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Steven A. Dean

Brooklyn Law School, steven.dean@brooklaw.edu

Dana Brakman Reiser

Brooklyn Law School, dana.brakman@brooklaw.edu

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HUNTING STAG WITH FLY PAPER: A HYBRID FINANCIAL INSTRUMENT FOR SOCIAL ENTERPRISE

DANA BRAKMAN REISER*

STEVEN A. DEAN**

Abstract: Social entrepreneurs and socially motivated investors share a belief in the power of social enterprise: ventures that pursue a “double bottom line” of profit and social good. Unfortunately, they also share a deep mutual suspicion. Recognizing that social ventures—just like traditional for-profit and nonprofit enterprises—need capital to flourish, this Article offers a financing tool to transform that skepticism into commitment. Unlike the array of new entities that have emerged in recent years—including L3Cs, benefit corporations, and flexible purpose corporations—the hybrid financial instrument this Article describes provides a robust and transparent solution to the puzzle that lies at the heart of every social enterprise: how to blend a profit motive with a social mission. Recognizing their shared dilemma as an example of what economists call a stag hunt, FLY Paper strikes that elusive balance by allowing investors and entrepreneurs to signal credibly a reciprocal commitment to the pursuit of a double bottom line.

INTRODUCTION

When Google issued shares to the public for the first time, the entrepreneurs at its helm had more than immediate self-gratification in mind.¹ They recognized that the transaction others disdained as a nec-

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* Vice Dean and Professor of Law, Brooklyn Law School.

** Professor of Law, Brooklyn Law School.

¹ Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1584 (2006) (“When Google structured its IPO as an auction, it reinforced Google’s identity as an innovative, egalitarian, playful, trustworthy company. Talking about Google’s IPO makes you want to use Google’s products.”).

essary evil—a dark brew of lawyers and bankers stirred by greed—could be far more.² The unconventional auction structure they employed left no room for doubt that Google’s “don’t be evil” mantra guided its leaders’ actions even when billions of dollars hung in the balance.³ Flexible Low-Yield (“FLY”) Paper, the hybrid financial instrument this Article describes, offers social entrepreneurs the same opportunity to remake a symbol of greed into proof of their commitment to leaven capitalism with idealism.

It is conventional wisdom that when social entrepreneurs⁴ accept capital from investors they take the first step down a slippery slope toward wholeheartedly embracing a profit motive.⁵ By contrast, when a charity raises capital from donors, its commitment to exclusively pursue social good is permanent.⁶ A charity’s assets possess complete legacy protection, guaranteeing their perpetual dedication to charitable purposes. Until now, outside that charitable context, investments seem invariably to undermine an enterprise’s commitment to the pursuit of its social objectives.⁷

FLY Paper succeeds where prior efforts have failed primarily because it reflects the insight—new to the literature—that the problem social entrepreneurs and investors face can be described as a stag hunt

² See *id.* at 1594 (“The challenge for Google was to turn a process associated with greed into something positive. Structuring its IPO as an auction did the trick.”).

³ See *id.* at 1604 (“Rather than having underwriters set the price using the traditional book-building method, investors set the price for shares over the Internet. The voice of the people, not Wall Street insiders, set the price.”).

⁴ The definition of the term “social entrepreneur” has been the subject of lingering scholarly debate in the legal and business literature. See Samer Abu-Saifan, *Social Entrepreneurship: Definition and Boundaries*, TECH. INNOVATION MGMT. REV., Feb. 2012, at 22, 22–23 (indicating that “social entrepreneur” has no uniform definition and that there is a need for a better definition of the term). This article embraces a general definition that has gained traction in the legal literature: “the social enterprise, can be defined as ‘an organization or venture that achieves its primary social or environmental mission using business methods.’” Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 59 (2010) (quoting *About Social Enterprise Alliance*, SOCIAL ENTERPRISE ALLIANCE, <http://www.se-alliance.org/about> (last visited July 20, 2013)).

⁵ This same fear rears its head whenever profit and philanthropy are blended. See, e.g., Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2466 (2009) [hereinafter Brakman Reiser, *For-Profit Philanthropy*] (“The ultimate mission-based fear raised by the for-profit philanthropy model is that resources contributed with much fanfare to achievement of philanthropic aims could, one day, be recaptured by the for-profit and used instead for profit-making purposes.”).

⁶ See *infra* note 32 and accompanying text (discussing how the nondistribution constraint imposed on charities ensures that all the assets contributed to the charity remain part of its operations permanently).

⁷ See *infra* notes 47–61 and accompanying text.

or assurance game.⁸ Just as the figurative hunters long to return home with a shared stag, investors and entrepreneurs prefer cooperation and a double bottom line.⁹ Although they would both benefit by balancing an enterprise's social mission alongside their own financial interests, doing so asks each to take a leap of faith.¹⁰ Low-profit Limited Liability Companies ("L3Cs"), benefit corporations, and flexible purpose corporations ("FPC")—although specifically designed for social enterprise—fail to give investors and entrepreneurs the confidence needed to make that leap.¹¹ They may provide one or the other with a means of making a credible commitment to the enterprise's social mission, but never both.

FLY Paper fills that gap by providing both entrepreneurs and investors with confidence that their commitment to the enterprise's mis-

⁸ See DOUGLAS G. BAIRD ET AL., *GAME THEORY AND THE LAW* 35–36 (1998) (describing a stag hunt). The stag hunt involves two hunters who would each prefer to hunt a stag (here, pursue a double bottom line) rather than a hare (maximize financial returns). To be successful in the stag hunt, the hunters must coordinate. To catch hares, they do not—but catching a hare yields a more minimal return. Each worries that the other hunter will abandon the joint stag hunt to catch a hare on his own (abandon the double bottom line to pursue his financial self-interest) and so neither is willing to commit to the stag hunt. Notwithstanding that concern, both hunters prefer the prospect of a shared stag to a hare (just as both the entrepreneur and investor prefer a blended return).

⁹ Social entrepreneurs and their investor counterparts operate under two conditions of uncertainty that prevent them from balancing profit-making and social good. First, and most importantly, at the outset each is unsure of the other's sincerity and commitment to the dual mission. Second, although each has a prospective sense of the range of potential profit and social gains to be generated by the venture, these estimates could turn out to be wildly off the mark. For example, the payoff for defection may turn out to be greater than what an investor had envisioned giving up for a social return (the equivalent of a hunter stumbling on an enormous hare). Even in this case, though, the social entrepreneur would want the investor to remain committed. FLY Paper provides both a clear signal of ex ante expectations and a commitment device to protect against future lapses. As such, FLY Paper operates as a valuable sorting mechanism; its terms will simply not attract investors or entrepreneurs looking to bilk each other with social-enterprise snake oil.

¹⁰ Investors and social entrepreneurs face a coordination problem (i.e., an assurance game or stag hunt) rather than a cooperation problem (i.e., a prisoners' dilemma). See Richard H. McAdams, *Beyond the Prisoners' Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209, 218–19 (2009) (noting that the distinction between coordination and cooperation is often overlooked). The would-be coventurers need only assure one another that they will look beyond their own self-interest to remain committed to the enterprise's social mission. Were it a prisoners' dilemma, each would prefer to defect—abandoning the double bottom line—even if the other remains committed. See *id.* at 215 (describing the prisoners' dilemma). The prisoners' dilemma label is often misapplied to the (perhaps more intuitive) situation in which both prisoners can go free if both refuse to confess. *Id.* at 217–18.

¹¹ See *infra* notes 62–92 and accompanying text (discussing new organizational forms).

sion will be reciprocated.¹² FLY Paper is a hybrid debt instrument that entitles investors to a modest, below-market return payable on a flexible schedule. This investment will provide entrepreneurs with capital, but will also test their resolve. If an entrepreneur agrees to sell her own shares, FLY Paper holders will have the option to convert their debt to equity on favorable terms, thereby capturing much of the gains that the entrepreneur would otherwise earn from “selling out.” Accordingly, FLY Paper creates a window of time during which social entrepreneurs can pursue their social missions without turning to the permanent legacy protection of a charitable organization. Rather than representing a threat to its social mission, the investment makes the mission “sticky” during the FLY Paper’s term.¹³ When social enterprises issue FLY Paper to investors, neither entrepreneurs nor investors need to worry that the other will “defect” by unilaterally pursuing their own self-interest.

In one sense, FLY Paper falls well short of the solution offered by entities such as the L3C, the benefit corporation, and the FPC. Those entities promise to strike a permanent, comprehensive balance between profit and mission. Although such a broad resolution would be ideal, none of those hybrid entities has achieved it.¹⁴ FLY Paper makes a more modest pledge: to give both investors and entrepreneurs a means of making credible commitments to the enterprise’s mission over a specified term.

This Article argues that FLY Paper, an incremental departure from existing legal technologies, will go further than hybrid organizations to secure an enterprise’s social mission. Part I describes three types of hybrid organizations—L3Cs, benefit corporations, and the FPCs—that occupy the same no man’s land between nonprofit and for-profit spaces as FLY Paper.¹⁵ Then, Part II examines how FLY Paper facilitates coordination between entrepreneurs and investors.¹⁶ Part III describes FLY Paper’s tax treatment, detailing how it allows investors to shoulder a por-

¹² FLY Paper serves simultaneously as a signal and a commitment device. See *infra* notes 116–130 and accompanying text.

¹³ That term could last fifteen years or more.

¹⁴ See Dana Brakman Reiser, *Theorizing Forms for Social Enterprise*, 62 EMORY L. J. 681, 705–06 (2013) [hereinafter Brakman Reiser, *Theorizing Forms for Social Enterprise*] (arguing that the current specialized forms available for social enterprise do not sufficiently address enforcement issues).

¹⁵ See *infra* notes 19–109 and accompanying text. Both FLY Paper and hybrid organizations seek investment rather than tax deductible contributions. That concession allows them to avoid both the operational constraints imposed on traditional tax-exempt charities and permanent legacy protection.

¹⁶ See *infra* notes 110–178 and accompanying text.

tion of a social enterprise's tax burden.¹⁷ Finally, Part IV considers what FLY Paper does—and no less important, what it does not—accomplish, identifying critical questions that remain for social entrepreneurs, investors, and the public.¹⁸

I. BUILDING A VEHICLE FOR SOCIAL ENTERPRISE

The founders of social enterprises want to “do well by doing good,” running entities that pursue both social good and profit for owners. These enterprises manufacture products using more expensive inputs to reduce their environmental impact, or give away some of their products to those in need.¹⁹ They employ workers who traditionally face obstacles to finding employment, despite these workers making their labor costs higher than their competitors' costs.²⁰ Social enterprises create technologies to improve the lives of those in the developing world, even though they could turn their research and development to pursuing first world inventions at greater profit.²¹ Yet the

¹⁷ See *infra* notes 179–240 and accompanying text.

¹⁸ See *infra* notes 241–245 and accompanying text.

¹⁹ See, e.g., *Our Promise*, HAPPY BABY, <http://www.happybabyfood.com/about-us/our-promise> (last visited July 5, 2013) (describing the company's commitment to environmentally friendly practices, using organic products, sustainable farming, and social responsibility); *We Are . . .*, METHOD, <http://methodhome.com/methodology/our-story/we-are/> (last visited July 20, 2013) (highlighting the company's green practices and environmental priorities); *TOMS: Giving Report*, TOMS 10, http://www.toms.com/media/TOMS_Giving_Report_2013.pdf (last visited Sept. 3, 2013) (describing how upon selling each pair of its shoes, TOMS will “send new pairs to our Giving Partners, who place the shoes directly on children's feet as part of . . . health checkups, distribution of medicine and vaccines, microfinance programs, youth leadership activities, school support and vocational training”); see also J. Gregory Dees & Beth Battle Anderson, *For-Profit Social Ventures*, in *SOCIAL ENTREPRENEURSHIP* 2, 3–5 (Marilyn L. Kourilsky & William B. Walstad eds., 2003) (describing how for-profit social ventures embed their social goals at various stages of their businesses).

²⁰ See, e.g., *Our Mission*, HOT BREAD KITCHEN, <http://hotbreadkitchen.org/about-us/our-mission> (last visited July 20, 2013) (detailing that “Hot Bread Kitchen increases economic security for foreign-born and low-income women and men by opening access to the billion dollar specialty food industry[.]” and indicating that Hot Bread Kitchen sells bread to offset the cost of training); *Social Mission*, GREYSTON BAKERY, <http://www.greystonbakery.com/social-mission/> (last visited July 20, 2013) (stating that Greyston Bakery aims to achieve “community economic renewal” and “personal transformation” of its employees); see also Dees & Anderson, *supra* note 19, at 4.

²¹ See, e.g., C.K. PRAHALAD, *THE FORTUNE AT THE BOTTOM OF THE PYRAMID* 275–79 (5th ed. 2010) (detailing a case study where a sculptor created rubber prosthetic limbs and purposely did not patent the product in order to ensure its availability in impoverished and war-torn regions); *Goal, Vision, Mission and Values*, E HEALTH POINT, http://ehealthpoint.com/?page_id=37 (last visited Sept. 3, 2013) (describing the mission of this “sustainable social business enterprise” as “[t]o provide high quality, affordable, health and

founders of social enterprises do not want to undertake these activities solely to benefit people and planet. The founders also want to hold an ownership stake in their ventures and to profit if their green or one-for-one product is a sensation, if their labor force is more stable, or if their “bottom of the pyramid” invention becomes a staple for the millions who reside there.²² Social entrepreneurs pursue neither exclusively social good nor solely profit, but a “double bottom line.”²³

This Part considers the obstacles faced by social enterprises and the limitations of the hybrid organizational forms meant to address those challenges.²⁴ Section A explains why social enterprises lack the access to capital enjoyed by traditional for-profit and nonprofit ventures.²⁵ Then, Section B examines new organizational forms, offering an overview of three hybrid entities designed to allow social enterprises to take their place alongside conventional businesses and charities: L3Cs, benefit corporations, and flexible purpose corporations.²⁶ Finally, Section C takes a critical look at those hybrid entities and briefly considers why a different approach, such as FLY Paper, might do more to address social enterprise’s capital access problem.²⁷

A. *Pushing the Boundaries*

Social enterprise appears to be a growing trend. Efforts to blend business and philanthropy are widely reported in the media.²⁸ Conferences, blogs, trade associations, and consultancies dedicated to the subject continue to spring up.²⁹ Top business schools are even creating

safe drinking water services in under-served communities by building and operating the necessary infrastructure”).

²² PRAHALAD, *supra* note 21, at 6 (explaining that “bottom of the pyramid” is a concept that originally attempted to identify the poorest among us, “*who are unserved or underserved by the large organized private sector . . .*”); see, e.g., *Social Mission*, *supra* note 20 (“We operate a profitable business.”).

²³ See, e.g., Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1377–78 (2011) (“[T]he social enterprise movement seeks structures that would enable social entrepreneurs to create businesses that pursue double or triple bottom lines and not subordinate mission to profits.”).

²⁴ See *infra* notes 28–109 and accompanying text.

²⁵ See *infra* notes 28–61 and accompanying text.

²⁶ See *infra* notes 62–92 and accompanying text.

²⁷ See *infra* notes 93–109 and accompanying text.

²⁸ See, e.g., Dan Pallotta, *Why Can't We Sell Charity Like We Sell Perfume?*, WALL ST. J., Sept. 15, 2012, at C1; Stephanie Strom, *A Quest for Hybrid Companies That Profit, but Can Tap Charity*, N.Y. TIMES, Oct. 13, 2011, at B1.

²⁹ See, e.g., SOC. ENTER. CONFERENCE, <http://socialenterpriseconference.org/> (last visited July 20, 2013); Blog SOC. FIN., <http://socialfinance.ca/blog> (last visited July 20, 2013).

programs devoted specifically to the study of social enterprise.³⁰ Yet social entrepreneurs and their advocates lament that the inadequacy of the traditional nonprofit and business forms stymies their desire to form social enterprises.³¹ Some of these concerns may reflect social entrepreneurs' undue pessimism about the law, excessive optimism about their likely success, or both. Still, social entrepreneurs do face real obstacles when they try to secure both access to capital and protection for social mission.

