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NONPROFIT ORGANIZATION REPORT – SPRING 2016

Redefining Social Enterprise and Benefit Corporations

Better to share the money than to share the mission

Our economic system has three sectors: the governmental sector, the private/for-profit sector, and the intermediate/nonprofit sector. The nonprofit sector is “intermediate” in that it shares traits with the other two: nonprofits are governed by private individuals (fiduciary boards of directors) but operate for the benefit of the public (as does the government).

Approximately 30 years ago the “social enterprise” movement emerged as a variation on this three sector system. It was assembled by combining DNA from the for-profit sector with DNA from the nonprofit sector to create a hybrid way of doing business with the following imperative: “make money, but do good things too.”

Despite its good intentions, the movement suffers the following structural and conceptual defects. First, there are no generally accepted standards or definitions of the terms social enterprise, social entrepreneur or social benefit (three synonyms of a sort used in the movement). Second, the dual imperative (“make money, but do good things too”) creates and imposes a board level conflict of interest between the missions. Third, from a conceptual perspective social enterprise falsely presupposes that there is an either/or choice to be made between profit and social good – failing to recognize that profit is a social good too.

In this newsletter we will suggest a method for pursuing the imperative to “make money, but do good things too” that is both more traditional and objective: make the money in business entities and pursue social benefits in nonprofit entities, but align their interests by giving the nonprofits equity-like (ownership) interests in the profits. We believe this approach would avoid the flaws identified above. First, the uniform and legally enforced standards of Section 501(c)(3) of the Internal Revenue Code would apply to the nonprofits. Second, there will be no conflict of interest because the organizations will each have a single mission. Third, the either/or question evaporates when profit is properly recognized as a social good.

In other words, it is better to share the money than to share the mission. Here is why and how it might be done:

Social Enterprise: the absence of substantive standards. At the start readers should recognize that the terms “social entrepreneur” and “social enterprise” are not trademarked or regulated in their use. They have no owner. They are not defined in any legal or uniform generally accepted manner – which means that any business can hold itself out to the public as a social enterprise. People are free to define “social” or “social benefit” to mean whatever they desire. Mr. Brown’s Petroleum Fracking Company and Mr. Green’s Wind Power Company can each make a *bona fide* claim to be a social enterprise. The absence of standards dilutes the value of the social enterprise brand to near zero.

This is not the case with nonprofits which must satisfy the finely honed and tested standards of Section 501(c)(3) of the Internal Revenue Code before holding themselves out as public benefit entities.¹

Benefit corporations. Benefit corporations (“B corporations”) are a formalized statute-based variation of what we have discussed so far. Whereas any business can simply proclaim itself to be a social enterprise, if the business is organized as a B corporation the social benefit component must be written into the certificate of incorporation where it becomes an enforceable legal obligation. B corporations and their directors can be sued for failure to advance the social benefit.

However, B corporations suffer the same flaw as social enterprises not organized as B corporations. This is because the “social benefit” (even though written into the certificate of incorporation) can still be defined to mean whatever the owners want it to mean, and they can change the meaning and amend the certificate of incorporation at will – which dilutes the value of the B corporation brand and methodology.²

Conflict of Interest and management burdens. Boards of directors have a fiduciary duty of loyalty requiring them to act solely in the “interests” of the for-profit or nonprofit they serve. In the for-profit context this duty was historically interpreted to require boards to act solely to maximize profitability for the shareholders. This interpretation was modified by statute over the years to *permit (but not mandate)* directors to use corporate resources (profits) to attend to social factors – but this was done by expanding the scope of what is deemed to be in the interests of the corporation and not by creating a separate social benefit interest to which fiduciary duties are owed by the directors. The voluntary efforts many public companies make to be “good corporate citizens” were enabled by this expanded interpretation of the interests of the corporation.

However, social enterprise, especially in its B corporation manifestation, is profoundly different because it requires the board to act in the interests of a social benefit – creating a duty to the social benefit on par with, if not superseding, the duty to shareholders to operate profitably, and to maximize

¹ There are international efforts afoot to promulgate Social Reporting Standards (SRS) which are intended to measure social performance in a manner similar to that in which Generally Accepted Accounting Principles (GAAP) measure financial performance on a uniform “apples to apples” basis. Presumably an organization which satisfies SRS would have a *bona fide* claim to call itself a social enterprise and be accepted as such in the marketplace. However, we believe the SRS effort is also quixotic because, while concepts such as “social benefit” have meaning in our daily discourse, they are too subjective to be objectified in the manner that SRS proponents believe. A story in the February 12, 2015, edition of the *Guardian* (England) (titled “Can You Set a Standard for Social Impact”) addresses the “proliferation of reporting standards...[t]here’s the [AccountAbility AA1000 audit](#); the [UN Global Compact](#); [ISO 26000](#); the [German Sustainability Code](#); the [Sustainability Accounting Standards Board](#); the [ESG Disclosure Framework](#); [HACT Value Insight](#); the [Global Reporting Initiative](#); the list goes on.” In addition, there are companies which have developed SRS standards and which have created a trademark/logo with which they are identified. For a fee they will audit and certify an enterprise’s compliance with their standards, and allow it to use the trademark/logo in its branding. A company called B Lab is an example. However, this arrangement simply kicks the flaw down the road because if someone does not, for example, like B Lab’s standards, he can make up his own and/or find or create another company to certify standards more to his liking.

