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Financing the Benefit Corporation

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CONTENTS

INTRODUCTION

The hybrid organizational forms designed with social enterprises in mind have proven to be hothouse flowers. Flourishing in state legislatures, even those with the most distinguished pedigrees—such as Delaware's public benefit corporation[1]—have so far failed to thrive in the marketplace. Fortunately, hybrid financial instruments offer a source of strength and stability that can help social enterprise to take root.

This Article examines the valuable role that financial instruments can play in providing social enterprises with the capital they need to grow. Debt with equity features and equity with debt characteristics constitute the lion's share of such financial tools. More exotic financial tools, including some tailor-made for social enterprise, can be deployed alongside hybrid debt and equity instruments that any venture might use.

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* Professor of Law, Brooklyn Law School. ** Professor of Law, Brooklyn Law School. We are grateful to have participated in the stimulating discussion at the 2016 Berle Symposium at Seattle University School of Law, which contributed greatly to the development of this article, to Alex Stein and Min Pease for helping us better understand the Seed Impact Investment Template Note, and for the research assistance of Christie McGuinness.

1. *See* DEL. CODE ANN. tit. 8, §§ 361–368 (2013).

To set the stage, Part I provides a brief overview of the achievements of the benefit corporation to date. These include their incredible success in state legislatures and their consciousness-raising about the legitimacy and value of companies dedicated both to achieving profits and generating social good. Part II considers next steps. In particular, it lays out the challenges faced by benefit corporations and other social enterprises seeking capital to enable them to survive and scale. Part III, which makes up the bulk of the essay, considers a variety of financial tools that could be harnessed to meet these challenges. Although common stock and standard corporate bonds will often fail to align the interests of entrepreneurs and investors in double-bottom line ventures, a variety of less conventional financial instruments offer considerable promise.

I. THE BENEFIT CORPORATION'S VICTORIES

The benefit corporation has swept the nation's state legislatures. This new specialized legal form of organization sets aside the nagging question of a corporation's proper objectives. Courts and commentators continue to debate whether generic for-profit corporations must pursue shareholder value maximization primarily or exclusively.[2] But, benefit corporation statutes offer a crystal clear alternative to these muddy waters. They must "have a purpose of creating general public benefit,"[3] defined as "[a] material positive impact on society and the environment, taken as a whole, assessed against a third-party standard, from the business and operations of a benefit corporation."[4]

These specialized for-profit corporations with shareholders pursue dual or multiple purposes and may sacrifice value for shareholders in pursuit of benefits for employees, the community, the environment, or a range of other groups and interests. Today, more than thirty jurisdictions offer the benefit corporation form of organization, and several more are poised to join their ranks.[5]

Even more impressive than the breadth of this trend may be the speed with which it spread. The first benefit corporation statute became effective in the state of Maryland in 2010.[6] Even Delaware—ordinarily the market

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2. *Compare, e.g.*, LYNN STOUT, THE SHAREHOLDER VALUE MYTH (2012), *with* Leo E. Strine, Jr., *Our Continuing Struggle with the Idea that For-Profit Corporations Seek Profit*, 47 WAKE FOREST L. REV. 135 (2012). *See also* Kevin V. Tu, *Socially Conscious Corporations and Shareholder Profit*, 84 GEO. WASH. L. REV. 121, 127–41 (2016) (offering an overview of these debates).

3. MODEL BENEFIT CORP. LEGIS. § 201(a) (2016).

4. *See id.* § 102.

5. *See Status Tool*, SOC. ENTER. LAW TRACKER, http://socentlawtracker.org/#/bcorps [https://perma.cc/H85Y-8EDY] (providing updated information on benefit corporation and other social enterprise legal form enabling legislation in state legislatures nationwide).

