positive effect (or reduction of negative effects) on one or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders) including, but not limited to, effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature"; Del. Code Ann. tit. 8, §362(b).
[210] 11A V.S.A. §21.03. Third-party standard is defined as "a recognized standard for defining, reporting, and assessing corporate social and environmental performance". Note that under Delaware law certification by a third-party standard is only optional; see Del. Code Ann. tit. 8, §366(b).
[211] The certifier is often B-Lab, although other certifiers may be used.
[212] 11A V.S.A. §21.07.

third of the shareholders control over the mission. In fact, the Greyston bakery recently converted into a New York Benefit Corporation, probably in anticipation of the Greyston Foundation's selling a stake to for-profit investors.[213] While this provision is helpful in creating a form of control mechanism, the same commitment device can be created with existing legal forms, for example, by adding a charter provision that gives a nonprofit control over the firm's mission.[214]

E. Environmentally-Friendly Firms

Many for-profit firms are gradually adopting environmentally-friendly policies, such as recycling, use of renewable energy, and cutting their carbon emissions. These firms may be viewed as hybrid organizations mainly because their consumers pay subsidies in the form of price premiums, which the firm uses to produce public goods.[215] There are two main types of environmentally-friendly firms. The first type includes firms such as Walmart, Nike, and IBM that have adopted environmentally-friendly policies as part of their corporate social responsibility agenda to boost reputation and goodwill.[216] As with general corporate social responsibility policies, many of these firms have not adopted a commitment device, and therefore there is a risk that they will draw goodwill and subsidies from consumers while overstating the extent of their contribution to the environment, a practice known as green-washing.[217]

The second involves firms that have adopted a commitment device. An example is Patagonia, a firm which produces high-quality outdoor clothing while pursuing a range of environmental policies, in particular the use of materials that are less harmful to the environment, for example organic cotton, and production processes that are more environmentally-friendly, including reduction of its carbon emissions and the use of recycled materials.[218] Patagonia's consumers appear to pay a premium for the environmental quality

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[213] New York law actually requires a three-fourths majority for terminating the Benefit Corporation status; see 17 N.Y. §1702(D).

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

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

[216] See DANIEL ESTY & ANDREW S. WINSTON, GREEN TO GOLD: HOW SMART COMPANIES USE ENVIRONMENTAL STRATEGY TO INNOVATE, CREATE VALUE, AND BUILD COMPETITIVE ADVANTAGE (Yale University Press 2009) (2006).

[217] In fact, even British Petroleum, an oil company that was involved in a series of environmental initiatives had a troubling record of violating safety regulations, culminating in the recent oil spill in the Gulf of Mexico in 2010; see Miriam A. Cherry & Judd NC. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing after the BP Oil Disaster*, 85 TUL. L. REV. 983.

[218] See Reinhardt et al., *Patagonia*, Harvard Business School Case 9-703-035 (2004) (henceforth "*Patagonia 1*"); Reinhardt et al, *Patagonia*, Harvard Business School Case 9-711-020 (2010) (henceforth "*Patagonia 2*"). Patagonia also donates 1% of its profits to environmental organizations, and requires its employees to work pro bono on environmental projects.

of its products,[219] and its sole owner seems willing to accept lower rates of return than he would if the company used materials and processes that were less environmentally-friendly.[220]

Patagonia has adopted several commitment devices, in particular a control mechanism and, more recently, various certifications. The firm is owned by a social entrepreneur who has a reputation for his commitment to the environment, and the firm has established trust with its customers over a long period of time. Moreover, the firm has recently reincorporated as a California Benefit Corporation in order to benefit from the provision that requires at least a two-thirds majority vote to change the firm's mission.[221] This provision potentially allows the firm to sell an equity stake to other investors while maintaining control of its mission as long as one third of the votes remain in the hands of a nonprofit or a social entrepreneur. However, because Patagonia seeks to attract subsidies from consumers, it also takes advantage of several certifications that measure its environmental performance.[222] Some of its products are certified by the bluesign®system, a certification awarded to textile products whose production complies with stringent environmental criteria relating *inter alia* to energy use, water consumption and use of hazardous chemicals. Moreover, as part of its reincorporation as a Benefit Corporation, the firm has obtained certification as a B-Corp.[223] Among other criteria, B-corp ratings include a separate score for environmental performance with respect to issues such as energy use, carbon emissions, hazardous substances, etc.

Although Patagonia's commitment to environmental causes is laudable, it is important to recognize that the true benefits of its policies are difficult to measure. Despite a growing consensus worldwide on the benefits of protecting the environment, such benefits are not easily observable and are often related to long-term effects that are difficult to quantify. A possible explanation for this is that the beneficiaries of environmentally-friendly firms are external. The benefits of environmentally-friendly policy are public goods; such benefits are non-rival and non-excludable, so that in principle anyone can consume them. Environmentally-friendly firms thus cannot transact with their beneficiaries who consume those public goods – anyone can enjoy the cleaner air and water that result from the firms' policies. Accordingly, as in the case of donative organizations, social enterprises have limited tools and incentives to measure the true benefits of their environmental policies. For example, while organic cotton

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[219] See Reinhardt et al., *Patagonia 1*, *id.*, at 10 (Patagonia's products sell for 15% to 50% or more above other similar brands, although this premium may be due to the higher quality of its products); Reinhardt et al., *Patagonia 2*, *id.*, at 4,27 (following the shift to use of organic cotton, Patagonia's margins decreased).

