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Michael D. Gottesman

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YALE LAW & POLICY REVIEW

From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations

Michael D. Gottesman*

INTRODUCTION

The U.S. legal system largely divides organizations into two categories: for-profit and nonprofit. Those wanting to operate between these categories have had to cobble together business solutions, mixing and matching subsidiaries, joint ventures, and partnerships. Recently, though, organizations from both the for-profit and nonprofit sectors have made new efforts to converge upon middle ground. These organizations, called “hybrid” organizations,¹ blend nonprofit and business values, but they are no longer mixing and matching subsidiaries, joint ventures, and partnerships. Rather, they are whole organizations that are operating on the cusp of the for-profit and nonprofit categories.²

Google’s new venture, “Google.org,” provides a salient example. Google.org *acts* like a nonprofit foundation by making grants to organiza-

* Yale Law School, J.D. expected 2008; University of Cambridge, M.Phil. 2003; Yale College, B.A. 2002. The author wishes to thank Annie Decker, Gail Fine, and Alex Neuhoff for their comments on this piece, Professor John Simon for his guidance, and Julianna Bentes for her patient, careful editing. The author welcomes comments at michael.d.gottesman@gmail.com.

1. See, e.g., Press Release, Nonprofit Sector Research Fund, Nonprofit Sector Research Fund Supports Study of “Hybrid” Organizations Seeking Social Change and Economic Change (Apr. 22, 2004), available at www.nonprofitresearch.org/newsletter1525/newsletter_show.htm?doc_id=224494.
2. In the past year alone, the *New York Times* has noted this trend toward hybridization three times. See David Haskell, *The Sixth Annual Year in Ideas; For-Profit Philanthropy*, N.Y. TIMES, Dec. 10, 2006, § 6 (Magazine) at 50; Stephanie Strom, *Make Money, Save the World*, N.Y. TIMES, May 6, 2007, at C1; Stephanie Strom, *What’s Wrong with Profit?*, N.Y. TIMES, Nov. 13, 2006, at F1.

tions in order to address social problems such as climate change.³ Yet Google.org is legally classified as for-profit. This status allows it to do several things that traditional nonprofits cannot do, such as raise equity capital, fund start-up companies, and grant money to individuals.

Conversely, some nonprofits have begun to act like for-profits. Altrushare Securities, for example, is a brokerage firm that buys and sells stock, yet it is actually majority-owned by a nonprofit and is guided by the mission of promoting growth and development in struggling communities.⁴

The recent flurry of hybrid activity has led commentators to propose reforms that foster hybrid organizations.⁵ None of these commentators, though, has paused to articulate what benefits hybrid organizations provide and, therefore, whether and why they should be encouraged at all. This Comment begins to fill that gap. It argues that hybridization would allow both nonprofit and for-profit organizations to work more effectively to achieve their social aims. Nonprofits are often constrained by a lack of capital. For-profits are often constrained by legal duties to maximize profit and not social outcomes. Hybrid organizations would address both of these constraints by allowing mission-driven nonprofits to access capital more readily and by allowing for-profits to commit themselves to achieving social goals.⁶

Concluding that there are compelling reasons to promote hybrid activity, this Comment then summarizes and assesses various reform proposals. Some have suggested creating new corporate forms. Some have proposed revamping tax laws. Some have argued for working within the existing corporate law to explore hybrids' potential. This Comment assesses the proposals offered to date and charts a way forward. Ultimately, this Comment argues that organizations can and should continue to explore hybrid activity while working within the existing laws.

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3. Katie Hafner, *Philanthropy Google's Way: Not the Usual*, N.Y. TIMES, Sept. 14, 2006, at A1.
 4. Altrushare Securities, History and Mission, http://www.altrushare.com/apps/altrushare/as_history_and_mission.html (last visited Dec. 13, 2007).
 5. See, e.g., THOMAS J. BILLITTERI, THE ASPEN INSTITUTE, NONPROFIT SECTOR RESEARCH FUND, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH (2007), www.nonprofitresearch.org/usr_doc/New_Legal_Forms_Report_FINAL.pdf.
 6. If these organizations face fewer structural constraints on pursuit of social goals, the ultimate beneficiaries of these organizations—e.g., the environment, individuals in need of social services, etc.—will benefit. This Comment does not discuss in detail how hybrid organizations will better serve those beneficiaries. It focuses instead on how to overcome the structural constraints on organizations.