6. MD. CODE ANN., Corps. & Ass'ns §§ 5-6C-01 to 5-6C-08 (2013) (adopted 2010).

leader in corporate law—has been unable to resist the benefit corporation's powerful pull. In 2013, it adopted a new public benefit corporation (PBC) form with a unique tripartite purpose.[7] A PBC is a for-profit corporation

> intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner. To that end, a public benefit corporation shall be managed in a manner that balances the stockholders' pecuniary interests, the best interests of those materially affected by the corporation's conduct, and the public benefit or public benefits identified in its certificate of incorporation.[8]

While differing in important ways from the typical benefit corporation statute, the Delaware PBC embraces the core idea of an entity with obligations beyond pursuit of profit, and explicit discretion for directors to balance its disparate imperatives. Statutes like these reassure social entrepreneurs worried that the legal burdens imposed on generic corporate forms will force them to marginalize their commitments to a social mission.[9]

The benefit corporation represents both an expressive victory and an insurance policy. Not only does it allow social enterprises to declare their commitment to mission but it also aims to shield that commitment. However helpful that might be for established social enterprises, for social enterprise startups lacking the financial resources to germinate and grow, the benefit corporation falls short.

II. THE IMPORTANCE OF FUNDING

Startups need capital, and social enterprise startups are no exception. A social entrepreneur with a vision can invest her own savings and max out her credit cards trying to build a company that produces both good for society and profit. Depending on her individual net worth and her pool of connections, she may be able to turn a good idea into a chugging small business. Eventually, though, she will need—or simply want—to fund her social enterprise with capital beyond the levels she and her personal network can supply. When she does so, she will face a daunting, and double-sided, trust problem. How can she identify investors with a commitment to a dual mission that matches her own, investors who will not push her to sideline her enterprise's social commitments in exchange for a greater financial return? And, if committed dual-mission investors

7. *See* DEL. CODE ANN. tit. 8, §§ 361–368 (2013).

8. *Id.* § 362.

9. Except when otherwise noted, future references to benefit corporations refer to entities formed under either the Delaware PBC statute or statutes adopting the Model Benefit Corporation Legislation approach.

can be found, how can she convince them she is not a wolf in sheep's clothing herself?

Game theorists would speak of stags and hares, instead of wolves and sheep, to elaborate this problem. As far back as Rousseau, situations like that facing social entrepreneurs and investors have been analogized to a stag hunt.[10] Two hunters would most like to bring down and bring home a stag—a large prize capable of feeding their families for a significant period. Yet the hunters can fell the stag only through coordinated effort. If one party remains intent on the stag while the other becomes weary of the hunt and goes off in search of hare—smaller prey he can snare alone—the dedicated stag hunter will fail in his efforts. He cannot do the job on his own. As they need to be certain they will come back from the hunt with something to feed their families, each will become distracted unless he has assurance of his fellow's commitment. Without assurances, the big prize will be elusive. For this reason, the stag hunt is also called an "assurance game."[11]

Social entrepreneurs and investors engage in a stag hunt of their own. The big prize for them, of course, is not a large, antlered animal, but a combination of social and financial returns. They both seek this blended value but cannot achieve it alone. The social entrepreneur needs capital. The investor, perhaps an impact fund, an individual investor seeking a combined social and financial return, or even a philanthropic foundation, needs entrepreneurs' ideas, creativity, and know-how to turn an investment into a return—on both the financial and social fronts. The temptation in this story is not a small, lop-eared creature, but the simpler, singular goal of profit. And the fear of each other's defection toward this single goal can scuttle the ability of the parties to collaborate in the first place. If the social entrepreneur believes an investor will push her to abandon her social commitments, she may well refuse the investment. If an investor fears the social enterprise's founder and management team will falter in its commitment to social good, she will seek out another destination for her dual mission investment. Without assurances of each other's commitments, the prospect of funding becomes precarious, if not impossible.

The benefit corporation can offer some solace, but many investors and entrepreneurs placing their funds and dreams at risk will need greater assurance. Ultimately, the stability of a benefit corporation's mission lies in the hands of its shareholders. As noted earlier, benefit corporations and

10. *See* DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 35–36 (1998); Richard H. McAdams, *Beyond the Prisoners' Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209, 220–22 (2009).

