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SE(c)(3): A Catalyst for Social Enterprise Crowdfunding

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SE(c)(3): A Catalyst for Social Enterprise Crowdfunding

DANA BRAKMAN REISER* & STEVEN A. DEAN**

The emerging consensus among scholars rejects the notion of tax breaks for social enterprises, concluding that such prizes will attract strategic claimants, ultimately doing more harm than good. The SE(c)(3) regime proposed by this Article offers entrepreneurs and investors committed to combining financial returns and social good with a means of broadcasting that shared resolve. Combining a measured tax benefit for mission-driven activities with a heightened burden on shareholder financial gains, the revenue-neutral SE(c)(3) regime would provide investors and funding platforms with a low-cost means of screening out "greenwashed" ventures.

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INTRODUCTION

Social enterprises—entities that use business strategies to advance both profit and social goals—suffer from a capital-access problem.[1] Scholars have responded to the

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‡ This Article benefited from thoughtful comments from Brian Galle and the participants in the 2013 Law & Society Association's Annual Meeting, the NYU-Stern Conference on Social Entrepreneurship, the Managing Social Enterprise seminar at the Yale School of Management, the Tax Justice & Human Rights Symposium at the McGill University School of Law, the 2013 Conference of the Association for Research on Nonprofit Organizations and Voluntary Action, the Tulane Tax Roundtable, and the Current Issues in Tax Law, Policy and Practice seminar at Harvard Law School.

1. Neil Parmar, *No Case for Causes: Social Enterprises Have a Hard Time Landing Capital*, WALL ST. J., June 12, 2014, at R3 (noting that as social enterprises "try to scale up, they're having a tough time landing investment capital to fund their growth, experts and entrepreneurs say").

suggestion that tax breaks could ease that logjam[2] with a resounding "no."[3] This Article offers a more nuanced answer, pairing a carrot with a stick to create a revenue-neutral[4] SE(c)(3) tax regime that rewards commitment to a double bottom line and provides a bulwark against faithlessness.[5]

The obstacles social enterprises face when raising capital are straightforward. Soliciting donations is difficult without the tax-deductibility incentive charities can offer.[6] Purely market-driven investors will reject social enterprise investments on just the whiff of potentially below-market returns. Even investors keen on earning a blend of financial and social returns will be wary.[7] That reluctance reflects the simple reality that when founders or entrepreneurs hold the reins of a social enterprise, they have the power to choose its path. Should they choose to forgo social good in order to maximize profits, passive investors on the retail level will be powerless to stop them.

The wave of hybrid organizational forms for social enterprise that has gained momentum in recent years has only managed to invert—rather than resolve—that threat.[8] Corporate hybrids, like the benefit corporation and Delaware public-benefit corporation, grant shareholders the power to embrace pure profit maximization.[9] As a result, dominant shareholders can transform these specialized entities into ordinary for-profit corporations. They can do so even if founders or dispersed shareholders object. More broadly, these hybrid entities lack both the organizational commitments

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2. *See generally* Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007) (proposing tax-exempt treatment for the mission-driven activities of for-profit corporations).

3. *See generally* Victor Fleischer, *"For-Profit Charity": Not Quite Ready for Prime Time*, 93 VA. L. REV. BRIEF 231 (2008); Mitchell A. Kane, *Decoupling?*, 93 VA. L. REV. BRIEF 235 (2008); Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819 (2012); Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387 (2014).

4. "Revenue neutral" refers to the impact of the regime on the federal budget. A tax break is not revenue neutral because it decreases revenues. A tax change can also increase revenues. Because the SE(c)(3) regime combines a tax penalty with a tax break, it can be revenue neutral in the aggregate even if particular enterprises fare better or worse than they would otherwise. *See infra* notes 109–11 and accompanying text.

5. As discussed below, the regime need not direct public resources to the social enterprise sector. Individual corporations may fare better (if they prioritize their mission) or worse (if they focus exclusively on shareholder financial rewards) than they otherwise would, but the regime is primarily a mechanism for attracting private capital by demonstrating a commitment to balancing social goals and private rewards. *See infra* Part III.

6. Traditional nonprofits face a similar obstacle when potential donors do not itemize their deductions and are thus unable to capitalize on the deductibility of contributions. *See* I.R.C. § 67(b) (2012) (treating charitable deductions as itemized deductions not subject to unfavorable "miscellaneous" treatment).

7. *See infra* note 88 and accompanying text.

8. The first entity tailored to meet the needs of social enterprise, the low-profit limited liability corporation (L3C), leaves entrepreneurs in the driver's seat. They may shed an L3C's special status and become an ordinary limited liability company (LLC) simply by changing their activities. *See* Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with Fly Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 B.C. L. REV. 1495, 1498 (2013).

9. *Id.* at 1506–13.

and enforcement mechanisms necessary to attract investors worried that the social commitments of entrepreneurs, or their fellow investors, will fade.

Sophisticated investors wielding significant capital, of course, need not rely on newfangled organizational forms to protect themselves. These savvy investors can instead use specialized financial instruments to overcome the trust issues inherent in double-bottom-line ventures.[10] Convertible debt, preferred stock, and other arrangements can be designed to incentivize entrepreneurs and fellow investors to stay on mission and to cabin the financial benefit of straying. "Mom-and-pop" investors, however, do not have the experience to develop specialized instruments or the sway to deploy them. If the social enterprise sector wants to reach the vast market of retail investors (and their capital), it must find a way to reassure these investors effectively and en masse.

The advent of crowdfunding—conceived as a means of pooling small amounts of capital to fund artistic, philanthropic, and business ventures[11]—throws this challenge and opportunity into stark relief. Crowdfunding offers social enterprises a means to access the retail-investor market more cheaply and readily than ever before.[12] But crowdfunding, with its promise of bypassing Wall Street to raise capital directly from Main Street, relies on a large class of investors with neither access nor influence; crowdfunding a social enterprise would invite the very type of faithlessness that keeps small investors at bay. Neither hybrid organizational forms nor hybrid financial instruments can provide a counterweight to profit's pull since in each case an outsider's power remains proportional to the size of his investment.[13] To successfully attract crowdfunding, insiders need a means of signaling a commitment to balancing social and financial returns.

This Article proposes a robust mechanism that would allow both insiders and outsiders to demonstrate their commitments to social mission. Rather than relying on organizational form to shield an enterprise's social mission, this Article crafts a tax regime designed to comfortably accommodate a double bottom line while inflicting pain on investors interested only in financial returns. The proposed regime taps the power of the tax law[14] to unlock the potential of innovative funding platforms capable of channeling capital toward social enterprise.[15]

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10. *See infra* note 92 and accompanying text.

11. As in the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 (the CROWDFUND Act), crowdfunding refers to the use of online tools to raise capital through the aggregation of many small investments. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 315 (2012).

12. *See* Parmar, *supra* note 1 (noting that crowdfunding is an "increasingly popular solution" for social enterprises seeking capital).

13. A supermajority of shareholders can decide to convert a hybrid corporation to a for-profit corporation. This supermajority requirement would not allow a small shareholder to prevent a conversion. Likewise, the owner of a handful of convertible debt would not, on her own, be able to inflict much punishment on a wayward shareholder. *See infra* note 92 and accompanying text.

14. The proposal relies on federal tax law, but most of the legislation encouraging social enterprise has been enacted at the state level. Although the national reach of the proposal is one of its virtues, state legislators could use state tax law to achieve similar ends.

15. Crowdfunding enthusiasts claim it allows small investors and small, often socially minded businesses to connect to create value. *See* Michal Lev-Ram & Kurt Wagner,

The core of the regime is straightforward: the first $250,000 of profit attributable to any for-profit corporation's 501(c)(3) activities goes untaxed each year.[16] An additional dollar-for-dollar—or in the vernacular of social enterprise, one-for-one—exclusion applies for each dollar of such income earned. The remainder of the corporation's income would be subject to the corporate income tax. The $500,000 annual exclusion limit on a corporate social enterprise (or SE(c)(3)) is both generous enough to accommodate the modest profit objectives of a typical social enterprise and small enough to ensure that it will not swallow the whole of the corporate tax.

The SE(c)(3) exclusion represents only one aspect of the regime. The iron fist inside the exclusion's velvet glove is ordinary income treatment for dividends paid by any corporation that has embraced SE(c)(3) status.[17] The same result applies to gains from the sale of SE(c)(3) stock. The relatively high tax burden on those financial returns transforms a simple subsidy into what is known as a "commitment device."[18]

As a drinker determined not to drive might hand his keys to a policeman, the SE(c)(3) regime allows entrepreneurs and investors devoted to social enterprise to

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Crowdfunding Tries To Grow Up, FORTUNE, May 20, 2013, at 40, 40 ("Proponents of crowdfunding believe it has the potential to upend traditional financing models, such as loans and venture capital, and unleash a tidal wave of capital for entrepreneurs, creative types, and, yes, cheesemongers. Reliable estimates of the industry's size are hard to come by, but one research outlet, Massolution, predicts some $5 billion will be raised through crowdfunding this year, up from $2.7 billion in 2012."). If SE(c)(3) status was made available, crowdfunding sites could use it as a screen for participating issuers, dramatically lowering their costs of vetting potential participants. The availability of SE(c)(3) status would tame one potent impediment to capital access for social enterprises for even the most vulnerable. *See infra* Part III.

16. The regime uses mission-driven expenditures as a rough measure of mission-driven income. *See infra* Part III.A.3.

17. The tax law offers a lower tax rate for taxpayer's capital gains. *See* I.R.C. § 1(h) (2012). In order to qualify for that treatment, the property sold at a gain must be a "capital asset." *See* I.R.C. § 1221 (2012) (listing property that is excluded from the preferred category). Adding SE(c)(3) shares to that list—alongside inventory, copyright in the hands of its creator, and an assortment of other types of properties deemed ineligible for capital-gain treatment—would subject gains on sales of SE(c)(3) shares to the relatively high rates that apply to, for example, wages. *Id.* at (a)(1), (3) (excluding "stock in trade of the taxpayer" and "a copyright . . . held by . . . a taxpayer whose personal efforts created such property" from the definition of a "capital asset"). Broadening the exclusion to cover financial instruments whose value is largely determined by or can be converted into SE(c)(3) shares would prevent end-runs around the exclusion. Excluding SE(c)(3) stock from § 1221 would, of course, cause losses to be treated as ordinary losses, a result that taxpayers generally prefer. A less generous approach would strip gains of preferential rates while denying ordinary treatment for losses.

18. Tax laws have long played a pivotal role in promoting both charitable and for-profit ventures. Usually, that assistance comes in the form of tax subsidies. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 881–84 (1980) (offering examples of the "special treatment under state and federal taxation" that subsidizes nonprofits). The SE(c)(3) exclusion would leverage the tax law to aid social enterprises, but not principally through its offer of modest tax relief. The more valuable function of the exclusion would be to provide small investors the reliable signal they need to sort double-bottom-line entities from "greenwashed" for-profit ventures that insincerely boast a commitment to a social mission but in reality focus only on profits.

enlist an unlikely ally to their cause: the Internal Revenue Service.[19] A strategic SE(c)(3) claimant would need to weigh the certainty of a heavy tax burden on stock sales and profit distributions against the possibility of a modest exclusion available only for mission-driven income. By contrast, the SE(c)(3) regime's combination of favorable treatment for SE(c)(3) income paired with unfavorable treatment for shareholder financial returns would hold great appeal for entrepreneurs and investors dedicated to pursuing a double bottom line. Best of all, SE(c)(3) status would send a credible signal to small investors, on crowdfunding platforms and elsewhere, that an electing social enterprise is worth their trust.

I. SOCIAL ENTERPRISE AND CROWDFUNDING

Human-interest stories about businesses with a social mission abound. Food purveyors are training hard-to-employ workers,[20] inventors are developing ideas for a low-cost light source or water filter to transform communities in developing countries,[21] and an ever-increasing range of consumer products are offered on a one-for-one model.[22] At the same time, investors at all levels display a growing interest in deploying their capital in a socially conscious fashion, and every day more people are eating at crowdfunded restaurants, watching crowdfunded movies, or sporting their latest crowdfunded knickknack. The 2012 JOBS Act included a regulatory structure to enable equity crowdfunding as part of its effort "[t]o increase American job creation and economic growth by improving access to the public capital markets for emerging growth companies."[23]

Still, social enterprises generally remain quite small and complain of a desperate need for capital. The catalyst this Article proposes to channel private capital—particularly small investments by ordinary individuals—toward double-bottom-line enterprises consists of a combination of penalties and rewards. Specifically, the SE(c)(3) tax regime provides a tax break targeted at the 501(c)(3) activities of

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19. *See infra* note 185 and accompanying text.

20. *See, e.g.*, Marilyn Jones, *Andrew Stoloff's Rubicon Bakery Gives a Second Chance to Ex-Cons*, CHRISTIAN SCIENCE MONITOR (Mar. 14, 2014), http://www.csmonitor.com/World/Making-a-difference/2014/0314/Andrew-Stoloff-s-Rubicon-Bakery-gives-a-second-chance-to-ex-cons ("Rubicon Bakery is a moneymaking business owned by Mr. Stoloff, employing 105 full-time staff, some with only a sixth-grade education and many having served time in prison.").

21. *See, e.g.*, Paula Goldman, *Impact Investing: Harnessing The Power of Business for Social Good*, GUARDIAN (Dec. 2, 2013, 7:25 AM), http://www.theguardian.com/global-development-professionals-network/2013/dec/02/impact-investing-business-charity-social-good?CMP=twt_gu (highlighting "d.light—a leading US manufacturer and distributor of solar lanterns . . . [which has] transform[ed] itself from a small-scale operation to a thriving global enterprise"); A.R., *Social Entrepreneurs in India: Water for All*, ECONOMIST (Mar. 20, 2013, 10:25 AM), http://www.economist.com/blogs/schumpeter/2013/03/social-entrepreneurs-india (profiling Sarvajal, a social enterprise that "sells clean drinking water to more than 70,000 people in rural India").

22. *See* Andrew Adam Newman, *'Buy One, Give One' Spirit Imbues an Online Store*, N.Y. TIMES, Nov. 5, 2013, at B7 (describing a number of one-for-one businesses, including TOMS Shoes and One World Futbol).

23. JOBS Act, Pub. L. No. 112-106, 126 Stat. 306, 306 (2012).

for-profit corporations[24] while withdrawing favorable capital-gain treatment from profits earned by shareholders of SE(c)(3)s.[25] By choosing the SE(c)(3) regime, a social enterprise publicly and irrevocably declares its commitment to balancing profits and social good.[26] This Part sets the stage for that proposal by introducing the notion of a dual-mission enterprise and explaining why the advent of JOBS Act–enabled equity crowdfunding will not suffice to unleash the retail-investment market to capitalize social enterprise.