1. Nonprofit Forms and Social Enterprise

Nonprofit forms provide superior protection for social mission, but limited access to capital. Under the “nondistribution constraint,”³² a nonprofit's assets must be dedicated permanently to nonprofit purposes, rather than distributed to those who control the nonprofit.³³ Thus, a nonprofit social enterprise will “do good” in perpetuity; in fact, its social mission has virtually complete legacy protection. But, its founders cannot “do well”—at least not by taking an ownership stake in the entity.³⁴ Likewise, nonprofits cannot entice non-founder investors by

³⁰ See, e.g., *Social Enterprise: MBA Experience*, HARV. BUS. SCH., <http://www.hbs.edu/socialenterprise/mba-experience/> (last visited June 2, 2013); *Public Management and Social Innovation Program*, STAN. GRADUATE SCH. OF BUS., <http://www.gsb.stanford.edu/mba/academics/pmp.html> (last visited June 2, 2013); *The Social Enterprise Program at Columbia Business School*, COLUM. BUS. SCH., <http://www8.gsb.columbia.edu/socialenterprise> (last visited July 5, 2013).

³¹ William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 851 (2012) (“The sustainable business movement, impact investing, and social enterprise sectors are developing rapidly, but are constrained by an outdated legal framework that is not equipped to accommodate for-profit entities whose social benefit purpose is central to their existence.”); Julie Battilana et al., *In Search of the Hybrid Ideal*, 10 STAN. SOC. INNOVATION REV. 51, 52 (2012) (describing the “confusing dilemma” faced by social entrepreneurs who can choose only from adopting a pure for-profit or pure nonprofit organizational form); Heerad Sabeti, *The For-Benefit Enterprise*, HARV. BUS. REV., Nov. 2011, at 99, 99 (“[S]ocially minded entrepreneurs end up shoehorning their vision into one structure or the other and accepting burdensome trade-offs in the process.”).

³² Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) (dubbing nonprofits' prohibition of distributing their profits as the “nondistribution constraint”).

³³ See *id.* (“A nonprofit organization is, in essence, an organization that is barred from distributing its net earnings, if any, to individuals who exercise control over it, such as members, officers, directors, or trustees.”); see also REVISED MODEL NONPROFIT CORPORATION ACT §§ 1.40(10), 13.01 (1986) [hereinafter RMNCA] (prohibiting distributions, defined in § 1.40(10) as “the payment of a dividend or any part of the income or profit of a corporation to its members, directors or officers.”).

³⁴ See Hansmann, *supra* note 32, at 838.

offering them a profit share midstream or as residual claimants.³⁵ If, for example, a low-cost water filter inventor sets up shop as a nonprofit, the entire net profit must be reinvested. The inventor cannot pay profits out to him or herself or to others as dividends or distributions.³⁶ A nonprofit's inability to raise equity investments imposes serious limitations on its ability to obtain capital, especially capital needed for growth.

The potential advantages of the nonprofit form in accessing donated capital³⁷ or retaining earned income³⁸ rarely overcome nonprofits' limitations. First, funding expansion through deductible contributions and tax-exempt earned income will not be a route available to every social enterprise formed as a nonprofit. Tax-exemption and eligibility to receive tax-deductible contributions are available only to those nonprofits that meet fairly exacting qualification criteria and submit to significant ongoing regulation.³⁹ It will be difficult for many social enterprises to meet these qualification criteria, especially avoiding limits on commerciality. Even among those whose purposes would likely qualify, many will prefer to avoid the complex web of regulations that would come along with favored status.⁴⁰

Further, not all revenue earned by tax-exempt nonprofit social enterprises is exempt from tax.⁴¹ The unrelated business income tax applies standard income tax rates to income earned by a tax-exempt entity from any active trade or business, regularly carried on, and not substantially related to the entity's exempt purposes.⁴² Thus, even for a social enterprise that could obtain tax-favored status, this status will

³⁵ *See id.*

³⁶ Investors may also only pay themselves or others reasonable compensation. *See* RMNCA § 13.01 cmt. (noting that "the payment of *reasonable* compensation for services rendered" will not run afoul of the nondistribution constraint (emphasis added)); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2024 (2007) (noting the same limitation).

³⁷ If a nonprofit social enterprise qualifies to receive tax-deductible contributions, this tax status will help it attract donations by lowering the real cost of contributions for donors. *See* I.R.C. § 170(c) (2006).

³⁸ If a nonprofit social enterprise qualifies as tax-exempt, this status will allow it to keep that share of earnings that it would otherwise owe to the government. *See id.*

³⁹ *See id.* §§ 501(c)(3), 170(c).

⁴⁰ *Cf.* Brakman Reiser, *For-Profit Philanthropy*, *supra* note 5, at 2454–62 (describing the limitations that the binary profit versus nonprofit structures pose and the regulatory architecture that a would-be philanthropist would avoid by organizing an enterprise as a for-profit entity).

⁴¹ *See* I.R.C. § 511.

⁴² *See id.*

provide only limited assistance in capital formation unless it can attract significant donated funds.

Debt financing remains available to nonprofit social enterprises, regardless of tax status. And debt can be an extraordinarily flexible and useful tool for raising capital.⁴³ Nonprofits often, however, have difficulty securing all of the debt capital they require due to their lack of an equity cushion, lenders' unfamiliarity and skepticism toward nonprofit status, or both.⁴⁴ Even when debt can be secured, nonprofits may not be able to fully take advantage of its benefits or its flexibility. Unconventional debt instruments could easily breach the nondistribution constraint and consequently become just as unlawful for a nonprofit to issue as common stock.⁴⁵ For nonprofit social enterprises that obtain tax-favored status, specialized debt instruments may transgress regulatory limits, subjecting an entity to loss of status or its founders or managers to penalty taxes.⁴⁶

All other things being equal, social entrepreneurs would obviously like to raise tax-favored donated capital and earn tax-free income. But forming a social enterprise as a nonprofit will not guarantee access to these advantages, will impose regulatory burdens, and will seriously limit capital formation through equity investment and debt. Thus, although nonprofit forms offer superior protection for social mission, their limited access to capital will often make them quite unattractive.

2. For-Profit Forms and Social Enterprise

By contrast, for-profit forms are tailor-made to expand an entrepreneur's access to capital. Yet social entrepreneurs do not see for-profit forms as ideal either. Social entrepreneurs recognize that for-profit forms will allow them to "do well," but they fear these forms will frustrate their capacity to "do good" by failing to protect social mission—or even betraying it. Singled out for particular derision is the for-profit corporation and the single-minded pursuit of shareholder wealth

⁴³ See *infra* notes 131–178 and accompanying text.

⁴⁴ Henry Hansmann, *The Rationale for Exempting Nonprofit Organizations from Corporate Income Taxation*, 91 YALE L.J. 54, 72–73 (1981). Indeed, the federal tax exemption for nonprofit charities may be justified as a subsidy to improve nonprofits' ability to raise capital through retained income. See *id.* at 75.

⁴⁵ Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (a/k/a "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 696 (2012).

⁴⁶ See *id.* Part of the vast regulatory web governing tax-favored nonprofits prohibits any inurement of nonprofit funds to its insiders, bars substantial benefits to any private parties, and penalizes excessive benefits if they flow to individuals with control over the entity's affairs. See I.R.C. §§ 501(c)(3), 4958 (2006).

maximization that corporate law supposedly requires.⁴⁷ Social entrepreneurs worry that this unforgiving mandate will give investors the ammunition to jettison their enterprises' social mission at will.⁴⁸

There is considerable debate over whether these concerns over shareholder wealth maximization are legitimate. On the one hand, the Supreme Court of Michigan's 1919 decision in *Dodge v. Ford* has taught generations of lawyers that a "business corporation is organized and carried on primarily for the profit of the stockholders."⁴⁹ Lest one think this idea outdated, the Court of Chancery of Delaware decided *eBay Domestic Holdings v. Newmark* in 2010, reminding us that the for-profit corporate form "is not an appropriate vehicle for purely philanthropic ends," and that for-profit corporate directors must "act[] to promote the value of the corporation *for the benefit of its stockholders*."⁵⁰ On the other hand, the corporate legal literature teems with refutations of shareholder wealth maximization as an unwavering and exclusive objective.⁵¹ These accounts argue that legal doctrine requires for-profits to view shareholder wealth maximization, on some relatively long-term time horizon, as only a default.⁵² *Ford* and *eBay* also both involved potentially oppressed minority shareholders and thus may not be generalizable to situations without a controlling interest.⁵³

The scholarship asserting a strong shareholder wealth maximization norm also addresses the for-profit corporate setting and particu-

⁴⁷ Leo E. Strine, Jr., *Our Continuing Struggle with the Idea That For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135, 155 (2012) (opining that "corporate law requires directors, as a matter of their duty of loyalty, to pursue a good faith strategy to maximize profits for the stockholders"); see also KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES* 41–42 (2006) (describing shareholder primacy as a "foundational principle" that "informs every aspect of corporate and securities law," and arguing more broadly that corporate law should embrace a broader sense of proper corporate purposes).

⁴⁸ See Dees & Battle Anderson, *supra* note 19, at 17–19 (describing the importance for social enterprises to "maintain control in sympathetic hands").

⁴⁹ *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

⁵⁰ *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 34 (Del. Ch. 2010) (emphasis added).

⁵¹ See, e.g., LYNN STOUT, *THE SHAREHOLDER VALUE MYTH* 25–31 (2012); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 744 (2005); Judd F. Sneirson, *Green Is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 IOWA L. REV. 987, 996–1007 (2009).

⁵² Elhauge, *supra* note 51, at 780–81; see also PRINCIPLES OF CORPORATE GOVERNANCE § 2.01 reporter's note 6 (1992) ("[T]here is little doubt that [restrictions on the general profit-making objective] would normally be permissible if agreed to by all the shareholders. Such an agreement might be embodied in the certificate of incorporation, or not.").

⁵³ See Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 167 (2008).

larly large, publicly held corporations. The inherent flexibility of a partnership, a limited liability company (“LLC”), or even a close corporation should permit entrepreneurs to bind investors to social mission through contractual precommitments. Additionally, any concerns regarding proper corporate objectives will be adjudicated only in suits alleging breach of fiduciary duty. There, the business judgment rule’s protection for any non-grossly negligent fiduciary decision,⁵⁴ the serious procedural hurdles that derivative plaintiffs must clear,⁵⁵ and the availability of opt-in charter provisions⁵⁶ make concerns of legal doctrine forcing for-profit social enterprises to pursue profit alone seem outsized, at least beyond the takeover context.⁵⁷

Nevertheless, social entrepreneurs do fear a financial success will make their social enterprises a ripe target for acquisition by less altruistic owners. They fret that would-be acquirers will see a moderately profitable social enterprise as the proverbial twenty-dollar bill lying on a sidewalk,⁵⁸ needing only to be stripped of its irksome social mission. Social entrepreneurs worry that if acquirers can convince or buy off a social enterprise’s investors, they can take over the social enterprise and abandon its social purpose.⁵⁹ These challenges become particularly acute if a social enterprise becomes highly successful, as every fledgling social entrepreneur seems to believe. For-profit forms themselves provide no mechanism to protect a social enterprise’s legacy—to lock in social mission and prevent investors from selling out.

Of course, entrepreneurs can take steps to vary for-profit forms’ defaults to prevent investors from forcing a sell-out. They can insert protective language in organic documents. They can keep their entities small and allow only the like-minded to invest. Indeed, a control posi-

⁵⁴ JAMES D. COX & THOMAS L. HAZEN, BUSINESS ORGANIZATIONS LAW 198–99 (3d ed. 2011).

⁵⁵ DEBORAH A. DEMOTT, SHAREHOLDER DERIVATIVE ACTIONS LAW & PRACTICE § 4:2 (West 2012) (providing a comprehensive overview of the numerous federal and state procedural requirements shareholders must satisfy to proceed with derivative litigation).

⁵⁶ See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(7) (2011).

⁵⁷ In the takeover context, directors of Delaware corporations must maximize “the company’s value at a sale for the stockholders’ benefit.” *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

⁵⁸ See Mancur Olson, Jr., *Big Bills Left on the Sidewalk: Why Some Nations Are Rich, and Others Poor*, J. ECON. PERSPS. Spring 1996, at 3, 3 (noting the widespread faith that “the market typically eliminates opportunities for supranormal returns [because] big bills aren’t often dropped on the sidewalk, and if they are, they are picked up very quickly.”).

⁵⁹ See Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TENN. J. BUS. L. 221, 234 (2012) (“[A] social enterprise may face a change in control transaction precisely because company earnings are not its only bottom line.”).

tion likely offers the best protection against suit or takeover by investors motivated purely by profit.⁶⁰ For-profit social enterprise founders cannot, however, protect their enterprises from the potential predations of their future selves.⁶¹ For instance, a malaria drug researcher herself could someday bow to pressure from an acquirer seeking to market the medicine she cultivated for aesthetic uses in the developed world. Without a stalwart founder, for-profit forms will not enforce commitment to social mission.

In sum, social entrepreneurs committed to “doing well by doing good” will find either traditional organizational pole lacking. They may be attracted to nonprofit forms’ ability to lock both investors and entrepreneurs into pursuit of social mission. But they will be dissatisfied with nonprofits’ limited access to capital. By contrast, social entrepreneurs will be keen on the broad access to capital offered by for-profit forms. But they will worry that for-profit forms insufficiently protect social mission from defection by investors, entrepreneurs, or both. They are left wondering “if only these attributes could be mixed and matched to ease capital access and to protect a legacy of social good” Recently, state legislatures across the U.S. have enacted legislation intended to make this dream a reality, attempting to create bespoke organizational forms to house social enterprises.

B. *New Organizational Forms*

This Section will offer a brief overview of three categories of new, hybrid organizational forms: the L3C, the benefit corporation, and the FPC.⁶² Importantly, none of these forms attempts to massage the non-

⁶⁰ See *eBay Domestic Holdings, Inc.*, 16 A.3d at 34 (noting that if Jim and Craig, together the majority stockholders in craigslist.com, were “the only stockholders affected by their decisions, then there would be no one to object”). Of course, in the rare case that a start-up achieves the success and scale that would propel it to issue shares widely, corporate law would, at least in some cases, compel directors to privilege profit over social good at points of conflict. See *Revlon, Inc.*, 506 A.2d at 182 (articulating the so-called *Revlon* duty, which when triggered requires directors to act to maximize value for shareholders).

⁶¹ Commitment devices offer one popular, but flawed, mechanism founders might employ to guard against future weakness. See generally Steven A. Dean, *The Tax Expenditure Budget Is a Zombie Accountant*, 46 U.C. DAVIS. L. REV. 265, 272–78 (2012) (describing the operation of commitment devices).

⁶² The discussion here is limited to three types of domestic forms, though others not necessarily within the three archetypes are also available abroad. See, e.g., Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CILL-KENT L. REV. 619, 630–36 (2010) (analyzing the United Kingdom’s community interest company); Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. &

distribution constraint or the restrictions on tax-exempt entities while retaining their access to tax-deductible contributions.⁶³ Rather, each modifies a taxable, for-profit entity to enable and protect social mission while still providing access to equity and other sources of capital. Forms taking these general types have now been authorized by a significant number of jurisdictions in the United States.⁶⁴ Although enacting legislatures often vary their versions quite a bit from that of the first-mover, the similarities within the three categories are sufficient to properly speak of them as archetypes.

1. The L3C

Vermont adopted enabling legislation for the first specialized organizational form for social enterprise in a brief 2008 L3C statute. The L3C starts with the LLC's highly contractual framework and then tweaks it to add the idea of a dual mission. Unlike an LLC, which "may have any lawful purpose,"⁶⁵ a Vermont L3C is formed "for a business purpose" but must "significantly further[] the accomplishment of one or more charitable or educational purposes" under the federal tax code and "would not have been formed but for the company's relationship

INT'L L. 291, 308–15 (2010) (describing the Belgian Société à Finalité Sociale and the United Kingdom's approach to social enterprise).