11. *See* McAdams, *supra* note 10, at 221.

Delaware PBCs must be formed to pursue a public benefit. This orientation can be changed only if the board resolves to take such action, and shareholders approve it—by supermajority.[12] The equivalent for a stag hunt might be a requirement that a defecting hunter formally and publicly announce their choice: an improvement over no warning at all but ultimately little comfort for a hunter struggling with her own decision.

How much assurance the board resolution and supermajority requirements provide to entrepreneurs and investors depends very much on the ownership stakes within each particular entity. An entrepreneur who retains a two-thirds' control position has little to fear from faithless investors. Supermajority control translates into control of the board and any shareholder vote. Investors who make up only a minority of shares will be unable to shift the enterprise away from its social mission without the entrepreneur's participation. On the other hand, socially minded investors fearful of a turncoat entrepreneur may be unwilling to buy into such a minority equity position. In the reverse situation, if an entrepreneur holds less than one-third control, investors are in the drivers' seat—provided there are few and committed enough investors that coordination problems do not undermine their ability to safeguard mission should they so choose.

Sadly, benefit corporations are not like the ball field in *Field of Dreams* where "if you build it, [they] will come."[13] Forging a hospitable organizational form will not ensure that investors will capitalize a social entrepreneur's dreams or that entrepreneurs will be willing to trust potential investors' motives. Fortunately, legal form is not the only tool suited to the task. A variety of financial instruments can help social entrepreneurs and investors find and trust one another.

III. FINANCE TO THE RESCUE

For incorporated businesses, common stock and corporate bonds are the fundamental building blocks of investment capital.[14] Investors who purchase common stock obtain equity—ultimate ownership of the corporation.[15] They have the residual claim on the corporation's assets after dissolution, once all creditors and other priority claimants have been

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12. *See* MODEL BENEFIT CORP. LEGIS. §§ 102, 105 (2016); DEL. CODE ANN. tit. 8, § 363 (2013).

13. FIELD OF DREAMS (Universal Pictures 1989).

14. Issuing equity or debt instruments, or any of the investment products described throughout this Part, typically will require compliance with securities law. Compliance with securities regulation, at the federal or state level, or both, may pose significant challenges for social entrepreneurs, but is beyond the scope of this essay.

15. *See* WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE 286 (10th ed. 2010).

satisfied.[16] They also can receive a share of midstream profits through dividends, which are issued at the discretion of the board of directors.[17] Through these mechanisms, stockholders enjoy a potentially unlimited upside. Whether stockholders will receive any return on their investment at all—indeed, whether they will ever even see the return of their invested capital—depends on the success of the business. Limited liability provides a cap on their downside risk; stockholders will not be answerable for the debts of their corporation in the ordinary course.[18]

Stockholders are also imbued with rights to elect directors, though not with management rights qua shareholders, as corporate entities embrace a norm of centralized management by the board.[19] Although directors and shareholders will often be the same individuals in small corporations, regardless of size, only directors are legally empowered to act on the corporation's behalf. Shareholders can vote them in or out, but cannot take the reins on their own.

Investors in corporate bonds hold a very different sort of interest in a corporation. They are entitled to receive payments of interest on a regular schedule and return of their principal at the conclusion of the bond's term.[20] These rights as creditors have seniority over stockholder interests, and they will be paid first and in full before any distributions to equity holders upon liquidation.[21] They benefit from greater downside protection, but their upside is limited. Bondholders also have no voting rights.[22] They must rely on their contracts to protect their interests and have no statutory role in corporate governance.[23]

Alone, ordinary common stock or straight corporate bonds will not solve the assurance game inherent in benefit corporation financing. The prior Part detailed the open questions for benefit corporation investors who buy common stock. Whether their votes will provide them the power to

16. *See id.*

17. *See* JAMES D. COX & THOMAS L. HAZEN, BUSINESS ORGANIZATIONS LAW § 20.1 (3rd ed. 2011) ("A dividend is properly declared by formal resolution of the board of directors . . . ."); *id.* § 20.2 (noting dividend distributions are "dependent on the exercise of the directors' good faith discretion").