A. The Puzzle of the For-Profit Charity

The idea of a social enterprise—a business entity with social and profit-making goals and a concomitantly double bottom line—strikes some as pure madness.[27] To its devotees and advocates, however, social enterprise offers the best of both worlds. Rather than leaving the community and the environment in its wake like full-throttle profit-maximizing capitalism, a successful social enterprise can turn a modest profit while doing good for society.[28] Moreover, instead of using small-time, inefficient, charitable techniques, successful social enterprises can use the innovation and discipline of business methods to solve social problems at scale.[29]

The trend to try to combine financial and social returns appears to be gaining steam. Prominent business schools have established social enterprise programs. They offer specialized curricula for interested students, research support for faculty, and networking opportunities for alumni.[30] Media accounts chronicle the entry of newly

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24. The SE(c)(3) regime measures the cost a social enterprise's mission imposes and—up to a $250,000 annual limit—provides an exclusion equal to that cost. It augments that exclusion with an additional $250,000 one-for-one exclusion. The end result is that a social enterprise can "earn" a tax break by engaging in the activities that might otherwise be conducted by a traditional 501(c)(3) nonprofit. *See infra* Part III.B.

25. Ordinarily when an investor sells shares of a corporation, any gains are taxed at a lower rate than the investor would pay on an equal amount of salary. *See* I.R.C. § 1(h)(1) (2012) (providing a special, lower tax rate applicable to income such as gains from stock sales that results in "net capital gain"). Corporate dividends are generally granted the same favorable treatment. *See* I.R.C. § 1(h)(11) (2012).

26. Part II explains the concept of the commitment device and how the SE(c)(3) regime permits investors and entrepreneurs to limit their future freedom of action in a manner that serves a larger goal. Simply put, the SE(c)(3) regime lowers the cost of pursuing social good and increases the costs of focusing on financial gain. *See infra* Part II.

27. Puzzling over the combination, Kane was reminded of a museum exhibit titled *Mythic Creatures: Dragons, Unicorns and Mermaids*. Kane, *supra* note 3, at 241.

28. *See* Heerad Sabeti, *The For-Benefit Enterprise*, HARV. BUS. REV., Nov. 2011, at 99, 104 (concluding that "[i]t will become clear that in organizing their enterprises for benefit, entrepreneurs have been the architects of a new, more sustainable capitalism").

29. *See, e.g.*, J. Gregory Dees & Beth Battle Anderson, *For-Profit Social Ventures*, 2 INT'L J. ENTREPRENEURSHIP EDUC. (SOC. ENTREPRENEURSHIP) 1, 5 (2003) ("Many social entrepreneurs believe that for-profit structures have virtues that are not easily mimicked by nonprofit or public sector counterparts."); Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 339 (2009) (explaining that social enterprise founders "embrace market-oriented solutions to social ills").

30. *See, e.g.*, *About*, HARV. BUS. SCH. SOC. ENTERPRISE, http://www.hbs.edu/socialenterprise

minted graduates of such programs into the social enterprise field, as well as their early successes.[31] The number of conferences dedicated to social enterprise continues to increase, including a number of annual meetings designed to convene social entrepreneurs, thought leaders in the space, and even funders.[32] The same is true of more scholarly meetings.[33] Media interest is high,[34] and even government entities have begun to get involved.[35]

Despite this enthusiasm, most social enterprises are small, and many are startups.[36] These mission-driven businesses need funding to develop, whether they are working to demonstrate proof-of-concept or to bring a small success to scale.[37] Fortunately, social entrepreneurs are not the only group interested in marrying social good with profit.

/about/; *The Tamer Center for Social Enterprise*, COLUM. BUS. SCH., http://www8.gsb.columbia.edu/socialenterprise/; *see also* Katie Smith Milway & Christine Driscoll Goulay, *The Rise of Social Entrepreneurship in B-Schools in Three Charts*, HBR.ORG (Feb. 28, 2013), http://blogs.hbr.org/2013/02/the-rise-of-social-entrepreneu/.

31. *E.g.*, Delece Smith-Barrow, *Make Money in Social Enterprise with a Business School Degree*, U.S. NEWS & WORLD REP. (May 29, 2013, 9:30 AM), http://www.usnews.com/education/best-graduate-schools/top-business-schools/articles/2013/05/29/make-money-in-social-enterprise-with-a-business-school-degree.

32. *E.g.*, SOC. ENTERPRISE ALLIANCE, CONFERENCE GUIDE (2014), *available at* http://summit14.org/wp-content/uploads/2014/04/SEA_2014_SummitProgGuide_web.pdf; *2013 Fall Conference*, SOC. VENTURE NETWORK, http://svn.org/attend-an-event/2013-fall-conference; *Selection in Progress: Good Deals Social Pitch Contest*, SOC. ENTERPRISE WORLD F., http://www.socialenterpriseworldforum.org/gooddealssocialpitchcontest/; SOC. ENTERPRISE CROWDFUNDING CONF., http://secfc.tumblr.com/; *see also CSR Events*, CORP. SOC. RESP. NEWSWIRE, http://www.csrwire.com/events (providing a nationwide, day-by-day list of events addressing social enterprise and corporate social responsibility).

33. *E.g.*, *2014 Social Enterprise Conference*, COLUM. BUS. SCH., http://www.columbiasocialenterprise.org/conference/; *Crowdfunding and Its Implications for the Entrepreneurial Ecosystem: Setting the Research Agenda*, LEEDS SCH. OF BUS., U. COLO. BOULDER, http://crowdfundconference.org/program-and-schedules/ (offering an academic panel devoted entirely to social enterprise issues); *Schedule*, SOC. ENTERPRISE CONF., http://socialenterpriseconference.org/ (describing an annual program copresented by students of the Harvard Business School and the Harvard Kennedy School of Government).

34. *See, e.g.*, Anne Field, *One-Stop Incubators Hatching Social Enterprise Startups*, FORBES.COM (Apr. 20, 2012, 10:57 AM), http://www.forbes.com/sites/annefield/2012/04/20/one-stop-incubators-hatching-social-enterprise-startups/; Tim Smedley, *Social Enterprises Aid Innovation in Education*, GUARDIAN (Aug. 2, 2013, 3:00 AM), http://www.theguardian.com/social-enterprise-network/2013/aug/02/social-enterprise-aids-education-innovation.

35. Chi Onwurah, *Lessons from Portugal: Social Enterprises and Economic Regeneration*, GUARDIAN (Aug. 5, 2013, 10:40 AM), http://www.theguardian.com/social-enterprise-network/2013/aug/05/social-enterprises-aid-economic-regeneration.

36. Keren G. Raz, *Toward an Improved Legal Form for Social Enterprise*, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 294 (2012) ("Once a social enterprise establishes itself, if it is successful as a business, the revenue it generates will cover its costs. The challenge, therefore, lies in financing its startup and growth phases.").

37. *See* John Walker, *A Financing Gap*, ECHOING GREEN (Jan. 20, 2011, 4:36 PM), http://www.echoinggreen.org/blog/financing-gap (describing social enterprises as falling into a "financing gap" between large institutional funding sources and smaller funding sources).

The community of sophisticated investors looking for social impact is large and growing.[38] JPMorgan identified 2200 impact investment transactions worth more than $4 billion in its recent study of the phenomenon.[39] Other studies share this optimism.[40] Indeed, our own prior work has suggested an important place for such impact investors in capitalizing social enterprises.[41] These investors have the ability, resources, and clout to demand or design specialized financial products to safeguard both their financial and their social goals.

Retail investors also desire investment vehicles that combine financial return and the "warm glow" of doing good (or at least avoiding evil).[42] These mom-and-pop investors cannot afford or even imagine bespoke financial instruments to protect their interests in social enterprise investment, however. To reach their shallow but numerous pockets, another approach is required. The obvious candidates are mutual funds and pension funds.

The socially responsible mutual fund category is large and growing, with investments into them rising every year.[43] The Forum for Sustainable and

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38. *Q&A Roundtable on Impact Investing Moderated by Johanna Mair & Katherine Milligan*, STAN. SOC. INNOVATION REV., Winter 2012, at 25, 25 ("The field of impact investing is attracting growing numbers of organizations and increasing amounts of money. By some estimates there are nearly 200 registered impact investment funds, and many foundations (such as Rockefeller), networks (like GIIN and ANDE), and mainstream financial institutions (including JPMorgan Chase) are active in the field.").

39. YASEMIN SALTUK, AMIT BOURI & GISELLE LEUNG, J.P. MORGAN, INSIGHT INTO THE IMPACT INVESTMENT MARKET 3 (2011), *available at* http://www.jpmorganchase.com/corporate/socialfinance/document/Insight_into_the_Impact_Investment_Market.pdf. *See generally* MONITOR INST., INVESTING FOR SOCIAL & ENVIRONMENTAL IMPACT: A DESIGN FOR CATALYZING AN EMERGING INDUSTRY (2009), *available at* http://www.cdfifund.gov/what_we_do/resources/Investing%20for%20social%20and%20environmental%20impact%20Monitor.pdf (providing an in-depth discussion of impact investing).

40. *See, e.g.*, CALVERT FOUND., 2012 SOCIAL IMPACT REPORT 5 (2012), *available at* http://www.calvertfoundation.org/storage/documents/social-impact-report-2012.pdf (indicating that in 2012, the investment community was significant enough in size to ensure the Calvert Foundation had $184 million in its lending portfolio); HOPE CONSULTING, MONEY FOR GOOD: THE US MARKET FOR IMPACT INVESTMENTS AND CHARITABLE GIFTS FROM INDIVIDUAL DONORS AND INVESTORS 61 (2010), *available at* http://www.hopeconsulting.us/pdf/Money%20for%20Good_Final.pdf (estimating the impact investment market at $120 billion).

41. Brakman Reiser & Dean, *supra* note 8.

42. *Cf.* CALVERT FOUND., GATEWAYS TO IMPACT: INDUSTRY SURVEY OF FINANCIAL ADVISORS ON SUSTAINABLE AND IMPACT INVESTING 1 (2012), *available at* http://www.gatewaystoimpact.org/images/gatewaystoimpact.pdf (valuing the near-term market potential for sustainable investing at $650 billion in the United States); FORUM FOR SUSTAINABLE AND RESPONSIBLE INV., REPORT ON SUSTAINABLE AND RESPONSIBLE INVESTMENT TRENDS IN THE UNITED STATES 11 (2012), *available at* http://www.ussif.org/files/Publications/12_Trends_Exec_Summary.pdf (reporting that "$3.31 trillion in US-domiciled assets at year-end 2011 held by 443 institutional investors, 272 money managers and 1,043 community investment institutions that apply various environmental, social and governance (ESG) criteria in their investment analysis and portfolio selection" (emphasis omitted)).

43. S*ee* FORUM FOR SUSTAINABLE AND RESPONSIBLE INV., 2012 ANNUAL REPORT: US SIF AND US SIF FOUNDATION 10 (2012), *available at* http://www.ussif.org/files/Publications/USSIF_2012AnnualReport_F.pdf (finding annual increases in investment funds

Responsible Investing found in its 2012 Trends Report that sustainably and responsibly invested assets increased "22 percent from year-end 2009 to year-end 2011 to a total of $3.74 trillion."[44] The Forum explains this rise as "driven in part by . . . the dramatic expansion in the number and assets of mutual funds and alternative funds that consider environmental, social and governance criteria."[45] Of course, socially responsible funds for retail investors vary in how they put their vision into practice. Negative screens, such as prohibitions on investment in tobacco or gambling companies, are easy and inexpensive to apply.[46] Positive screening is more challenging, requiring the investment vehicle to select criteria for screening in socially responsible companies and then apply them.[47] Whatever their approach, the growth of socially responsible mutual funds demonstrates small investors' appetites for investing for blended value.

Mutual funds themselves, however, are unlikely to inject much capital into social enterprises, which are primarily small and privately held. Under SEC guidance, an open-end mutual fund cannot invest more than fifteen percent of its assets in private

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incorporating ESG factors from 2001 onward); *see also* Ronald J. Colombo, *The Naked Private Square*, 51 HOUS. L. REV. 1, 22 (2013) (reporting research showing growth of SRI mutual fund category); Joel C. Dobris, *SRI—Shibboleth or Canard (Socially Responsible Investing, That Is)*, 42 REAL PROP. PROB. & TR. J. 755, 757, 762–65 (2008) (observing that "social investing is hot").

44. FORUM FOR SUSTAINABLE AND RESPONSIBLE INV., *supra* note 43, at 10. According to its 2012 Trends Report:

> The total assets that are managed according to ESG [(environmental, social and governance)] factors that are explicitly incorporated into investment analysis and decision-making are valued at $3.31 trillion. Of this total, $1.41 trillion were identified within specific investment vehicles managed by money managers or community investing institutions, while $2.48 trillion were identified as owned or administered by institutional investors. Of these institutional ESG assets, $581.6 billion were managed for institutions through investment vehicles captured in research on money managers.

FORUM FOR SUSTAINABLE AND RESPONSIBLE INV., *supra* note 42, at 12.

45. FORUM FOR SUSTAINABLE AND RESPONSIBLE INV., *supra* note 43, at 10.

46. *Cf.* Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681, 686 (2002) ("According to the Social Investment Forum (SIF), the umbrella group for SRI professionals and organizations, as of 2000, the most common screen is for tobacco, with ninety-six percent of all screened assets steered away from tobacco. The next most common screens are for gambling, alcohol, and weapons. According to the SIF, more than eight out of every ten dollars in screened assets are in portfolios that avoid companies in each of these industries." (footnote omitted)).

47. *Id.* at 687 (Positive screening "is more difficult to implement . . . because investors cannot simply look at the nature of the business in the broadest sense. Instead they must examine corporate performance in detail, and the information they seek is often not public nor easy to get. Even if investors can get the information, it is likely to be in a form that is difficult or expensive to evaluate. Moreover, investors, once they have evaluated the information, are often left balancing performance across areas: a company that does very well in some areas might do poorly in others." (footnote omitted)).

companies.[48] Practical constraints are an even more important factor.[49] Mutual funds need liquidity and transparency in their investments to allow them to set appropriate prices for their open-end investors.[50] Even small-cap and growth funds will shy away from many social enterprises based on their size alone. Their double bottom lines further impede mutual fund investment, as assessing these companies and their prospects will require even greater time and resources than other private companies of a similar size.

Individuals save for retirement through mutual funds, but trillions of dollars in retirement assets are also managed directly by public and other pension funds.[51] ERISA and fiduciary obligations will add to the difficulty of using these funds to capitalize social enterprises.[52] Social enterprise explicitly contemplates the possibility of trading financial return for social good. Pension funds investing pooled assets in the best interests of future claimants will often be unwilling, and may be unable, to embrace such a tradeoff.

The retail investment market holds a deep pool of capital that could be used to start and scale social enterprises, and the evidence suggests many retail investors would be interested in investing for a blend of financial and social return. But mutual and pension funds do not provide ready vehicles for matching investor capital and social enterprise. Crowdfunding platforms may provide an attractive alternative.