⁶³ Of course, it would be impossible for a state organizational form to change the federal tax requirements for tax exemption and eligibility to receive tax-deductible charitable contributions.

⁶⁴ Over one third of jurisdictions have adopted legislation permitting hybrid organizations. See CAL. CORP. CODE §§ 2500–3503 (West 2013) (California's FPC statute); *Laws, AMERICANS FOR COMMUNITY DEV.*, <http://americansforcommunitydevelopment.org/laws.html> (last visited July 21, 2013) (listing nine states and two Native American tribes with L3C statutes); *State by State Legislative Status*, BENEFIT CORP INFO. CENTER, <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited June 26, 2013) (listing eighteen states with benefit corporation statutes); see also 79 Del. Laws ch. 122, § 8 (2013) (adding Sections 361–368 to the Delaware General Corporation Law to create a "public benefit corporation," which shares some attributes of the FPC); 2013 Tex. Sess. Law Serv. ch. 100 (S.B. 849) (West) (Texas's new "flexible purpose corporation" statute, which does not resemble the California model at all); WASH. REV. CODE ANN. § 23B.25.020 to .040 (West 2013) (Washington's social purpose corporation legislation, which resembles California's FPC legislation in some respects).

⁶⁵ REVISED UNIF. LTD. LIAB. CO. ACT § 104 (2006) [hereinafter REVISED LLC ACT]. Eight states have enacted the Revised LLC Act. *Legislative Fact Sheet—Limited Liability Company (Revised)*, UNIF. L. COMM'N, [http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20\(Revised\)](http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Limited%20Liability%20Company%20(Revised)) (last visited June 11, 2013). Although the Revised LLC Act states that an LLC may have "any lawful purpose, regardless of whether for profit," its predecessor stated only that an LLC may have "any lawful purpose." UNIF. LTD. LIAB. CO. ACT § 112 (1996).

to the accomplishment of charitable or educational purposes.”⁶⁶ In addition,

[n]o significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that [an L3C] produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.⁶⁷

For-profits formed as L3Cs may thus pursue social mission along with profits for equity investors.

L3C statutes, however, offer little protection for social mission legacy. If, at any point, an L3C no longer satisfies the purpose requirements, it will automatically transform into a standard LLC.⁶⁸ No investors need approve, and no regulator need decide whether the requirements cease to be satisfied.⁶⁹ The entity simply and automatically transforms into a fully for-profit LLC, and its assets, fiduciaries, and managers remain unchanged. To illustrate, imagine that a job-training social entrepreneur sets up a bakery as an L3C. One day, the entrepreneur or a successor decides to fire the workforce of unskilled new immigrants and halt their training. The following day, the entity could hire a crew of expert and more productive bakers. Overnight, it would have transformed from a bakery and job training social enterprise into a standard-issue bakery. It would also shift from an L3C to a standard-issue for-profit LLC. There might be community outcry or bad press over this move, but legally, there would be no fanfare at all.

⁶⁶ VT. STAT. ANN. tit. 11, § 3001(27)(A) (2012).

⁶⁷ *Id.* § 3001(27)(B). Although the idea of business purpose is not retained in all subsequent L3C enactments, *see, e.g.*, LA. REV. STAT. ANN. § 12:1302(A) (2012), they use the ideas of significantly furthering charitable or educational purposes and but-for cause. *See, e.g.*, ME. REV. STAT. ANN. tit. 31, § 1611(1) (2012); N.C. GEN. STAT. ANN. § 57C-2-01(d)(1) (West 2012). L3Cs also permit income production or capital appreciation to occur but prohibit it as a significant purpose of an L3C. *See, e.g.*, R.I. GEN. LAWS ANN. § 7-16-76(b)(1) (West 2012); UTAH CODE ANN. §§ 48-2c-412(1)(b)(iii), 48-2c-412(3) (West 2012).

⁶⁸ *See* VT. STAT. ANN. tit. 11, § 3001(27)(D); *see also* ME. REV. STAT. ANN. tit. 31, § 1611(1) (“A company that no longer satisfies the requirements of this section continues to exist as a limited liability company and shall promptly amend its certificate of formation so that its name and purpose no longer identify it as a low-profit limited liability company, L3C or I3C.”).

⁶⁹ *See* VT. STAT. ANN. tit. 11, § 3001(27)(D) (not including any requirements for approval).

2. The Benefit Corporation

Following swiftly on the heels of the L3C's enactment, in 2010 Maryland adopted first-in-the-nation legislation enabling a second type of hybrid form: the benefit corporation.⁷⁰ The benefit corporation begins with a corporate law framework, varying a few key components to accommodate the mission-based concerns of social entrepreneurs.⁷¹ For example, the Maryland statute requires a benefit corporation to have a "material, positive impact on society and the environment."⁷²

One of the major innovations of the benefit corporation form is how this impact is measured. An entity's public benefit must be measured with respect to a third-party standard, meaning "a standard for defining, reporting, and assessing best practices in corporate social and environmental performance" that is publicly available and developed by a party unrelated to the benefit corporation using the standard.⁷³ Some benefit corporation statutes further require third-party standards to be "comprehensive" and "credible," but none establishes a mechanism for screening or monitoring the content of third-party standards.⁷⁴ Fur-

⁷⁰ B Lab, *Maryland First State in Union to Pass Benefit Corporation Legislation*, CSRWIRE (Apr. 14, 2010, 10:57 AM), http://www.csrwire.com/press_releases/29332-Maryland-First-State-in-Union-to-Pass-Benefit-Corporation-Legislation.

⁷¹ See MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01(b) (West 2012) (defining a "benefit corporation" as "a Maryland corporation that elects to be a benefit corporation").

⁷² *Id.* § 5-6C-01(c).

⁷³ *Id.* § 5-6C-01(e); see also N.J. STAT. ANN. § 14A:18-1 (West 2011) (providing a third-party standard for "defining, reporting and assessing corporate social and environmental performance" developed by an independent party through transparent measures); VT. STAT. ANN. § 21.03(a)(8) (same); Brakman Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 14, at 729 (describing this innovation); J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 22, 30 (2012) (discussing benefit corporations' third-party standard).

⁷⁴ Compare CAL. CORP. CODE § 14601(g)(1) (West 2012) (including a comprehensiveness requirement), HAW. REV. STAT. § 420D-12(1) (2012) (same), 805 ILL. COMP. STAT. 40/1.10 (2012) (same), LA. REV. STAT. § 1803(A)(12)(a) (2012) (including a comprehensiveness requirement, though not styled as such), 2012 Mass. Legis. Serv. 964 (West) (including comprehensiveness and credibility requirements), and H.B. 4766, 119th Cong. 2nd Reg. Sess. § 33-38-130(A)(9)(a) (S.C. 2012) (enacted) (including a comprehensiveness requirement), with MD. CODE ANN., CORPS. & ASS'NS § 5-6C-01(e) (requiring only transparency and independence), N.J. STAT. ANN. § 14A:18-1 (same), N.Y. BUS. CORP. LAW § 1702(g) (McKinney 2012) (same), VA. CODE ANN. § 13.1-782 (2012) (same), and VT. STAT. ANN. § 21.03(a)(8) (same). The comprehensiveness requirement requires that the third-party standard consist of a "comprehensive assessment of the impact of the business and the business's operations" on the established goals of the business. See, e.g., CAL. CORP. CODE § 14601(g)(1). The "credible" aspect of the third-party standard ensures that the report is "credible because the standard is developed by a person that: (i) has access to necessary expertise to assess overall corporate social and environmental performance; and (ii) uses a balanced multi-stakeholder approach." 2012 Mass. Legis. Serv. 964.

thermore, establishing an entity as a benefit corporation is an almost entirely self-service affair. The entity first selects a third-party standard. Then, the entity itself must judge whether it creates a material, positive impact on society and the environment under the standard it selects. If an entity finds itself in compliance with this metric, it may register as a benefit corporation.

Benefit corporation statutes also explicitly reject shareholder wealth maximization.⁷⁵ Going even further than a standard constituency statute's permissive approach, benefit corporation statutes *require* directors to consider the impact of their decisions on employees of the corporation, its subsidiaries and suppliers, "customers [to the extent they are] beneficiaries of the general or specific public benefit purposes of the benefit corporation," the community, society, and the local and global environment.⁷⁶ Although shareholders are empowered to enforce directors' obligations,⁷⁷ the expansive set of stakeholder interests that benefit corporation directors must consider will make their decisions virtually unreviewable.⁷⁸ If and when shareholders challenge

⁷⁵ See, e.g., HAW. REV. STAT. § 420D-5(c) (identifying "general and specific public benefits" as being in the best interest of the corporation); MD. CODE ANN., CORPS. & ASS'NS § 5-6C-06 (indicating that "[e]ach benefit corporation shall have the purpose of creating a general public benefit" and that "[t]he creation of a general public benefit or specific public benefit . . . is in the best interests of the benefit corporation").

⁷⁶ See, e.g., MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(a)(1); N.J. STAT. ANN. § 14A:18-6(a).

⁷⁷ In fact, benefit corporation statutes often state specifically that no new potential plaintiffs beyond shareholders will have standing to challenge fiduciaries' actions. See, e.g., 805 ILL. COMP. STAT. 40/4.01(d) ("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) (West 2012) ("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."). New experimental findings suggest that siting enforcement with shareholders alone will undermine statutory mandates requiring directors to consider multiple constituencies in making corporate decisions. See Sven Fischer et al., *Cui Bono, Benefit Corporation? An Experiment Inspired by Social Enterprise Legislation in Germany and the US*, MAX PLANK INST. FOR RES. ON COLLECTIVE GOODS 2–3 (Feb. 8, 2013), http://www.coll.mpg.de/pdf_dat/2013_04online.pdf.

⁷⁸ See Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Social Enterprise?*, 46 WAKE FOREST L. REV. 591, 599–600 (2011). A similar criticism is often laid at the feet of constituency statutes, which merely permit, but do not require, directors to consider the interests of various constituencies. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1493 (1992) ("[T]he primary effect of these constituency statutes is simply to enhance managers' discretion in responding to hostile takeover bids."); Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 582 (1992) ("[B]y acknowledging the interests of other corporate constituents, constituency statutes diminish the board's accountability to stockholders . . ."); Rima Fawal Hartman,

a fiduciary's decision, the fiduciary can likely avoid liability by explaining that the decision was intended to improve the lot of some other constituency. The statute ensures that benefit corporation directors will have a long list of such constituencies at the ready.⁷⁹

Unlike L3Cs, benefit corporations face some barriers to shedding their social mission. To transform a benefit corporation into a standard for-profit one, its directors must propose an article amendment or transaction with that effect and shareholders must approve it by a supermajority vote.⁸⁰ A water filtration social entrepreneur could not switch production from super-low-cost filter units to high-end bidets without board approval and a decisive shareholder vote. Investors could, however, make this move over the entrepreneur's objections, provided insurgents control enough shares to shift the board to their viewpoint. The newly sympathetic board could then endorse a change of purpose and present it to shareholders for their approval. Either way, if enough investors want to change status, the assets and goodwill of a benefit corporation can be shifted to purely for-profit purposes without any regulatory oversight or other outside review.

Note, *Situation-Specific Fiduciary Duties for Corporate Directors: Enforceable Obligations or Toothless Deals?*, 50 *WASH. & LEE L. REV.* 1761, 1763 (1993) ("By allowing but not requiring corporate directors to consider the interests of nonshareholders, and by not identifying situations in which directors should give special consideration to particular groups' interests, the majority of [constituency] statutes actually serve to expand directorial discretion.").

⁷⁹ Benefit corporation directors are also granted immunity from liability when they act in furtherance of these purposes. *See, e.g.*, MD. CODE ANN., CORPS. & ASS'NS § 5-6C-07(c) (West Supp. 2010); N.J. STAT. ANN. § 14A:18-6(c) (West 2011). In addition, benefit corporation legislation relies heavily on the power of disclosure. A benefit corporation must annually report to its shareholders and publicize, among other things, how it pursued public benefit and an assessment of its performance. *See, e.g.*, CAL. CORP. CODE § 14630(a)–(c); N.Y. BUS. CORP. LAW § 1708(a)–(c). Some versions of the statute also require benefit corporations to seat special benefit directors or officers to monitor these reports. *See, e.g.*, N.J. STAT. ANN. § 14A:18-7(a) (West 2011). They also create a new benefit enforcement proceeding in which to enforce "[t]he duties of directors and officers . . . and the general and any specific public benefit purpose of a benefit corporation" *See id.* § 14A:18-10(a); *see also* HAW. REV. STAT. § 420D-7(c) (requiring the director's report to include ways in which the benefit corporation, its officers, or its directors failed to comply with requirements under the statute); S.C. CODE ANN. § 33-38-410(c) (2012) (requiring that the director's annual report include information as to whether the directors complied with the statute and a description of any failures to comply).

⁸⁰ *See, e.g.*, CAL. CORP. CODE § 14604 (West 2012); MASS. GEN. LAWS ANN. ch. 156E, § 6; N.J. STAT. ANN. § 14A:18-4. A supermajority vote generally requires two-thirds of the shareholders to vote in favor of the change. *See, e.g.*, MASS. GEN. LAWS ANN. ch. 156E § 2; N.J. STAT. ANN. § 14A:18-1.

3. The Flexible Purpose Corporation

California pioneered the latest type of hybrid organization with the FPC legislation effective in January 2012.⁸¹ Again, this is a modified corporate form, but with some important distinctions from the benefit corporation. An FPC is instructed to pursue objectives beyond shareholder wealth maximization, but these objectives need not be vetted for compliance with a third-party standard.⁸² Rather, the founders of each FPC select the entity's special purpose or purposes from a broad range of possibilities permitted by the statute and simply state those purposes in the charter.⁸³ Under the California statute, permissible special purposes include:

- (A) One or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out, or
- (B) The purpose of promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the flexible purpose corporation's activities upon any of the following:
 - (i) The flexible purpose corporation's employees, suppliers, customers, and creditors.
 - (ii) The community and society.
 - (iii) The environment.⁸⁴

The FPC statute also varies directors' duties from a real or perceived norm of shareholder wealth maximization alone.⁸⁵ Directors are permitted, but importantly not required, to consider "factors, as the director deems relevant, including the short-term and long-term prospects of the flexible purpose corporation, the best interests of the flexi-

⁸¹ *Two New Types of Corporations effective January 1, 2012*, SEC. OF ST., ST. OF CALIF. (Dec. 14, 2011), <http://www.sos.ca.gov/business/be/forms/flexible-purpose-corp-and-benefit-corp.pdf>. See generally Dana Brakman Reiser, *The Next Big Thing: Flexible Purpose Corporations*, 2 AM. U. BUS. L. REV. 55 (2012) (describing and critiquing this latest social enterprise form).

⁸² See CAL. CORP. CODE §§ 2602(b)(2) (describing the corporate purposes that may be included in the articles of incorporation), 2700(c) (setting forth factors other than shareholder wealth maximization directors may consider), 3500(b)(4) (requiring the corporation to disclose in an annual report the process for selecting evaluation measurements and the measurements selected).

⁸³ *Id.* § 2602(b)(2).

⁸⁴ *Id.* § 2602(b)(2)(A)–(B).

⁸⁵ See *id.* § 2700(c) (indicating that directors may consider the "purposes of the flexible purpose corporation as set forth in its articles" along with the interest of the corporation and its shareholders).

ble purpose corporation and its shareholders, and the purposes of the flexible purpose corporation as set forth in its articles.”⁸⁶ Like in benefit corporations, directors have broad immunity for actions taken in furtherance of these objectives and only shareholders have standing to challenge directorial actions.⁸⁷

The FPC form also imposes slightly different limits on exit than do benefit corporations. An FPC must obtain a two-thirds vote of the outstanding shares of each class of its shares to approve article amendments that would “materially alter any special purpose of the flexible purpose corporation stated in the articles” or to approve transactions with similar effects.⁸⁸ This language places identical limits on wholesale abandonment of FPC status to those in most benefit corporation statutes.⁸⁹ It also, however, requires board and shareholder approval for changes of special purpose even if a new special purpose would still qualify the entity as an FPC.⁹⁰ Shareholders would have to approve a change from producing organic baby food to green power as well as from organic baby food to pink slime.⁹¹ Still, FPC statutes impose only a procedural hurdle for shareholders. Investors controlling sufficient shares may abandon or change social purpose with or without the entrepreneur’s agreement, without regulatory involvement, and without any impact on its assets or personnel.⁹²

C. *Life on the Frontier*

Five years and dozens of enactments later, multiple specialized forms are now available to house social enterprises. As for-profit entities with no legal restrictions on their access to capital, these entities can al-

⁸⁶ CAL. CORP. CODE § 2700(c) (West 2012).