[220] Reinhardt et al., *Patagonia 1*, *id.*, at 16 (some environmental policies increased costs, though some saved money); Reinhardt et al., *Patagonia 2*, *id.*, at 4 (the costs of production increased following the shift to use of organic cotton), 8-9 (describing the additional expected costs from Patagonia's repair and recycle initiative).

[221] CAL. CORP. CODE. §14604; see the discussion of Benefit Corporations in section V.D.

[222] As discussed in section IV.C., control mechanisms usually serve as a commitment by the firm to the owners who provide the subsidy to the firm.

[223] As explained in section V.D., most Benefit Corporation statutes require that impact on society and the environment be measured by a third-party standard.

has advantages in terms of pesticide use, toxic chemical use, and energy and water use, such benefits may be difficult to quantify.

To be sure, environmentally-friendly firms, especially those such as Patagonia with a strong commitment device, perform an important function, albeit a different one than social enterprises that transact with their beneficiaries. Given their commitment to adopting environmentally-friendly processes, these firms have a profit incentive to reduce the costs of producing public goods. As commercial enterprises, they have incentives to constantly test their business model to ensure they are profitable. The subsidies in these firms are used to fund the costs of creating a business model that generates public goods, but otherwise, they have incentives to cut their costs just like profit-maximizing firms. In some cases, such business models may fail. For example, there have been several unsuccessful attempts to make shoes from recyclable materials.[224] On the other hand, Patagonia has successfully developed efficient processes for making clothes from organic cotton, where such production is more costly than producing conventional cotton.[225] Reducing the production costs of environmentally-friendly products may be particularly important for the sake of leading other firms to adopt similar policies or making a case for environmental regulation, especially when the benefits are difficult to quantify.

F. Using Hybrid Organizations to Increase Donative Capital

While social enterprises may involve collaborations between nonprofits and for-profits, not all such collaborations necessarily create a social enterprise. Sometimes a donative organization will simply set up a for-profit in order to make investments that increase the size of its assets. It then invests donative capital in the for-profit entity, and the returns on that investment are distributed to external beneficiaries of the donative organization. One notable example that has existed for many years in the U.S. is museum shops that sell books and artwork to museum visitors. The shop is typically a for-profit entity owned by the nonprofit museum. Because the shop receives subsidized capital, it qualifies as a hybrid organization. However, it is not a social enterprise because it has no commitment to transacting with disadvantaged individuals. Another more recent example is Housing Works, an organization dedicated to combating AIDS and homelessness in New York City.[226] It is composed of several businesses, including a coffee shop, a secondhand bookstore, and a secondhand clothing store. The capital of the shops is partly sourced from donations, and the profits made by the shops are distributed to the owner, i.e., the donative organization. The profits are then used to allocate subsidies to external beneficiaries, especially through housing assistance. Although Housing Works is often

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[224] See, for example, Paul W. Hardy, *DEJA SHOE (A): Creating The Environmental Footwear Company* (University of Michigan CEPM Case Study, 1996); Paul W. Hardy, *DEJA SHOE (B): Product Launch* (University of Michigan CEPM Case Study, 1996).

[225] Reinhardt, et al., *Patagonia 1*, *supra* note 218, at 26 (detailing Patagonia's evaluations of the costs of using organic cotton fabric as compared to the costs of conventional cotton), 27 (quality problems included poor colorfastness, shrinkage, and pilling).

[226] See the website of Housing Works at http://www.housingworks.org/ (last visited Jan. 4, 2014).

referred to as a social enterprise, its economic function is fundamentally distinct from social enterprises that transact with patron-beneficiaries.[227]

VI. DISADVANTAGES OF SOCIAL ENTERPRISE

Social enterprise like any form of organizing capital has disadvantages.

A. Risk-Bearing

Social enterprises must generate profits to be sustainable. Therefore, their ability to take on very risky projects with uncertain expected returns is limited. As discussed above, social enterprises are generally not designed to transact with patron-beneficiaries with very low abilities, who are incapable of performing at a level that will allow the enterprise to rely on their performance. Donative organizations remain the appropriate form of organization for dealing with those beneficiaries whose abilities to transact with social enterprises are too low. Social enterprises are also not well positioned to carry out risky tasks that could generate public goods, but might jeopardize their sustainability, for example, research and development projects with extremely unpredictable or uncertain results. Donative organizations are best suited to address such tasks.

B. Mission-Drift

A common criticism of for-profit social enterprises is that they have incentives to seek profits at the expense of their social mission. This criticism may broadly be divided into two claims. First, social enterprises have an incentive to transact only with patron-beneficiaries with fully competitive abilities and avoid those who have below-competitive abilities. However, this is only a problem where the subsidies provided to the social enterprise are intended also to be used as disbursals to patron-beneficiaries with below-competitive abilities. Such subsidies may be distributed to the owners as profits or simply wasted. In this situation, the commitment device should identify the beneficiaries as including those with below-competitive abilities and specify the disbursals afforded to them. In practice, though, there do not seem to be many known cases of such problems.[228] Organizations that focus on patron-beneficiaries with higher

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[227] For analysis and criticism of another notable example involving the Hershey Company, which is partly owned and controlled by a charitable trust, see Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749 (2008).