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48. *See* Janet Kiholm Smith, Richard L. Smith & Karyn Williams, *The SEC's "Fair Value" Standard for Mutual Fund Investment in Restricted Shares and Other Illiquid Securities*, 6 FORDHAM J. CORP. & FIN. L. 421, 446–47 (2001) ("Based on concerns that open-end funds maintain adequate liquidity, the SEC recommends that they limit investments in illiquid assets to a maximum of ten to fifteen percent of fund value. Even open-end funds that specifically target investments in small and early-stage companies have adopted the SEC's guidelines." (footnote omitted)).

49. *See* Rachel Louise Ensign, *Fundamentals of Investing: Buying Stocks Before They Go Public*, WALL ST. J., May 2, 2011, at R2 (describing the risks and potential benefits of mutual fund investments in private companies).

50. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1318–19 (1991) (describing the "acute" liquidity concerns of open-end mutual funds as well as their "need to be able to report the current market value of their investments").

51. *See* PHILLIP VIDAL, U.S. CENSUS BUREAU, ANNUAL SURVEY OF PUBLIC PENSIONS: STATE- AND LOCALLY-ADMINISTERED DEFINED BENEFIT DATA SUMMARY REPORT: 2013, at 2 (2015), *available at* http://www2.census.gov/govs/retire/g13-aspp-sl.pdf (finding "[t]otal holdings and investments for state- and locally-administered pension systems grew by 8.7 percent, from $3.0 trillion in 2012 to $3.3 trillion in 2013"); *see also* TOWERS WATSON, GLOBAL PENSION ASSETS STUDY 2013 4, 7 (2013), *available at* http://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2013/01/Global-Pensions-Asset-Study-2013 (detailing the trillions of dollars in value in global pension funds).

52. *See* Dobris, *supra* note 43, at 771 (noting that "fiduciary duties . . . currently seem to forbid (or at least frown on) [Socially Responsible Investing]"); Maria O'Brien Hylton, *"Socially Responsible" Investing: Doing Good Versus Doing Well in an Inefficient Market*, 42 AM. U. L. REV. 1, 40 (1992) ("These twin obligations of the ERISA fiduciary, the duties of loyalty and of prudence, form the crux of the debate concerning the propriety of ethical investing. Opponents of SRI argue vigorously that SRI practitioners violate these two duties whenever a trustee favors a social cause over the beneficiaries' financial gain.").

B. The Promise of Crowdfunding

Crowdfunding is the practice of aggregating funds from many small investors, typically using an online platform.[53] Crowdfunding addresses a well-known gap in financing, for companies and projects with prospects too uncertain to qualify for bank loans as well as business plans too small or esoteric to attract angel investors or venture capital funding.[54] Sites use various models to entice investors: pure donation models offering only psychic income, reward models that offer investors a set of tiered rewards for their participation (often including the product of the project they are funding), lending models that may or may not offer investors any interest, and equity models providing investors shares in exchange for their contributions.[55] Highly publicized runaway crowdfunding hits like smartwatch manufacturer Pebble have raised millions of dollars[56] through reward crowdfunding sites like Kickstarter[57] and Indiegogo.[58] These sites, as well as lending-based crowdfunding platforms, however, market themselves much more broadly as vehicles for funding projects for whom traditional financing is unavailable or priced out of reach.[59]

Advocates see crowdfunding not only as a means to bridge the capital gap for small businesses but also as an opportunity to open up business investment to a wider class of investors. Investments in startups have traditionally been available only to the exceedingly well-heeled. Some see crowdfunding as a means to democratize investment in small and startup businesses,[60] offering individual nonaccredited

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53. *See* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 10.

54. *See id.* at 100–04.

55. *See id.* at 10–14.

56. Deborah Netburn, *Pebble Smartwatch Raises $4.7 Million on Kickstarter Funding Site*, L.A. TIMES (Apr. 18, 2012), http://articles.latimes.com/2012/apr/18/business/la-fi-tn-pebble-smart-watch-kickstarter-20120418; *see also* David McGrail, *"Crowdfunding" a Chapter 11 Plan*, AM. BANKR. INST. J., Feb. 2013, at 30, 30 ("Oculus Rift, which is producing a 'truly immersive virtual reality headset for video games,' raised about $2.5 million.").

57. *See Seven Things To Know About Kickstarter*, KICKSTARTER, http://www.kickstarter.com/hello?ref=nav.

58. *See Indiegogo Basics*, INDIEGOGO, http://www.indiegogo.com/indiegogo-faq.

59. *See* Lisa T. Alexander, *Cyberfinancing for Economic Justice*, 4 WM. & MARY BUS. L. REV. 309, 336–37 (2012) (describing lending-based crowdfunding as "enabl[ing] economically marginal and geographically isolated borrowers to obtain loans on terms that were otherwise difficult for them to obtain through traditional or even fringe financial markets"); *see also, e.g.*, *How It Works*, INDIEGOGO, http://www.indiegogo.com/learn-how-to-raise-money-for-a-campaign (noting that using their website launching a fundraising campaign "takes only minutes"); *Peer-to-Peer Lending Means Everyone Prospers*, PROSPER, http://www.prosper.com/welcome/how-it-works/ (explaining its platform as designed to "cut out the middleman to connect people who need money with those who have money to invest"); *Where Businesses Looking for Funding Can Meet Real People To Lend*, LINKEDFINANCE.COM, https://linkedfinance.com/business-loans/investment/crowdfundingIreland.html ("At LinkedFinance, we offer trustworthy small businesses a new viable alternative to borrowing from the banks. Real people like you can lend small amounts to great Irish businesses at very attractive interest rates. The Banks get bypassed, the wheels keep turning and everyone wins!").

60. *See, e.g.*, Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your*

investors a chance to participate and, perhaps, to profit. Of course, detractors worry these unsophisticated investors will make foolish choices and fall prey to fraudsters, condemning crowdfunding as little more than an "alluring trap."[61] After all, if successful, crowdfunding aggregates many investments, each so small they justify little investigation, into an enticing pot for both true innovators and those intent on fraud.

Clearly, crowdfunding requires careful regulation to balance its ability to open a potentially rich source of capital for small business with its potential for harm to an unsophisticated investor population. A growing literature already debates the optimal regulatory approach, much in response to the proposals and ultimate provisions of the 2012 JOBS Act.[62] The Act permits crowdfunded securities to be sold through registered funding portals subject to less regulation than other issues[63] and for the first time permits equity crowdfunding in the United States. The SEC remains at work drafting the final regulations under which funding portals would operate.[64] The United Kingdom has somewhat deeper experience: businesses there have already raised over one billion

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Peril: Crowdfunding and the Securities Act of 1933, 78 TENN. L. REV. 879, 962 (2011) (pointing out "crowdfunding's promise—as a means of raising investment funds for small businesses and allowing individual retail investors to access a user-friendly business finance market"); James J. Williamson, Comment, *The Jobs Act and Middle-Income Investors: Why It Doesn't Go Far Enough*, 122 YALE L.J. 2069, 2073–74 (2013) ("True equity investments would allow small businesses the chance to achieve a broader funding base, but they remained blocked by the 1933 Act's restrictions."); Caron Beesley, *Crowdfunding—Is It Right for Your Business? Where Do You Start?*, U.S. SMALL BUS. ASS'N (July 8, 2013), http://www.sba.gov/community/blogs/crowdfunding-%E2%80%93-it-right-your-business-where-do-you-start; Tom Szaky, *Why Start-Ups Need 'Crowd-Funding,'* N.Y. TIMES (Dec. 5, 2011, 1:00 PM), http://boss.blogs.nytimes.com/2011/12/05/why-start-ups-need-crowd-funding/ (As chief executive of recycling company TerraCycle, Szaky states that equity crowdfunding "would have reduced the pressure on us to produce big returns for each investor, because each investor would have had less at risk. It also would have given us access to more people who would have been vested in our success, which would have produced more leads and opened more doors.").

61. Michael B. Dorff, The Siren Call of Equity Crowdfunding 31 (Sept. 13, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=2325634; *see also* Bradford, *supra* note 53, at 105–09 (describing the high risks of failure and fraud in small business investment, as well as the risks and costs of the illiquidity of such investments).

62. *E.g.*, Bradford, *supra* note 53; Heminway & Hoffman, *supra* note 60; Andrew A. Schwartz, *Crowdfunding Securities*, 88 NOTRE DAME L. REV. 1457 (2013); J.D. Harrison, *Can Crowdfunding Fill Stock Market's "Black Hole" for Startups and Small Businesses?*, WASHINGTONPOST.COM (Aug. 26, 2013), http://www.washingtonpost.com/business/on-small-business/can-crowdfunding-fill-stock-markets-black-hole-for-startups-and-small-businesses/2013/08/26/0098dc9c-0e64-11e3-85b6-d27422650fd5_story.html.

63. JOBS Act, Pub. L. No. 112-106, § 302, 126 Stat. 306, 315 (2012); *see also Jumpstart Our Business Startups Act Frequently Asked Questions About Crowdfunding Intermediaries*, U.S. SEC. EXCHANGE COMMISSION (May 7, 2012), http://www.sec.gov/divisions/marketreg/tmjobsact-crowdfundingintermediariesfaq.htm.

64. In the meantime, equity crowdfunding enthusiasts have developed creative equity-like products to fit investor demands. *See, e.g.*, Iris Dorbian, *A Twist on Crowdfunding: New Sites Let Startups Give Backers a Temporary Piece of the Profits*, WALL ST. J., Aug. 19, 2013, at R3 ("The twist is in what backers get in return. The entrepreneurs agree to give backers a small percentage of their earnings each month for a certain period. In effect, they're selling a temporary equity stake in themselves.").

pounds using equity crowdfunding platforms,[65] but it remains a novel approach. We leave to securities law experts the questions of whether and how the JOBS Act or other interventions might properly balance the advantages and disadvantages of crowdfunding in general. Instead, our purpose here is to identify and address the unique obstacles involved in using crowdfunding to capitalize social enterprises.

After all, crowdfunding seems tailor-made for social enterprises. It offers a source of funding for small, private companies. Most social enterprises are small, all are privately held,[66] and nearly all need financing. Crowdfunding allows nonaccredited "everyday" investors to take part in financing startup businesses. Crowdfunding success occurs when a project stirs the interests (and often the heartstrings) of a large pool of potential investors reached online. Social enterprises embrace a community ethic, and their double-bottom-line vision fits with crowdfunding platforms' commitments to funding creativity and inspiration. Social enterprise founders, employees, and customers already have much in common with the hipster, millennial crowd involved in crowdfunding. Using crowdfunding to attract their capital as well seems like a no-brainer.[67] Social enterprises, however, face unique and serious challenges in accessing capital—and crowdfunding only magnifies them.

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65. Tanya Powley, *Kevin McCloud Turns to Crowdfunding for Property Business*, FIN. TIMES (London), Aug. 3, 2013, at 4; *see also* Juliet Mann, *Is Tapping the Crowds the Future of Funding?*, CNN (Nov. 18, 2011, 3:30 AM), http://www.cnn.com/2011/11/17/world/europe/crowd-funding-europe/index.html?iref=allsearch.

66. As this article goes to press, one business some would deem a social enterprise is poised to go public. Etsy, the online craft marketplace, announced a price range for its impending IP on March 31, 2015. *See* Michael J. de la Merced, *Etsy Sets Price Range for Its I.P.O.*, N.Y TIMES (Mar. 31, 2015), http://www.nytimes.com/2015/04/01/business/dealbook/etsy-sets-price-range-for-its-ipo.html. The for-profit company embraces a social mission, describing "Etsy's mission [a]s to reimagine commerce in ways that build a more fulfilling and lasting world." *About*, ETSY, https://www.etsy.com/about/?ref=ftr. Etsy's IPO is a major event for the social enterprise sector, but highly unusual.

67. *Cf.* J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 49–51 (2012) ("The potential blended value return offered by social enterprises, which may often be a below-market *financial* return, may be more appealing to a large number of people who only have to part with small amounts of money than it would be to a few people investing very large amounts of money." (emphasis in original)); Chance Barnett, *Will Crowdfunding Ignite Investing for Profits and Purpose?*, FORBES.COM (Aug. 9, 2012, 11:10 AM), http://www.forbes.com/sites/chancebarnett/2012/08/09/will-crowdfunding-ignite-investing-for-profits-purpose/ ("Consumers want to align their money with their values and are choosing triple-bottom-line brands that support people, the planet, and profit . . . . [A] company with a purpose is becoming increasingly important to investors—rather than just making a quick buck at the expense of society or the environment." (emphasis omitted)); *see also* Shruti Rana, *Philanthropic Innovation and Creative Capitalism: A Historical and Comparative Perspective on Social Entrepreneurship and Corporate Social Responsibility*, 64 ALA. L. REV. 1121, 1167–68 (2013) (describing the campaign by Escape the City, a U.K.–based website for professionals shifting careers to the nonprofit sector, which raised over $800,000 on the equity crowdfunding website Crowdcube).

C. Capitalizing Social Enterprise

Entrepreneurs and investors committed to pursuing both profits and social good find themselves in the same quandary.[68] Neither can succeed in their aims without the other, but both fear entrusting their ideas and resources to someone whose motivations are necessarily suspect. Crowdfunding exacerbates the need for assurances yet makes them harder to provide. The large numbers of investors—and the modest size of each investment—make the communication essential to building that trust virtually impossible.[69]

An entrepreneur sets up a social enterprise with dual goals in mind—earning a financial return and providing some social good like environmental conservation, poverty reduction, or education. The need for capital to survive or scale up pushes social entrepreneurs to seek investors. But, having committed significant amounts of their own time, energy, and often financial resources to their enterprises, social entrepreneurs (like all entrepreneurs) worry about the potential power of investors to steer them away from their visions.[70]

Whereas an entrepreneur might be able to suss out the bona fides of one or a few large investors and craft individualized commitment devices to limit risk, crowdfunding would involve numerous small investors, making such artisanal arrangements impossible. As noted earlier, the corporate hybrid forms springing up across the country continue to permit shareholders to abandon an adopting enterprise's social mission, so long as a supermajority of shareholders agree.[71] Although the potentially huge sums of capital crowdfunding platforms could reach will be enticing to entrepreneurs, they have reason to hesitate at the thought of a "crowd" of investors, especially shareholders empowered to overthrow social mission if the price proves right.

The challenge for capitalizing social enterprises, though, is two-sided. Investors devoted to achieving a blend of financial and social returns will be equally suspect of entrepreneurs' commitment to social mission—perhaps even more so. Again, when large individual investors are involved, these suspicions can be overcome through carefully negotiated creative deals.[72] A specialized financing structure can lock entrepreneurs and investors into their commitments, or at least create credible

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68. The quandary is one economists refer to as a "stag hunt." As described below, the basic notion is that two hunters must find a way to rely on one another to achieve a mutually desired result: catching a stag. *See infra* note 89 and accompanying text.

69. Central to game theory are the challenges of promoting mutually beneficial coordination in the absence of communication, illustrated by the famous "focal point" thought experiment in which individuals are asked to choose a time and place to meet in New York without the opportunity to speak to the other person. *See infra* notes 84–85 and accompanying text.