² Here is a hypothetical: Mert owns several run-down apartments in a sleazy part of town. In polite social circles people have started referring to him as a slum lord. Mert wants to improve his image and brand and decides to become a social entrepreneur. He incorporates his apartment business in the form of a B corporation and includes the following social benefit standard in the certificate of incorporation: *Making affordable housing available to people who would otherwise be homeless.*

profits. In other words, the B corporation statute actually creates a conflict of interest between the two different missions and foists it on the board of directors and management to resolve.³ Boards of directors and management are not burdened by conflict when separate for-profit and nonprofit entities are used, because each has only one mission.

The either/or fallacy of social enterprise. Finally, the social enterprise movement is biased against for-profit private enterprise. The placement of the word “social” before the word “enterprise” says it all – implying that a business and its profits are “good” if derived in a “socially beneficial” manner and “not good” if they are not.

In the first instance, we do not see how it is possible for social enterprises generally to pass judgment on other (non-social) enterprises because of the lack of a measuring stick – definitions or standards to make comparison even possible. It would be like saying an inch is as long or as short as you want it to be. But on a secondary level the either/or question baked into the social enterprise project is false because profit is a social good *per se* – as necessary to society as the fulfillment of the social missions pursued by nonprofits. Profit is necessary to our jobs and survival; it is the source of tax revenue and charitable donations.⁴ Similarly, nonprofits are necessary because they make civil society possible by attending to needs outside the domain of the for-profit sector. The sectors are not opponents caught in an interminable tug of war over resources and claims to the moral high ground.

Redefining the method. We first wrote about Social Enterprise in the Spring 2009 special supplement of this newsletter (*Social Entrepreneurship – When Worlds Collide or the Best of Both?*). At that time we concluded that its motives were honorable, but that time would tell if it is an evolutionary dead end or a revolutionary step forward. Today we are opining that it is more likely the former for the reasons stated above. It is too cumbersome and unwieldy to try to jam a dual mission

³ For example: Should board members of a B corporation vote to invest in a risky new product that may lose money for a while (and possibly fail) but which has great upside potential – meaning fewer resources would be available currently for the “social benefit”? The very existence of this question is an encumbrance on board deliberations. Maintaining profitability is a full-time job for most boards. Moreover, the social enterprise/B corporation methodology is extraordinarily complicated in that the monetary expense of fulfilling the social benefit is incurred at the operational level – baked into the profit and loss statement requiring that ordinary course of business decisions on everything from pricing and vendor selection to HR policies be made on the basis of its bearing on the social benefit and not solely on the basis of cost and quality. This point becomes clear by looking at the scope of the questions B Lab (Footnote 1) asks of organizations seeking its certification, such as: what portion of management is evaluated in writing on their performance relative to social targets; do you evaluate the social and environmental performance of your vendors and suppliers; do you permit employees paid or nonpaid time off for community service; what percentage of the company is owned by employees; and do you give preference to sustainable or fair trade suppliers? While there is nothing wrong with these inquiries *per se*, the point is that attending to them introduces a level of operational complexity and expense – almost as if the enterprise is supposed to weave its “charitable donation” into the operating budget each year in the form of the additional costs incurred to fulfill the social mission.

⁴ We suspect that this antipathy to profit is rooted in the false but lingering medieval belief that profit-making is by its nature a zero sum game in which one wins (profits) only if someone else loses – meaning that profit will always bear the moral taint of having been “taken” from the loser. Our claim about the nature of profit as a social good is derived from the fact that the “value added” in products and services that leads to profitability is primarily a function of what someone is willing to pay for them in the market – and from the necessity of distinguishing profit from the people who make and control its distribution. There are bad people who make a profit (or excess profit) by exploiting people and resources, and there are good people who make a profit fairly and are generous with its use.

into a for-profit vessel, and we need these vessels creating as much profit as possible to circulate through the system. Let for-profits do what they do best, and let nonprofits do what they do best.

However, we also believe it would be a good thing if more of the profit being created found its way into the budgets of nonprofit organizations, and suggest that social entrepreneurs would be better off trying to find ways to make this happen. In essence, they should try to monetize a business's claim to be a social enterprise by measuring the extent to which it is willing to commit to putting its money (profit) where its mouth is.

The monetization could take different forms, but our suggestion is a derivative of the means by which nonprofits with endowments enjoy dividends and capital gains each year (both of which are a function of profitability). A few years ago we prepared documentation for a corporate client to create a class of "special preferred" stock which by its terms could only be owned by Section 501(c)(3) organizations and which paid a preferred dividend and enjoyed a "liquidation preference" in the event of a sale of the company. Something of this type might also be accomplished with phantom shares or appreciation rights, or in the case of a limited liability company, an economic interest that would be entitled to some percentage of annual profit. An interesting side effect of a technique like this is that the nonprofit would have an interest in the for-profit's operating as profitably as possible. Finally, if someone's claim to be a social enterprise were based on this platform, it would be easier to create uniform standards for comparison purposes because the amount distributable to the nonprofits could be expressed as a percentage of profits (as calculated in accordance with Generally Accepted Accounting Principles).

As always, we invite relevant comments from our readers.

The Reid and Riege Nonprofit Organization Report is a quarterly publication of Reid and Riege, P.C. It is designed to provide nonprofit clients and others with a summary of state and federal legal developments which may be of interest or helpful to them.

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