[228] One situation when this may be possible is where the definition of patron-beneficiary is inadequate. Arguably, under the Fair Trade standards, small producers may not always be disadvantaged, for example, where small producers' cooperatives have sufficient capital and resources. In that case, the disbursals to such farmers in the form of social premiums and a floor price may be excessive; see Marc Sidwell, *Unfair Trade* (Adam Smith Institute 2008), *available at* http://www.adamsmith.org/research/reports/unfair-trade (last visited Jan. 4, 2014). Concerns that social enterprises transact with patron-beneficiaries with higher abilities have been raised also in the context of WISEs; see Carlos Borzaga & Monica Loss, *Profiles and Trajectories of Participants in European Work Integration Social Enterprises, in* SOCIAL ENTERPRISE AT THE CROSSROADS OF MARKET, PUBLIC POLICIES AND CIVIL SOCIETY 169 (Marthe Nyseens ed., 2006).

abilities are usually committed to serving only such patrons. For example, Compartamos, which is often criticized for neglecting the destitute, is admittedly committed only to serving the vulnerable non-poor and the moderately poor.[229] There presumably is scope both for organizations that serve only patrons with fully competitive abilities and for those that also serve patron-beneficiaries with lower abilities. Thus, nonprofit MFIs tend to focus more on small loans to poorer borrowers and women, while for-profit MFIs tend to make larger loans to less-poor borrowers.[230]

Second, the profit motive may induce for-profit social enterprises to abuse their patron-beneficiaries by offering them unfavorable terms. This concern applies primarily to social enterprises that are not committed to providing disbursals to their patron-beneficiaries. The most conspicuous example is the recent criticism of predatory lending practices employed by MFIs in some regions, which include exorbitant rates, misleading advertising, excessive penalties, and aggressive or illegal collection methods.[231] Compartamos, for example, has been criticized for its loan rates, which may exceed 100 percent.[232] The problem, however, seems to lie less in the design of social enterprises and more in the lack of effective regulatory frameworks in many developing countries to protect consumers and employees.[233] In the context of MFIs, there have been proposals to reform consumer protection laws to address the risk of predatory lending.[234]

C. Difficulties in Attracting Capital

Social enterprises are generally better at attracting capital than traditional nonprofits. For-profit social enterprises can attract equity capital, and some, like Compartamos, are publicly listed on a stock exchange. Moreover, as discussed above, there is a growing trend among institutional investors to invest in socially responsible businesses, and the social investment sector is gradually growing. Nonetheless, many social enterprises still face capital constraints, which are more likely to exist when there is a lack of external subsidies and subsidies are sourced from investors. Social enterprises that rely on control mechanisms vesting control in the hands of a small group of nonprofits and social investors have difficulty tapping capital markets. Some social enterprises,

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229 Compartamos Offering Circular, *supra* note 20, at 77.
230 Conning & Morduch, *supra* note 170, at 413-414.
231 See Conning & Morduch, *id.*, at 411-412; Eric Bellman & Arlen Chang, *India's Major Crisis in Microlending*, WALL. ST. J., OCT. 28, 2010; Keith Epstein & Geri Smith, *The Ugly Side of Microlending*, BUS. WK., Dec. 13, 2007.
232 See Elisabeth Malkin, *Microfinance's Success Sets off a Debate in Mexico*, N.Y. Times, Apr. 5, 2008.
233 The high rates that Compartamos charges its borrowers are also partly due to the lack of competition in the Mexican banking industry. See Chu, *supra* note 22.
234 See Brigit Helms & David Porteous, *Protecting Microfinance Borrowers* (CGAP Focus Note No. 27, 2005), *available at* http://www.cgap.org/publications/protecting-microfinance-borrowers (last visited Jan. 4, 2014). Another mechanism for mitigating a firm's incentives to exploit its consumers may be to give consumers ownership of the firm or adopt the nonprofit form; see Ryan Bubb & Alex Kaufman, *Consumer Biases and Mutual Ownership*, 105 J. PUB. ECON. 39 (2013). Of course, the downside of this approach is that it may inhibit the firm's ability to raise capital and lower incentives for socially valuable innovation.

such as Triodos Bank and Cafédirect, do issue public shares, though such issuances are usually of relatively small amounts of shares with limited voting rights, and the shares are often traded on matched-bargain systems that lack the liquidity afforded by large stock exchanges.[235]

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

D. Excess Subsidies

If social enterprises receive excess subsidies their incentives to measure their beneficiaries' attributes and allocate subsidies efficiently may be weakened. By "excess subsidies" I mean subsidies that exceed those necessary to fund the costs of measurement and the direct allocation of subsidies to beneficiaries. If the commitment device is somewhat flawed, these "excess subsidies" may simply be distributed to the owners. Where the commitment device is strong, the excess subsidies may simply flow to the beneficiaries, also an inefficient outcome, as they presumably will be used in a way inconsistent with the intention of the subsidy-providers. The greater problem, however, is that managers can alternatively use the excess subsidies to cover up economic losses, while exerting less effort to enhance performance.[236] The profitability of the social enterprise firm will be less dependent on the performance of its patron-beneficiaries, and more reliant on the provision of subsidies. The social enterprise is then left with limited incentives to obtain information on its patron-beneficiaries or monitor their performance. The effect of excess subsidies is to transform an enterprise from a social enterprise into a donative organization that transfers subsidies to beneficiaries. To take an extreme example, if a government effectively guaranties any credit losses made by a CDFI or MFI, such a CDFI or MFI may be inclined to make loans to many borrowers, even if they are incapable of paying back these loans (i.e., they have NC abilities), or simply to neglect to monitor borrowers' efforts. An example of such excess

[235] Jamie Hartzell, *Creating an Ethical Stock Exchange* (Oxford Said Business School, Skoll Centre for Social Entrepreneurship Research Paper, Aug. 2007), *available at* http://www.sbs.ox.ac.uk/ideas-impact/skoll/research/social-finance-reports-resources/creating-ethical-stock-exchange (last visited Jan. 4, 2014).