I. AFFIRMATIVE ARGUMENTS FOR HYBRID ACTIVITY

The discussion about legal reform to foster hybrid activity has not focused on the question of why more hybrid activity would be good. By briefly outlining affirmative arguments for hybrid activity from both the for-profit and the nonprofit perspectives, this Part tries to bring greater clarity to—or at least to provoke further discussion of—this preliminary issue of why we want hybrid organizations. Each section describes problems that result from the binary classification of organizations and outlines the argument for how a new hybrid structure can help overcome these problems.

A. From the Nonprofits' Perspective

There are two broad categories of nonprofit organizations: service organizations, which spend money in support of social goals, and grant-making foundations, which raise money and distribute it to service organizations. The law treats these two types of nonprofits differently, and each type faces different obstacles when attempting to engage in hybrid activity. Whereas service organizations worry most about regulations governing how they can get money, foundations worry most about regulations governing how they can spend money.

The overarching problem service organizations confront in the current binary system—in which social organizations are forced into one of two legal categories, for-profit and nonprofit—is one of access to capital. This problem manifests itself in a number of ways. First, these nonprofits must generate their own revenue in the face of manifold legal restrictions on profit-making activity. Historical developments have created pressure for nonprofits to generate their own revenue. Starting with President Reagan, the government has shifted more responsibility to nonprofits for providing social services, while at the same time reducing nonprofit funding.⁷ To keep their doors open, nonprofits learned to find money elsewhere, including generating it themselves. Then, during the rise of internet entrepreneurship in the 1990s, general enthusiasm for innovative business methods reached a fever pitch. In this environment nonprofit managers wanted to be seen as

7. LESTER M. SALAMON & ALAN J. ABRAMSON, *THE FEDERAL BUDGET AND THE NONPROFIT SECTOR* 3 (1982). William Foster and Gail Fine suggest that the data tell a different story, but they do not entirely negate this point because they do not specify whether government funding has kept pace with the increased demands government has been placing on nonprofits. William Foster & Gail Fine, *How Nonprofits Get Really Big*, *STAN. SOC. INNOVATION REV.*, Spring 2007, at 46, 53. (“Many people talk about the government getting out of the social sector, but available data tell a different story. Not only our findings, but also national data show that government funding of the nonprofit sector is growing faster than the nation’s GDP.”).

entrepreneurial, too,⁸ and nonprofit funders also began demanding that nonprofits be innovative in how they generate money.⁹

Yet, laws limit the extent to which nonprofits may use entrepreneurial business methods. To win exempt status, a nonprofit “must be both organized and operated exclusively for one or more exempt purposes.”¹⁰ Pursuing public benefit is an “exempt purpose”; pursuing profit usually is not.¹¹ Then, once an organization has secured exempt status, it still faces taxes on certain profits—those that result from trade or business regularly carried out and not substantially related to the performance of an organization’s exempt purposes.¹² Thus, at the same time that nonprofits face pressure to generate revenue, the legal system also creates disincentives to generate revenue. A more capacious legal structure that allows organizations to pursue public benefit and does not impose such stringent restrictions on generating revenue would help resolve this tension.

The second conundrum service organizations face in accessing capital is that they cannot raise equity capital (i.e., capital raised by owners). A for-profit can raise capital by attracting investors; if it succeeds, it pays some financial return to those investors. Nonprofits cannot do this because they cannot distribute profits.¹³ As a result, the nonprofit capital market is less disciplined than the for-profit capital market. Money does not always follow success in the nonprofit market¹⁴—money often flows to new ideas rather than proven ones.¹⁵

8. William Foster & Jeffrey Bradach, *Should Nonprofits Seek Profits?*, HARV. BUS. REV., Feb. 2005, at 92, 92.

9. *Id.* at 95.