⁸⁷ *Id.* § 2700(d)–(e). FPC statutes also require adopting entities to make comprehensive annual disclosures to their shareholders and the public, addressing both financial achievements and progress on social mission. *Id.* § 3500.

⁸⁸ *Id.* § 3000(b). The statute includes analogous protections for mergers, and reorganizations. *See id.* §§ 3201 (addressing mergers), 3401 (addressing reorganizations).

⁸⁹ *Compare* CAL. CORP. CODE §§ 3001, 3002 (providing procedure for converting an FPC to a nonprofit or cooperative corporation and a domestic corporation, respectively), *and id.* § 3000(b) (detailing voting procedures with regard to passing amendments), *with* MASS. GEN. LAWS ANN. ch. 156E, § 6 (West 2012) (permitting a benefit corporation to terminate its status through an amendment to its articles of organization), *and* N.J. STAT. ANN. § 14A:18-4 (West 2011) (indicating that a benefit corporation can terminate its status subject to amending its certificate of incorporation).

⁹⁰ CAL. CORP. CODE § 3000(b).

⁹¹ *See id.*

⁹² *See id.*

low their founders and others to “do well.”⁹³ By requiring their adopters to make claims to pursuing social goals, they simultaneously create an expectation that these enterprises will “do good.”⁹⁴ The new forms carve out space in the legal and economic landscape for mission-driven enterprises with equity-like capital structures; that expressive victory is no small accomplishment.⁹⁵ Yet none of the forms thus far developed sufficiently protects social mission to attract capital from investors and interest from entrepreneurs. This Section describes the weaknesses unique to each form and briefly notes the general problems with using organizational form to meet the desires of social entrepreneurs.⁹⁶

1. Entities and Enforcement

The new hybrid forms provide limited mechanisms to enforce their technically required social missions when legacy is at stake. L3C statutes require these entities “to significantly further . . . a charitable or educational purpose[.]” but they do not state that these purposes must be primary or prioritized.⁹⁷ Although “[n]o significant purpose of *the company*” may be “the production of income or the appreciation of property,”⁹⁸ individual decisions to pursue profit over social good seem permissible. So long as the overall charitable and educational purpose remains significantly furthered by the company in general, the statute’s purpose requirements have been met.⁹⁹ Not every commentator would agree with this interpretation.¹⁰⁰ Even assuming, *arguendo*, that an entity must prioritize social good as long as it remains an L3C, an entre-

⁹³ See, e.g., *id.* § 2602 (FPC); VT. STAT. ANN. tit. 11, § 3001(27)(B) (West 2012) (L3C); VA. CODE ANN. §§ 13.1-626, 13.1-782 (2012) (benefit corporation).

⁹⁴ See, e.g., CAL. CORP. CODE § 2602(b)(2)(A)–(B) (West 2013) (mandating that an FPC state its “special purposes” in the charter); MD. CODE ANN., CORPS. & ASS’NS § 5-6C-01(c) (West Supp. 2012) (defining a benefit corporation as having a “material, positive impact on society and the environment”); N.C. GEN. STAT. ANN. § 57C-2-01(d)(1) (requiring L3Cs to have “charitable or educational purposes”).

⁹⁵ Allowing social entrepreneurs to signal their commitment to pursuing a double bottom line to their customers—facilitating more sales and higher profits—may actually help them meet that commitment.

⁹⁶ See *infra* notes 97–109 and accompanying text.

⁹⁷ VT. STAT. ANN. tit. 11, § 3001(27)(A).

⁹⁸ *Id.* § 3001(27)(B) (emphasis added).

⁹⁹ VT. STAT. ANN. tit. 11, § 3001(27) (West 2012).

¹⁰⁰ One scholar who disagrees, for example, argues that L3C fiduciaries’ decisions must always be made to further charitable and educational goals over profit-oriented ones, as “the L3C statutes clearly impose an unambiguous ordering of fiduciary priorities.” John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 141 (2010). This Article disagrees that the statutes offer such clarity, and the matter has yet to be litigated.

preneur running an L3C may transform the entity into an ordinary LLC if the opportunity to sacrifice social good for profit is too enticing. An entrepreneur need not obtain the approval of the L3C's investors to do so, and the transformed now-LLC will take all of the L3C's assets.¹⁰¹ The sole penalty will be the loss of the L3C moniker.¹⁰² Thus, the L3C form offers investors no protection for legacy.

Benefit corporation statutes instead empower investors with ultimate control over enforcing social mission and legacy, but they leave entrepreneurs' commitments to social mission unprotected. Midstream, fiduciaries are given wide discretion to self-regulate, complemented by serious disclosure obligations. Third-party standard setters play a supporting role, but they do not engage directly in social mission enforcement. Fundamentally, shareholders are charged with enforcement, and it remains to be seen how much enforcement these investors can and will supply.

Benefit corporations also impose only marginally greater legacy protection than disfavored traditional for-profit entities. The statutes prevent entrepreneurs from abandoning their social missions over shareholder objections.¹⁰³ But benefit corporation shareholders determined to pursue profit alone can transform their entities unilaterally.¹⁰⁴ They can elect a new board, approve amendments to the charter or strategic transactions, or combine these tactics to oust a recalcitrant founder. If two-thirds of a benefit corporation's shareholders favor such a change, a committed entrepreneur is powerless to stop it.

FPC statutes too rely on fiduciaries and investors to preserve an FPC's social mission. Directors again have great discretion. Shareholders alone can litigate midstream decisions to forsake social mission, guided by annual disclosures of each entity's special purpose triumphs and failures.¹⁰⁵ Again, like a benefit corporation, legacy protection is one-sided. For entrepreneurs to move an FPC away from its social mission, even to another purpose also furthering social good, they will need to win shareholders' support.¹⁰⁶ But FPC shareholders possess the power to shift or abandon social mission unilaterally, and enough motivated FPC shareholders can push past any founder's opposition.¹⁰⁷

¹⁰¹ See *supra* notes 68–69 and accompanying text.

¹⁰² See *supra* notes 68–69 and accompanying text.

¹⁰³ See *supra* note 80 and accompanying text.

¹⁰⁴ See *id.*

¹⁰⁵ See CAL. CORP. CODE §§ 2700(e)–(f), 3500 (West 2012).

¹⁰⁶ See *supra* notes 88–92 and accompanying text.

¹⁰⁷ See *supra* notes 90–92 and accompanying text.

2. The Credibility Gap

Despite their claims to offer an ideal legal form for social enterprise, current hybrids fall short of social entrepreneurs' desires. All enable socially motivated entrepreneurs to found entities claiming a social mission and permit them to raise equity capital to support and scale them. Still, these forms offer only scattershot enforcement; they all leave a social enterprise's legacy vulnerable to unilateral abandonment by either investors or entrepreneurs acting alone.

Hybrid entities do attempt to constrain midstream decisions regarding an enterprise's operations—FLY Paper does not. Instead, FLY Paper limits entrepreneurs' capacity to benefit by sacrificing mission in favor of increased profitability. As a practical matter, when considering the few enforcement mechanisms policing midstream decision making in the new hybrid organizational forms, the fact that FLY Paper does not address this problem leaves it at no serious comparative disadvantage.¹⁰⁸ From the outset, the mere novelty of new hybrid forms may further frustrate their adopters' ability to access capital markets. Even sophisticated investors like venture capital firms tend to favor well-known legal forms, such as the familiar Delaware corporation.¹⁰⁹ Perhaps this problem can be overcome through education or marketing, but even then, other obstacles would remain.

In particular, hybrid forms' failure to protect social mission poses a more enduring barrier to investors' capital and entrepreneurs' interest. Unlike customers—who can simply cease patronizing a restaurant that abandons its L3C status—investors that value a double bottom line over their own financial interests would be foolish to rely on an entrepreneur's promises. For precisely that reason, entrepreneurs unable to provide a credible signal of their commitments to a double bottom line will find it difficult to attract capital from those investors. Without a credible signal of investors' commitment, wizened entrepreneurs should likewise be wary of the benefit corporation or FPC form. Either

¹⁰⁸ See generally Brakman Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 14 (discussing the lack of enforcement of dual mission in midstream decision making under the L3C, benefit corporation, and FPC forms).

¹⁰⁹ Due in part to the view that "sophisticated investors are not likely to experiment with organizational innovations that carry uncertain consequences," venture capitalists continue to choose the corporate entity over alternatives, despite favorable tax and flexibility attributes of other forms. See Richard A. Mann et al., *Starting from Scratch: A Lawyer's Guide to Representing a Start-Up Company*, 56 ARK. L. REV. 773, 804 (2004) (quoting Deborah A. DeMott, *Agency and the Unincorporated Firm: Reflections on Design on the Same Plane of Interest*, 54 WASH. & LEE L. REV. 595, 609, 611 (1997)).

one ultimately leaves entrepreneurs' legacy in the hands of investors, whose true preferences might be hidden or easily manipulated.

II. FLY PAPER

In two respects, FLY Paper represents a sharp break from efforts to bring social investors and entrepreneurs together by creating new organizational forms. First, by making the standard Delaware corporation safe for social enterprise, FLY Paper obviates the need for L3Cs, benefit corporations, or FPCs.¹¹⁰ Second, FLY Paper recognizes that the relationship between investors and entrepreneurs—rather than the organizational forms available to them—will determine the fate of their dual mission.

This Part describes how FLY Paper goes further than other hybrids to secure an enterprise's social mission. FLY Paper investors cannot compel entrepreneurs to abandon their social purpose because they hold debt, not equity.¹¹¹ Entrepreneurs cannot succumb to the temptation to abandon their social purpose without handing the lion's share of resulting gains to investors. This is because investors have the power to convert their FLY Paper into equity on favorable terms should entrepreneurs sell their stock.¹¹² By jointly embracing those limitations, investors and entrepreneurs credibly signal their commitment to pursuing a double bottom line.

Section A of this Part examines social enterprise's capital access problem through the lens of game theory, discussing the assurance game that results when investors and entrepreneurs attempt to balance

¹¹⁰ Although the following discussion assumes the social enterprise issuing FLY Paper will be a conventional corporation—a reasonable assumption given the popularity of the corporate form—a limited partnership or limited liability company would work equally well.

¹¹¹ By contrast, shareholders in benefit corporations can vote to set aside the social mission. This action may require two steps, first an ouster of uncooperative directors and then a vote to abandon social mission. Shareholders, however, can make this decision on their own. *See supra* note 80 and accompanying text.

¹¹² An L3C's managers can abandon the enterprise's social mission at any time. *See supra* notes 68–69 and accompanying text. Additional protections would have to be included in a FLY Paper indenture and associated documentation, preventing excessive compensation, dividends, the use of the enterprise's equity as collateral for shareholder loans, or other equity-depleting maneuvers. As Professor Brian Galle notes, “[A] founder could cause the firm to issue high-interest, subordinated debt, and use the proceeds to issue herself dividends.” Brian Galle, *Social Enterprise: Who Needs It?*, 54 B.C. L. REV. (forthcoming Nov. 2013). Fortunately, this is a problem faced by every lender rather than one specific to FLY Paper or even to social enterprise. Measures used to “reduce the potential for opportunistic behavior by junior security holders . . . commonly take[] the form of contractual limitations expressed . . . in the bond indenture” Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency* 70 VA. L. REV. 549, 614 (1984).

profit and social good.¹¹³ Then, Section B describes FLY Paper, a novel solution to their dilemma that appropriates the hybrid financial instrument for the ninety-nine percent.¹¹⁴

A. *Game Theory and Social Enterprise*

Arming investors or entrepreneurs with tools designed with a double bottom line in mind is no different than providing would-be stag hunters with weapons ideally suited to a stag hunt. Unless each has confidence that his counterpart will let a hare pass him by, he would be foolish to do so himself.¹¹⁵ For the hunters, even the most skillfully crafted weapon will not supply the mutual trust they lack. By allowing both investors and entrepreneurs to credibly signal their commitment to the double bottom line, FLY Paper supplies that critical missing element.

1. Stag Hunt

The stag hunt or assurance game recognizes that—notwithstanding the virtues of rugged individualism—some enterprises simply cannot succeed without teamwork.¹¹⁶ To catch the stag, both hunters need to remain committed to the hunt. For that to be true, each needs to be confident that they will not find themselves alone at the moment when the stag appears.¹¹⁷

Unlike in the more well-known prisoners' dilemma game, in which at most one prisoner can go free, both players in a stag hunt can share the ultimate prize.¹¹⁸ They will not do so, however, unless each can be

¹¹³ See *infra* notes 115–130 and accompanying text.

¹¹⁴ See *infra* notes 131–178 and accompanying text.

¹¹⁵ See *infra* notes 116–130 and accompanying text (describing the stag hunt and applying it to social enterprises).

¹¹⁶ The stag hunt or assurance game can be traced back to Jean-Jacques Rousseau. BAIRD ET AL., *supra* note 8, at 49.

¹¹⁷ The stag hunter's dilemma, like all two party games, is traditionally represented as a "bimatrix." See *id.* at 303 (defining a bimatrix as "the standard way of illustrating" a game "in which there are two players and each has a small number of strategies"). Here, a bimatrix would illustrate why although both hunters would prefer to jointly catch a stag, they fear being left with no prize at all if they pursue a stag while the other defects. If they are unable to credibly signal their commitment to the stag hunt, each will simply hunt hare on his own.

¹¹⁸ In the prisoners' dilemma, the prosecutor has enough evidence to convict both prisoners of a minor offense. See McAdams, *supra* note 10, at 215. Even if both prisoners refuse to cooperate, each will nevertheless be convicted and serve a short prison sentence. *Id.* The prisoners' dilemma is often misdescribed, however, so that silence from both prisoners will allow them both to go free. *Id.* at 217–18.

sure that he is not being naïve by pursuing the stag.¹¹⁹ The problem in a nutshell is that each hunter wants to know the intentions of the other in order to plan the hunter's own actions accordingly. Unfortunately, knowing what weapon a hunter wields is no substitute for knowing precisely how he will use it. In game theory terms, his intentions are "private, nonverifiable information" and remain so whether he holds a bow and arrow, a spear, or a gun.¹²⁰

The hybrid entities described above only provide entrepreneurs (in the case of the L3C) or investors (in the case of the benefit corporation and FPC) with weapons tailored to the pursuit of a double bottom line.¹²¹ Of course, no matter how well-suited to nurturing social enterprise, none of them reveals the true intentions of the parties. Investing in an L3C reveals that an investor is serious about pursuing a double bottom line, just like helming a benefit corporation or FPC does the same for an entrepreneur—but that signaling is not enough.¹²² Should an entrepreneur decide to cast aside L3C status in favor of a traditional LLC, for instance, investors would essentially find themselves on a stag hunt alone.¹²³

Without confidence that the founder of an L3C, or the shareholders of a benefit corporation or FPC, will remain committed to a double bottom line, investors will remain wary of L3Cs, while entrepreneurs will do the same for benefit corporations and FPCs. Either would end the stag hunt before it begins. What both need—and what FLY Paper

¹¹⁹ The hunters could use any number of techniques in their effort not to be duped. Each might, for instance, ensure that the other sports a weapon ideally suited to a stag hunt. Even that would be insufficient. A hunter could decide to pursue a hare even though his weapon is a poor match for small game. Alternatively, he might have concealed other weapons nearby.