70. The apocryphal story of Ben & Jerry's may reveal more about the anxiety outside investors stir in entrepreneurs than it does about the circumstances surrounding the social enterprise's sale to Unilever. *See* Antony Page & Robert A. Katz, *The Truth About Ben & Jerry's*, STAN. SOC. INNOVATION REV., Fall 2012, at 39, 39 (questioning widespread belief that going public forced the founders to sell to Unilever).

71. *See supra* note 9 and accompanying text.

72. *See generally* Brakman Reiser & Dean, *supra* note 8 (proposing a contingent convertible debt instrument designed to promote trust between investors and entrepreneurs).

signals, but arcane financial instruments will not work for small-fry crowdfunding investors. Incorporated hybrid forms do require supermajority shareholder approval to permanently shift an adopting entity to pure for-profit status, offering the hope of investor protection.[73] This hope may be unwarranted, however, as the only tools for enforcement are commands that fiduciaries "consider" or "balance" profit and social goals, weak and costly claims of fiduciary-duty breach, and disclosure.[74] In the absence of a robust enforcement mechanism, with or without the use of specialized forms, small investors have little recourse against an entrepreneur who casts aside an enterprise's social mission.

Small investors operating as part of a "crowd" face the further risk that fellow investors may come to prefer a purely profit-driven firm. A social enterprise with one or a handful of nonfounder investors could once again negotiate and structure a deal to provide assurances. Crowdfund investors with no control, or indeed knowledge, of their fellow investors will have greater need for assurances from their peers and no ability to contract for (or with) those other investors. The current corporate hybrids' supermajority rules leave individual investors at the mercy of large players, or a large group of small players.[75] If enough of the crowd decides to cash in, the stalwart social investor will be left out in the cold.[76] Even formerly committed dual-mission investors may join a sellout rather than engage in a costly fight to halt what may seem like an inevitable result.

The opportunity to reach millions of small investors simultaneously through online platforms is an exciting one for social enterprises in need of capital infusions. Legalizing and optimally regulating crowdfunding platforms, however, will not suffice to enable social enterprises to access this new stream of capital.[77] Individualized arrangements are ill suited to the crowdfunding context,[78] and current hybrid forms neither ensure nor even credibly signal commitment to social mission on either side.[79] In the crowdfunding context, social entrepreneurs will need a reliable mechanism to differentiate committed impact investors in the crowd; investors need a strong signal to reassure them their investment is not a foolhardy leap of faith.[80]

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73. *See id.* at 1511 & n.80, 1513 & n.88.

74. *See, e.g.*, Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L.J. 681, 694–704 nn.54–92 (2013) (discussing corporate governance mechanisms for enforcing dual missions).

75. Of course, controlling shareholders owe a fiduciary duty to their corporations, and their transactions can be subjected to a fairness review. *See* Pepper v. Litton, 308 U.S. 295, 306 (1939) ("A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders." (citation omitted)). But, at least in an ordinary corporation, this fiduciary obligation would be unlikely to extend to maintaining a commitment to pursuing social good in the face of an opportunity for profit—personal or corporate.

76. In some cases, appraisal may be available. But, appraisal remedies offer only monetary compensation, which may not make disappointed social investors or entrepreneurs whole.

77. The challenges presented by these tasks are, of course, considerable. *See supra* note 61 and accompanying text.

78. *See supra* text accompanying note 72.

79. *See supra* text accompanying note 71.

80. *See supra* notes 68–69 and accompanying text.

II. COMMITMENT

To successfully husband a social enterprise, entrepreneurs and investors dedicated to pursuing a double bottom line of profits and social good must telegraph that resolve to one another. Devising means to persuade others of such commitments lies at the heart of game theory.[81] This Part first describes the "game" that impedes the flow of capital to social enterprises, then shows how the SE(c)(3) tax regime can serve as both a commitment device and the credible signal needed to encourage the participation of even the small investors that occupy the crowdfunding space.

A. Assurance Game

In some respects, social enterprises are no different from other ventures. Every venture, wherever it lies on the profit spectrum, metabolizes a blend of capital and ideas. Beyond such commonalities, social enterprises stand apart, both in terms of their strengths and their weaknesses. On the one hand, social enterprises' shared emphasis on profits and social good allows them to lash the idealism of charity to the rigor of business methods;[82] on the other, serving two masters presents its own challenges.[83]

Traditional for-profit businesses enjoy the benefit of an obvious focal point (profit) around which entrepreneurs and investors can gather.[84] Social enterprise lacks the benefit of a singular, galvanizing objective—a meeting spot so obvious that coordination becomes superfluous.[85] When investors and entrepreneurs combine their capital and labor to form a for-profit corporation, profit provides such inviting common ground that the mechanisms provided by state law to ensure consensus may sometimes be superfluous.[86] So long as profit remains the most salient corporate goal, it need not be the only permissible objective.

Social enterprises do not have that luxury. Given the presence of two equally compelling goals, double-bottom-line investors and entrepreneurs face a more complex task in aligning their interests. Setting aside questions of simple fraud,[87] any

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81. *See* THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT 28 (1960) (noting that strategic bargaining—an aspect of game theory—relies "not only on incurring a commitment but on communicating it persuasively to the other party").

82. *See supra* text accompanying notes 28–29.

83. *See* Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2466 (2009) (noting the risk of a "shifting mission" when an enterprise attempts to combine for-profit and charitable aims).

84. *See* SCHELLING, *supra* note 81, at 54–58 (considering capacity of "focal points" to promote tacit coordination when communication is difficult).

85. The classic illustration of such a meeting spot arises in the experiment in which individuals—given the task of meeting another person in New York with no prior coordination—reliably choose to meet at the Grand Central Terminal information booth at noon. *Id.* at 55 n.1.

86. The state law requirement that corporations maximize shareholder wealth—whether real or perceived—offers an example of the ways in which state law serves to align the interests of entrepreneurs and investors. That requirement, although contested, helped inspire the creation of hybrid forms designed to house social enterprises by being seen as a threat to ventures open to objectives other than maximizing profits. *See* Brakman Reiser & Dean, *supra* note 8, at 1503–06.

87. *See supra* note 61 and accompanying text.

stakeholder might reasonably wonder whether others share her commitment to balancing both objectives.[88]

The resulting uncertainty creates what economists call an "assurance game" or "stag hunt."[89] In the classic illustration of this game, two hunters can fell a stag if they work as a team but only hares if they work on their own. Assurance games such as this stylized hunt offer participants two plausible objectives. Unless each hunter offers a robust signal of their commitment to capture a stag, both will hunt hares to avoid returning home empty-handed. A successful stag hunt would provide the most food for both hunters, but each needs assurance that the other will not defect.

When a small number of deep-pocketed investors join forces with an entrepreneur, it would be possible to manufacture the missing focal point, effectively ridding the forest of hares.[90] They could, in other words, reach an "enforceable agreement" that would produce "the only possible focal point for the necessary subsequent tacit collaboration . . . [so that] no one has a unilateral preference . . . to do anything but what he is expected to do."[91] Such an approach would allow sophisticated entrepreneurs and investors to achieve the entrepreneurial equivalent of tearing a treasure map in half to ensure reciprocal loyalty.[92]

Private agreement, like the treasure map gambit, has practical limits.[93] As described in Part I, social enterprise crowdfunding provides a stark illustration of those limitations. Retail crowdfunding, drawing a substantial number of insubstantial investments to nurture the growth of an enterprise, would inevitably involve groups too large to squeeze into the conference room of a law firm where a hybrid financial

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88. *See, e.g.*, Brakman Reiser & Dean, *supra* note 8, at 1514–17 (noting that even with the help of hybrid forms designed to house social enterprise, entrepreneurs and investors have reason to remain wary of one another).

89. *See* DOUGLAS G. BAIRD, ROBERT GERTNER & RANDAL C. PICKER, GAME THEORY AND THE LAW 35–36 (1994) (describing the "stag hunt" game). The assurance game is distinct from the better known "prisoners' dilemma" game. *See* Richard H. McAdams, *Beyond the Prisoners' Dilemma: Coordination , Game Theory, and Law*, 82 S. CAL. L. REV. 209, 220–22 (2009) (explaining that an assurance game differs from the prisoners' dilemma game because the proverbial hunters can share the big prize—the stag—while in the classic prisoners' dilemma at most one prisoner will go free).

90. If the forest could be stripped bare of hares, there would be no need for either hunter to commit to the stag hunt since the temptation to defect would no longer exist. The stag would have become a focal point of sorts for the hunters, allowing tacit cooperation between them.

91. SCHELLING, *supra* note 81, at 135.

92. The hybrid financial instrument we call FLY (Flexible Low-Yield) Paper would accomplish precisely that by eliminating founders' incentives and investors' opportunities to defect. *See* Brakman Reiser & Dean, *supra* note 8, at 1523–25. As lenders, outside investors would not acquire control of the enterprise. Founders could not sell their shares without triggering a conversion right that those outside investors could use to seize control along with the founders' financial rewards. Like a forest without hares, a social enterprise financed with FLY Paper would solve the assurance problem by eliminating the incentives for defection.

93. A map torn into a hundred pieces simply becomes confetti. Abramowicz and Ayres reach a similar conclusion with regard to their own variant of a commitment device. *See* Michael Abramowicz & Ian Ayres, *Commitment Bonds*, 100 GEO. L.J. 605, 646 (2011) (noting that when adapting their commitment bonds to involve mutual commitment among multiple parties, "it may be difficult to reach an agreement").

instrument might be crafted.[94] No less important, those crowdfunded investments would almost certainly be too small to justify the costs of reaching such an agreement.

B. A Commitment Device for Crowdfunding Social Enterprise

Fortunately, private agreement represents only one possible solution to the quandary faced by double-bottom-line investors and entrepreneurs. Although hybrid forms have proved inadequate to the task of striking a balance between social enterprise's dual missions, they represent only one arrow in the public's quiver.[95] Government intervention to permit likeminded entrepreneurs and investors to reassure one another could take a very different form. By providing social enterprises and their investors with an environment that rewards a commitment to a double bottom line but imposes steep costs on defectors, the state could create an off-the-rack alternative to the designer arrangements considered above. Moreover, the signal such an alternative sends to social entrepreneurs and socially minded investors looking to identify committed counterparts is the key for social enterprises to access retail investors and their capital.

The SE(c)(3) tax regime described in Part III provides an example of such an intervention. Allowing investors and entrepreneurs to embrace a tax regime that imposes costs on those who stray from the pursuit of a double bottom line offers a commitment mechanism within the reach of even the smallest investors. By pairing favorable treatment for mission-driven income with higher tax rates on shareholder profits, the SE(c)(3) regime provides a readymade signal of a commitment to a double bottom line. On an individual basis, or through crowdfunding platforms that use SE(c)(3) status as a sorting mechanism, investors seeking blended value will be able to find true fellow travelers and reliably dual-mission firms.

Such arrangements designed to bolster resolve, known as commitment devices, have a pedigree every bit as distinguished as the notion of the assurance game.[96] Ulysses, of course, bound himself to the mast to allow him to listen to the sirens without endangering himself or his crew.[97] Today, commitment devices employing the same core principles operate in a variety of contexts.[98] Smokers hoping to quit, dieters, and even policymakers aiming to reach a consensus have relied on commitment devices with varying levels of success.[99]

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94. *See supra* text accompanying note 53.

95. *See supra* text accompanying note 9.

96. An army that eliminates all hope of retreat by literally burning the bridge behind it would "commit" itself to battle and signal that commitment to a potential adversary. Telegraphing that commitment could discourage an attack by the potential adversary. *See* Jon Elster, *Don't Burn Your Bridge Before You Come to It: Some Ambiguities and Complexities of Precommitment*, 81 TEX. L. REV. 1751, 1761–63 (2003).

97. *See* HOMER, THE ODYSSEY 272–73 (Robert Fagles trans., 1996).

98. Central banks, through which governments precommit themselves to anti-inflationary policies, offer an illustration of precommitment quite different from the reformed smokers and drinkers usually considered. *See* Elster, *supra* note 96, at 1763–64 (explaining that governments use independent central banks to ensure that future governments will not abandon anti-inflationary goals in the face of future policy pressures).

99. *See* Thomas C. Schelling, *Enforcing Rules on Oneself*, 1 J. L ECON. & ORG. 357,

Whatever their aim, two characteristics largely determine the degree to which commitment devices allow a group or individual to "bind" themselves to a particular course of action.[100] For a commitment device to be effective, one must first be able to determine whether a promise has been kept.[101] The European Union financial crisis, for instance, might not have occurred had Greece not been able to disguise its borrowing, maintaining the appearance of a sober debt-to-GDP ratio without the burden of actually limiting its debt.[102] Because it relied on an inadequate definition of a loan, the European Union Growth and Stability Pact[103] proved to be a paper tiger despite its sophisticated monitoring and enforcement mechanisms.[104]

Once compliance can be reliably distinguished from cheating, the emphasis shifts to enforcement. Here, the critical issue is the existence of an individual or entity with the authority to enforce a commitment.[105] A would-be drunk driver who has given his keys to a sober companion will be better protected than one who merely enlists a friend to counsel him. Entrusting keys to a reliable third party will be more effective because it relies on the actions of the sober friend rather than on the willingness of an inebriated potential driver to accept advice after he has become intoxicated.[106]

Along both dimensions, the SE(c)(3) regime offers an appealing combination of simplicity and strength.[107] The core of the regime—the relatively high rates imposed on shareholder profits—does not ask tax authorities to step outside their traditional roles of measuring and taxing income.[108] Since highly profitable social enterprises

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357–61 (1985) (referring to a wide range of circumstances in which a commitment device might be deployed).

100. *See* Elster, *supra* note 96, at 1754 ("When precommitting himself, a person acts at one point in time in order to ensure that at some later time he will perform an act that he could but would not have performed without that prior act.").

101. *See* Schelling, *supra* note 99, at 366–67 ("It seems more likely that one will abide by a self-imposed rule if it is perfectly clear whether or not the rule has been adhered to or violated.").

102. *See* Louise Story, Landon Thomas Jr. & Nelson D. Schwartz, *Wall St. Helped To Mask Debts Shaking Europe*, N.Y. TIMES, Feb. 14, 2010, at A1 (noting that Greece's ability to disguise its borrowing—thereby avoiding the consequences threatened by the Pact—lay at the heart of the debt crisis).

103. *See Stability and Growth Pact*, EUR. COMMISSION, http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm.

104. *See* Story et al., *supra* note 102.

105. *See* Schelling, *supra* note 99, at 373 (noting that a commitment device enforced by a referee (possessing merely moral authority) will be less effective than one enforced by a judge (possessing actual authority)).

106. *See id.*

107. Rather than monitoring one another directly or relying on state attorneys general to oversee the actions of entrepreneurs and investors, the regime invokes the monitoring and enforcement architecture of the corporate income tax. Although not without its flaws—particularly in the cross-border context—the corporate tax can and does measure shareholder profits. Collecting the additional tax imposed on shareholders via the SE(c)(3) regime would impose no significant administrative burdens on tax authorities.