18. *See id.* § 1.5 ("Shareholders are immune from personal liability for corporate debts and torts beyond the amount of their agreed investments in the corporation's stock."); *id.* § 7.3 (describing situations in which exceptions to limited liability rule are made).

19. *See* KLEIN & COFFEE, *supra* note 15, at 108 ("Although shareholders elect the directors and must vote on certain fundamental corporate changes, corporate law denies shareholders authority to make ordinary business decisions.").

20. *See* RICHARD A. BREALEY ET AL., PRINCIPLES OF CORPORATE FINANCE 356 (11th ed. 2014) ("When companies borrow money, they promise to make regular interest payments and to repay the principal.").

21. *See id.*

22. *See* RICHARD A. BOOTH, FINANCING THE CORPORATION § 1:4 (2015 ed.) (explaining that "creditors have no control rights").

23. *See id.* ("creditors must negotiate for any positive protections they want").

reject or retain social mission is entirely dependent on their place in the capital structure. Shareholders with control will decide on the board and on actions or transactions that might imperil a corporation's social commitments—provided they can coordinate effectively to wield it. If entrepreneurs and investors share equity control, they will have to trust each other's motives and commitments.

Straight debt does little to change this scenario for investors. Bondholders will simply have to trust the dedication of a social entrepreneur to be willing to invest in straight debt and allow the entrepreneur to retain all or a controlling equity stake. Unless additional features like those discussed below are added to the deal, they will have no recourse for deviations from mission. Entrepreneurs may find bondholders' lack of control attractive, but will need confidence that their cash flow can support interest obligations to holders of straight debt.

While neither of these plain vanilla investment products provides social entrepreneurs and investors with strong assurances of each other's commitments, they can be remixed into hybrid versions that can. In fact, traditional investors and their investee companies have long experience developing hybrid financial instruments to mitigate the downside risks of equity and improve the upside potential of debt. Benefit corporation statutes do not narrow the range of financial products available to generic for-profit corporations. That menu of options offers a starting point for developing financial vehicles that respond to the unique assurance game facing social entrepreneurs and committed social investors.

A. Debt with Equity Attributes

Convertible bonds or notes[24] are one such important, existing hybrid. A convertible bond is ultimately a debt instrument, which pays interest to holders and promises repayment of principal at the conclusion of its term. These products hold a position senior to all equity investments, and they will entitle holders to payment before shareholders of any class and, thus, provide protection from downside risk. The conversion feature, however, edges these debt products closer to equity as their holders can become equity investors if they so wish.[25]

Convertible debt has long been a favorite tool of angel investors, who prize it in part for this ability to cash in on the upside of successful

24. The term "note" tends to refer to shorter-term obligations while "bond" and "debenture" refers to debt instruments with longer terms. *See* BREALEY ET AL., *supra* note 20, at 251. Unless specifically indicated, here the terms do not imply a particular duration.

25. *See* KLEIN & COFFEE, *supra* note 15, at 311 (describing a convertible debt instrument's conversion feature as "a right of the holder to convert it into common stock").

investees.[26] It also appeals to these early-stage investors because it allows them to delay valuation. Valuing the issuing company is a necessary part of an equity transaction. Debt issues do not require investors and founders to agree on a valuation in advance and allow them to put off this complicated and risky proposition until later in an early-stage company's life cycle.[27]

Convertible debt can also be useful outside the startup context. It can be a bargain for issuers when contrasted with straight debt issues, as the conversion feature offers added value to investors without increasing issuers' borrowing costs.[28] Convertible bonds can also compare favorably to additional issues of common stock from an already-public company; such issues can come with reputational risk, as they sometimes fuel a perception that existing share prices are inflated.[29]