¹²⁰ Solomon, for example, needed to decide which would-be parent was telling the truth, but the true feelings of the claimants was "private nonverifiable information." See BAIRD ET AL., *supra* note 8, at 122 (using the biblical story of Solomon to illustrate the concept of private nonverifiable information). The fact that such "information is only revealed by the actions that individuals take" makes it essential to rely on inferences when making judgments about individuals' likely actions. *Id.*

¹²¹ The L3C situates control over pursuing or abandoning social mission in the hands of the entrepreneur. See *supra* notes 68–69 and accompanying text. The benefit corporation gives that power to the shareholders. See *supra* note 80 and accompanying text.

¹²² It might be optimistic to believe that benefit corporations and FPCs allow entrepreneurs to send a credible signal regarding their intent to pursue a double bottom line. That would be true only if investors can successfully enforce the dual mission. There is good reason to doubt that they can. See, e.g., Brakman Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 14, at 705–17 (describing the obstacles to shareholder enforcement of social mission in flexible purpose and benefit corporations).

¹²³ The same is true for the entrepreneur if the shareholders decide to abandon benefit corporation or FPC status.

provides—is a means of credibly signaling their shared commitment to a double bottom line.¹²⁴

2. Social Enterprise's Double Bottom Line

Hybrid organizational forms can be thought of as an effort to help the stag hunt succeed. Rather than resolving the tension between investors and entrepreneurs over how to balance social and financial returns, those hybrid forms simply bolster the arsenal they wield. For example, by requiring a shareholder vote to authorize changes in its social mission benefit corporations and FPCs empower investors to police entrepreneurs' commitment to the social mission.¹²⁵ That, of course, leaves entrepreneurs at the mercy of shareholders should they decide to abandon benefit corporation or FPC status.¹²⁶

FLY Paper employs a fundamentally different strategy. Rather than becoming owners of a hybrid entity, investors become the owners of a hybrid debt instrument with only the rights expressly granted by its terms. The primary right would be to receive a modest, potentially deferred financial return.¹²⁷ The other would be the power to preserve their promised social return by commandeering the ill-gotten gains of entrepreneurs that abandon their principles to sell their shares.¹²⁸

Part I catalogued the shortcomings of the hybrid entities designed for social enterprise. Fortunately, their failures point the way towards a less radical solution. Specifically, recognizing that entrepreneurs and investors confront a stag hunt scenario reveals why hybrid entities have failed to achieve their objective. Each entity attempts to create a mecha-

¹²⁴ See BAIRD ET AL., *supra* note 8, at 123 (explaining the role of signaling in overcoming obstacles presented by private nonverifiable information).

¹²⁵ Although shareholders vote on these changes, they cannot propose them. Any such proposal must originate with the board. Of course, shareholders elect the board and can use that power to ensure that such a proposal is presented for their approval.

¹²⁶ Conversely, the L3C grants entrepreneurs the power to keep investors in line. See *supra* notes 68–69. Put differently, L3Cs and benefit corporations are commitment devices. Just as drinkers might hand their car keys to a sober friend to ensure they will not drive drunk, social entrepreneurs signal their rejection of pure profit seeking by choosing a hybrid organizational form. Unfortunately, L3Cs are relatively flimsy commitment devices. Unlike an army burning the bridge they might retreat across, an L3C does little to discourage an entrepreneur's retreat. 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) (explaining how an army can gain a strategic advantage by eliminating some of its options). Were an entrepreneur to abandon an L3C's social mission, the only sanction would be the loss of the L3C designation. See *supra* notes 68–69 and accompanying text.

¹²⁷ See *infra* text accompanying notes 139–140.

¹²⁸ See *infra* text accompanying notes 140–141.

nism to make an enterprise's commitment to its social mission verifiable but, unsurprisingly, none succeeds.¹²⁹

An enterprise's commitment can be no more robust than that of the entrepreneurs and investors controlling it. The true commitment of each is "private, nonverifiable information that neither the other party nor any third party can acquire directly."¹³⁰ Hybrid entities represent a fruitless effort to render nonverifiable information verifiable.

As with the would-be stag hunters—capable of jointly hunting a stag or individually catching a hare—investors and entrepreneurs need a means to credibly signal their commitment to their common goal. Just as the hunters would prefer the stag, but face the risk that the other hunter will abandon pursuit of the stag should the opportunity to catch a hare arise, investors and entrepreneurs would prefer to pursue a double bottom line. FLY Paper offers each a way to reassure the other that they will not abandon the hunt.

FLY Paper makes investors mere lenders, allowing the entrepreneur to retain control over the enterprise and its social mission. By ceding that control while accepting a modest financial yield on their investment, FLY Paper purchasers demonstrate their commitment to the double bottom line. An entrepreneur signals commitment by handing investors a cudgel they can use if the entrepreneur attempts to defect. A FLY Paper purchase provides both entrepreneurs and investors with the confidence to pursue the stag.

B. *Financing Social Enterprise*

In their need for capital, social entrepreneurs are no different than their charitable and profit-maximizing counterparts.¹³¹ In another

¹²⁹ The complex third-party verification mechanism that benefit corporations employ as well as the "rigorous level of disclosure" that California's FPC statute requires are examples of how hybrid entities fail in making social missions verifiable. *See supra* notes 73–74, 87 and accompanying text. The sophisticated mechanisms each employ suggest that conclusively demonstrating an enterprise's commitment to a double bottom line represents an engineering challenge. The benefit corporation could be seen as an elaborate lie detector, designed to ensure that entrepreneurs are committed to a dual mission. The problem, in fact, is much more fundamental: the problem is one of verifying information about the intent of each party. Ultimately, and unfortunately, there is no way to prove precisely how committed investors or entrepreneurs are to the notion of a double bottom line. Because the information is nonverifiable, like Solomon presented with the two claimed parents, the best entrepreneurs and investors can do is rely on inferences based on the behavior of the other. *See supra* note 120.

¹³⁰ BAIRD, ET AL., *supra* note 8, at 122.

¹³¹ *See supra* notes 32–61 and accompanying text (discussing for-profit and nonprofit forms). In a sense, the challenge of attracting capital mirrors social enterprise's operational

respect they are unique. Unlike charities and for-profit entities, social enterprises cannot rely on external actors to enforce their respective social missions. State attorneys general and the IRS can punish a wayward charity for pursuing the self-interest of its managers.¹³² Market forces—perhaps in the guise of hedge funds or creditors—stand ready to seize control of profit-oriented ventures that lose their way. Unfortunately, social enterprise fits neatly into neither category. Hybrid entities do not change that result.¹³³

On a spectrum between the permanent legacy protection granted to charities by the state and the perceived jeopardy social mission faces when exposed to the market, hybrid entities fall dishearteningly close to the latter.¹³⁴ On the one hand, L3Cs allow entrepreneurs to showcase their aspirations but provide no mechanism to hold them to their ideals.¹³⁵ On the other hand, benefit corporations and FPCs leave entrepreneurs vulnerable to investors' temptation to abandon that hybrid status.¹³⁶ Each party's commitment to the double bottom line remains unknowable.¹³⁷ Because entrepreneurs at the helm of an L3C and investors in a benefit corporation or FPC lack a means to signal credibly their commitment to pursuing a dual bottom line, they are unlikely to return home with a stag.

1. A Focus on Investment

FLY Paper upsets the existing dynamic by shifting the focus from new entities to a new financial instrument. It allows entrepreneurs and

objective: to fill a need that traditional market actors have ignored and that governments and charities have proven unable to meet. Take, for example, the Q-Drum, a simple means of transporting water that is currently being manufactured and sold by a South African social enterprise. Q DRUM, <http://www.qdrum.co.za/> (last visited July 27, 2013). FLY Paper could be a similarly unconventional tool that allows social enterprise to flourish by tapping into the billions of dollars of capital some see standing on the sidelines. See *infra* notes 138–161 and accompanying text.

¹³² See Kevin E. Davis & Anna Gelpern, *Peer-to-Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. J. OF INT'L L. & POL. 1209, 1239 (2010) (stating that enforcement for the "U.S. charities regime . . . relies primarily on the Internal Revenue Service and state attorneys general").

¹³³ See Brakman Reiser, *Theorizing Forms for Social Enterprise*, *supra* note 14, at 738–39.

¹³⁴ The L3C, for example, can become an ordinary LLC without any prior approval process or possibility of redress. See *supra* notes 68–69 and accompanying text.

¹³⁵ See *supra* notes 68–69 and accompanying text.

¹³⁶ See *supra* notes 80, 88–92 and accompanying text.

¹³⁷ Signaling occurs when possessors of nonverifiable information can communicate that information through their choice of actions. BAIRD ET AL., *supra* note 8, at 123 (discussing the challenges posed by private nonverifiable information possessed by one party but that "neither the other nor any third party can acquire directly").

investors to signal credibly their commitment to a double bottom line for a specific period of time. By ensuring that *neither* can unilaterally abandon the enterprise's mission in the pursuit of self-interest without meaningful sacrifice, FLY Paper invites both to join the hunt.¹³⁸

FLY Paper achieves its aim by separating the task of mission preservation from the choice of business entity. Whatever type of entity houses the social enterprise—a point emphasized here by assuming the enterprise issuing FLY Paper is an ordinary corporation—purchasing FLY Paper allows investors to signal their commitment to the enterprise's social mission and simultaneously acquire the power to preserve it. If the social entrepreneur elevates social mission alongside personal financial rewards, investors do the same by accepting a modest, potentially deferred yield. If the entrepreneur yields to temptation, investors can seize the entrepreneur's prize.¹³⁹

Social ventures will not take their place between the extremes of charity and capitalism without access to capital. FLY Paper fills that gap by providing investors with an instrument of equal parts carrot and stick. By accepting a portion of their return in the form of a blossoming social mission while acquiring the power to punish entrepreneurs that succumb to self-interest, FLY Paper investors transcend the traditional dichotomy of “doing well” or “doing good.”¹⁴⁰

Simply put, FLY Paper is a debt instrument with two special features. First, because it provides investors with an opportunity to earn social returns to supplement their financial return, FLY Paper lenders demand no more than a modest, potentially deferred financial yield. Second, if an entrepreneur sells her stock, those lenders have an opportunity to claim the entrepreneur's gains.¹⁴¹ The sale activates an in-

¹³⁸ As described above, in game theory terms, investors and entrepreneurs are engaged in a coordination game similar to a stag hunt. A joint effort would allow them to catch a stag. Working independently, each party will catch only a hare. In the social enterprise context, entrepreneurs and investors could pursue both social and financial returns while the risk of defection encourages both to focus only on financial returns. A FLY Paper purchase credibly signals that both are committed to the stag hunt. Like the stag hunt, the pressure on entrepreneurs and investors to choose financial returns versus the preferred double bottom line can be represented by a bimatrix.

¹³⁹ FLY Paper obviously represents only one way financial incentives can be used to enforce commitments. *See, e.g.*, Michael Abramowicz & Ian Ayres, *Commitment Bonds*, 100 GEO. L.J. 605, 607 (2012) (suggesting that commitment could be made more attractive if “instead of simply promising to forfeit money to a charity in the event of a failed commitment, the committing party sells the right to receive any forfeited funds to a third party”).

¹⁴⁰ *See* Brewer, *supra* note 45, at 685 (lamenting that “social enterprises are orphans when it comes to ready sources of capital”).

¹⁴¹ The same restrictions need not apply to issuances of stock by the social enterprise itself. Recruiting talent, for example, by issuing equity to managers would be entirely con-

vestor's option to convert debt to stock on favorable terms.¹⁴² Assuming that does not occur, a FLY Paper investor would receive a return of and on the original investment, leaving the entrepreneur to sell her shares if she chooses once the FLY Paper matures or to make a renewed commitment to the social enterprise by issuing additional FLY Paper.

While addressing social entrepreneurs' need for capital, FLY Paper also meets two critical investor concerns. First, social investors need assurance that their willingness to sacrifice financial returns will not merely provide a windfall to entrepreneurs.¹⁴³ Second, investors must understand the nature of the investment being offered to them.

FLY Paper's contingent conversion feature addresses investors' first concern—that their sacrifice will merely line entrepreneurs' pockets. An entrepreneur's sale of stock will allow FLY Paper holders to convert their debt to equity on favorable terms, nullifying their commitment to a double bottom line.¹⁴⁴ As a result of the conversion, they would control a share of the enterprise's equity that their initial investment would have purchased, leaving a correspondingly reduced share for the entrepreneur's buyer and a correspondingly smaller purchase price.

As to the second concern, unlike the untested new breed of hybrid social enterprises, hybrid instruments like FLY Paper have flourished on financial markets for decades.¹⁴⁵ Sophisticated investors will readily understand FLY Paper's details. Even neophytes will appreciate the shared trust it creates.

sistent with the existence of FLY Paper. So long as those shares were subject to the same restrictions as existing shares, FLY Paper's power would remain undiminished.

¹⁴² This essentially enables lenders to acquire whatever stock their investment would have purchased had they purchased equity rather than debt up front. Although FLY Paper's conversion feature is designed to produce results so unpalatable to the entrepreneur that it will never be triggered, it is possible that investors might negotiate with an entrepreneur to retire the FLY Paper before its term ends. That could produce results similar to those that "tag-along rights" produce in the for-profit context (i.e., allowing small shareholders to participate in sales arranged by insiders, thereby receiving a portion of the control premium otherwise paid only to the insiders). See M. Todd Henderson, *Deconstructing Duff and Phelps*, 74 U. CHI. L. REV. 1739, 1750–52 (2007) (describing the operation and significance of tag-along rights). The redemption price for the FLY Paper would simply include the FLY Paper holders' share of the sales proceeds.

¹⁴³ Investors would be disappointed, to say the least, if they made below-market loans to an L3C with the understanding that social returns would supplement their financial returns, but then the social returns do not materialize because the entrepreneur has chosen to forgo L3C status.

¹⁴⁴ In addition, FLY Paper's terms will either prohibit the payment of dividends or treat the payment of dividends as a triggering event allowing holders to convert to stock.

¹⁴⁵ Common examples of hybrid financial instruments include convertible bonds and preferred stock.

For small investors, FLY Paper will be a “credence good” whose “quality is difficult to assess even after purchase, like financial advice, auto repair, or education.”¹⁴⁶ Fortunately, they need understand the mechanics of FLY Paper no more than participants in the Google offering understood the intricacies of the auction process.¹⁴⁷ Just like the broad audience targeted by Google’s “brilliant”¹⁴⁸ use of its offering as a consumer-oriented marketing effort showcasing its “innovative, egalitarian, playful” culture¹⁴⁹ a social enterprise’s potential investors (and customers) need only know that issuing FLY Paper demonstrates a meaningful commitment to pursuing a double bottom line.

FLY Paper can be issued by any entity that can borrow, including familiar entities such as a Delaware corporation. Over its term—even if the enterprise were housed in an entity synonymous with profit maximization—a substantial FLY Paper investment would do more to protect an enterprise’s social mission than any of the hybrid entities considered above. In game theory parlance, it would eliminate the financial temptation for entrepreneur and investor defection.¹⁵⁰ As described above, by allowing entrepreneurs and investors to signal their commitment while screening out the uncommitted, FLY Paper gives them both the confidence they need to jointly pursue the stag.¹⁵¹

2. Broadening the Investor Base

Precisely who will provide the capital that social enterprise needs—rejecting both the traditional for- and nonprofit enterprise models in order to embrace the potential of a double bottom line—remains the subject of speculation. For their part, the creators of the L3C had a very specific type of investor in mind: philanthropic foundations.¹⁵² Each

¹⁴⁶ See Fleischer, *supra* note 1, at 1600 (distinguishing credence goods from goods whose quality can be readily determined before or after purchase).

¹⁴⁷ Compare *id.* at 1594–99 (discussing the intricacies of Google’s IPO and auctioning process), with *id.* at 1600–01 (discussing Google’s marketing successes that attract customers, even though, as a credence good, the value is difficult to predict).