[236] The assumption here is that the managers cannot distribute the subsidy to the owners; rather, they can either use it to measure patron-beneficiaries' attributes or to exert less effort and use the subsidies to cover up the resultant losses to profitability.

subsidies is credit subsidies offered by state development banks, such as the India Rural Development Program ("IRDP"), a heavily subsidized government program to fund loans from state banks to excluded groups in India.[237] Under the IRDP, credit was allocated to certain excluded groups according to arbitrary lending targets. The IRDP repayment rates were as low as 30% and many debts were forgiven, mainly because banks had little incentive to allocate credit to the most productive borrowers.[238]

VII. OTHER ACCOUNTS OF SOCIAL ENTERPRISE AND HYBRID ORGANIZATIONS

There are several other theories that have attempted to explain social enterprises and hybrid organizations. As I will show below, these theories have failed to provide a convincing account of social enterprise and hybrid organizations. It is noteworthy that these theories do not generally make a distinction between social enterprises and hybrid organizations and discuss these forms of organization as largely identical.

A. Stakeholder Theories and the Costs of Decision-Making

The upshot of stakeholder theories is that managers should maximize the interests of all stakeholders of the firm, including employees, customers and even the public at large.[239] Some commentators have advanced a view of social enterprise and hybrid organizations as a form of for-profit that maximizes the interests of its stakeholders.[240] The major problem with these theories is that they fail to explain how managers should balance competing claims. Without providing clear criteria as to how the stakeholders' interest should be considered in corporate decision-making, broad managerial discretion enables managers to pursue their own interests.[241] Hybrid organizations with a broad social and environmental mission are particularly vulnerable to this risk, because of the difficulty of defining and verifying what kind of action maximizes the social mission.

Stakeholder theories also advocate allocating voting rights and decision-making power to specific stakeholders. Some accounts have emphasized participatory decision-making by those affected by a decision as one of the

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[237] See *supra* section I.B.
[238] See Armendáriz & Morduch, *supra* note 14, at 9-12.
[239] There are numerous articles on the topic. For several notable examples, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, VA. L. REV. 247 (1999); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733 (2005). To be sure, most proponents of shareholder primacy agree that a corporation can and should act in the interests of its stakeholders to the extent that doing so indirectly promotes the shareholders' interest; see Michael C. Jensen, *Value Maximization, Stakeholder Theory, and the Corporate Objective Function*, 14(3) J. OF APPLIED CORP. FIN. 8 (Fall 2001); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001).
[240] See generally Borzaga & Defourny eds., *supra* note 9; Becchetti & Borzaga eds., *supra* note 11; Nyseens ed., *supra* note 228.
[241] Jensen, *supra* note 239; Hansmann & Kraakman, *supra* note 239, at 447-449.

defining elements of social enterprise.[242] In fact, in some social enterprises, such as FTSEs, there may be board members that represent a class of beneficiaries[243] or a class of beneficiaries that owns some shares in the firm.[244] However, only rarely do beneficiaries of social enterprises and hybrid organizations take an active part in decision-making. Others advocate employee participation in decision-making as a means to facilitate a mixed mission. For example, the economist Edward Glaeser contemplates a firm in which both workers and shareholders have voting stock and the firm must both return a decent profit to shareholders and cater to employees' desire to do something good.[245] Not only is such a contractual arrangement rare in practice, however, but experience indicates that worker participation in decision-making tends to make it cumbersome and inefficient.[246]

In contrast to the high costs of decision-making in pro-stakeholder corporations, decision-making in social enterprises seems relatively efficient; that is because social enterprises must adopt a commitment device, which not only resolves the potential contract failure in utilizing subsidies, but also addresses the problem of decision-making. The commitment device essentially defines how the firm utilizes its subsidies. Certification and contractual mechanisms define the class of beneficiaries and the terms of their transactions with the enterprise. Control mechanisms may potentially be susceptible to tension between investors who want to maximize profits and the nonprofit controllers who are satisfied with below-market returns. But as long as the nonprofit maintains clear control of the social enterprise firm, there seems to be relatively little scope for conflict; moreover, there does not seem to be strong tension between different classes of owners in any of the social enterprises discussed above. Accordingly, managers are left with the task of pursuing profits, subject to the commitment to transacting with a class of beneficiaries. In this way, the commitment device effectively defines how to balance the profit and nonprofit missions against each other, and the margin of discretion left to managers is relatively limited.

B. Economies of Scope

Malani & Posner ("MP")[247] and Henderson & Malani ("HM", and together "MPH")[248] argue that for-profits are more efficient than nonprofits in pursuing

[242] See Jacques Defourny, *Introduction: From Third Sector to Social Enterprise*, *in* Borzaga & Defourny, eds., *supra* note 9, at 1 (defining social enterprise as meeting certain criteria, including participatory nature, which involves the persons affected by the activity, and decision-making power not based on capital ownership).

[243] E.g., the producers of Cafédirect, an FTSE that sells hot drinks, have the right to appoint two directors to its board.

[244] For example, the borrowers of Grameen Bank, a prominent MFI in Bangladesh, hold approximately 94% of its shares as well as 75% of the voting rights.

[245] Edward Glaeser, *Let's Move beyond Milton Friedman's Icy Purity*, *in* CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET AND OTHER ECONOMIC LEADERS 60 (Michael Kinsley ed., 2009).

[246] Hansmann & Kraakman, *supra* note 239, at 444-446.

[247] Malani & Posner, *supra* note 6.