10. 26 C.F.R. § 1.501(c)(3)-(1)(a)(1) (2007).

11. Although the doctrines growing out of this restriction are complex, in practice, this provision threatens to revoke favorable tax status for nonprofits that engage in too much profit-making activity. For helpful discussions of this topic, see John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 495-507 (2002); and Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2473-83 (2005).

12. This tax is called the Unrelated Business Income Tax (UBIT). 26 U.S.C. § 513 (2000); 26 C.F.R. § 1.513-1 (2007).

13. Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501 (1981) (discussing how nonprofits are “barred from distributing profits, or net earnings, to individuals who exercise control over it, such as directors, officers, or members”).

14. “The fact that dollars seldom follow success is one of the most vexing challenges nonprofit leaders face . . . [T]he consequence is that proven solutions to pressing problems do not spread.” Jeffrey L. Bradach, *Going to Scale: The*

A new hybrid structure could help address this problem. A legal form that would allow organizations to attract equity capital and to pursue social aims would help recalibrate the flow of money to social organizations.¹⁶ Doing so would allow proven organizations to spend more time growing their impact and less time fundraising.¹⁷

Finally, grant-making foundations—key players in the nonprofit world—face restrictions on how they can spend money to achieve their social mission. Broadly, the law requires that grant-making foundations invest only in nonprofit organizations.¹⁸ Congress created an exception to this rule that allows a certain amount of hybrid activity: Foundations can make program-related investments (PRIs), which are investments, primarily

Challenge of Replicating Social Programs, STAN. SOC. INNOVATION REV., Spring 2003, at 19, 25.

15. Christine Letts et al., *Virtuous Capital: What Foundations Can Learn from Venture Capitalists*, HARV. BUS. REV., Mar.-Apr. 1997, at 36.
16. An equity capital market for hybrids could take one of many forms. It could rely on a system where organizations are subject to asset locks and the rates of return to investors are capped at fairly low levels, as is the case with Community Interest Companies in the United Kingdom. See HER MAJESTY'S CABINET OFFICE, STRATEGY UNIT, PRIVATE ACTION, PUBLIC BENEFIT: A REVIEW OF CHARITIES AND THE WIDER NOT-FOR-PROFIT SECTOR 54 (2002), www.cabinetoffice.gov.uk/strategy/downloads/su/voluntary/report/download/s/strat-data.pdf. Alternatively, a hybrid capital market might include for-profit organizations that do not cap rates of return, but simply state at the outset that they will be pursuing social goals as well as profit. Articulating this bifurcated commitment will indicate to investors that rates of return might be lower than they would be in organizations pursuing only profit. Although some potential investors would be deterred by the prospect of low returns, some would likely still invest equity capital in these organizations. The latter model paraphrases the concept of B Corporations, discussed *infra* Section III.C.
17. Lincoln Caplan, *Premium Blend: Is Google.org the Future of Philanthropy?*, SLATE, Sept. 21, 2006, <http://www.slate.com/id/2150047> (“[E]ven the best nonprofits have to spend too much time raising money. When they’re ready to multiply their contributions to society through the growth of their organizations, they have to mount expensive fund drives.”).
18. The tax code imposes an excise tax on a foundation and its managers if it “invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes.” I.R.C. § 4944(a)(1)-(2) (2007). This language has been interpreted to mean foundations cannot make investments that are “unduly risky.” Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 TAX L. REV. 59, 66 (2004) (“[T]he legislative history and background behind this provision suggest that what Congress primarily meant was simply investments that were unduly risky.”).

in the form of loans, in for-profits that help accomplish the foundation's goals. For example, a foundation that aims to expand affordable housing might lend money to a housing development company. If the development project succeeds, the foundation would receive some return on its original investment. The problem, though, is that in practice nonprofits rarely make PRIs.¹⁹ One reason may be that they fear the excise taxes that they would incur by making an investment in a for-profit organization that the IRS later deems not to further the foundation's goals.²⁰

A hybrid structure could address this problem by encouraging capital to flow more readily between like-minded organizations. It would do so by increasing nonprofits' investments in for-profit companies. Allowing capital to flow between organizations with common interests, rather than allowing capital to flow only between organizations with common legal structures, would likely allow organizations to achieve their social missions more effectively.