¹⁴⁸ See *id.* at 1600 (“From a corporate-finance perspective, the [public offering] was at best mediocre. From a marketing perspective, it was simply brilliant.”).

¹⁴⁹ See *id.* at 1584.

¹⁵⁰ See *supra* notes 117, 137 and accompanying text.

¹⁵¹ Although FLY Paper could conceivably be used in conjunction with a hybrid form, the advantages of a combination are not obvious. For example, if a benefit corporation’s shares were owned by the entrepreneur, the shareholder vote requirement for a conversion would do nothing to protect FLY Paper holders.

¹⁵² See Brewer, *supra* note 45, at 681 (describing L3Cs as “designed to facilitate the flow of both private and philanthropic capital to ventures” and as especially “intended to en-

year, foundations must satisfy a range of regulatory requirements, including the distribution of a specified percentage of their assets in furtherance of their charitable aims. The design of the L3C embraced the spirit—and even incorporated the language—of those requirements.¹⁵³ Specifically, L3Cs were created to serve as a ready-made outlet for foundations' distributions by streamlining the cumbersome approval process for program-related investments.¹⁵⁴

To date, this particular ambition appears to have gone unrealized.¹⁵⁵ Although deep-pocketed foundations with a commitment to increasing social welfare and a mandate to deploy their capital represent one obvious source of capital for social enterprise, they are not the only option. Indeed, social entrepreneurs have a much broader audience in mind than philanthropic institutions.¹⁵⁶ In theory, anyone prepared to accept modest financial returns when supplemented by a positive social impact—sometimes referred to as impact investors—could prove to be an important source of investment.¹⁵⁷

According to a series of recent reports, the future of impact investing seems bright. A significant number of investors, and well-heeled investors in particular, appear to have embraced the concept.¹⁵⁸ A recent

courage private foundations . . . to make certain expenditures that qualify as program-related investments" for tax purposes).

¹⁵³ See *id.* at 681–82 n.10 (indicating that the language varies among L3C statutes, but follows closely the tax regulations imposed under I.R.C. § 4944(c)).

¹⁵⁴ *Id.* at 681.

¹⁵⁵ See *id.* at 682 (describing program-related investments as “underutilized”). Program-related investments “are special types of investments available to private foundations under narrow circumstances.” *Id.* at 681 n.10 (citing I.R.C. § 4944(c) (2011)); Treas. Reg. § 53.4944-3 (2011).

¹⁵⁶ The breadth of the potential pool of investors is suggested by the growth in crowdfunding: the act of “rais[ing] money from the general public,” through websites such as Kiva. See C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5 (noting that “[b]illions of dollars have been raised through Internet-based crowdfunding since its inception just a few years ago”).

¹⁵⁷ Unlike the familiar category of socially responsible investors that merely seek to minimize the negative effects of for-profit activity, “impact investing” is defined as “the placement of capital (into social enterprises and other structures) with the intent to create benefits beyond financial return.” *A Framework for Action: Social Enterprise & Impact Investing*, UNITED NATIONS GLOBAL COMPACT 4 (June 2012), http://www.unglobalcompact.org/docs/issues_doc/development/Framework_Social_Enterprise_Impact_Investing.pdf.

¹⁵⁸ See *2012 Social Impact Report*, CALVERT FOUNDATION (2012), <http://www.calvertfoundation.org/images/literature/cf-sir-2012-final.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). Calvert Foundation has offered Community Investment Notes for over fifteen years—an investment that, like FLY Paper, is designed to provide a blend of financial and social returns. *Community Investment Notes*, CALVERT FOUNDATION, <http://www>.

survey of impact investments by JP Morgan identified 2,200 transactions worth more than \$4 billion.¹⁵⁹ Although substantial, those figures may represent just the tip of the iceberg. A second survey estimated that impact investing represents a potential \$120 billion market.¹⁶⁰

Beyond institutions and wealthy investors lie other potential sources of capital. For example, the recent emergence of social stock exchanges suggests growing interest from investors of modest means.¹⁶¹ For those mom-and-pop investors, the need for a robust, off-the-shelf remedy for the mistrust that keeps social investors and entrepreneurs apart will be particularly valuable.¹⁶²

3. A Hybrid Financial Instrument for the Ninety-Nine Percent

Although it may seem exotic, FLY Paper builds on a long tradition of financial products designed to serve the needs of issuers and investors.¹⁶³ In some respects, such as the issuer's option to defer payments

calvertfoundation.org/invest/how-to-invest/community-investment-note (last visited July 22, 2013).

¹⁵⁹ Yasemin Saltuk et al., *Insight into the Impact Investment Market*, J.P. MORGAN SOC. FIN. RES. 3, 3 (2011), http://www.jp.morganchase.com/corporate/socialfinance/document/Insight_into_the_Impact_Investment_Market.pdf. The J.P. Morgan study is neither the only nor the first to explore the potential of impact investing. See generally Jessica Freireich & Katherine Fulton, *Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry*, MONITOR INST. (2009), http://www.cdfifund.gov/what_we_do/resources/Investing%20for%20social%20and%20environmental%20impact%20Monitor.pdf (providing an in-depth discussion of impact investing).

¹⁶⁰ *Money for Good: The US Market for Impact Investments and Charitable Gifts from Individual Donors and Investors*, HOPE CONSULTING 1, 61 (May 2010), http://www.hopeconsulting.us/pdf/Money%20for%20Good_Final.pdf.

¹⁶¹ See *supra* note 156.

¹⁶² Unlike the deep-pocketed actors considered above, such retail investors lack the resources to police a balance between social mission and financial returns. Although large investors can negotiate ex ante safeguards and carefully monitor performance, small investors ordinarily will not. See Thomas Lee Hazen, *Crowdfunding or Fraudfunding? Social Networks and the Securities Laws—Why the Specially Tailored Exemption Must be Conditioned on Meaningful Disclosure*, 90 N.C. L. REV. 1735, 1766 (2012) (noting that “the solicitation of small investors is likely to attract more unsophisticated investors who are in need of the investor protection provisions generally found in the securities laws”). See generally Steven A. Dean & Dana Brakman Reiser, *SE(c)(3): A Tax Regime to Catalyze Social Enterprise Crowdfunding* (unpublished manuscript on file with authors) (proposing a specialized tax regime to catalyze social enterprise crowdfunding by providing entrepreneurs and small investors a ready-made signal of their commitment to the double bottom line).

¹⁶³ The Monthly Income Preferred Securities (“MIPS”) described below occupy a prominent place in that history and typify the careful craftsmanship that goes into their creation. See *infra* note 168. By today's standards, MIPS are as cutting edge as brick-sized cell phones from the 1980s.

to investors, it is no different than many that exist in the marketplace.¹⁶⁴ In others, FLY Paper is unique.¹⁶⁵

The low financial yield FLY Paper investors receive is arguably its most unusual feature, but it addresses a universal problem: risk. Financing a social enterprise—particularly one in its earliest stages—with large amounts of debt would be risky. Given their double bottom line, social enterprises will have a more modest capacity to service debt than a comparable for-profit enterprise.

Hybrid financial instruments have long allowed businesses to raise capital without fear of either sacrificing control to new equity investors or stifling growth with up-front interest obligations.¹⁶⁶ High-yield, pay-in-kind debt offers one popular, and relatively simple, example.¹⁶⁷ Such an instrument offers investors a high yield to compensate for the risk that they might bear significant losses. At the same time, because it is pay-in-kind debt, that yield need not be paid currently in cash, but can instead be deferred.¹⁶⁸ Temporarily deferring payment of the promised high yield offers the enterprise a period of time in which it can focus on satisfying other financial commitments.

As with a high-yield debt instrument, FLY Paper promises the repayment of an initial investment plus an additional yield. Both instruments grant an enterprise the freedom to forgo current payments, just as the recipient of an equity investment might forgo the payment of

¹⁶⁴ That a debt instrument can offer issuers the right to defer interest payments without casting doubt on the instrument's status as a loan was once the subject of some controversy, but it received the blessing of tax authorities nearly two decades ago. See David P. Hariton, *Distinguishing Between Equity and Debt in the New Financial Environment*, 49 TAX L. REV. 499, 503 (1994) (noting that tax authorities had indicated the right to defer interest might cause debt to be recharacterized as equity, but regulations viewed it as entirely consistent with debt classification).

¹⁶⁵ FLY Paper is a low-yield instrument. High-yield debt, although often criticized, has been broadly used for many years. See William A. Klein, *High-Yield ("Junk") Bonds as Investments and as Financial Tools*, 19 CARDOZO L. REV. 505, 505 (1997) (noting that these debt instruments "acquired a bad name during the late 1980s when they were used to finance transactions that left target corporations with an excessive risk of insolvency").

¹⁶⁶ High-yield debt gained popularity by allowing enterprises to avoid sacrificing control through selling equity or subjecting themselves to "stifling" commercial bank loans. See *id.* at 506.

¹⁶⁷ See Hariton, *supra* note 164, at 507–08 (describing the operation of pay-in-kind bonds).

¹⁶⁸ A very popular form of this hybrid financial instrument went by the acronym "MIPS" which designated "Monthly Income Preferred Securities." See *id.* at 517–18 (discussing how MIPS operate and noting that tax authorities have noted and responded to "the issuance of a significant volume" of such instruments).

dividends.¹⁶⁹ Purchasing FLY Paper from a corporation would grant the investor an economic stake in the corporation's future, entitling the investor to a repayment of the initial investment plus a modest return. That return could be calculated in any number of ways, including by reference to standard commercial terms or could employ more idiosyncratic metrics.¹⁷⁰

Although in some respects FLY Paper is a quintessential debt instrument, some of its characteristics fall comfortably between the extremes of debt and equity. FLY Paper holders would have a claim that is superior to that of common stock owners but inferior to that of its conventional lenders.¹⁷¹ FLY Paper has neither the brief lifespan of short-term debt nor the permanence of common stock, but it would instead mature over a relatively long period.¹⁷² Although the duration of each investment would vary according to the particular needs of the enterprise and the goals of its investors, a term of fifteen years would be consistent with the long-term goals of a typical social enterprise.

FLY Paper's ordinarily dormant conversion feature offers investors a possibility—but no promise—of a far higher return on their investment. Unless entrepreneurs sell their stock, FLY Paper would mature

¹⁶⁹ Particularly in its early years, if the enterprise chooses, it can issue additional FLY Paper that mirrors the terms of the original FLY Paper, rather than making payments in cash. That would provide entrepreneurs with considerable flexibility to manage cash flow to meet the needs of the enterprise. MIPS provided borrowers with similar flexibility, as “borrower[s] may defer payments of interest for a period of up to five years,” and if they so choose, “interest accrues on unpaid interest.” *See id.* at 517.

¹⁷⁰ One relatively anodyne option is the Applicable Federal Rate (“AFR”). The government regularly publishes AFRs for instruments of varying maturities, with yields determined on a quarterly, semiannual, or annual basis. *See Index of Applicable Federal Rates (AFR) Rulings*, IRS, <http://apps.irs.gov/app/picklist/list/federalRates.html> (last visited July 23, 2013) (indicating that the IRS publishes the AFR monthly, and providing links to revenue rulings containing the AFR in reverse-chronological order). The AFR establishes a baseline measure of the minimum yield expected in an arm's-length financing transaction. That would suit FLY Paper's goal of assuring a modest—yet plausible—financial return. A variety of tax provisions rely on the AFR to determine whether a transaction represents something other than what it purports to be. For example, a mother might lend her son \$10,000 for five years at an interest rate of 1%. If the relevant AFR were 3%, the mother could be viewed as generously forgiving two-thirds of the interest that her son would owe in an arm's-length transaction. *See* I.R.C. § 7872 (addressing tax treatment of below market gift loans). That distinction would be relevant if such a gift would have tax consequences. *Id.*

¹⁷¹ Such subordination is not, on its own, enough to trigger recharacterization. In the MIPS era, tax authorities suggested that nonrecourse debt might be at risk of recharacterization since “[s]uch an instrument . . . offer[s] the investor no more than a stockholder's claim in the event of the issuer's bankruptcy.” *See* Hariton, *supra* note 164, at 513.

¹⁷² *See id.* at 504–08 (discussing the impact of an instrument's term on its debt classification).

per its low-yield terms. If such a sale were to occur, FLY Paper investors would have an opportunity to convert their investment into equity on what could be quite favorable terms. In broad strokes, FLY Paper investors would have a second bite at the apple, a chance to acquire equity that would give them a stake comparable to that they would have held had they initially purchased equity rather than FLY Paper.

FLY Paper's unconventional design offers social enterprises an opportunity to simultaneously grow and protect their social missions.¹⁷³ Its capacity to solicit capital while promoting social mission will be surprising to many. In fact, taking a step back from FLY Paper's details, hybrid financial instruments might seem a poor match for the transformative aims of social entrepreneurs.¹⁷⁴ Until now, such financial instruments have been the exclusive province of the one percent, the weapons of choice for corporate raiders.¹⁷⁵

Despite their origins, hybrid financial instruments could prove to be just as well-suited to the needs of social enterprise as they once were to the "junk-bond, bust-up takeover."¹⁷⁶ The best-known hybrids, such as Monthly Income Preferred Securities ("MIPS"), were designed to qualify as debt for tax purposes—providing interest deductions for issuers—while managing to avoid the accounting burdens associated with borrowing.¹⁷⁷ Others, like the contingent convertible debt instruments discussed below, pushed the boundaries still further.¹⁷⁸ Through

¹⁷³ This is, of course, precisely what high-yield, pay-in-kind debt accomplishes: allowing risky ventures a window of time in which to find their footing before interest obligations must be satisfied. See *id.* at 507–08. Pay-in-kind debt can crowd out equity investors under ordinary capital market conditions. In the social enterprise context, however, where access to capital is the very problem to be solved, this effect should not be too worrisome for entrepreneurs weighing whether to issue FLY Paper.

¹⁷⁴ They are, in a sense, the mirror image of their high-yield counterparts, which are primarily known for their role in corporate raiding, a far cry from social enterprise's lofty aspirations.

¹⁷⁵ High-yield debt, pejoratively known as "junk" bonds, came to be associated with the "abusive takeover tactics" of 1980s-era corporate raiders such as the "junk-bond, bust-up takeover." Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 11 (1987) (internal quotation marks omitted). Those raiders and transactions were popularized, or perhaps demonized, in the Oliver Stone movie "*Wall Street*." See *WALL STREET* (20th Century Fox 1987).

¹⁷⁶ Lipton, *supra* note 175, at 11.

¹⁷⁷ See Hariton, *supra* note 164, at 518 (noting that MIPS received more favorable treatment from credit rating agencies than ordinary debt because of their long term, subordination and the borrower's interest deferral option).

¹⁷⁸ See generally Edward D. Kleinbard et al., *Contingent Interest Convertible Bonds and the Economic Accrual Regime*, 95 TAX NOTES 1949 (2002) (describing the emergence of and response to contingent convertible debt instruments).

FLY Paper, these hard-wrought feats of financial engineering can redound to the benefit of social enterprises.

III. THE EYE OF THE HOLDER

FLY Paper could upend the tension between social entrepreneurs and investors so that raising capital would make social mission more—not less—secure. By allowing social entrepreneurs and investors to signal credibly their commitment, the hybrid financial instrument's intrinsic elasticity allows it to serve the ninety-nine percent just as effectively as it has long catered to the needs of for-profit enterprises.¹⁷⁹

Part III highlights a distinct aspect of FLY Paper's flexibility: its ability to act as equity or debt, depending on its context. Not only can its design be altered to suit a broad range of financial circumstances, FLY Paper is a tax law chameleon.¹⁸⁰ For mature enterprises, it offers a means of shielding income from taxation. For fledgling ventures with more potential than profits, FLY Paper produces tax consequences that parallel the fortunes of the enterprise. Only if and when investors receive a cash return on their FLY Paper might they be taxed.