108. Disguising distributions of corporate profits as capital gains in order to qualify for low tax rates—referred to as "bailout transactions"—has a long history in the corporate income tax context. *See* Eric M. Zolt, *Corporate Taxation After the Tax Reform Act of 1986: A State of Disequilibrium*, 66 N.C. L. REV. 839, 852 (1988) (noting that even before 1986 "a large part of corporate tax planning focused on extracting funds out of corporations in transactions that

will almost certainly bear the substantial burden the SE(c)(3) regime promises, investors and entrepreneurs intent on maximizing such profits would find little to love in the SE(c)(3) regime. SE(c)(3) status also provides a strong but simple signal. Nascent crowdfunding sites unable to devote many resources to screening the mission commitments of their issuers can leverage the work of the tax system to reach a socially conscious class of retail investors. If she understood the commitment device SE(c)(3) status represents, an individual investor could even do so on her own.

C. Subsidy Vs. Commitment Device

Governments frequently use tax laws to encourage or discourage particular behaviors.[109] By offering individuals or businesses a credit or deduction for a particular expense, or an exclusion for a specific type of income, a legislature can put a thumb on the scale in favor of owning a home or saving for retirement.[110] These provisions, known as "tax expenditures," provide a subsidy for favored activities. Tax penalties do just the opposite, discouraging disfavored behavior such as bribery.[111]

Combining elements of both, the SE(c)(3) regime is neither a subsidy granted to nor a penalty imposed on taxpayers.[112] Instead, claiming the SE(c)(3) exclusion constitutes a commitment by a corporate social enterprise to pursuing a double bottom line. Like agreeing to send a big check to an unappealing charity for each cigarette smoked or pound gained, claiming the exclusion represents a "self-limiting act carried out by an agent for the purpose of achieving a better outcome, as assessed by his preferences at the time of action, than what would occur had he retained his full freedom of action."[113] Agreeing to pay a higher tax on shareholder profits today constrains the SE(c)(3)'s freedom to pursue future profits.

The subsidy aspect of the SE(c)(3) regime distinguishes it from a typical commitment device. In addition to the benefits of commitment—here, increased access to capital rather than weight loss—the SE(c)(3) regime compensates

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qualified for capital gain treatment"). The corporate income tax has been crafted in large part in response to the pressures of such bailout transactions. *See, e.g.*, I.R.C. §§ 302, 304 (2012) (creating an elaborate antibailout system treating sales of shares that would ordinarily receive exchange treatment as dividends). The SE(c)(3) regime would operate in large part by leveraging the statutory and doctrinal safeguards created to prevent bailouts.

109. This phenomenon received critical attention in the United States decades ago. *See* STANLEY S. SURREY, PATHWAYS TO TAX REFORM: THE CONCEPT OF TAX EXPENDITURES 6 (1973) (noting that although the economic equivalent of "direct government expenditures," tax benefits largely escaped "critical analysis").

110. *See* Linda Sugin, *Tax Expenditures, Reform, and Distributive Justice*, 3 COLUM. J. TAX L. 1, 3 (2011) ("Tax expenditure provisions were adopted to incentivize particular activities or to reduce the burden on certain individuals, families or businesses.").

111. *See* Eric M. Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. REV. 343, 350–51 (1989) ("Congress now uses tax penalty provisions to increase the cost of illegal activities by disallowing deductions for amounts paid for fines or similar penalties, bribes or kickbacks, . . . certain losses incurred in connection with illegal activities, and expenses incurred in drug trafficking." (footnotes omitted)).

112. As described in detail in Part III, the regime combines an exclusion for up to $500,000 per year of a corporation's income with special higher rates on shareholder profits.

113. Elster, *supra* note 96, at 1783 (emphasis omitted).

participating social enterprises by providing a tax benefit in the form of an exclusion for mission-driven income.[114] Like the up-front payment received by issuers of the compensating commitment bonds proposed by Abramowicz and Ayres, the exclusion creates a dynamic closer to a "fair bet rather than a one-way ratchet."[115] In both cases, the commitment contemplates both costs and benefits for the agent seeking to constrain her own future behavior.

Although they may escape the scrutiny imposed on other forms of spending,[116] tax expenditures reduce government revenues.[117] Tax penalties, of course, do the reverse.[118] In the aggregate, the SE(c)(3) regime would represent neither a special benefit nor a particular burden for the social enterprise sector. For individual ventures, the impact of the SE(c)(3) regime is a function of balancing mission and profit. Social enterprises emphasizing mission would benefit while "greenwashed" ventures prioritizing shareholder profits would suffer.

The SE(c)(3) regime, unlike that governing nonprofits, does not forbid a social enterprise from promoting shareholders' financial interests.[119] When an SE(c)(3) deemphasizes mission in favor of the financial gains of its owners, the result is a higher tax burden. Those increased taxes cross-subsidize the lighter burden enjoyed by more mission-focused enterprises. Rather than drawing resources away from or directing them to the social enterprise sector, the SE(c)(3) regime simply siphons a portion of outsized shareholder profits to nurture the missions of other ventures.[120]

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114. *See infra* Part III.A.3.

115. Abramowicz & Ayres, *supra* note 93, at 607–08. Compensating commitment bonds aim to provide a commitment device with a modest expected value to a committing party (the certain up-front payment and the possibility of the future penalty being more or less equal). *Id.* The SE(c)(3) regime obviously does not tailor the size of the exclusion or the rates applicable to shareholder profits to match the commitment (or lack thereof) of particular social enterprises. Instead, the regime will be designed to preserve the current tax treatment of a prototypical social enterprise. Ventures generating a disproportionate amount of mission-driven income or shareholder profits will bear lower and higher tax burdens, respectively.

116. *See supra* note 109.

117. Since the 1970s, an annual budget of the costs of tax expenditures has been required by statute. *See* Congressional Budget Act of 1974, Pub. L. No. 93-344, § 3, 88 Stat. 297, 299.

118. *See* Zolt, *supra* note 111, at 360 (contemplating a "tax penalty budget" that would estimate the government revenues generated by tax penalties).

119. Commitment devices operate either "by *deleting elements* in the set of feasible actions or by *affecting the consequences* of choosing them." Elster, *supra* note 96, at 1754 (emphasis in original). The SE(c)(3) regime falls into the latter category. Which type of commitment device the nonprofit regime represents depends on whether earning profits or distributing those profits to owners is viewed as problematic.

120. Over time, a single SE(c)(3) could fill both roles, evolving from a mission-focused enterprise early in its lifecycle and only later turning to shareholder profitability. In such a case, the SE(c)(3) exclusion might be thought of as, in part, a form of deferral. Early tax savings at the corporate level would be offset by higher taxes in later years. Although deferral is an important element of tax planning, this deferral would not necessarily be valuable enough to offset the costs of the higher future taxes.

III. SE(C)(3)

The commitment device detailed in this Part could deliver a subsidy to the social enterprise sector but need not.[121] Certainly, as compared to the sharply limited charitable deduction afforded to for-profit corporations, the SE(c)(3) exclusion appears generous.[122] Unlike the deduction, the SE(c)(3) regime could allow a moderately profitable social enterprise to completely shed its income tax burden.[123] The operation of the SE(c)(3) regime, however, involves both a carrot and a stick. The burden it imposes on shareholder profits could ensure that the overall tax burden on a dual mission enterprise and its shareholders will be comparable to that borne by a similar non-SE(c)(3) corporation and, no less important, that strategic claimants will not receive a windfall.[124]

This Part explores the contours of the SE(c)(3) regime, describing how it supports mission-focused social enterprises while penalizing greenwashed ventures. Social enterprise places social mission at the center of a venture rather than at its periphery.[125] The SE(c)(3) regime does likewise, identifying and shielding a limited amount of mission-driven income from tax. While an ordinary for-profit corporation might be allowed a deduction for incidental charitable activities, the SE(c)(3) regime provides an exclusion for up to $250,000 of income attributable to an enterprise's social mission and an additional one-for-one exclusion for each dollar of SE(c)(3) income.[126] Pairing

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121. The relationship between the tax penalty and tax expenditure elements will determine whether the SE(c)(3) regime is the "fair bet" that Abramowicz and Ayres envision with their compensating commitment bond. Abramowicz & Ayres, *supra* note 93, at 607–08. Inevitably, as individual enterprises focus more heavily on mission or profits, their results under the regime will diverge. The aggregate results for the regime overall would be less random.

122. Individuals can deduct an amount equal to fifty percent of their charitable contributions for many charities while corporations face a much lower ten percent limit. *Compare* I.R.C. § 170(b)(1)(A) (2012) (providing the higher limit for individuals), *with* I.R.C. § 170(b)(2)(A) (2012) (providing the lower limit for corporate donors).

123. The SE(c)(3) exclusion is neither a credit nor a deduction. It instead excludes a portion of an SE(c)(3)'s income from the tax law's definition of "income." Generally, the tax law provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived . . . ." I.R.C. § 61(a) (2012). Like the exclusion providing for $500,000 of gain on the sale of a home by a married couple, the SE(c)(3) exclusion would be such an exception. *See* I.R.C. § 121 (2012) (providing that "[g]ross income shall not include gain from the sale or exchange of property if . . . such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more," up to $250,000 for individual taxpayers or $500,000 for a married couple).

124. The carrot of the exclusion for mission-driven income will be balanced by the stick of higher taxes on shareholder financial profits. Strategic claimants with little or no mission-driven income and significant shareholder profits will feel the brunt of the stick without the benefit of the carrot.

125. While a for-profit corporation might engage in charitable activity and a charity may engage in some amount of business, the social mission and the profit are closely linked. For example, the mission may dictate how the enterprise's products are manufactured or distributed. *See* Brakman Reiser & Dean, *supra* note 8, at 1499 ("These enterprises manufacture products using more expensive inputs to reduce their environmental impact, or give away some of their products to those in need.").

126. To prevent taxpayers from taking a heads-I-win, tails-you-lose approach by waiting

that contingent benefit with a relatively high tax on distributions of profit and sales of shares produces a tax regime uniquely suited to social enterprise.[127]

A. A Tax Regime for Social Enterprise

Social enterprises fall somewhere on the spectrum between robber-baron capitalism and the pure selflessness of a charity. Of course, the same might be said of many nonprofits and the entire Fortune 500.[128] What distinguishes social enterprise is not its rejection of unfettered greed as a guiding principle, but the degree to which social mission is integrated into a venture's core. Google would still be Google without Google.org.[129] By contrast, without its one-for-one model to "transform[] . . . customers into benefactors[,]" TOMS Shoes would be unrecognizable.[130] As described below, the SE(c)(3) regime's exclusion exploits that intimate connection between social mission and business methods.

1. For-Profit Charity: UBIT and Charitable Deductions

The tax law accepts that charities may seek profits and that profit-seeking firms may act charitably. A tax-exempt entity that engages in an "unrelated business" finds itself subject to tax on any resulting income.[131] Conversely, a corporation enjoys a respite from tax by deducting charitable contributions much as an individual would.[132]

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until a tax return would be due—potentially more than a year after the formation of the corporation—it would be reasonable to require an up-front declaration as to whether the exclusion will be claimed. *See, e.g.*, I.R.C. § 1362(b)(1) (2012) (requiring S Corporations to file an election by the middle of the third month of a given year); I.R.C. § 1221(a)(7) (2012) (requiring a hedging transaction to be "clearly identified as such before the close of the day on which it was acquired, originated, or entered into . . . .").

127. As detailed below, the distribution of profits by an SE(c)(3) incurs a higher tax burden than would apply to a similar distribution by a non-SE(c)(3) corporation. Paired with the relatively high rates that would apply to each dollar of distributed profit or capital gain, the SE(c)(3) exclusion's apparent subsidy becomes something else entirely. By encouraging the pursuit of social mission while penalizing shareholder profit taking, the SE(c)(3) regime serves as a commitment device designed to shield an enterprise's social mission.

128. The ubiquitous museum gift shop offers an illustration of a nonprofit engaging in commerce. *See, e.g.*, MOMA STORE, http://www.momastore.org/ (the online store associated with New York's Museum of Modern Art). The charitable activities of Fortune 500 businesses receive considerable attention. *See, e.g.*, Ben Gose, Marisa López-Rivera, Emma Carew Grovum & Sarah Frostenson, *With Cash Giving Flat, Big Companies Offer Other Aid*, CHRON. PHILANTHROPY, July 18, 2013, at 1 (describing a wide range of philanthropic efforts by major for-profit companies).

129. *See* Brakman Reiser, *supra* note 83, at 2437–46 (discussing Google.org).

130. *General TOMS Questions*, TOMS, http://www.toms.com/faq#faq (describing TOMS' one-for-one model of providing shoes to those in need whenever a pair of its shoes is sold).

131. I.R.C. § 511(a)(1) (2012) (imposing a tax on the "unrelated business taxable income" of otherwise tax-exempt organizations).

132. I.R.C. § 170 (2012) (providing for a charitable deduction for corporations as well as individuals).

In each case, the applicable regime treats the secondary mission as an aberration. Consistent with that notion, the Unrelated Business Income Tax (UBIT) calves off commercial activities by tax-exempt entities, subjecting only the "unrelated" income to tax.[133] This approach quarantines commercial activity from a tax-exempt organization's primary undertaking, simultaneously preserving the organization's preferential treatment and the tax preference itself.[134]

The charitable deduction obviously does not penalize a corporate contribution. It does, however, require a for-profit business to give without the expectation of receiving a benefit in return.[135] While not unique to the corporate context, this requirement obliges a for-profit enterprise to take an action that—in the narrowest sense—runs contrary to its nature. One might reasonably perceive self-interest at work in corporate charity, but the tax law demands selflessness. A profit motive could be fatal to a charitable deduction, even if the underlying action has a big positive social impact.

The suspect status of corporate charity under the tax law can be seen more vividly by comparing the treatment corporate and individual contributions receive.[136] Even when a for-profit corporation can demonstrate the requisite altruism, the deduction it receives in return for its generosity is sharply limited. While a noncorporate donor may offset as much as half its income through charitable contributions, a corporation can only deduct an amount equal to one-tenth of its profits.[137] Although they are permitted to make charitable contributions, for-profit corporations are constrained in their ability to deduct them.

To the extent that a social enterprise treats social mission and investor profit as interrelated, core objectives, a tax regime that marginalizes one or the other is a poor fit. Of course, that tension simply echoes the broader challenges of operating in the poorly charted territory between for-profit and nonprofit.[138] Here, as in other

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133. I.R.C. § 512(a)(1) (2012) (defining unrelated business taxable income as "the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business . . . .").

134. *See* Ethan G. Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 54 EMORY L.J. 1475, 1479–80 (2005) (arguing that although it is traditionally "justified . . . as a measure to protect taxable businesses from unfair tax-exempt competition and to protect against erosion of the tax base by rapacious charities buying or crushing taxable businesses . . . the UBIT protects the symbolic meaning of the [§ 501(c)(3)] exemption, rather than an instrumental policy goal").