B. From the For-Profit's Perspective

The primary problem for-profits face in our binary legal system is an inability to commit themselves to achieving social goals. For-profits wanting to commit themselves to the pursuit of social goals face a number of legal limitations. Courts have made clear that companies may not operate primarily for the benefit of third parties.²¹ That is, when the goals of maximizing profit and maximizing public benefit are in tension with one another, directors bear a legal obligation to shareholders to choose profit over public benefit.²² In addition, the tax code creates incentives for corporations to

19. The Foundation Center reports that "only a tiny number of the many thousands of foundations" in its foundation directory make PRIs. THE FOUNDATION CENTER, THE PRI DIRECTORY: CHARITABLE LOANS AND OTHER PROGRAM-RELATED INVESTMENTS BY FOUNDATIONS, at v (Jeffrey A. Falkenstein ed., 2003). "In 2001, over 61,000 active foundations paid \$30.5 billion in grants," and PRIs accounted for only 232.9 million dollars of foundation disbursements—or less than 1%. *Id.* at v-vi.

20. THOMAS J. BILLITTERI, ASPEN INSTITUTE, NONPROFIT SECTOR RESEARCH FUND, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH? 5-6 (2007), available at www.nonprofitresearch.org/usr_doc/New_Legal_Forms_Report_FINAL.pdf.

21. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 683 (Mich. 1919) (finding invalid Henry Ford's explanation for why he did not distribute larger dividends to his shareholders—that his ambition was "to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes").

22. "Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers." Stephen M. Bainbridge, *In De-*

limit their charitable contributions.²³ As a result of these constraints, for-profits struggle to remain committed to a social mission.

A new hybrid structure could address this problem. Creating a legal form that allows simultaneous pursuit of profit and mission would give socially inclined for-profits the opportunity to institutionalize their commitments to goals beyond profit. This, in turn, would allow organizations to chart a stable, sustained approach to—and therefore to work more effectively toward—those social goals.

A second, related, problem for-profits face is that they cannot signal their social commitments clearly. They may promote themselves as socially conscious, yet there is no standardized way to certify companies' assertions or to compare practices across companies. Hence, the consumer rarely knows how to weigh a company's claims. A new type of organization that clearly denotes social responsibility by, for example, creating a new, visible, formal designation, would allow businesses to signal their commitments more effectively. Adding this level of clarity would help businesses brand themselves, which would allow them to cash in on their good deeds more efficiently.

II. THE WAY FORWARD (FOR NOW)

Commentators have championed three approaches to promoting hybrid activity: (a) creating new corporate forms, (b) changing tax laws, and (c) working within current laws. I briefly summarize and assess each proposal below. Ultimately, I find the last option holds considerable promise for organizations in the immediate future.

A. Creating New Corporate Forms

State legislatures have recently attempted to create two new corporate forms. Minnesota and Hawaii proposed almost identical legislation to create "Socially Responsible Corporations" (SRCs). Organizations with this designation would commit themselves to maximizing both shareholders' profits and social impact, and directors would bear an obligation not only to maximize profit but also to pursue "public benefit."²⁴ A publicly traded

fense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 WASH. & LEE L. REV. 1423, 1423 (1993).