A. *Tax Consequences of Raising Capital*

Obviously, FLY Paper will only be successful if it allows social entrepreneurs to join with investors to pursue shared goals. Here, as elsewhere, the influence of tax in promoting capital acquisition by an enterprise is less apparent—but only modestly less important. For charities, tax plays an affirmative role in promoting fundraising.¹⁸¹ In the for-profit context, the tax law more often presents a minefield rather than an opportunity.¹⁸²

¹⁷⁹ See Hariton, *supra* note 164, at 501 (“In exchange for capital, corporations can offer investors any set of rights that can be described by words, subject to any conceivable set of qualifications, and in consideration of any conceivable set of offsetting obligations.”).

¹⁸⁰ The infinite potential variations among hybrid instruments ensure that characterization of those instruments as debt or equity (or something else entirely such as “option premium, prepayment of a forward contract, swap premium, cap or floor premium, mere collateralization, acquisition of income or royalty rights, and actual ownership of unrelated property”) no easy task. See *id.* at 499–501.

¹⁸¹ See I.R.C. § 170(c) (2006) (providing a tax deduction for contributing to approved charitable organizations).

¹⁸² In addition to the overarching risk that debt might be recharacterized as equity, narrower constraints may also strip away tax benefits that taxpayers seek to incorporate into their capital structure. See, e.g., I.R.C. § 163(e)(5)(A)(i) (disallowing interest deductions attributable to some high-yield debt).

Fittingly, the tax treatment FLY Paper would produce for social enterprise falls somewhere between those two extremes. In part that is simply a function of the income tax's focus on profits and financial returns. Unprofitable enterprises owe no tax even if they operate on a large scale.¹⁸³ For social ventures, only financial returns give rise to income tax obligations.¹⁸⁴ Social returns are no more taxable than the proverbial beachcomber's happiness.¹⁸⁵ Of course, even financial returns would go untaxed in the hands of tax-indifferent FLY Paper holders such as tax-exempt entities.¹⁸⁶

As described in detail below, the tax treatment that FLY Paper receives—like any other financial instrument—depends heavily on context.¹⁸⁷ Even a transaction with superficially unimpeachable loan credentials, including a fixed interest rate and term, could be

¹⁸³ See *id.* § 61(a) (defining gross income as “all income from whatever source derived”); *id.* § 63(a) (defining taxable income as gross income minus allowable deductions). Income tax is structured to tax only income; thus, after deducting expenses, only profits are taxed. If there are no profits then, generally, there is no tax.

¹⁸⁴ As long as the yield equals or exceeds the relevant (and relatively modest) AFR, see *supra* note 170, the fact that the investor could have secured a higher yield should be immaterial. See I.R.C. § 7872(e) (defining a “below-market loan” as one yielding less than the AFR). In theory, authorities could infer a second transaction in which the investor receives additional income and makes a gift of that income to the corporation (either a single gift coincident with the purchase equal to the present value of the forgone yield or an annual gift of the forgone yield).

¹⁸⁵ Under an income tax, an individual who could earn a great deal—but chooses not to—is not taxed on the income they choose not to earn. The hypothetical that has been much discussed in the tax literature is the beachcomber who has affirmatively rejected a high income. See, e.g., Kirk J. Stark, *Enslaving the Beachcomber: Some Thoughts on the Liberty Objections to Endowment Taxation*, 18 CAN. J. L. & JURIS. 47, 47–48 (2005) (describing the hypothetical and the key questions it raises); Linda Sugin, *A Philosophical Objection to the Optimal Tax Model*, 63 TAX L. REV. 229, 243–44 (2010) (discussing the beachcomber paradigm).

¹⁸⁶ Tax-exempt investors such as pensions and universities would, in essence, project their tax preference to shield a portion of the social enterprise's income.

¹⁸⁷ Despite the dramatic difference in the treatment of debt and equity forms of investment, tax law has never managed to produce a bright-line rule to distinguish between the two. Instead, it has long relied on a standard that readily identifies paradigmatic instances of stock or debt, but it does a poor job in close cases. The facts-and-circumstances test tax authorities and courts employ considers an improbably long list of factors. See William T. Plumb, Jr., *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369, 411–12 (1971) (identifying four distinct categories of factors courts consider in distinguishing between debt and equity, including 1) “[t]hose involving the formal rights and remedies of creditors as distinguished from stockholders;” 2) “[t]hose bearing on the genuineness of the intention to create a debtor-creditor relationship;” 3) “[t]hose bearing on the reasonableness or economic reality of that intention;” and 4) “[t]hose which are merely rhetorical expressions of a result, having no proper evidentiary weight in themselves”).

recharacterized as equity.¹⁸⁸ That would be true when circumstances reveal that the investment possesses the economic characteristics of stock, even if the parties to the transaction hoped for debt treatment. A financial instrument that—like FLY Paper—displays a preponderance of formal debt characteristics is no different.

The remainder of this Part explores two contexts in which FLY Paper could be deployed. First, it considers a FLY Paper issuance by a mature social enterprise.¹⁸⁹ There, FLY Paper would be acknowledged as debt, producing a reliable and modest stream of deductions for issuers and income for investors. That arrangement—with investors effectively shouldering a portion of the enterprise's tax burden—provides investors with a secondary means of supporting the enterprise's social mission.

This Part then describes the treatment of FLY Paper issued by an early stage venture.¹⁹⁰ There, given the significant risk borne by investors, equity treatment would apply, eliminating the issuer's deductions. As explained below, classifying investors as shareholders for tax purposes would also impose a less onerous tax burden on investors. Those results—a respite from tax for a mature enterprise and tax consequences for investors in a start-up venture only if their investment bears fruit—would suit social enterprise.

B. *Mature Social Enterprise*

Purchasing FLY Paper will produce one of two starkly different outcomes. When a mature social enterprise issues FLY Paper, both the enterprise and the investor are taxed as though parties to an ordinary loan. As a result, each will have either interest income or deductions that must be taken into account on a current basis.¹⁹¹ That will be true even if the issuer exercises its option not to pay interest currently.¹⁹² By

¹⁸⁸ Because the formal characteristics of the instrument are not determinative, courts look beyond an instrument's form (such as the labels used by the parties to the transaction) to determine its true character. *See generally* Hariton, *supra* note 164 (exploring the differences between debt and equity, and when instruments with mixed characteristics will be considered one over the other).

¹⁸⁹ *See infra* notes 191–225 and accompanying text.

¹⁹⁰ *See infra* notes 226–240 and accompanying text.

¹⁹¹ Borrowers generally deduct the interest they pay. *See* I.R.C. § 163(a) (2006). Lenders are taxed on the interest they earn. *See id.* § 61(a)(4).

¹⁹² *See id.* § 1272(a)(1) (providing that deferred interest, referred to as original issue discount, is currently included in a lender's income).

contrast, when an enterprise issues FLY Paper in its formative stages, neither party is likely to bear up-front tax consequences.¹⁹³

1. Tax Classification

When a relatively mature social enterprise issues FLY Paper, the enterprise is treated as a borrower. Like any borrower, it receives capital that it will deploy in its business and that it has the wherewithal to repay according to its terms.¹⁹⁴ Although it can defer current interest payments until maturity, deferred amounts will themselves incur additional interest obligations.¹⁹⁵

The substantial certainty that investors will be repaid is instrumental to FLY Paper's status as debt for tax purposes.¹⁹⁶ That confidence is, in a sense, reflected in what tax law refers to as the enterprise's debt-equity ratio.¹⁹⁷ If the proceeds of a loan represent the overwhelming bulk of a borrower's capital, the debt-equity ratio will be implausibly high, suggesting investors' long odds of repayment.¹⁹⁸ Compared to one in its infancy, a corporate enterprise that has a proven—albeit modest—track record of profitability will have relatively valuable equity.

¹⁹³ There is no broadly applicable analogue to the original issue discount regime of I.R.C. § 1272 for equity.

¹⁹⁴ See *Gilbert v. Comm'r*, 248 F.2d 399, 402 (2d Cir. 1957) (“The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof.”).

¹⁹⁵ The optional deferral essentially allows the borrower to expand the amount of the original loan. All borrowed amounts (that borrowed originally and amounts borrowed subsequently) accrue interest at the same rate.

¹⁹⁶ Risk—or more precisely, the absence of risk—is one of the defining attributes of debt. “Equity permits an investor to participate in corporate profits in exchange for assuming corporate risks. Debt, on the other hand, permits an investor to avoid risk, in so far as that is possible, in exchange for forgoing participation.” See Hariton, *supra* note 164, at 500 (noting that risk is at the core of what separates debt from equity). Lenders sacrifice the tremendous potential upside available to equity owners for the greater security offered by debt. FLY Paper issued by a mature enterprise would provide investors with the stability associated with debt investments.

¹⁹⁷ The debt-equity ratio, a measure of the relative size of investors' equity stake in a corporation to the corporation's outstanding debt, is a rough measure of the safety of a debt investment in the corporation. See Plumb, *supra* note 187, at 507 (“One evidentiary factor which gained prominence long before the articulation of the risk test as such, but which survives today principally as an element of that test, is the inadequacy of the equity capital of the corporation.”). A corporation with an excessively high debt-equity ratio is considered a risky borrower because it has limited capacity to pay its lenders.

¹⁹⁸ By contrast, if a corporation has ample equity relative to the amount it seeks to borrow, a lender can be confident that the corporation could use that equity to repay borrowed amounts (even if, hypothetically, it is unable to repay the loans out of profits).

As a result, the same FLY Paper issuance would produce a significantly lower debt-equity ratio if issued by a mature enterprise than one that is more speculative.¹⁹⁹

As an economic matter, the contingent convertibility feature nudges FLY Paper closer to equity status. Nevertheless, for reasons more historical than logical, even an investor's unrestricted conversion right is not sufficient to transform a debt instrument into equity.²⁰⁰ Here, the conversion right remains dormant unless the entrepreneur acts against his or her own interests.²⁰¹

2. Tax Consequences

For the reasons enumerated above, when a mature social enterprise issues FLY Paper, both the enterprise and its investors will be treated as engaging in a lending transaction.²⁰² Some of the consequences of debt classification will be obvious. As the borrower, the enterprise will be entitled to interest deductions when it makes payments according to the default schedule.²⁰³ As lenders, investors will have income when they receive interest payments.²⁰⁴

¹⁹⁹ Assume two enterprises, Mature (valued at \$200,000) and Fledgling (valued at \$10,000) issue \$100,000 worth of FLY Paper. They would have debt to equity ratios of 1:2 and 10:1, respectively. The former is modest, but Fledgling's 10:1 debt to equity ratio would weigh strongly against debt classification.

²⁰⁰ Tax law so thoroughly ignores the conversion feature of convertible debt that it does not even give rise to original issue discount. See David P. Hariton, *The Taxation of Complex Financial Instruments*, 43 TAX L. REV. 731, 780 (1988) ("[A] convertible debt obligation, if issued at par, has no original issue discount. Interest accrues on the obligation at its stated coupon rate, which is generally below market."). A more rational take on convertible debt might do just the opposite and ignore its debt features in order to recast it as equity. This counterintuitive, and decidedly pro-taxpayer, treatment which tax law provides for convertible debt has been subject to critique. See William A. Klein, *The Convertible Bond: A Peculiar Package*, 123 U. PA. L. REV. 547, 570 (1975) ("[W]hy cannot the government take the financial analysts and the corporate financial officers at their words, treat all convertible bondholders like shareholders and, based on this analysis, deny the corporation a deduction for the 'interest' payments made to them?").

²⁰¹ By contrast, when conversion is a forgone conclusion, authorities do sometimes treat convertible debt as equity. See, e.g., Rev. Rul. 83-98, 1983-2 C.B. 40 (treating convertible debt as equity where the instrument was "structured so that under most likely eventualities they will be converted into . . . common stock").

²⁰² See *supra* notes 194–201 and accompanying text.

²⁰³ See I.R.C. § 163 (2006) (providing a deduction for interest payments).

²⁰⁴ See *id.* § 61(a)(4) (providing that interest is generally included in gross income).

a. *Phantom Deductions*

The issuer's option to defer the payment of cash interest by substituting IOUs raises the question of whether that deferral option has any effect on the timing of interest income or deductions.²⁰⁵ One might expect a borrower would only be entitled to a deduction when a cash payment is made and that no tax would be imposed on an investor who has received no cash with which to pay that tax.²⁰⁶ Alternatively, and more favorably, a relatively sophisticated accrual method borrower might be allowed to deduct interest as the obligation to pay that interest matures, while cash method investors would be allowed to wait until they receive cash payments.²⁰⁷

Specifically in response to such arrangements which cause interest deductions to precede interest income,²⁰⁸ the income tax has long employed a special timing rule that causes income from deferred interest to be taken into account currently.²⁰⁹ Under the same regime, borrow-

²⁰⁵ Even setting aside the potential impact of optional interest deferral on an instrument's classification, the ability of taxpayers to claim deductions before they have made the related payment would—in the absence of special rules to accelerate the lender's income to match the borrower's deductions—be prone to abuse by taxpayers. The original issue discount rules provide that safeguard, mandating a single schedule for both issuers and purchasers of original issue discount debt instruments. See I.R.C. §§ 1272–75.

²⁰⁶ Individuals and small businesses report income and expenses using what is called the cash method, with cash receipts and payment generally determining the timing of income and expense for tax purposes. Treas. Reg. § 1.446-1(c)(1)(i) (1960) (“Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income . . . are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made.”).

²⁰⁷ Daniel I. Halperin, *Interest in Disguise: Taxing the “Time Value of Money,”* 95 YALE L.J. 506, 509 (1986) (noting that until 1969, borrowers could deduct interest obligations as they economically accrued, but lenders were not required to include original issue discount in their income currently).

²⁰⁸ See Peter C. Canellos & Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 TAX L. REV. 565, 568 (1983) (noting that even after current inclusion rules were created in 1969, taxpayers were still able to exploit the “straight-line” inclusion method, prompting Congress to provide for economic accrual of original issue discount); Lawrence Lokken, *The Time Value of Money Rules*, 42 TAX L. REV. 1, 20 (1986) (tracing the history of the Congressional response to the timing mismatch allowed by prior rules).

²⁰⁹ Because FLY Paper's yield is not “unconditionally payable in cash or in property” it is excluded from the “qualified stated interest status.” See Treas. Reg. § 1.1273-1(c)(1) (as amended in 1996). Because it is not qualified stated interest, it increases the instrument's “stated redemption price at maturity.” See *id.* § 1.1273-1(b). Stated redemption price at maturity is a key determinant of original issue discount, which the regulations allocate across the term of the instrument as interest. See *id.* § 1.1272-1(a) (providing that a holder includes original issue discount in income “regardless of the holder's regular method of accounting”).

ers deduct interest before they have paid it.²¹⁰ As compared to a regime that decouples deductions from both the payment and the taxation of the associated income, this “matching” rule does not seem particularly attractive for taxpayers. It can nevertheless produce surprisingly appealing results.

Because lenders and borrowers differ in many ways, eliminating the timing differential described above does not entirely foreclose mismatching opportunities. For example, tax-exempt investors such as pensions and university endowments can purchase investments that generate large amounts of “phantom income”²¹¹ without suffering any adverse consequences.²¹² For borrowers, the potential advantages of such an arrangement—enjoying the tax benefits of interest payments while deferring the payments themselves—can be considerable.

Nowhere is the counterintuitive appeal of phantom income more evident than in the instruments known as contingent convertibles.²¹³ The confluence of two distinct rules that apply to debt instruments allow borrowers to generate interest deductions that are both early and large.²¹⁴ The tax law’s matching rule for interest payments applies to debt instruments with even the most unpredictable payment schedules.²¹⁵ For those contingent debt instruments, the regulatory framework calls for lenders and borrowers to use a comparable noncontingent bond as a reference for calculating their interest deductions and income.²¹⁶ Tax law only ignores the conversion feature of convertible debt instruments when making a threshold determination as to whether the contingent debt rules apply. When the contingent debt rules apply,

²¹⁰ See I.R.C. § 163(e) (2006) (allowing borrowers to deduct original issue discount).

²¹¹ “Phantom income” refers to income tax liability arising before the related cash inflow.