[248] M. Todd Henderson and Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 111 COLUM. L. REV. 571 (2009).

social goals because they benefit from economies of scope.[249] A car company may have more ample resources and knowledge to invest in research on hybrid engines than government or nonprofits. However, other examples provided by MPH have questionable theoretical and empirical support. For example, they suggest that multinational coffee companies are more efficient in disbursing charity to poor farmers. As discussed above, multinational companies have generally avoided transacting with poor disaggregated farmers primarily because the costs of transacting with those farmers tend to be high. Suggesting that multinationals are best positioned to deliver aid to poor farmers assumes that they import coffee from poor farmers anyway. In fact, the contacts between most large firms and small farmers are initiated and fostered by nonprofits.[250] To take another example, MPH argue that clothing and footwear manufacturers are better positioned than nonprofits to monitor the working conditions in factories in developing countries. They mention specifically Nike's decision to establish a department to monitor the health, safety and environmental conditions in its factories. Surely, every organization that is contravening certain standards is best positioned to ensure that such standards are held in compliance. But this clearly does not imply that the firm is an efficient monitor of itself, especially where manufacturers have an obvious incentive to shirk on the quality of working conditions to save costs. In fact, the pressure on Nike and other manufacturers comes from various nonprofits. Accordingly, MPH's efficiency claim is not convincing.

MPH also claim that for-profits are just as trustworthy or committed as nonprofits. Donors or subsidy-providers do not need to patronize a nonprofit to use their funds for charitable purposes; rather, they can simply channel their donation or subsidy through a for-profit firm. The non–distribution constraint is not essential as a commitment device. For-profits can simply commit by a contract not to distribute profits and a private auditor can monitor this commitment.[251] However, the feasibility of this contract depends on the availability of measurable standards.[252] As discussed above, although some social rating systems have been developed in recent years, they are still in a nascent stage and subject to substantial uncertainty.[253] Moreover, even if firms could enter into such a contract, in practice virtually all the examples of for-profit charities discussed by MPH do not involve such a contract. These examples include: Google.org, a charitable arm that makes donations and below-market investments in the areas of climate change, poverty and emerging disease; fair trade coffee produced by small farmers in developing countries and sold by Starbucks; and Nike's abstinence from purchasing supplies from sweatshops, even those that comply with their local law. None of these firms have contracted to not distribute profits to its owners. Accordingly, the accounts

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[249] For elaborate criticisms of the "economies of scope" theory, see James R. Hines Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179 (2010); Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1212 (2010).
[250] For examples, see Austin & Reavis, *supra* note 135; Argenti, *supra* note 135.
[251] Malani & Posner, *supra* note 6, at 2035-2036.
[252] For a detailed criticism of private monitoring of the non-distribution constraint, see Galle, *supra* note 249, at 1218-1221.
[253] See *supra* section V.C.

provided by MPH simply fail to describe what substitutes for the non-distribution constraint have been adopted by for-profits as a commitment device.

C. Corporate Social Responsibility Theories

Several theories have been offered to explain the economic function of Corporate Social Responsibility ("CSR") policies. Such theories generally define the role of CSR as reducing the externalized costs of business or mitigating distributional unfairness.[254] There are two main strands of the CSR literature. The first states that CSR policies indirectly enhance the long-term profits of the firm. CSR policies, such as saving energy costs or reducing pollution levels, may generate profits by reducing liabilities and creating new sources of revenue. Likewise, CSR policies may create goodwill and strengthen the firm's reputation among consumers. However, this view of CSR is entirely consistent with the profit-maximization norm, which asserts that corporate managers may take into account the interests of stakeholders and society at large if doing so indirectly maximizes shareholders' profits. It thus fails to recognize a new form of organization that diverges from the standard notion that profit-maximizing corporations indirectly benefit society as a whole.

The second version of CSR theories is close in spirit to the "economies of scope" theory discussed above. It conceives CSR as a form of delegated charity, whereby shareholders or consumers agree to sacrifice money, i.e., provide a subsidy, to further a social goal. The underlying rationale is that for-profits have some advantage in pursuing social goals over nonprofits. Some proponents of CSR focus on the ability of CSR to resolve regulatory imperfections in areas such as the environment, consumer protection or working conditions, especially in developing countries.[255] Others emphasize the technical expertise of corporations and their ability to exploit complementariness to deliver goods or services.[256] However, even if corporations have some advantages in carrying out social missions, the second version of CSR theories fails to adequately address the issue of commitment. Evaluating whether or not a firm is effectively pursuing a social mission is subject to a measurement problem. As pointed out above, while some general standards have been introduced in recent years to evaluate the overall social performance of corporations, such measurements remain very imprecise and potentially misleading. This problem is further exacerbated by firms' incentive to exaggerate the significance of their social performance.[257] In fact, CSR policies may even be used by inefficient managers to entrench themselves by gaining stakeholders' and media support.[258]

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[254] Heal, *supra* note 72 at 389, 392-393; Ronald Benabou & Jean Tirole, *Individual and Corporate Social Responsibility*, 77 ECONOMICA 1 (2010); Porter & Kramer, *supra* note 12.
[255] Nike's decision to avoid purchasing supplies from sweatshops is a typical example.
[256] Porter & Kramer, *supra* note 12; Benabou & Tirole, *supra* note 254, at 10-11. Some also claim that corporations may face less transaction costs in disbursing charity to beneficiaries; see Benabou & Tirole, *Id.*, at 10-11. A common example is fair trade coffee. But, as explained above, this claim is based on the mistaken assumption that the firm already transacts with poor farmers.
[257] See Kerr, *supra* note 11; Friedman, *supra* note 7; Aneel Karnani, *The Case Against Corporate Social Responsibility*, WALL. ST. J., Aug. 23, 2010; Manne, *supra* note 7.
[258] Giovanni Cespa & Giacinta Cestone, *Corporate Social Responsibility and Managerial Entrenchment*, 16(3) J. OF ECON. & MGMT. Strategy 741 (2007).