23. Whereas an individual may deduct a charitable gift up to either 30% or 50% of his taxpayer contribution base, a corporation may deduct gifts only up to 10% of its taxable income. 26 U.S.C. § 170(b)(1)(A)-(B), (b)(2) (2000).
24. Public benefit is defined as "general public well-being of present and future generations including, but not limited to, the economy, natural environment, public health, public safety, human rights, educational and other human developmental opportunities, and the general well-being of the local, state, national, or world community." See S.F. No. 3786, ch. 304A, § 2(2), 84th Legis.

corporation would have to affirm its commitment to “public benefit” by filing a “public interest report” along with its annual financial report. In addition, SRC boards would have to include directors who represent both the employees’ interests and the public interest.²⁵ The Minnesota legislation did not propose to give SRCs favorable tax treatment; instead, that legislation simply proposed to allow SRCs to pursue something other than short-term profit-maximization. Hawaii, however, was poised to grant SRCs tax breaks. It did not flesh out the details, but the legislation said that a “company incorporated as a responsible business corporation under this chapter shall be exempt from ___ per cent of all corporate taxes.”²⁶ Critics took aim at this provision.²⁷ Ultimately, neither state passed the legislation, but Minnesota is considering similar legislation this session.²⁸

Such legislation would offer several benefits. It would allow organizations to make explicit commitments to both profit and social mission simultaneously. Since SRCs would technically operate as a new type of for-profit organization, they could attract investors and draw on the for-profit capital markets to accomplish their social mission. In addition, the SRC designation would build a clear brand that would give organizations a reliable way to broadcast their social commitments to consumers. The primary drawback of this approach to fostering hybrid organizations is that passing the legislation will likely consume significant time and money. Strident opposi-

Sess. (Minn. 2006), available at <http://www.revisor.leg.state.mn.us/bin/bldbill.php?bill=S3786.o.html&session=ls84>; see also H.B. 3118, § 2, 23d Leg. (Haw. 2006), available at <http://www.capitol.hawaii.gov/site/archives/2006/getstatus.asp?query=HB3118&showstatus=on&showtext=on&showcommrpt=on&currpage=1>.

25. At least one-fifth of directors must be nominated and elected by the corporation’s employees and charged with advocating for those employees. For Minnesota, see *supra* note 24, at § 304A.06.b; for Hawaii, see *supra* note 24, at § 6(b). At least one-fifth of directors “must represent and advocate for the public interest.” Existing board members are to elect these members “after seeking input from persons or groups representing the public interest.” For Minnesota, see S.F. No. 3786, *supra* note 24, § 6.b.; for Hawaii, see H.B. 3118 *supra* note 24, at § 6(c).
26. See H.B. 3118, *supra* note 24, § 10.
27. Editorial, “Responsible” Firms Don’t Merit New Prize, HONOLULU ADVERTISER, Mar. 29, 2006, at 14A (“The proposal is, at best, silly and unproductive, and at worst, a loophole through which more business-paid tax revenue could leak needlessly.”).
28. H.F. No. 404, 85th Leg. (Minn. 2007-2008), available at <http://www.revisor.leg.state.mn.us/bin/bldbill.php?bill=Ho404.o.html&session=ls85>.

tion to this legislation²⁹ and multiple failed attempts to pass it suggest that creating the SRC designation will be no small task.

The North Carolina legislature is trying to create a different kind of corporate form: low-profit, limited liability companies (L3Cs).³⁰ This designation would be available to LLCs that generate modest profit while carrying on business activities with a charitable purpose. The criteria for L3C status, a status that offers no tax benefit, closely track the characteristics for-profits must possess in order to be eligible to receive a PRI.³¹ Thus, an L3C designation would act as a pre-approval for a PRI. Pre-approval is meant to reassure foundations that they may give PRIs to L3Cs without risking punishment for making “jeopardizing investments.” North Carolina did not enact this legislation.

The North Carolina legislation would have one clear benefit: “facilitat[ing] the flow of philanthropic capital to economic development activities such as creating jobs in economically depressed areas.”³² Although L3Cs show promise, they would accomplish fairly limited objectives. First, they serve a narrow charitable purpose at this point: job creation in distressed industries. Second, they create a limited benefit: L3Cs would affect the flow of a relatively small amount of capital, since they affect only the flow of PRIs and, as discussed above, PRIs comprise a relatively small amount of foundation grants.³³ For this amount to rise to a level of significance, PRIs would have to increase dramatically.