The most powerful component of convertible debt is, obviously, the conversion feature. It allows investors to essentially have it both ways, the security of debt with the upside potential of equity. To harness this power, this conversion feature must be both priced and timed. Convertible bonds must contain a conversion ratio—the number of shares into which each bond may be converted.[30] For example, a convertible bond may entitle the holder to transform it into 10 shares, 100 shares, or 1,000 shares. The ratio selected, combined with one's predictions about the direction and magnitude of likely changes in the company's stock price, will determine the value of the conversion component to investors.

Particularly in the startup context, the deferred valuation allowed by convertible notes can leave noteholders frustrated. By pegging valuation to a percentage discount of the valuation set by the next financing round, convertible noteholders may lose out on the large gains they might have earned by purchasing equity from the start. A valuation cap allows noteholders to avoid missing out on at least some of that upside.[31] If the

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26. *See* MIT ENTREPRENEURSHIP CTR., VENTURE SUPPORT SYSTEMS PROJECT: ANGEL INVESTORS 38 (2000), https://www.angelcapitalassociation.org/data/Documents/Resources/AngelGroupResarch/1d%20%20Resources%20%20Research/35%20Research_VentureSupportProject.pdf (describing ways in which angel investors use convertible debt).

27. *See id.* ("The convertible debt mechanism allows venture capitalists to set the valuation and eliminates the battle between the angel and the entrepreneur in setting the valuation.").

28. *See* BREALEY ET AL., *supra* note 20, at 620 (noting that "growing firms . . . may be willing to provide the conversion option to reduce the immediate cash requirements for debt service").

29. *See id.* at 387–89 (noting that a modest fall in price of stock in the wake of secondary issuances is generally attributed not to "increased supply but simply . . . the information that the issue provides").

30. *See id.* at 617 ("The number of shares into which each bond can be converted is called the bond's conversion ratio.").

31. For example, they might agree to a 20% valuation discount while the value of the startup triples between the two financing rounds. A valuation cap might limit the cost of conversion by counterfactually treating the valuation of the company as only 150% of its prior value rather than

valuation of the company exceeds the cap when shares are issued, converting bondholders may still convert to equity at the cap.

Timing is also key. While convertible bonds may be issued to offer conversion immediately, triggering events are more typical. In the venture capital context, the conversion feature can be tied to a future sale of equity.[32] Other convertible bonds trigger conversion rights when stock prices reach a certain point, called the "strike price." If a strike price is selected, again one's predictions about the likelihood that the stock will reach that level become pivotal in valuing the bonds. But strike pricing is not the only available option, and conversion can be triggered by whatever events might appeal to issuers—if investors share this inclination, they will buy them.[33]

Beyond convertibility, debt's malleability offers investors and issuers further tools to craft a mutually satisfying investment product. As debt, convertible bonds offer investors interest, and companies must be comfortable subjecting themselves to this ongoing payment obligation. Buyers will often accept convertible bonds with a lower yield than that of comparable non-convertibles. This lower cost of borrowing can appeal to issuers and the conversion feature compensates investors for it by operating as a baked-in option with additional value. Lower yields are not universal, however. If issuers set conversion contingencies that inject additional downside risk for investors, such as in the bank capital ratio example above, buyers may demand a higher than comparable yield to compensate for facing that additional exposure. The company's risk profile, capital structure, and the segment of the investor market to which bonds are marketed will also impact the interest rate necessary to generate buyer interest. For example, new, highly leveraged, or high-risk firms may need to entice convertible bond purchasers with higher yields.[34]

300%. Had the original value been $5, the conversion discount would provide a price of $12 while the cap would provide noteholders with a relative bargain with a price of $7.50. *See* John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 164–65 (2014).