²¹² Wherever asymmetries exist between holders and issuers, possibilities for mismatching remain. See Diane M. Ring, *One Nation Among Many: Policy Implications of Cross-Border Tax Arbitrage*, 44 B.C. L. Rev. 79, 92 (2002) (noting that, to the extent foreign investors are not taxed on original issue discount, the timing rules would not eliminate the possibility for mismatching).

²¹³ See generally Kleinbard et al., *supra* note 178 (describing contingent convertible debt instruments and their tax treatment).

²¹⁴ See *id.* at 1955 (explaining why tax authorities chose to apply the higher yield associated with a comparable nonconvertible bond and exploring the differences between treatment of nonconvertible and contingent convertible bonds).

²¹⁵ Treasury regulations describe the complex framework used to apply the original issue discount framework to contingent payment debt instruments (“CPDI”). See Treas. Reg. § 1.1275-4 (as amended in 2004). Although convertible bonds are, as an economic matter, CPDIs, the regulations specifically exclude ordinary convertible bonds from the contingent payment debt instrument regime. Kleinbard et al., *supra* note 178, at 1953.

²¹⁶ This is referred to as the noncontingent bond method. Treas. Reg. § 1.1275-4(b).

the conversion feature of contingent convertible debt instruments is treated like any other contingency.²¹⁷ As a result, a contingent debt instrument that can reasonably be expected to yield 2% annually in interest could actually produce interest *deductions* of 5% per year when the value of the conversion feature is taken into account.²¹⁸

Although complex, the tax rules that apply to contingent convertible debt instruments produce a clear result. The addition of virtually any contingency allows the issuers of a convertible debt instrument to extract current tax benefits from a conversion feature that would otherwise have been ignored.²¹⁹ When the holders of those contingent convertible debt instruments pay no tax on that heightened phantom yield, the arrangement is not zero sum. The borrower deducts, but the lender is not taxed.

b. *Shouldering Social Enterprise's Tax Burden*

For FLY Paper, those same rules produce a more modest, but no less appealing, result. Under the matching rule described above, both the social venture and investors would take interest into account on a current basis whether or not it is paid currently.²²⁰ Only the conversion feature—which will be ignored for purposes of determining whether a debt instrument is subject to the contingent debt rules—is contingent, causing the matching rule to apply but not the non-contingent bond method.²²¹ Only the relatively modest yield FLY Paper expressly calls for will be deducted and taxed as interest.

²¹⁷ “As discussed above, the conversion option is a contingency like any other if such option is part of a CPDI, and, accordingly, a nonconvertible fixed rate comparable yield must apply to a CPDI that features a conversion option as one of its several contingent payments.” Kleinbard et al., *supra* note 178, at 1955.

²¹⁸ Assuming purchasers enjoy some form of immunity from phantom income, the combination of those two rules can be quite advantageous.

²¹⁹ Kleinbard et al., *supra* note 178, at 1952–53 (explaining the convertible bond exception).

²²⁰ See *supra* notes 215–219 and accompanying text.

²²¹ See Treas. Reg. § 1.1275-4(a)(4) (as amended 2004) (“A debt instrument does not provide for contingent payments merely because it provides for an option to convert the debt instrument into the stock of the issuer . . .”). Even if one were to determine that the contingency attached to the conversion feature denies FLY Paper the benefit of the convertible debt exception, because the conversion feature is designed *not* to be triggered, it would likely be disregarded as a remote contingency. See Treas. Reg. § 1.1275-4(a)(5). Of course, by adding an additional conversion feature, an issuer could choose to skirt this exception in order to increase the debt instrument’s yield under the noncontingent bond method, just as the contingent convertibles did by adding the “‘bonus’ interest payments,” which caused the contingent payment debt rules to apply. See Kleinbard et al., *supra* note 178, at 1953.

Because the amount of phantom income FLY Paper generates is modest, even those investors that ordinarily shy away from it will be less wary. More important, any tax burden borne by investors comes paired with a tax benefit for the social enterprise.²²² FLY Paper held by tax-exempts will produce the same tax benefit without the tax cost, supplying the favorable and asymmetric result described above. Adding an additional contingency could produce the same enhanced stream of deductions enjoyed by issuers of traditional contingent convertible debt instruments. More generally, whenever an investor's marginal tax rate lies below the rate applicable to the enterprise, the social enterprise's tax bill will not merely be shifted to investors but partly subsidized by the fisc.

FLY Paper would, in some respects, enjoy even more favorable treatment than ordinary hybrid instruments. When for-profit borrowers work to exploit the boundaries of the rules governing unconventional debt instruments, they encounter a variety of anti-abuse rules.²²³ High-yield debt, for example, must run a gauntlet of rules that can treat a portion of those high yields as equity.²²⁴ When they apply, the recharacterized portions of the yield will not produce interest deductions for the borrower. Because FLY Paper has a low yield, such rules pose little threat.²²⁵

C. *Early Stage Social Enterprise*

FLY Paper's hybrid nature produces tax results that depend substantially on the context in which it is deployed. As described above, when an investor purchases FLY Paper from a mature social enterprise, the resulting relationship will be one between a lender and a borrower for tax purposes. Purchasing FLY Paper from a more speculative venture produces markedly different results.²²⁶

²²² In essence, FLY Paper shifts the tax burden that would otherwise fall on the social enterprise to its investors, allowing investors to partially foot the enterprise's tax bill.

²²³ See, e.g., I.R.C. §§ 163(e)(5), 163(l)(3) (2006).

²²⁴ The rules under I.R.C. § 163(e)(5), for example, prevent an issuer from deducting excessive interest under certain circumstances.

²²⁵ Other anti-abuse provisions target "equity-linked debt." See I.R.C. §§ 163(l)(1), 163(l)(3) (disallowing interest on debt where holders have an option to convert debt to equity). Because any conversion would require affirmative steps on the part of both the issuer and the investor, even these provisions would not taint FLY Paper or strip issuers of the tax benefits that debt produces.

²²⁶ Because the enterprise is speculative, even a relatively secure debt investment would be speculative. Presumably the FLY Paper will represent the lion's share of the corporation's capital, giving it a high debt-equity ratio and supporting a conclusion that what

1. Tax Classification

Although many traits distinguish social enterprises from traditional businesses, risk is one they share. In their formative stages, neither type of venture can expect to secure much in the way of borrowed capital. Without either a significant track record of success or a meaningful pool of assets to serve as security, lenders would be right to be skeptical of the certainty of repayment. The repayment of any investment would inevitably be a product of the venture's future success.²²⁷ Even if the investment is called a loan, it would represent a gamble on the enterprise's future.

Tax law responds to such loans with an appropriate degree of skepticism. By employing a standard that embraces a wide variety of considerations, tax law evaluates investments at their inception to determine whether to classify investments as debt or equity.²²⁸ Any purported borrowing by an early-stage social enterprise would almost inevitably be regarded as too speculative to warrant debt classification.²²⁹ Whatever labels the parties choose to apply, such an investment would be taxed as equity.

2. Tax Consequences

From an income tax perspective, FLY Paper issued by a start-up social venture would be treated as preferred stock, and therefore as a form of equity rather than debt.²³⁰ Even if its terms were identical to FLY Paper classified as debt, investors and issuers would be subject to a

is in form debt is in substance equity. *See supra* notes 197–199 (distinguishing the roles of equity and debt and describing the effect of enterprises' debt-equity ratio).

²²⁷ Because they would only receive their promised yield if the venture proves successful, FLY Paper investors would inevitably "participate in corporate profits." *See* Hariton, *supra* note 164, at 500.

²²⁸ *See id.* at 499–501 (discussing the common law approach of using defining characteristics to categorize instruments).

²²⁹ *See id.* at 503 (quoting I.R.C. Notice 94-47, 1994-1 C.B. 357, which outlined as one of the categories for classification "whether the issuer is thinly capitalized").

²³⁰ Tax law provides a variety of definitions of preferred stock, but the most relevant definition appears in the context of the rules governing distributions on preferred stock. They specify that preferred stock is "stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges . . . but does not participate in corporate growth to any significant extent." *See* Treas. Reg. § 1.305-5(a) (as amended in 1995). The conversion feature—although theoretically offering FLY Paper holders a route to participation in earnings—would not create a different result. Because conversion itself is such a remote possibility, "there is little or no likelihood of such stock actually participating." *See id.*

significantly different set of rules.²³¹ Current income and deductions give way to a regime that is more forgiving for holders and less generous toward issuers.

Perhaps the starkest difference between debt and equity classification lies in the fact that interest gives rise to deductions but dividend payments do not.²³² Even if—as is often the case with preferred stock—dividends are mandatory rather than discretionary, their payment ordinarily has no immediate tax consequences for the payor; the payment of that equity return will often trigger a variety of bookkeeping adjustments, but nothing more.²³³

For recipients, a cash dividend generally results in the imposition of tax upon receipt.²³⁴ In other words, the matching rule that imposes current taxation on investors even when a borrower elects to defer the payment of interest typically does not apply to equity. For a FLY Paper investor who is treated as an equity holder for tax purposes, that generally means no phantom income. When dividends are ultimately received and taxed, that dividend income will generally qualify for the low rates ordinarily granted to long-term capital gains.²³⁵

As with all instruments treated as preferred stock, there are circumstances under which FLY Paper will produce the same phantom income as a debt instrument.²³⁶ In the for-profit context, the careful design of a preferred stock investment can minimize the risk of phantom income.²³⁷ Specifically, by imbuing preferred stock with features that grant its hold-

²³¹ Compare Treas. Reg. § 1.1275-4 (as amended in 2004) (tax treatment of convertible bonds, debt) with I.R.C. §§ 243, 301 (2006) (tax treatment of dividends and distributions, equity).

²³² To be precise, the payment of dividends does not give rise to deductions for the payor, but may give rise to “dividends received” deductions for corporate recipients. See I.R.C. § 243.

²³³ See I.R.C. § 312 (describing adjustments to earnings and profits of payor corporation upon the payment of a dividend).

²³⁴ See I.R.C. § 316 (defining a dividend as a distribution of cash or property); I.R.C. § 301(c) (requiring that dividends generally be included in gross income).

²³⁵ See I.R.C. § 1(h)(11) (providing that qualified dividends are entitled to the low rates applicable to capital gains).

²³⁶ See Peter A. Furci & David H. Schnabel, *Convertible Preferred Stock Investments by Private Funds: A Practical Guide to Tax Structuring*, 726 P.L.I./TAX 601, 609 (2006) (noting that in some circumstances “deemed dividends on the preferred stock . . . result in taxable income to the investor without a corresponding receipt of cash (the dreaded phenomenon known as phantom income)” (internal quotation marks omitted)).

²³⁷ *Id.* at 615–33 (describing structures that defuse the threat of phantom income).

ers a largely theoretical stake in the enterprise that mimics common stock, the risk of such phantom income can be minimized.²³⁸

Fortunately, even in the absence of such safeguards, FLY Paper characterized as equity presents a lower risk of phantom income than a typical preferred stock investment in a traditional start-up. That is because dividends only trigger tax for investors when—and to the extent that—corporate payors are profitable.²³⁹ For purely profit-seeking enterprises, limiting phantom income by limiting profits is hardly an appealing solution.²⁴⁰ Given their dual focus on social as well as financial returns, profits are likely to be both relatively modest and slow to arrive for social enterprises. Fortunately, that means that phantom income will be too.

IV. PRIVATE AUTONOMY AND THE PUBLIC INTEREST

FLY Paper accomplishes much that hybrid entities do not. Most important, it allows investors and entrepreneurs to reach a mutual understanding regarding their commitment to balancing social good and personal financial rewards.²⁴¹ FLY Paper also provides a mechanism through which investors can support a mature social enterprise by shouldering a portion of its tax burden.²⁴²

Critically, FLY Paper does both without relying on public intervention. Charitable organizations receive tax subsidies while operating under the watchful eyes of state attorneys general.²⁴³ The important role charities play in meeting public needs not met by government actors easily justifies extensive public involvement.

Although the case can be made that social enterprises serve the same ends, they do so entirely at the discretion of private parties. Entrepreneurs and investors can—unilaterally in the case of hybrid entities or cooperatively when using FLY Paper—set those public ends aside to pur-

²³⁸ *Id.* at 615 (“[T]he phantom dividend issues that normally arise in the case of preferred stock investments can generally be avoided if . . . the stock is designed so that it is treated as common stock . . .”).

²³⁹ *Id.* at 614 (“[P]antom dividend income with respect to preferred stock investments generally only arises where the issuing corporation has current or accumulated [earnings and profit (“E&P”)].”).

²⁴⁰ *Id.* (“Although most start-up companies have significant losses and do not have E&P, many investors are understandably reluctant to rely on that fact in structuring preferred stock investments.”).

²⁴¹ See *supra* notes 110–178 and accompanying text.

²⁴² See *supra* notes 179–240 and accompanying text.

²⁴³ See *supra* note 132 and accompanying text.

sue purely private aims.²⁴⁴ Nothing prevents FLY Paper holders from negotiating with entrepreneurs to exchange hybrid interests for stock.

They might do precisely that if they jointly determine that the potential benefits of transforming a social enterprise into a pure for-profit endeavor outweigh the risks. That choice could either represent a triumph of self-interest over self-restraint or a calculated decision to shift attention to a new, more worthy project, reinvesting any gains in a new double-bottom-line venture. Either result presents private actors reaping the fruits of their collective efforts and choosing whether to rededicate those gains to social enterprise.

The primacy of private autonomy in social enterprise gives critics and policymakers pause when they consider devoting public resources to promoting social enterprise. This reluctance partly explains why statutes enabling hybrid entities contain no expensive public commitments to enforcement. The freedom of private actors to decide the fate of a successful social enterprise makes justifying the dedication of public resources directly to them—by providing tax subsidies, for example—very difficult. Our turbulent financial times do not help either.

The trouble with hybrid forms, however, runs deeper than legislatures' unwillingness or inability to fund enforcement or offer enticing tax subsidies. Today's L3C, benefit corporation, and FPC fail because they offer no public or private assurances to convince social entrepreneurs and investors to trust each other's commitments. New or revised hybrid forms could be more effective if carefully crafted to ensure the entities' prioritization of public good and to enable enforcement. Fortunately, we do not have to rely on state legislatures to reach the pinnacle of some race-to-the-top.

As FLY Paper demonstrates, social enterprise can succeed without public intervention and it can succeed right now. Its fate need not turn on the willingness or the ability of policymakers to enforce a balance between "doing well" and "doing good." The proliferation of hybrid entities suggests that socially motivated investors and social entrepreneurs do not control their own fortunes.²⁴⁵ Nothing could be further from the truth.

²⁴⁴ The entrepreneur in charge of an L3C must merely begin pursuing profits. Shareholders of benefit and FPCs face only procedural obstacles to abandoning an enterprise's mission. If FLY Paper holders and entrepreneurs can agree on the terms of an exchange of FLY Paper for stock, they are free to do so.

²⁴⁵ See *supra* notes 63–92 and accompanying text.

CONCLUSION

Social enterprise challenges the prevailing legal order on many fronts. FLY Paper demonstrates that responding to those challenges sometimes requires help from unusual allies. In this case, the hybrid financial instruments most closely associated with bare-knuckled capitalism allow investors and entrepreneurs to telegraph their commitment to “doing well” while also “doing good.” Investors accept a relatively modest financial return and, in exchange, entrepreneurs embrace limits on their ability to profit from their own efforts. That truce offers no guarantee that an enterprise will enjoy two equally robust bottom lines, but it does ensure that neither investors nor entrepreneurs can unilaterally upset the balance between them. None of the existing hybrid entities can promise that.

FLY Paper suggests a new way forward for social enterprise. Rather than relying on state governments to create untested business entities to constrain self-interest, FLY Paper allows entrepreneurs and investors to proudly display their commitment to a double bottom line. On its own, that shift from increasingly complex restraints to a focus on improved understanding between investors and entrepreneurs would be significant. Coupled with the insight that private action can advance social enterprise without government involvement through the power of hybrid financial instruments, that transformation reveals FLY Paper to be an ideal fit for social entrepreneurs and investors.