Taken together, these legislative proposals would go a long way toward fostering hybrid activity. But there are reasons hybrid enthusiasts may not want to wait for such legislation before pursuing further hybrid activity. Each piece of legislation addresses only some of the constraints on organiza-

29. See, e.g., Jerry Coffee, *It's the Worst Business Law Ever*, MIDWEEK.COM, Apr. 12, 2006, available at http://www.midweek.com/content/columns/coffeebreak_article/its_the_worst_business_law_ever/.

30. S.B. 91, General Assemb., Sess. 2007, pt. 3 (N.C. 2007), available at <http://www.ncleg.net/sessions/2007/Bills/Senate/PDF/S91v5.pdf>; H.B. 39, General Assemb., Sess. 2007, pt. 3 (N.C. 2007), available at <http://www.ncleg.net/sessions/2007/bills/house/PDF/H39v1.pdf>.

31. The L3C designation would be limited to business activities that significantly further a charitable or educational purpose, do not have a significant goal of producing income or capital appreciation, and do not accomplish political or legislative purposes. S.B. 91, General Assemb., Sess. 2007, pt. 3 (N.C. 2007), available at <http://www.ncleg.net/sessions/2007/Bills/Senate/PDF/S91v5.pdf>, at § 3.1.

32. Council on Foundations., 2007 Agenda for Philanthropic Partnership, <http://www.cof.org/Action/content.cfm?ItemNumber=9783&navItemNumber=2320#l3c> (last visited Dec. 13, 2007).

33. See *supra* note 19 and accompanying text.

tions. SRC legislation, for example, does not help nonprofit money flow across the boundary to for-profits; L3C legislation neither helps mission-based organizations raise money nor allows profit-based organizations to spend money and resources on social goals. To develop a comprehensive solution to the current constraints on organizations, then, states must pass both types of legislation. Given that no state has managed to pass either SRC or L3C legislation so far, it is not clear when a state will pass both. Thus, hybrid enthusiasts would be best served by a solution that allows for more immediate pursuit of all types of hybrid activity.

B. Changing Tax Laws

One pair of academics proposes changing tax laws to give for-profits tax breaks for their charitable activities.³⁴ Anup Malani and Eric Posner note that nonprofits do not pay corporate income taxes, and their donors may deduct donations from their income for personal income tax purposes. If a for-profit conducts charitable work, though, it must pay corporate income taxes on its profits and donors may not deduct donations. Malani and Posner argue that these asymmetric benefits create structural incentives to support charitable activities carried out by the formal nonprofit sector. This incentive structure creates inefficiencies: The current coupling of tax treatment with nonprofit form might “discourage[] talented altruists from establishing charitable enterprises.”³⁵ In addition, the current coupling may even give a competitive advantage to inefficient producers in the nonprofit sector. Assume, for example, that A and B produce the same thing as one another and B has higher production costs. If B opts for nonprofit status, he will get certain tax breaks. Those tax breaks might allow B offer his product at a price lower than A’s price. If so, then inefficient B will take business away from efficient A.³⁶

Posner and Malani argue for symmetry between for-profit and nonprofit tax systems. Just as nonprofits are treated like for-profits when they engage in commercial ventures, for-profits should be treated like nonprofits when they engage in charitable ventures.³⁷

If this proposal were adopted, it presumably would exempt for-profits from corporate income taxes on their charitable activities and would make donations to these charitable activities tax-deductible. Decreasing the cost of engaging in charitable activities by giving these tax breaks should create

34. Anup Malani & Eric A. Posner, *The Case for For-Profit Charities* 17-18 (Univ. of Chi. John M. Olin Program in Law and Econ., Working Paper No. 304, 2006), available at http://papers.ssrn.com/abstract_id=928976.