32. In the venture capital context, the future sale of equity can serve a central role by allowing a founder to "tell his investors that they would receive the same security that a future venture capitalist would receive in the next financing round, but at a discounted price." Coyle & Green, *supra* note 31, at 162. Conversion is not only contingent on the subsequent sale of equity, that sale determines the price at which the conversion occurs.

33. In one controversial example, following the post-2008 increased bank capital requirement regulations, some banks issued convertible debt that would automatically convert into equity if the bank's capital reserves dropped below certain levels. The automatic conversion would restore compliance with required capital ratios without the need for the bank to take other action. *See* Hilary J. Allen, *COCOs Can Drive Markets Cuckoo*, 16 LEWIS & CLARK L. REV. 125, 126–27 (2012) (describing this use of contingent convertible notes and highlighting its risks).

34. *See* KLEIN & COFFEE, *supra* note 15, at 254 (describing the origins of high-yield "junk" bonds).

In addition to setting interest rates, convertible debt issuers must also choose a term for these securities, at the end of which principal will be repaid to investors (unless they have converted prior to its completion). The term selected will again depend on capital structure, the risk profile of the underlying company and the pool of targeted investors. The most obvious example of this is that if a company's survival prospects are slim, few investors will purchase long-term bonds from it (at least not without very high interest payments and perhaps other protections). To the extent it can secure debt financing at all, such a company will need to issue short-term notes. On the other hand, long-term bonds can be a very attractive investment if issued by a company with solid long-term prospects. Convertibility can further enhance such a bargain—especially if the strike price and conversion are set favorably for investors.

Payment holidays are another possible tool for companies seeking patient capital and investors interested in providing it. These allow the issuer to put off making interim interest payments on a schedule or in response to particular events. Payment obligations may accrue, or issuers may be permitted to make interest payments with additional debt rather than cash (called payments-in-kind).[35]

Convertible bonds might also incorporate a call feature, allowing the company to elect to repurchase them by paying their principal and accrued interest before their term expires, perhaps along with an additional premium to compensate bondholders.[36] The call feature imposes a practical limit on the value of conversion—and the resulting value of the underlying bond. Bondholders cannot continue observing a stock price rise indefinitely and bank on their ability to turn their bond into shares at any time. Instead, the company can choose to stop the party at any point and offer the call price or (more likely) force conversion.

Finally, convertible debt, like other debt products, can include endlessly customizable contractual components. These promises, often called covenants, can provide debt holders (who do not have statutory governance rights) substantial control over issuers' business decisions.[37] Of course, for a convertible debt issue to include such covenants, company leaders must be willing to part with this control—potentially undermining the value of adding debt to its capital structure in lieu of equity.

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35. *See* BREALEY ET AL., *supra* note 20, at 622 (defining pay-in-kind bonds as instruments whose "[i]ssuer can choose to make interest payments either in cash or in more bonds with an equivalent face value").

36. *See id.* at 611–13 (describing mechanics and implications of bond call options).

37. *See id.* at 613–14 ("[T]he loan agreement usually includes a number of debt covenants that prevent the company from purposely increasing the value of its default option" that are "relatively light for blue-chip companies but more restrictive for smaller, riskier borrowers.").

Conversion rights, as well as other features available to enhance convertible bonds, can be used to structure a tidy solution to the assurance game inherent in social enterprise investing. Social entrepreneurs wary of investors with a fickle commitment to their social mission can be reassured by its initial structure as debt. No matter how much capital they inject, bondholders have no voting powers to infiltrate the board or management team to shift company policy more singularly toward profit. The entrepreneur can avoid any future influence by avoiding the conversion trigger. Setting the proper contingency provides assurances to investors. Bondholders may know themselves to be fully committed to the company's dual mission but fear the entrepreneur or management may not be as stalwart. Conversion rights can offer chary investors comfort by making it more difficult or costly for an entrepreneur to abandon her benefit corporation's social commitments.