D. Public Good Theories

The above discussion has assumed that social enterprises are designed for the benefit of a specified class of patrons, such as consumers or employees. In practice, however, many commentators have viewed the role of social enterprises as being to generate public goods, like other types of hybrid organization, such as environmentally-friendly firms. For example, MFIs and CDFIs are widely regarded as tools for alleviating poverty. Social enterprises, on this view, are supposed to benefit external beneficiaries who are affiliated with the patron-beneficiaries. A borrower that receives a loan from an MFI may be able to send his or her children to school and obtain better healthcare services. Similar effects potentially occur with respect to external beneficiaries affiliated with small farmers that sell their products to FTSEs or disadvantaged employees that work at a WISE. Likewise, the availability of healthcare services, medicines or products, such as reading glasses and bed-nets, enhances productivity and reduces the costs of illness.

However, the evidence on the effects of social enterprises as providers of public goods is largely equivocal. MFIs are a case in point. Empirical studies show no clear evidence that MFIs uniformly alleviate poverty and improve the standard of living in a given community in areas such as healthcare and education.[259] On the other hand, there is strong evidence that access to credit has improved the lives of the borrowers themselves.[260] It seems to be the case, then, that the patron-beneficiaries of MFIs have substantially benefited from the ability to transact with them, while the benefits to the community at large are inconclusive.

The distinction between patron-beneficiaries and external beneficiaries may be the reason for these results. The positive externalities which arguably flow to external beneficiaries of MFIs are somewhat uncertain and may depend on numerous factors. For example, the availability of credit may improve a family's financial situation, but without educational opportunities or the availability of healthcare services, it will do little to improve education or health. There is similar empirical data with respect to fair trade and its effect on

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[259] See, for example: David Roodman & Jonathan Morduch, *The Impact of Microcredit on the Poor in Bangladesh: Revisiting the Evidence* (Center for Global Dev. Working Paper #164, June 2013), *available at* http://www.cgdev.org/content/publications/detail/1422302 (last visited Jan. 4, 2014); Abhijit Banerjee et al., *The Miracle of Microfinance? Evidence from a Randomized Evaluation* (MIT Dep't. of Econ. Working Paper No. 13-09, 2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 2250500; Dean Karlan & Jonathan Zinman, *Expanding Microenterprise Credit Access: Using Randomized Supply Decision to Estimate the Impacts in Manila*, (Yale Econ. Dep't Working Paper No. 68, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id= 1444990.

[260] Banerjee et al., *id.* (finding that microcredit supports household borrowing and investments and the creation and expansion of small businesses, but has no impact on health, education and women's decision-making); Karlan & Zinman, *id.* (finding that the introduction of micro-lending to new populations leads to an increase in business profits for male borrowers, but no overall effects on income or poverty); Collins et al., *supra* note 152 (claiming that microfinance may be most effective at smoothing out borrowers' cash flows, so that poor borrowers are less vulnerable to fluctuations in their income).

communities of small farmers.[261] The ability to transact with FTSEs has increased the income of individual farmers and their households, but though there is some evidence of modest positive effects on education and health, it is inconclusive and falls short of showing clear results.[262] There are apparently no detailed empirical studies of the overall impact of social investment firms, CDFIs, WISEs, or low-cost sellers. However, it seems reasonable to presume that the results would be similar.

In fact, consistent with my claim, most social enterprises simply evaluate their impact by measuring the extent to which they transact with patron-beneficiaries, e.g., the total output sold to low-income consumers, the number of disadvantaged workers employed, or the number of loans made.[263] Accordingly, it appears to be relatively easier to measure the effects of social enterprises when they engage in transactions with their patron-beneficiaries. Absent such transactions, measuring social impact remains imprecise.[264] Vis-à-vis their external beneficiaries, social enterprises are in a similar position to donative organizations; unless the benefits to external beneficiaries are measurable at reasonable cost, they remain uncertain.

E. Sustainability and Scale

Several commentators have suggested that social enterprises have emerged as a solution to capital constraints faced by donative organizations. According to this view, social enterprises are more financially sustainable than donative organizations because they can generate revenues. Donative organizations are ineffective in pursuing their mission due to limited funding from donors.[265] Greater sources of revenue enable social enterprises to scale the firm's operations.[266] Without scaling, firms cannot reach a large number of

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[261] For a review of impact studies, see Chapter 9 in Nicholls & Opal, *supra* note 38, at 201-228; Anne Le Mare, *The Impact of Fair Trade on Social and Economic Development: A Review of the Literature*, 2/6 GEOGRAPHY COMPASS 1922 (2008).

[262] Nicholls & Opal, *id.*, at 208-209; Mare, *id.*

[263] MFIs and CDFIs primarily measure the amounts of loans they make to low-income borrowers and their repayment rates, though CDFIs have attempted with limited success to measure also the number of jobs created by the businesses in which they invest (see Robinson Hollister, *Measuring the Impact of Community Development Financial Institutions' Activities*, *in* FINANCING LOW-INCOME COMMUNITIES (Julia S. Rubin ed., 2007); WISEs evaluate the number of disadvantaged workers employed, their wellbeing and their performance (see Barker, *Open-hiring Policy*, *supra* note 48, at 7-8); social investment firms measure primarily the number of patron-beneficiaries served by the investee, e.g., the amount of bed-nets sold (see *The Best Available Charitable Option*, *supra* note 159); low-cost sellers measure the number of consumers they serve (for example, The Aravind Eye Care measures the number of surgeries it performs, and VisionSpring measures the number of affordable reading glasses it sells).