35. *Id.* at 17.

36. *Id.*

37. *Id.* at 2.

incentives for for-profits to engage in more charitable activities. Nonetheless, for-profit directors would still face legal obligations to maximize short-term profit. These obligations would limit the extent to which directors could engage in this newly incentivized charitable activity.

Regardless of the extent to which for-profits would be able to take advantage of this new incentive, this proposal would likely meet stiff, perhaps insurmountable, opposition. Critics have leveled two criticisms at tax-exemptions for nonprofits: First, these exemptions potentially erode the tax base by diminishing the total tax revenues government collects from business; second, they threaten to permit the inefficiencies discussed above.³⁸ The prospect of expanding tax exemptions to include for-profits would likely meet similar criticism. Furthermore, expanding tax exemptions for for-profits would likely result in abuse and exploitation of those exemptions. Companies that do not intend to accomplish any social goals, for instance, might try to use these new exemptions as tax shelters for their for-profit operations.³⁹

C. Reinterpreting and Working Within Current Laws

The most promising schemes for exploring hybrid organizations in the immediate future are those that propose to reinterpret and work within current laws. These schemes accomplish most of the same goals the more ambitious reforms seek, but they do not involve the massive investment of resources and time necessary to change the laws.

The first approach creates a new corporate designation, but it does so within the current laws. Jay Coen Gilbert, the for-profit entrepreneur who founded And1, a basketball apparel company, is spearheading an effort to create For-Benefit Corporations (also called "B corporations"). B corporations incorporate under states' current corporate statutes and are subject to private-sector tax laws. They differ from traditional corporations (e.g., S corporations, C corporations), though, in that they spell out their social commitments in their corporate governing documents for all potential investors to see.

38. Much of the literature on UBIT discusses these two types of concerns. See, e.g., Boris I. Bittker & George K. Rahdert, *The Exemption of Nonprofit Organizations from Federal Income Taxation*, 85 YALE L. J. 299, 316-30 (1976); Charles T. Clotfelter, *Tax-Induced Distortions in the Voluntary Sector*, 39 CASE W. RES. L. REV. 663, 677-80 (1988-1989); Henry B. Hansmann, *Unfair Competition and the Unrelated Business Income Tax*, 75 VA. L. REV. 605 (1989); Susan Rose-Ackerman, *Unfair Competition and Corporate Income Taxation*, 34 STAN. L. REV. 1017, 1017-19, 1025-30 (1982).

39. Supporters of increasing exemptions might devise safeguards to limit such exploitation. Discussion of such safeguards, however, is not within the scope of this Comment.

To qualify as a B corporation, a company must first commit itself to a governance structure that reflects a broad set of stakeholders.⁴⁰ This ensures that a B corporation aims not only to maximize profits for shareholders but also to pursue the interests of its employees and, more broadly, of the communities and environments in which it operates. Second, a B corporation has to commit to meeting a set of social and environmental performance standards.⁴¹ B Lab, a nonprofit organization, functions as an impartial third-party that certifies and rates B corporations on how well they actually meet these standards.

This approach to hybrid activity accomplishes a lot. It allows an organization to commit itself to maximizing both profit and social impact. These organizations would be able to tap into both the for-profit capital market and the nonprofit capital market (namely, by receiving PRIs). The designation as a B corporation would create an identifiable brand for socially responsible companies, and the rating system would preserve the integrity of that brand by giving investors transparency into the organizations' practices. This scheme accomplishes all of this without relying on legislative victories.