The flexible-low-yield paper instrument (FLY Paper) we have proposed in other work makes conversion rights contingent on sale of the entrepreneur's stock to serve both purposes.[38] A contingency whereby a founder's agreement to sell her shares triggers bondholders' right to convert to common stock will influence the incentives of both parties. Having to share the spoils of a sellout with the former bondholders can reduce the attractiveness of such a sale in the first place. Accordingly, fewer such sales should take place. FLY Paper makes social mission sticky, but does not preclude sale altogether. When sales do happen, though, conversion to equity at least allows former debt holders to share in any financial upside of a shift to a more singularly profit-motivated orientation.

A sale contingency is a single and simple conversion trigger with much to recommend it, but benefit corporations and their investors may prefer multiple or more nuanced triggers to empower debtholders in situations short of sale. Triggers could be keyed to important governance events, like failure to issue required benefit reports or to maintaining a third party certification. Performance metrics could also be incorporated, though doing so raises risks due to the inherent difficulty in measuring social performance and concerns about managers pushing to avoid triggers by means that could undermine the social mission of the organization. For example, a convertible note issued by a benefit corporation engaged in microfinance might be made contingent on failures to enter particular new markets by agreed-upon dates or maintain a targeted repayment rate for

38. *See* DANA BRAKMAN REISER & STEVEN A. DEAN, SOCIAL ENTERPRISE LAW: TRUST, PUBLIC BENEFIT AND CAPITAL MARKETS (forthcoming Oxford University Press, 2017); Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with FLY Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 B.C. L. REV. 1495 (2013).

borrowers. But either contingency might be criticized as insufficiently indicative of mission drift and subject to manipulation by managers.

Selecting the right contingency is only part of designing a convertible note; it also must be priced effectively. A conversion right priced to ensure significant sway for the new equity holders in corporate decision-making can empower former bondholders to use their new voting rights to change the board or block a transaction or article amendment that would undermine the company's social mission. Whether such an impact will occur depends on what the relative positions of the various parties in a benefit corporation's capital structure would be after conversion. Bondholders' right to convert to common stock could sufficiently dilute the entrepreneur's stake to frustrate the potential buyer's plans. For example, if after conversion, the former bondholders would hold more than one third of a benefit corporation's shares, they could block amendments to the articles or transactions that would abandon the company's social commitments. In situations when bondholders hold a smaller stake, conversion would not secure effective veto rights but could still provide them a governance role.

Convertibility is a pivotal feature, but not the only design element that can help social entrepreneurs and investors overcome the assurance game they face in benefit corporations and other social enterprises. The "flexible, low-yield" components of the FLY Paper moniker refer to the additional attributes that we advocate. Although a conversion feature will already often allow bonds to be attractive with a lower yield than non-convertible market equivalents, we believe an even lower rate is desirable for convertible bonds offered by benefit corporations and social enterprises. Most importantly, investors' willingness to accept a low yield provides an additional measure of reassurance to entrepreneurs. Like a hunter publicly leaving his hare traps at home, investors who choose FLY Paper, rather than a comparable, higher-yielding bond, leave financial value on the table. The very purchase of a below-market-yield bond acts as a signal of investors' commitment to achieve nonfinancial gains.

This signaling effect can also be important to investors. Depending on the body of investors to be taken on, individual investors have reason to worry not only about the commitments of a benefit corporation's founders but also those of their fellow investors. One FLY Paper investor can be reassured of parallel investors' dedication to their enterprise's social goals by these other investors' willingness to take a below-market yield as well.

A low yield also offers benefits to the entrepreneur by reducing the cash flow she needs to service the debt. The other features we recommend—long term and payment-in-kind rights—enhance this benefit and make FLY Paper investments patient capital. The longer term speaks for itself, and if it again compares negatively with market substitutes, investors accepting it further signal their desire to achieve something beyond financial return from their investment, reassuring entrepreneurs and each other.