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

[265] Dees, *supra* note 9; Jerr Boschee & Jim McCurg, *Toward a Better Understanding of Social Entrepreneurship* (Minnesota, MN: Institute of Social Entrepreneurs, 2003); MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM (Public Affairs 2008); Pallotta, *supra* note 171.

[266] Yunus, *id.*; J.P. Morgan & The Rockefeller Foundation, *supra* note 3, at 13.

beneficiaries and have a substantial social impact. For example, an MFI with a small number of borrowers arguably has only a modest social impact, whereas one with numerous branches and borrowers has a larger social impact. Some go further by arguing that the ability to distribute profits and tap equity capital is critical to obtaining the capital necessary to scale the firms' operations, and hence their social impact; for example, a for-profit MFI can reach more borrowers than a nonprofit MFI.[267]

These views, however, suffer from several weaknesses. First, there is no systematic evidence that earned income is more sustainable than donative income.[268] Donative organizations, such as large foundations and aid agencies, have very substantial funds. The real problem is that the utilization of these funds, particularly towards development goals, has been for the most part ineffective.[269] In fact, there is little reason to believe that simply increasing the amounts of donations would generate different results. Second, evidence suggests that nonprofits with no access to equity capital can achieve a substantial scale similar to that of for-profits. Many large social enterprises are incorporated as nonprofits. Nonprofit MFIs, such as ASA and BRAC, serve millions of borrowers and have as wide a reach as for-profit MFIs. In some cases, attracting equity capital may be necessary for scaling. As explained above, however, when social enterprises transact with beneficiaries with lower abilities, equity capital is less likely to be available, and subsidies in the form of donations and income tax exemption remain essential.

To be sure, social enterprises are better than donative organizations at scaling their social impact. But the reason for this is that social enterprises allocate subsidies more efficiently. For example, whereas a donative organization distributes a good (e.g., bed-nets) worth $5 to say 200 beneficiaries, a social enterprise using the same amount of subsidies (i.e., $1,000) may be able to sell this good at say $2.5 to 400 beneficiaries, assuming beneficiaries can pay $2.5 themselves. Social enterprises can reach more beneficiaries because they have information on beneficiaries' abilities to pay. The measurement role of social enterprise thus enables them to scale their social impact as compared to donative organizations.

VIII. A NOTE ON PROFIT-MAXIMIZATION AND ORGANIZATIONAL DESIGN

Social enterprise and other hybrid organizations are often mentioned as an alternative to the traditional form of capitalism, which is based on the norms of profit-maximization and shareholder primacy. The theory offered herewith effectively dispels such claims because the role it ascribes to social enterprise is not intrinsically inconsistent with these norms. Social enterprises can be profit-maximizing if the subsidies they receive flow from government or consumers rather than owners. Even if the owners do provide the subsidies, social

[267] Chu, *supra* note 22.
[268] Beth Battle Anderson & Gregory J. Dees, *Rhetoric, Reality, and Research: Building a Solid Foundation for the Practice of Social Entrepreneurship*, in Nicholls ed., *supra* note 9, at 144, 148-150.
[269] See references *supra* note 80.

enterprises still act under a shareholder primacy norm as long as the owners agree to provide such subsidies. Accordingly, the theoretical underpinning of social enterprise is not, as some have argued, its apparent divergence from profit-maximization or shareholder primacy.

Social enterprise should be understood in a broader framework of capitalism. Firms may be viewed as a nexus of contracts between an enterprise and its patrons. Contract prices generally provide information on the value of the contracts to both the enterprise and its patrons. Where the parties are unable to evaluate the quality or quantity of the other party's performance, there is a contract failure due to information asymmetries. When there are information asymmetries the law may rely on two main alternatives: (1) transparency mechanisms and (2) incentive mechanisms. Transparency mechanisms are designed to make one party reveal information to the other party. Incentive mechanisms are designed to either align the incentives of one party with those of the other or curtail one party's ability to act in a way that is inconsistent with his obligations under the terms of the contract.

Traditional for-profits and nonprofits are shaped primarily by parties' ability to enter into contractual relationship on the basis of full and accurate information. Profit-maximization and shareholder primacy are norms that reflect the implicit contract between the corporation and its owners, pursuant to which it is the former's duty to pursue the interests of the latter. These contracts are not susceptible to a contract failure because transparency mechanisms, such as accounting standards and disclosure requirements, provide shareholders with information on the firm's performance. Nonprofits, especially donative organizations, are formed primarily when transparency mechanisms are not available to address contract failure. It would be prohibitively costly for donors to gather information on how a donative organization uses their donations. The non-distribution constraint is an incentive mechanism because it proscribes conduct (i.e., distribution of profits) which may be inconsistent with the firm's contractual obligation to distribute subsidies to beneficiaries.

In the same manner, the design of social enterprises is dictated by the feasibility of contracting on the basis of full information. Social enterprises, like donative organizations, are a conduit for subsidies. Evaluating and monitoring how subsidies are used is extremely costly, and therefore transparency mechanisms are not available. Social enterprises therefore need to be structured as incentive mechanisms. But whereas donative organizations are largely designed to distribute subsidies, social enterprises are designed to use subsidies in more complex situations, to increase employment opportunities or facilitate access to credit. The contract failure in channeling donations or subsidies is particularly acute where subsidies are supposed to be employed to resolve complex development goals, such as poverty and unemployment. In these circumstances, the non-distribution constraint, which largely protects subsidy-providers against expropriation of the subsidies, is insufficient on its own because it does not provide sufficient assurance that subsidies will be used effectively. Moreover, in some cases, the non-distribution constraint may unduly limit the firm's ability to obtain capital.