Over twenty companies have already opted for this designation.⁴² The first, Upstream 21, a holding company in Oregon, rewrote its Articles of Incorporation to commit itself to pursuing the "best interests" of the company which it defined to include:

[D]ue consideration of: the Company's and its subsidiaries' social, legal and economic effects on their employees, customers and suppliers and on the communities and geographic areas in which the company and its subsidiaries operate; the long-term as well as short-term interests of the Company and its shareholders; and the Company's and its subsidiaries' effects on the environment.⁴³

Although these terms take a big step toward creating a genuine hybrid organization under current laws, it remains to be seen whether courts would uphold such Articles of Incorporation as valid. The case law against such commitments applies only to for-profits that have not spelled out in their Articles of Incorporation any commitments beyond profit maximization. No law prevents companies from articulating social commitments in their Articles of Incorporation and pursuing those social commitments in addi-

40. B Corporation, About B, <http://www.bcorporation.net/about> (last visited Dec. 13, 2007).

41. *Id.*

42. B Corporation, B Community, <http://www.bcorporation.net/community/> (last visited Dec. 13, 2007).

43. Restated Articles of Incorporation of Upstream 21 Corporation (undated) (on file with author).

tion to pursuing profit. The law simply has established profit-maximization as a default rule. The B corporation approach is essentially allowing a company and its investors to contract around that rule. Only thirty-one states have expressly permitted companies to add these types of provisions to their Articles of Incorporation.⁴⁴ No court has yet determined whether these provisions are legally binding.⁴⁵

Opponents of this idea might claim that these broad commitments set such wide parameters for directors that these terms effectively free directors from any legal obligations. In turn, this might undermine investor confidence in directors. In practice, the market will determine whether this is a valid concern. That is, if people feel uncomfortable with broad social commitments then they will not invest in B corporations and the corporations will fail. A second criticism is that companies will exploit the new legal form. B corporations do not receive any tax breaks, but they do benefit from the millions of dollars B Lab spends each year promoting B corporations. Companies might try to freeride on this marketing by incorporating as a B corporation and not meeting their stated social commitments. Coen Gilbert anticipated this problem, though. B Lab's impartial certification of B corporations' practices makes transparent the companies' practices and reveals those companies that are attempting to exploit the designation.

The second proposal for exploring hybrid activity within the current legal system aims to increase foundations' use of PRIs. To do so, Marcus Owens, former head of the Internal Revenue Service Exempt Organizations Division, proposes drawing brighter lines to guide foundations toward companies that would be appropriate PRI recipients. We need not create a new corporate form like L3Cs in order to draw these bright lines, though. Instead, Owens suggests that the IRS could simply identify a number of for-profit entities that accomplish what it considers to be charitable goals. The IRS could then issue a roster of these organizations doing PRI-worthy work.⁴⁶

Publishing this roster would facilitate PRIs in two ways. It would remove the risk of punishment for foundations granting loans to non-PRI-worthy companies. In addition, it would help foundations, especially small ones, learn which companies are doing work that aligns with the foundations' missions.⁴⁷ By reducing the risks involved in making PRIs this plan

44. Hannah Clark, *A New Kind of Company: B Corporations Worry About Stakeholders, Not Just Shareholders*, INC.MAG, July 2007, at 23, 24, available at <http://www.bcorporation.net/blog/IncMagazine.pdf>.

45. *Id.*

46. See THOMAS J. BILLITTERI, *supra* note 20, at 10-11 (summarizing Owens's proposal of this plan to an Aspen Institute working group).

47. See *id.*

would likely increase the existing underused mechanism for foundations to invest in for-profits.

Each of these proposals charts a complementary course for development of hybrid structures. B Corporations address many of the problems our binary legal structure creates for both service-oriented nonprofits and for-profits. Owens's idea addresses the central problem foundations face. Together, these proposals present fairly comprehensive solutions to the current restrictions on hybrid activity, and they allow further exploration of hybrid organizations to proceed immediately and without waiting to change any laws.

CONCLUSION

We have seen a recent flurry of interest in hybrid social organizations that try to operate in the legal space between for-profits and nonprofits. These types of organizations appear to have potential to address some of the problems for-profits and nonprofits face when they try to address social problems. As such, there are compelling reasons to continue exploring how the laws can foster such hybrid structures. After assessing current proposals to do so, the best road forward is to work first within existing laws, while continuing efforts to change the laws comprehensively.