135. *See* United States v. Am. Bar Endowment, 477 U.S. 105, 116 (1986) ("A payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return."). One of the most famous cases involves an attempt by Singer to take a deduction in connection with discount sales of sewing machines to schools. The court rejected Singer's claimed deduction because it made the discount sales with an expectation of generating future sales of sewing machines to former students. Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971).

136. *See supra* note 122.

137. *See supra* note 122.

138. *See, e.g.*, Brakman Reiser, *supra* note 74, at 683 (describing social entrepreneurs' concerns that "traditional for-profit and nonprofit legal forms frustrate social entrepreneurs' bold new vision for achieving social change").

areas, social enterprise's interstitial nature presents practical obstacles as well as conceptual incongruities.[139]

Simply put, social enterprise seems a square peg to the round holes of the for-profit and nonprofit tax regimes. Although a tax-exempt entity may conduct an unrelated business of significant size,[140] no distributions of profit may ever be made to investors.[141] That nondistribution constraint may make sense for a tax-exempt organization engaged in a business ancillary to its social mission. It is fundamentally incompatible with the aim of a double-bottom-line organization to provide financial rewards to investors in tandem with social good.

Structural constraints imposed on charitable contributions made by for-profit ventures would similarly frustrate the hybrid nature of a social enterprise, even if the percentage limitations did not. Although a business may choose which charity receives its largesse, it does not itself oversee the delivery of the charitable goods or services.[142] To earn a charitable deduction, the for-profit venture must contribute to a charity or other eligible organization, rather than engaging directly in charitable activities.[143]

The animating insight of social enterprise is that business methods have great power to advance social good. Unfortunately, the tax law simply does not contemplate direct involvement by for-profit ventures in charitable endeavors. Like charity law's nondistribution constraint, the tax law's insistence on segregating charitable and profit-seeing activities—here, by hobbling the mission-driven activities of businesses—makes a true double bottom line impossible.[144]

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139. *See* Brakman Reiser & Dean, *supra* note 8, at 1501 (noting that, given the poor fit between dual-mission enterprises and traditional single-mission business forms, "social entrepreneurs . . . face real obstacles when they try to secure both access to capital and protection for social mission").

140. A tax-exempt organization may earn a large amount of unrelated business income, but must also "carry[] on . . . a charitable program commensurate in scope with its financial resources." Rev. Rul. 64-182, 1964-1 C.B. 186.

141. Hansmann, *supra* note 18, at 838 (identifying this prohibition on profit distributions to owners as the "nondistribution constraint").

142. *See* I.R.C. § 170(c) (2012) (defining "charitable contribution" as a "gift to or for the use of" a short list of entities including charitable organizations and governments). As discussed below, outside of the charitable deduction, corporate altruism is not generally deductible. *See infra* notes 152–57 and accompanying text.

143. Although for-profit ventures can claim a deduction for charitable contributions just as any individual might, charitable activities do not entitle individuals or for-profit ventures to the special tax benefits open to charities. *See* Malani & Posner, *supra* note 2, at 2020 (noting that "for-profit charities . . . forfeit all the state and federal tax benefits available to nonprofit charities").

144. The statute governing charitable contributions prevents corporations from shielding more than a small fraction of its income from tax with charitable deductions. A corporation may, for example, deduct no more than ten percent of its taxable income in any year. *See supra* note 122. While presumably sufficiently generous to accommodate the needs of most businesses, such a deduction would be wholly inadequate for a social enterprise equally devoted to profit and mission.

2. Extraordinary Expenditures

Freeing social enterprises of those constraints is not simply a matter of easing limitations on corporate charitable contributions[145] or curbing the reach of the UBIT.[146] The SE(c)(3) regime represents an approach built from the ground up with social enterprise in mind. Rather than retrofitting regimes designed to police the traditional for-profit and nonprofit dichotomy, it offers a solution tailor-made for a double bottom line.

In a sense, the fact that any business manages to turn a profit is surprising. Competition and the vagaries of the public's taste—not to mention Murphy's Law—all conspire to make losing money much easier than making it. For a social enterprise, the task is made all the more difficult by the unorthodox combination of social good and profits.

Perversely, from a tax perspective, the downward pressure social mission exerts on a venture's profitability should constitute a blessing.[147] An enterprise that sufficiently prioritizes a social mission should have little to fear from a tax on profits.[148] Employing an unskilled labor force in order to provide those employees with valuable job skills imposes clear costs on an enterprise. The more urgently it pursues the social goal of training its employees, the less likely such a venture is to earn a profit that might be subject to tax.

Although it may seem improbable, profitability for such a double-bottom-line enterprise is not impossible. Customers appear willing to pay an altruism premium for the satisfaction of knowing that by purchasing a good or service, they will provide a significant benefit to a hard-working employee.[149] A sufficiently high premium could more than offset the negative profit impact of the venture's social mission. In such a case, a social enterprise's economic return—like that of any other venture—would be subject to the income tax.[150]

Unlike a for-profit venture, a social enterprise may be systematically taxed on more than its economic profit. Mission-driven expenditures might not be

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145. *See supra* note 122.

146. *See supra* note 133 and accompanying text.

147. The income tax is, after all, a tax on *net* income, rather than *gross* income. *See* I.R.C. § 63(a) (2012) (specifying that "'taxable income' means gross income minus the deductions allowed" by the Code).

148. In addition to the limits on extraordinary expenditures discussed below, *see infra* notes 151–57 and accompanying text, other potential tax problems for a social enterprise with negative cash flows might be the result of timing or character mismatches. For example, an expenditure might generate significant current income but be considered a capital expenditure so that any deductions arising from the expenditure arise largely or entirely in future years. *See* I.R.C. § 263(a) (2012) (providing that "no deduction shall be allowed for . . . permanent improvements or betterments made to increase the value of any property or estate").

149. *See* Brakman Reiser & Dean, *supra* note 8, at 1499–500 (describing a range of dual mission enterprises premised on the notion that customers will help to subsidize the enterprise's social mission).

150. A corporate social enterprise would itself be considered a taxpayer. *See* I.R.C. § 11(a) (2012) ("A tax is hereby imposed for each taxable year on the taxable income of every corporation.").

deductible.[151] At some point, mission-driven expenditures, such as the costs of extra training for nontraditional employees or using a costly and unconventional production process, fall afoul of the requirement that deductible expenses be "ordinary and necessary."[152] In *Welch v. Helvering*, a taxpayer paid debts of his former employer despite the fact that, first, they were not his obligations and, second, they had been discharged in bankruptcy.[153] His motivation—"to reestablish his relations with customers whom he had known" as an employee of the bankrupt company "and to solidify his credit and standing"—prevented him from deducting those payments.[154]

While commendable, his actions were extraordinary. The Supreme Court explained that "[u]nless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world," no deduction is permitted.[155] Despite *Welch v. Helvering*'s holding, resources that social enterprises devote to mission at the expense of profit—like the thousands of dollars that Welch paid although not legally required to do so—tend to not only be "well and wisely spent" but also deductible.[156] Nevertheless, when its mission-driven expenditures extend far beyond those a typical business would incur, a social enterprise may find those extraordinary expenses disallowed on *Welch v. Helvering* grounds so that it is viewed as profitable through an income tax lens even if it loses money.[157]

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151. This limitation is one reason that a for-profit corporation might not be able to "produce[] a tax result nearly as beneficial as a charitable donation" by using a "subsidiary's operating losses . . . to offset taxable income from other profitable subsidiaries." Fleischer, *supra* note 3, at 232 (noting that for-profit corporations might be able to deduct the losses of the mission-driven affiliates). While the subsidiary's mission-driven expenditures would reduce economic profits, they might not generate tax losses.

152. I.R.C. §162(a) (2012) ("There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .").

153. 290 U.S. 111 (1933).

154. *Id.* at 112.

155. *Id.* at 115.

156. *Id.* at 116. Other courts have allowed similar payments to be deducted. *See* Dunn & McCarthy, Inc. v. Comm'r, 139 F.2d 242, 244 (2d Cir. 1943) (allowing a deduction arising from the satisfaction of a moral obligation "when the directors in good faith and with good reason authorize the payment for the purpose of preserving the loyalty of employees and the good will of customers").

157. Deciding whether that would represent an appropriate burden or might better be thought of as a departure from the tax law's generosity towards public-spirited activities lies beyond the scope of this Article. *See generally* Leff, *supra* note 3 (offering a thorough exploration of the proper treatment of charitable activities of entities other than nonprofits). One way of understanding the question is considering whether mission-driven income should be taxed on a net (rather than a gross) basis. Generally, the income tax is imposed on a net basis. *Compare* I.R.C. § 63(a) (2012) (specifying that "taxable income" means gross income less permitted deductions), *with* I.R.C. § 871 (2012) (imposing a gross thirty percent tax on certain types of income earned by nonresident individuals), *and* I.R.C. § 881 (2012) (imposing a gross thirty percent tax on certain types of income earned by foreign corporations).

3. The SE(c)(3) Exclusion

The SE(c)(3) regime embraces the notion of a double bottom line by providing an exclusion for up to $250,000 of income attributable to a social enterprise's mission. Each dollar of mission-driven expenditures that an enterprise incurs—money spent primarily to further its social mission—results in the exclusion of a dollar of otherwise taxable SE(c)(3) income.[158] The additional one-for-one feature doubles the amount of that exclusion to provide an additional dollar of tax-free income for each dollar of excluded SE(c)(3) income. As a result, even a moderately profitable social enterprise would owe no tax so long as its revenues do not exceed its conventional outlays by more than double its mission-driven expenditures.

Take a corporate social enterprise that spends $25,000 on conventional business expenses and another $25,000 a year on mission-driven training while earning $100,000 in revenues.[159] The SE(c)(3) exclusion would shield a portion of the enterprise's income with its mission-driven expense. The SE(c)(3) need only demonstrate that the mission-driven expenditures were incurred with a principal purpose of advancing a charitable or educational purpose that would be consistent with the tax-exempt activities of a 501(c)(3) entity.[160] No deduction would be allowed for those expenditures, even if they would have satisfied the ordinary and necessary standard.[161]

Excluding $25,000 of the enterprise's income would provide a result broadly consistent with a deduction—gross income of $75,000 less deductions totaling $25,000 producing a taxable income of $50,000—by ensuring that the hypothetical social enterprise described above is taxed on net income.[162] The additional

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158. The carrot in the regime operates like a limited version of the exemption for "charitable" income earned by a for-profit enterprise. *See* Malani & Posner, *supra* note 2, at 2039 (proposing such an exemption in order to end "tax discrimination against for-profit firms"). Critics have noted the likelihood that such an approach would create a "flood of companies that currently pay taxes—for example, biotech and cleantech startups engaged in 'scientific' activities or web companies engaged in 'literary' activities—attempting to qualify as charities." Fleischer, *supra* note 3, at 232. In the simplest case, the SE(c)(3) regime requires social enterprises to demonstrate their commitment to mission by incurring mission-driven expenses. Conditioning the exclusion on the existence and amount of those mission-driven expenses—particularly when paired with the high rates on sales of SE(c)(3) shares and distributions of SE(c)(3) profits—serves to exclude strategic claimants. *Id.*

159. Even if they would otherwise be deductible—by virtue of being deemed ordinary and necessary—no deduction would be allowed for SE(c)(3) expenses identified as mission driven. Allowing a single expense to give rise to both an exclusion and a deduction would allow taxpayers two bites at the proverbial apple.

160. At the risk of understatement, it is not easy to draw a line between those activities that qualify for 501(c)(3) tax exempt status and those that do not. *See* Fleischer, *supra* note 3, at 232 (expressing skepticism regarding the possibility of reliably "distinguishing a charitable endeavor from any other business" under such circumstances). This makes the limit on the amount of the exclusion and the threat of higher rates on shareholder capital gains and profit distributions important to discourage greenwashing.

161. *See supra* Part III.A.2.

162. The income tax is generally a tax on profits (net income) because taxpayers are allowed to deduct expenses they incur in generating income. *See supra* note 147. The SE(c)(3)

one-for-one exclusion of $25,000 would go further. The social enterprise's gross income falls to $50,000, an amount that is again reduced by $25,000, now producing a taxable income of $25,000.

The basic exclusion amount ensures that mission-driven expenses will not be treated less favorably than conventional expenses on *Welch v. Helvering* grounds. Conceptually, the one-for-one exclusion allows for the possibility of mission-driven profits, perhaps as the product of an altruism premium. In other words, if mission-driven expenditures more than pay for themselves, a social enterprise could shield the resulting income from tax.[163] At a more practical level, the enhanced exclusion provides a safety margin for social enterprises.[164]

A different sort of social enterprise—for example, one that serves its mission not by incurring mission-driven expenditures, but by offering mission-focused discounts—could also fit within the SE(c)(3) regime. If the one-for-one exclusion were linked to either extraordinary expenses or mission-driven discounts, it could shield an amount of income equal to the discounts it provides.[165]

In essence, a social enterprise that manages to be profitable despite the economic burden associated with its social mission would treat a portion of its income equal to that burden as excludable SE(c)(3) income. The additional resources a social enterprise devotes (as compared to a for-profit business) to training its employees, providing discounted services to customers, or deploying environmentally friendly production technology[166] would serve as a benchmark for that burden.[167] Managers would be offered a clear incentive to promote the enterprise's mission.[168]

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exclusion would avoid the arguably perverse result of penalizing a social enterprise for not conforming to for-profit industry standards.

163. Imagine a case in which TOMS spends two dollars on shoes for a needy person but charges its customers a ten-dollar premium for a comparable for-profit product.

164. The SE(c)(3) exclusion might likewise be leveraged to lighten the administrative burden on heavily mission-driven social enterprises. A clear showing that its revenues do not more than double its mission-driven expenses (or, in closer cases, revenues less conventional expenses) could eliminate the need to file a traditional tax return.

165. In a variation on the illustration offered above, take a corporate social enterprise that spends $25,000 on conventional business expenses and offers discounts totaling $25,000 per year to further its mission ($75,000 in revenues rather than the $100,000 it might otherwise have earned). Here, the enterprise would ordinarily be subject to tax on $50,000 of income. Such an enterprise would only qualify for a $25,000 one-for-one exclusion (i.e., it would not be granted both the SE(c)(3) exclusion *and* the one-for-one exclusion).

166. Mission-driven expenditures of this sort raise important questions of timing. Ordinarily, major expenditures such as this would be capitalized and recovered over time. *See supra* note 148. The SE(c)(3) regime might offer a simplified analog of this approach, permitting these costs to give rise to SE(c)(3) (plus one-for-one) exclusions over, say, a ten-year term.

167. In all of these cases, identifying which expenditures (or what portions of which expenditures) would qualify as mission driven would not always be easy. In most cases, however, it should not be difficult for a social enterprise to distinguish mission-driven expenditures. After all, those expenditures are their raison d'être, what distinguishes them from an ordinary for-profit venture.