The commitment of social enterprises to transacting with the beneficiaries is the key element in assuring subsidy-providers that their subsidy will be used effectively. This commitment is essentially an incentive mechanism, first because it proscribes certain conduct, i.e., avoiding transactions with disadvantaged individuals, and more importantly because it aligns the interests of the firm with those of the subsidy-providers.[270] Given their dependence on the performance of their beneficiaries, social enterprises have an interest in ensuring that the subsidies are not wasted, and that beneficiaries are provided with the adequate amount and type of disbursal. They therefore have incentives to employ the subsidy to measure their beneficiaries' attributes through diligence and monitoring. In this way, the interests of social enterprises are aligned with the interests of subsidy-providers who presumably want their subsidy to be used effectively. Accordingly, the measurement role of social enterprise provides a solution to information problems in allocating subsidies for complex development missions. In this way, social enterprises complement traditional organizational forms that lack the incentives to utilize subsidies to address these goals in an effective way.

Finally, it is also important to emphasize that the "social enterprise" status of a firm may, and perhaps should ideally, be only a transitory phase. As social enterprises gather information on their patron-beneficiaries, such information may accumulate over time and ultimately information asymmetries regarding the beneficiaries' attributes may gradually disappear. Compartamos has evolved from a nonprofit social enterprise into a for-profit social enterprise. It will likely become, or some would argue has already become, a strictly profit-maximizing firm.[271] The reason is partly because Compartamos has gathered a large database on individuals' creditworthiness in its target market and gradually improved its own process of credit evaluation. Unfortunately, some segments of society may always be excluded and therefore there will always be a role for social enterprises. CDFIs, for example, operate in developed countries despite the availability of ample mechanisms to evaluate borrowers' creditworthiness. The key point, though, is that social enterprises are not supposed to replace strictly profit-maximizing firms. Rather, they are tools to assist disadvantaged groups reach the point where they can transact on commercial terms with any firm.

IX. CONCLUSION AND POLICY IMPLICATIONS

Most accounts of social enterprises tend to define them simply as organizations that mix profit-seeking with social missions, and consider the many forms of commercial firm that channel subsidies to beneficiaries as indistinguishable. Therefore, they view social enterprises, such as MFIs and FTSEs, as performing a similar function to other hybrid organizations, especially corporations that initiate corporate social responsibility policies. These accounts thus fail to explain the apparent effectiveness of many social enterprises as compared to other forms of hybrid organization whose effectiveness is much

[270] To be sure, certification and contractual mechanisms make some use of transparency mechanisms to the extent that they verify the status of beneficiaries as such (e.g., welfare recipients or small producers) and the terms of the transactions offered to them. Control mechanisms are more akin to the non-distribution constraint, as they essentially rely on the incentives of the nonprofit to control the mission.

[271] See Chu, *supra* note 22.

harder to measure. I have suggested here that the term "social enterprise" should be limited to a specific set of enterprises that serves a specific measurement function. That function is a response to a well-defined set of economic problems which arise in the context of different types of transaction, particularly subsidies to promote development. By identifying the distinctive role of social enterprise, the theory advanced herewith will, I hope, inform a legal policy that helps social enterprises fulfill their function.

The theory I offer may provide guidance on various related policy issues. First, it strongly indicates that the relative success of social enterprises does not justify a shift to stakeholder or corporate social responsibility models of the corporation, which allocate greater discretion to managers to pursue social missions. Moreover, subsidizing for-profits that claim to do good things, as effectively proposed by Malani and Posner, is not a good policy.

Second, the limited usefulness of new legal hybrid forms, such as the L3C or the Benefit Corporation, is to a large extent due to their questionable theoretical underpinnings. Legal forms for incorporating firms with a mixed mission inevitably fail to identify the essential elements that make firms effective in utilizing subsidies as well as prescribe adequate commitment devices. It is therefore not surprising that such forms have generally failed to attract subsidies from tax authorities,[272] which tend to view them with suspicion, and are seldom used by entrepreneurs, who question their utility. In future work, I will consider a new legal form which is based on the notion of commitment to transacting with specified classes of patron-beneficiaries. Such a legal form may be effective in streamlining subsidized investments from foundations as well as attracting subsidies from government and consumers.

Finally, my theory may provide a normative framework for designing effective subsidy programs to promote development goals, such as increasing access to capital and improving employment opportunities. Many subsidy programs allocate subsidies to corporations that transact with disadvantaged groups. For example, pursuant to the Small Business Act, the Small Business Administration, a government agency, provides subsidies, mainly loan guaranties, to small businesses.[273] Under the Work Opportunity Tax Credit, businesses receive tax credits for hiring economically disadvantaged individuals, including welfare-benefit recipients and people with disabilities.[274] Compared to the relative success of social enterprises, these programs have had disappointing results, mainly because they fail to give corporations the incentives to use subsidies effectively.[275] A new social enterprise legal form may be a more effective target for channeling subsidies to promote development.

[272] Callison & Vestal, *supra* note 8.
[273] 15 U.S.C. §§631-657q.
[274] See Anne L. Alstott, *Work vs. Freedom: A Liberal Challenge to Employment Subsidies*, 108 YALE L.J. 967 (1999).
[275] Ofer Eldar, *Reforming Corporate Subsidies to Promote Development: A Proposal for a Social Enterprise Law* (unpublished manuscript) (on file with author).