168. The creation of a shareholder gross-up provision—providing that the corporation, rather than the shareholders, will shoulder the loss of capital-gains treatment—would provide

B. A Commitment to Social Mission

Of course, providing an exclusion for up to $500,000 of income while requiring only that the enterprise in question demonstrate that it has incurred mission-driven expenditures would, without more, invite abuse.[169] Even defining "mission" in 501(c)(3) terms, requiring an SE(c)(3) to articulate the charitable, educational, or scientific goal an expenditure advances would only go so far in screening out strategic claimants.[170] As Victor Fleischer notes, such a tax benefit would unleash "a flood of companies that currently pay taxes—for example, biotech and cleantech startups engaged in 'scientific' activities or web companies engaged in 'literary' activities—attempting to qualify as charities."[171]

In the tax-exempt context, the nondistribution constraint serves as a gatekeeper, discouraging insincere claims of altruism designed to provide access to the generous and wide-ranging tax preferences available to charities.[172] The higher tax rates on shareholder profits imposed by SE(c)(3) status[173]—accomplished as a technical matter by excluding SE(c)(3) stock from the tax law's definition of "capital asset" and thereby withholding capital-gain treatment—would serve the same purpose[174] with respect to the relatively modest SE(c)(3) exclusion.[175] Distributions by an SE(c)(3) would also be excluded from the definition of "qualified dividend income" and subject to tax at ordinary rates.[176]

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a further incentive for managers (or at least moderate contrary incentives) to deemphasize profit in favor of mission. Corporations have sometimes chosen to "gross up" or reimburse executives for taxes triggered, for example, by inversions, thereby reducing the tax cost of those transactions for the executives in question. *See* Liz Hoffman, *Corporate Watch*, WALL ST. J., Sept. 2, 2014, at B4 (noting that Medtronic and AbbVie had agreed to pay taxes imposed on executives as the result of inversion transactions); *see also infra* note 173.

169. Although some cheating is inevitable, it is difficult to imagine a determined tax cheat picking the SE(c)(3) regime as her preferred tax-avoidance vehicle (outright fraud does not require the bells and whistles that would accompany an SE(c)(3) claim).

170. *See supra* note 160. The more prototypically charitable a social enterprise's mission, the more confident it would be in its claim to the exclusion. The opposite is true, of course, for truly outlandish claims.

171. Fleischer, *supra* note 3, at 232.

172. *See id.* at 231–32; Mayer & Ganahl, *supra* note 3, at 405–08.

173. Although the SE(c)(3) regime's "penalty" is triggered by distributions of profit or sales of shares, the financial burden of the penalty need not fall directly on shareholders in order to be effective. If, for example, an SE(c)(3) agreed to "gross up" shareholders for any additional taxes, the shareholders would still bear the economic burden of the tax as the firm's residual claimants. That would, of course, not be true if only insiders got the benefit of the gross up. If those insiders exercised sufficient control over the SE(c)(3)'s fate, shifting the higher taxes imposed by the SE(c)(3) regime to the corporation (i.e., other shareholders) would undermine the regime's incentives.

174. As a price of access to an exceptionally broad (and unlimited) tax exemption, the nondistribution constraint prevents any access to profits by owners or shareholders. The SE(c)(3) regime imposes a more modest cost in exchange for a more modest benefit.

175. *See supra* note 17.

176. I.R.C. § 1(h)(11) (2012) improves the treatment of dividends by granting them "net capital gain" status. I.R.C. § 1(h)(11)(B)(ii)(I) (2012) excludes dividends paid by tax exempt corporations and would be modified to also exclude SE(c)(3)s.

A business could, of course, exploit the SE(c)(3) exclusion despite a ruthless focus on its financial bottom line. Research and development expenses—recast as scientific research—that might otherwise produce tax benefits in the future could instead be used to exclude current income.[177] The one-for-one exclusion would only augment the appeal of the regime for for-profit businesses. Such a venture need not have an interest in pursuing social good as an end in itself.

The SE(c)(3) exclusion on its own might be vulnerable to such strategic claims, but the SE(c)(3) regime taken as a whole is not. Its design exacts a price for the SE(c)(3) exclusion that, while palatable for a venture pursing a double bottom line, could be steep for a strategic claimant. Simply put, for a purely profit-seeking firm, the cost of the relatively high rates imposed on distributions of SE(c)(3) profits and sales of SE(c)(3) shares would more than outweigh the advantages of the limited SE(c)(3) exclusion. Even a business with no shortage of plausibly mission-driven expenditures would be reluctant to assert a questionable claim to a limited $500,000 entity-level exclusion if the certain result would be an uncapped, permanent increase in shareholder-level taxes.

There are other, less obvious costs to SE(c)(3) status. Foreign investors in SE(c)(3)s would find what would otherwise have been tax-free capital gains transformed into taxable income.[178] To claim the SE(c)(3) exclusion, a social enterprise must operate in corporate form.[179] In its startup phase—precisely when the enhanced funding access provided by SE(c)(3) status would be most important—embracing the corporate form would represent a lost opportunity for a strategic claimant. Fledgling businesses often lose money, generating valuable tax losses that would sit idle in a corporate shell but could shelter unrelated income from tax if the startup were unincorporated. It would be imprudent of an entrepreneur to precipitate such costs merely to enable him to assert a marginal claim to an SE(c)(3) exclusion.

C. The Limits of Commitment

In the crowdfunding context, in which promises would be easy for insiders to make and impossible for small, dispersed investors to verify, a robust collective signal of commitment to a double bottom line is invaluable.[180] The SE(c)(3) regime serves as a commitment device capable of delivering precisely such a signal.[181] The regime would, of course, serve a useful role outside of the crowdfunding context by limiting the impact of the complex assurance game confronted by every social

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177. The research and development tax credit might, of course, provide a current tax benefit in these circumstances. *See* I.R.C. § 41 (2012) (providing a credit for "qualified research expenses").

178. *See* I.R.C. § 871(a) (2012) (exempting capital gains—but not ordinary income—of nonresident alien investors from U.S. taxation).

179. That might mean an actual corporation. It could also mean another entity, perhaps an LLC or partnership, electing to receive corporate treatment.

180. *See supra* note 67 and accompanying text.

181. The regime combines a carrot only appealing to mission-driven ventures, *see supra* note 158 and accompanying text, with a stick that only hurts shareholders that derive significant financial gains from a purported social enterprise, *see supra* note 124 and accompanying text.

enterprise. For the mom-and-pop investors[182] occupying the crowdfunding space, that signal would make SE(c)(3) status an indispensable trusted brand.[183]

Investors always face a principal-agent problem when they place their capital in the hands of managers with the opportunity to shirk, squander, or steal. This problem imposes agency costs on investors who try to limit agents' misdeeds through monitoring, attempt to realign the incentives of principals and agents to coincide, or must make an untimely or unprofitable exit. The SE(c)(3) regime complicates the principal-agent story of a traditional, purely for-profit firm. Indeed, the SE(c)(3) is designed to decrease the cost of monitoring—particularly monitoring compliance with a social mission far more difficult to track than profit alone—and to align the incentives of agents and principals by allowing them to preselect for commitment to a double bottom line. On the other hand, its reduction of the after-tax value of profits investors take out of the firm could increase managers' existing temptation to retain earnings[184] and magnify the cost of investor exit. One cannot be certain how this trade-off will turn out but in our view, SE(c)(3)'s focused protection for social mission is worth the risk, particularly in the typically small, illiquid social enterprise, whose investors' ability to sell is already limited. After all, we are only contemplating a commitment device, and in turn a signal, to enable the creation of a primary market for small-scale social enterprise investments. The possibility of a secondary market is even more remote.

Of course, the SE(c)(3) regime's success as a commitment device also depends on the participation of the federal government. The executive branch, specifically the Internal Revenue Service, would be called on to play the role of "judge" by rewarding compliance and penalizing defection.[185] Fortunately, although the IRS's

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182. The SE(c)(3) regime is designed with nonaccredited crowdfund investors in mind; but its signaling value could also make it useful to accredited investors already being sought out by platforms designed for them. For example, CircleUp markets itself as a crowdfunding platform offering accredited investors access to invest in a range of small companies. *See Getting Started*, CIRCLEUP, https://circleup.com/getting-started/. With the JOBS Act's lifting of the ban on general solicitation of accredited investors, efforts like these are likely to rise. JOBS Act, Pub. L. No. 112-106, § 201(a)(1), 126 Stat. 306, 313–14 (2012).

Additionally, while SE(c)(3) is targeted at domestic individual investors, nothing would prevent foreign investors from purchasing SE(c)(3) shares or a big public corporation from forming an SE(c)(3) as a subsidiary. Since corporations do not enjoy a rate preference for capital gains, the stick employed by the SE(c)(3) regime would not affect them directly. Subjecting sales of the stock of "affiliated" corporations to ordinary rates would subject the ultimate shareholders of those corporate owners to the higher rates on all of their stock—not just a relatively small portion related to the SE(c)(3) subsidiary. *See infra* note 194. Foreign investors would find gains that might otherwise entirely escape U.S. taxation being heavily taxed, a bigger penalty than the rate differential faced by domestic sellers of SE(c)(3) shares.

183. Although not explicitly excluded from investing in SE(c)(3)s, existing corporate groups would face a steep potential cost from an investment in an SE(c)(3). If their ownership stake exceeded specific thresholds, they might themselves become an SE(c)(3), imposing a higher tax burden on their ultimate owners. *See infra* note 194.

184. *See generally* Steven A. Bank, *A Capital Lock-In Theory of the Corporate Income Tax*, 94 GEO. L. J. 889 (2006) (describing how corporate forms tend to lock in capital, a feature that explains entity-level corporate taxation).

185. Although its interpretations and actions are subject to judicial review, the Internal

powers are limited, the SE(c)(3) regime does not require tax authorities to stray beyond their comfort zone.[186]

Unless an SE(c)(3) distributes profits to shareholders or those shareholders sell their shares, tax authorities cannot penalize an enterprise that abandons its social mission to pursue profits. If a decision short of profit distribution or sale drives a social enterprise to forsake its mission, the Internal Revenue Service as judge would be powerless to preserve that mission.[187] But a sell-out is what insiders and outsiders alike fear most.[188]

Since the SE(c)(3) regime targets only distributions of profits by SE(c)(3)s and sales of SE(c)(3) shares, routine tax-planning techniques could substitute economically equivalent transactions designed to skirt the edges of the regime. Fortunately, the corporate tax has long experience defeating such efforts.[189] As elsewhere, those responses could impose broad limitations on the structure and operations of SE(c)(3)s[190] or narrowly target specific abuses.[191]

For example, the owner of an SE(c)(3) might contribute its shares to a holding company in order to sell shares of its new parent free of the SE(c)(3) taint.[192] The owner might instead strip away the SE(c)(3)'s corporate shell and replace it with an ordinary corporation.[193] Alternatively, the SE(c)(3) might purchase shares of a sibling corporation from their shared owner, resulting in (1) a meaningless reshuffling of corporate ownership and (2) the receipt of cash by the SE(c)(3)'s owner from the SE(c)(3) without any distribution or sale of SE(c)(3) shares taking place.

Revenue Service possesses ample "actual authority" over the tax law. *See supra* note 105.

186. *See infra* note 221 and accompanying text.

187. In other words, the SE(c)(3) regime would "protect investors and entrepreneurs from opportunistic sales by their counterparty . . . [rather than] bind either side during the ordinary course of the firm's dealings." *See* Brian Galle, *Social Enterprise: Who Needs It?*, 54 B.C. L. REV. 2025, 2026 (2013) (noting the same limitation in a prior proposal).

188. That fear is perhaps best illustrated by the well-known, but dubious, story of the sale of Ben & Jerry's to Unliver. *See supra* note 70. Taken as a cautionary tale of the risks of going public for mission-driven enterprises—thereby inviting outside investors into the proverbial boardroom—that sale illustrates how the SE(c)(3) regime might operate to dissuade insiders as well as outsiders from seeking to cash in. Had Ben & Jerry's been an SE(c)(3), the insiders would have been subject to the regime's relatively high rates on their sale, making the sale to Unilever less profitable (and presumably less appealing).

189. *See, e.g.*, *supra* note 108 and accompanying text.

190. The regime for S corporations provides favorable treatment of corporations owned by a relatively small group of individuals. *See* I.R.C. § 1363(a) (2012) (providing that "an S corporation shall not be subject to . . . tax[]"). To ensure that the regime is not abused, an S corporation may only have "one class of stock." *See* I.R.C. § 1361(b)(1)(D) (2012). The regime also forbids, with limited exceptions, an S corporation from having owners that are not individuals. *See* I.R.C. § 1361(b)(1)(B) (2012). Those broad limitations foreclose a host of planning opportunities, some troubling and some not.

191. *See infra* notes 194–96.

192. The formation of the holding company would ordinarily be tax free under I.R.C. § 351 (2012), which is designed to promote corporate formation.

193. Such a liquidation and reincorporation might not trigger much tax if it were carried out while the enterprise remained focused on pursuing a double bottom line.

None of those strategies would pose any particular challenge for the SE(c)(3) regime. Extending the election to closely related corporations would defeat the first.[194] The second represents precisely the sort of liquidation-reincorporation technique once used to purge corporations of unwanted characteristics and long since addressed by an affirmative use of tax-free reorganization provisions.[195] The third technique likewise invokes a response from a longstanding anti-abuse statute, recharacterizing the purchase as a distribution paid by the SE(c)(3) to its owner.[196]

IV. CATALYZING SOCIAL ENTERPRISE CROWDFUNDING

Government has been more of a hindrance than a help to the maturation of the social enterprise sector. The traditional dichotomy of for-profit and nonprofit has produced tax and corporate laws that cater to the extremes, while creating obstacles for entrepreneurs and investors working at the intersection of profit and social mission. The SE(c)(3) regime described here offers a regulatory structure designed to remedy that failure.

Of course, other paths are open to policymakers. The state law that governs both for-profit and nonprofit enterprises could be amended to address the needs of dual-mission ventures. By failing to strike a balance between securing a venture's mission and preserving shareholder autonomy, the hybrid entities that have proliferated in the United States over the past few years have fallen short.[197] However frustrating, those failures—compounded by the reluctance to retrofit the tax law to address the needs of social enterprises—should not be taken as proof that policymakers are powerless to support the efforts of double-bottom-line enterprises.

Legislators committed to crafting specialized organizational forms to attract capital to social enterprises need to do two things: (1) provide a clear standard requiring adopting entities to prioritize social good and (2) develop meaningful

194. The parent might, for example, be treated as part of an SE(c)(3) "affiliated group" so its stock would also be excluded from § 1221. *See* I.R.C. § 1504(a) (2012) (defining an "affiliated group" as a group of corporations connected by a chain of ownership). The rules for a "controlled group" of a corporation might also by invoked to ensure that taxpayers are not unfairly getting more than one bite at this proverbial apple. *See, e.g.*, I.R.C. 179(d)(6)(A) (2012) (invoking § 1563 controlled-group rules to limit the availability of favorable expense-recovery rules by requiring that "all component members of a controlled group shall be treated as one taxpayer"). While it might make sense to apply the $500,000 cap to a controlled group of corporations to prevent double dipping, treating each member of a controlled group as an SE(c)(3) if any one of them is an SE(c)(3) might be overkill. One could imagine an entrepreneur owning both an SE(c)(3) and a traditional for-profit corporation. As long as the corporations transacted at arm's length (or not at all), having a common owner should not, on its own, be a problem.

195. *See* I.R.C. § 368(a)(1)(D) (2012) (providing that such a nondivisive reorganization will cause the new corporation to be treated as an alter ego of the old).

196. *See* I.R.C. § 304(a)(1) (2012) (providing that if one corporation acquired stock in another commonly controlled corporation from their shared owner, the purchase price of that stock "shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock").

197. *See supra* notes 8–9 and accompanying text. It is not impossible that the SE(c)(3) regime could prove a complement to the existing menu of hybrid corporate forms, securing each enterprise's mission more firmly than the hybrid forms can on their own.

enforcement mechanisms.[198] With only a couple of exceptions, the current mass of hybrid forms available in the United States do not require adopting entities to prioritize social good over profit.[199] Instead, they merely require adopting entities to "do both."[200] Perhaps over time courts will interpret fiduciary obligations in the context of these specialized forms to impose a social-good-prioritization standard,[201] but it is doubtful they will do so consistently or soon. Legislatures must impose such a standard to reassure entrepreneurs and investors of the commitment of their counterparts.

This can be done. In 2004, the United Kingdom introduced the community interest company (CIC), a new incorporated form to house social enterprises.[202] The CIC imposes a commitment to social good over profit, requiring adopting entities to pursue "community benefit."[203] This command is backed up by an asset lock, which allows distributions to shareholders only at capped levels and permits assets to be transferred on dissolution only to other CICs or charitable entities.[204] The Belgian Société à Finalité Sociale (SFS) form requires a statement in the charter limiting the company's profit goals and imposes a similar asset lock and caps on returns to investors.[205] As was noted earlier, a pair of outlier statutes do impose social-good prioritization. New York's 2012 benefit corporation statute states that "[t]he purpose to create general public benefit shall be a limitation on the other purposes of the benefit corporation, and shall control over any inconsistent purpose of the benefit corporation."[206] Minnesota's statute instructs directors that they "may not give regular, presumptive, or permanent priority to: . . . the pecuniary interests of the shareholders . . . ."[207] Perhaps more states will follow these examples and adopt social-good prioritization in new enabling-legislation adoptions or amendments to existing laws.[208]

Social-good prioritization is vital not only for specialized forms to be meaningfully distinct but also as a necessary predicate to effective enforcement. The

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198. *See* Brakman Reiser, *supra* note 74, at 692.

199. *See id.* at 695.

200. *See id.* at 694–96.

201. *See id.* at 696–98.

202. The Companies (Audit, Investigations and Community Enterprise) Act, 2004, c. 27, § 26(1) (U.K.) ("There is to be a new type of company to be known as the community interest company.")

203. *See Community Interest Companies: Guidance* Chapters, GOV.UK, https://www.gov.uk/government/publications/community-interest-companies-how-to-form-a-cic (follow "Chapter 1: introduction" to pages 6–7, describing the community benefit requirement).

204. *See id.* (follow "Chapter 6: the asset lock" to pages 4–6).

205. *See* Matthew F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 309 (2010) (explaining the elements of SFS status); *see also* Jacques Defourny & Marthe Nyssens, *Social Enterprise in Europe: Recent Trends and Developments*, 4 SOC. ENTERPRISE J. 202, 207 (2008) (describing the SFS and various other European cooperative and other social enterprise models).

206. N.Y. BUS. CORP. LAW § 1706(a) (McKinney Supp. 2014). *Compare id.*, *with* N.J. STAT. ANN. § 14A:18-5(a) (West Supp. 2014) ("This purpose is in addition to, and may be a limitation on, its purpose under its certificate of incorporation and any specific purpose set forth in its certificate of incorporation.").

207. MINN. STAT. ANN. § 304A.201(1)(2)(i) (West 2015).

208. *See State by State Legislative Status*, BENEFIT CORP INFO. CENTER, http://www.benefitcorp.net/state-by-state-legislative-status.

goal of "doing both" sets up an insurmountable enforcement challenge. How can investors police an entrepreneur they view as pursuing too little social mission? How can entrepreneurs defend against investors who decide to pursue more profit? Only if adopting a specialized form means a social enterprise has signed on to be meaningfully different than both a nonprofit—by contemplating profit distribution to investors—and a for-profit—by prioritizing social good over profit, on balance—can enforcement even be contemplated.

Unfortunately, enforcement, the second of the two challenges faced by a state government intent on promoting social enterprise, appears the more daunting one. Like other business forms, current specialized forms enforce standards of conduct on managers and fiduciaries through private, internal policing. They empower investors with a range of informational, voting, and litigation rights.[209] These investors—alone or in addition to other interested constituencies like employees, customers, and beneficiaries—could likewise be drafted to enforce the obligation to pursue social good. Each of these groups, though, may be rationally apathetic.[210] Whether their commitment to the social enterprise ethic will prove strong enough to overcome this apathy will depend on the costs of enforcement and the impact of coordination problems.

Imagine an investor in a social enterprise adopting a specialized form; imagine further that the investor believes the enterprise's managers are failing to prioritize social good by changing from local, environmentally sensitive production to less costly but highly polluting production overseas. Most specialized forms provide for significant reporting to investors, so our investor may well be aware of this decision. But what can she do about it? If she is a large shareholder in a small social enterprise, perhaps she can vote to remove the current fiduciaries and push through a change in policy. The corporate franchise, however, is of little help to a small investor incapable of coordinating a response with even like-minded fellows among the crowd. If enabling legislation adopted a social-good-prioritization standard for fiduciaries of adopting entities, she might sue for enforcement. Or, she might not.

Litigation over fiduciary compliance is an expensive proposition with unpredictable outcomes. Even a large investor may prefer to cut her losses and find a new enterprise in which to invest her money to avoid spending her time and money on litigation. At the moment, no specialized-form legislation empowers employees, customers, beneficiaries, or other constituencies to sue fiduciaries. In fact, many expressly state that only investors have standing.[211] Even if new legislation empowered these groups, the expense of litigation and the difficulties of coordination would frustrate their ability to effectively enforce social-good prioritization. For private enforcement within social enterprises to be viable, specialized forms must

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209. *See* Brakman Reiser, *supra* note 74, at 706–16.

210. *See* STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 485 (2002) (explaining that under the rational apathy theory, "[f]or the average shareholder, the necessary investment of time and effort in making informed voting decisions simply is not worthwhile").

211. *See, e.g.*, 805 ILL. COMP. STAT. ANN. 40/4.01(d) (West Supp. 2014) ("A director does not have a duty to a person that is a beneficiary of the general public benefit purpose or a specific public benefit purpose of a benefit corporation arising from the status of the person as a beneficiary."); MASS. GEN. LAWS ANN. ch. 156E, § 10(e) (2013) ("A director shall not have a fiduciary duty to a person that is a beneficiary of the general or specific public benefit purposes of a benefit corporation arising from the status of the person as a beneficiary.").

offer accessible methods of effective enforcement. Thus far, enabling legislation has failed to provide them.

Alternatively, legislation imposing a social good prioritization standard could empower government agencies to enforce it. The United Kingdom took just this approach. The CIC legislation created a dedicated, albeit not "heavy-handed," regulator[212] to monitor CIC compliance with the community-benefit standard and asset lock, and to set dividend-cap levels.[213] No U.S. jurisdiction adopting a specialized form has empowered a dedicated regulator, and only one state, Illinois, has indicated it will take any regulatory role.[214] The strapped condition of state budgets will likely doom the Illinois position to remain an outlier. Attorneys general tasked with enforcing the obligations of charities are massively underfunded for their current tasks,[215] and state revenues across the country are in crisis. While politicians in the United Kingdom might not think twice about creating a specialized regulatory apparatus for social enterprise, state legislators here will be wary of even adding to the portfolio of existing regulators.

Enabling private regulation, however, is much more in sync with the current political winds. State legislatures might see fit to deputize private organizations to engage in enforcing social good prioritization. In fact, such enabling legislation already relies on private bodies to establish standards that adopting entities must then apply to themselves and claim they meet in order to adopt a specialized form.[216] Legislatures could take these efforts a step further and create or incentivize a private-certification requirement to adopt a specialized form.[217] Sadly, this solution is not the free and easy remedy to the enforcement conundrum that it might seem. For a certification system to be reliable, someone—in this case, presumably the state relying upon it—must find and expend resources monitoring the certifying entities.[218]

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212. *See Community Interest Companies: Guidance* Chapters, *supra* note 203 (follow "Chapter 6: the asset lock" to page 3).

213. The initial dividend caps were imposed under the 2005 CIC Regulations. *See* The Community Interest Company Regulations, 2005, S.I. 1788 (U.K.), *available at* http://www.legislation.gov.uk/uksi/2005/1788/contents/made. They have been changed over time, most recently in December 2013. *See* DEP'T FOR BUS. INNOVATION & SKILLS, CHANGES TO THE DIVIDEND AND INTEREST CAPS FOR COMMUNITY INTEREST COMPANIES: RESPONSE TO THE CIC CONSULTATION ON THE DIVIDEND AND INTEREST CAPS (2013), *available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/264664/CIC-13-1333-community-interest-companies-response-on-the-cic-consultation.pdf (announcing the results of a consultation and of changes to the cap on performance-related dividends).

214. The Illinois L3C statute subjects L3Cs and their "chief operating officer[s], director[s], or manager[s]" qualifying as "trustee[s]" to the Attorney General's registration and reporting requirements. 805 ILL. COMP. STAT. ANN. 180/1-26(d) (West 2010); *see also* 760 ILL. COMP. STAT. ANN. 55/5, 6, 7 (West 2007). *See* Dana Brakman Reiser, *Regulating Social Enterprises*, 14 U.C. DAVIS BUS. L. REV. 231, 235–36 (2014).

215. *See* Thomas Lee Hazen & Lisa Love Hazen, *Duties of Nonprofit Corporate Directors—Emphasizing Oversight Responsibilities*, 90 N.C. L. REV. 1845, 1879 n.163 (2012) (cataloguing scholarship on the topic).

216. *See* Brakman Reiser, *supra* note 74, at 725–28.

217. *See id.* at 728–32.

218. *See id.* at 731–32.

Much work remains to be done for specialized-form legislation to offer the real assurances that investors and entrepreneurs need to open up capital access for social enterprise. Thankfully, crafting a prosocial enterprise policy for the United States does not depend upon eradicating rational apathy and collective-action problems, reviving state economic prosperity nationwide, or changing the deeply antiregulatory bias of American political culture. The SE(c)(3) regime offers a simple, revenue-neutral, and uniquely American approach to the matter. Its use of tax rules to further goals far afield from measuring or redistributing income would certainly raise eyebrows in jurisdictions accustomed to relying on direct regulation to achieve social objectives.[219] Here, though, reliance on the tax system for ends that might be served by direct government action has become commonplace.[220]

Although it will never warm the hearts of tax purists or tax phobics, the use of the tax law to catalyze social enterprise crowdfunding has much to recommend it. Perhaps most importantly, its twin focus on mission-driven expenditures and shareholder profits capitalizes on the tax law's strength in measuring net income.[221] Rather than attempting to develop a taxonomy of mission-driven activities or to monitor their implementation, the SE(c)(3) regime measures cash flows.

A cynic might also note that tax breaks tend to fare better in the political process than economically equivalent government spending.[222] That result may be neither logical nor desirable, but for whatever combination of reasons "[t]ax expenditures have grown in importance to the point where they are now the dominant instruments for implementing new discretionary spending policies."[223] While the tax law need not be the only mechanism through which government promotes the pursuit of double bottom lines, its use as a mechanism for promoting social and economic objectives would hardly be unique.

A further argument in favor of using the tax system to deliver this particular benefit boils down to flexibility. The combination of the tax penalty on shareholder profits with the tax benefit for mission-driven expenses could be calibrated to achieve a rough revenue neutrality. That would mean that the heavier burden imposed on

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219. Even in the United States, where the use of tax expenditures is commonplace, critics have long complained that tax laws should not be used as vehicles for government spending. *See* SURREY, *supra* note 109, at 6 (lamenting the implications of the "injection of extraneous, costly, and ill-considered expenditure programs" into the tax law).

220. *See* Edward D. Kleinbard, *The Congress Within the Congress: How Tax Expenditures Distort Our Budget and Our Political Processes*, 36 OHIO N.U. L. REV. 1, 17 (2010) ("The United States appears . . . to be among the leaders in the proportion of benefits delivered through the tax system. And, very interestingly, the United States appears to be an outlier in its extensive use of tax subsidies for business and capital investments . . . .").

221. *See* David A. Weisbach & Jacob Nussim, *The Integration of Tax and Spending Programs*, 113 YALE L.J. 955, 1009 (2004) ("The tax system . . . specializes in income measurement and has invested billions of dollars in this expertise, including in computer systems that can match income reports and in agents trained to ferret out fraud.").

222. See Edward A. Zelinsky, *Do Tax Expenditures Create Framing Effects? Volunteer Firefighters, Property Tax Exemptions, and the Paradox of Tax Expenditure Analysis*, 24 VA. TAX REV. 797, 799 (2005) (noting that because of psychological phenomena, "policies unacceptable when framed as direct expenditures become supportable when labeled as tax subsidies, even though the economic substance of the policies is the same").

223. Kleinbard, *supra* note 220, at 3.

SE(c)(3)s emphasizing shareholder profit would indirectly ease the load on mission-focused enterprises, leaving a light footprint on the federal budget.[224] Crafting a more generous exclusion or a more narrowly targeted penalty would make SE(c)(3) status more attractive for ventures but more expensive for taxpayers.

Either approach would allow government to support the growth of social enterprise without attempting to seize control of it. Rather than elevating a particular constituency or a specific approach, the SE(c)(3) regime invites social enterprises to choose for themselves. In fact, by offering a readily recognizable signal that small investors can use to identify enterprises committed to balancing social mission and profit, the SE(c)(3) regime cedes decision-making authority to the wisdom of the crowd.

CONCLUSION

Social enterprise and crowdfunding strain the conventional boundaries of corporate and tax laws. The SE(c)(3) regime offers a fittingly radical architecture to house those double-bottom-line ventures, permitting them to embrace and advertise their dual pursuits of profits and social good. A measured tax benefit linked to the costs of its mission paired with higher taxes when its shareholders cash in offers an appropriate balance of rewards and sanctions to ensure fidelity.

224. One could imagine a world in which enterprises would choose the SE(c)(3) regime not to claim the exclusion, but merely as a means of committing to dedicate a share of their profits with mission-focused social enterprises. That would obviously require a commitment on the part of the federal government not to treat the SE(c)(3) regime's tax penalty like just another revenue stream (a surplus could be used to expand the exclusion, for example). It would also require real generosity on the part of an SE(c)(3) having little expectation of benefitting from the exclusion.