Payment-in-kind rights allow the borrower to make interest payments in the form of additional bonds, rather than in cash. If a benefit corporation is strapped for cash or sees greater value in reinvesting the funds it has for future growth and scale, it can make interest payments as they come due with (free) promises to pay later. Startups and small businesses often need patient capital, whose investors are willing to wait for financial returns through a slow building period. The challenges inherent in implementing a dual mission business model can magnify this need for patience. For some benefit corporations, a payment-in-kind feature may be unnecessary or make its bonds too unpalatable to raise the capital they require. For those that can utilize it, however, payment-in-kind rights provide a longer runway and further proof of investors' commitments to achieve blended returns.

In particular circumstances, entrepreneurs and investors might also find other features commonly used in structuring convertible debt attractive. If an entrepreneur is not sufficiently reassured by the signals a FLY Paper investment sends, investors might agree to a call feature. Investors still unwilling to trust entrepreneurs and company managers might contract for board representation, notice, or veto rights over particular corporate actions.[39] If the parties can agree, these elements can be easily added to a FLY Paper structure or engrafted onto a convertible debt instrument with non-sale contingencies instead of or in addition to a sale trigger. This menu of options extends the value of convertible debt as a tool to reassure entrepreneurs and investors—and help them capture their stag.

The Seed Impact Investment Template Note (SeedIIT), made available by Echoing Green, illustrates many of these possibilities.[40] The SeedIIT adapts conventional debt terms to suit the needs of social entrepreneurs and investors "principally concerned with assisting the social or environmental mission of the Company and not with earning a

39. Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1407 (2008) (noting that investors can guard against "potential opportunism by entrepreneurs" by demanding rights to "screen, monitor, and control their investments through a combination of staged financing, preferred stock, board seats, negative covenants, and specific exit rights").

40. ECHOING GREEN, INC., SEED IMPACT INVESTMENT TEMPLATE NOTE (2016), http://bit.ly/22CZ6bD (form template is available as downloadable Word document only from this link) [hereinafter SEED TEMPLATE].

speculative financial return on their investment."[41] Harnessing the flexibility of debt by tweaking terms that would be familiar to purely for-profit ventures, the SeedIIT Note introduces features that help investors and entrepreneurs balance a modest financial return and a meaningful social impact.

The standard terms of the SeedIIT, for example, allow cash payments to be deferred. While many debt instruments allow such a deferral, for a social enterprise, this flexibility can provide important protection for mission by easing pressure to generate cash immediately. The SeedIIT likewise offers assurance to mission-driven investors by targeting the information asymmetry that inevitably separates them from entrepreneurs. Along with the standard covenants to provide financial information and to comply with applicable laws, the SeedIIT calls for the issuer to provide holders with "a report of reasonable length and detail on the Company's progress on its achievement of its [social] [and] [environmental] mission."[42]

B. Equity with Debt Attributes

Preferred shares offer another route to align entrepreneurs and investors through an instrument that is a kind of mirror image of convertible debt. While convertible bonds are debt enhanced by equity-like features, preferred stock is equity embroidered with attributes reminiscent of debt. As equity, preferred stock provides investors with claims on a firm's residual value. But the preferences that give the instrument its name come paired with limitations.[43] Preferred stock generally provides investors with a significant and predictable midstream return along with the security that comes with a liquidation preference. Like debt, preferred stockholders' claims have priority over those of common shareholders. The plasticity that the range of preferences and limitations provides allows preferred shares to be both the typical investment vehicle employed by venture capital firms investing in startups

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41. ECHOING GREEN, INC., SEEDIIT Q&A (May 2016), http://www.echoinggreen.org/pubs/SeedIIT-Note-Q+A-Impact-Investing.html.

42. SEED TEMPLATE, *supra* note 40, § 7(b) (alterations in original). SeedIIT purchasers may wish to request additional assurances regarding entrepreneurs' commitment beyond what is included in the SeedIIT template. For instance, the template permits the company to prepay the note without penalty. After such a prepayment, the company would no longer be required to provide the SeedIIT purchaser whose note had been repaid with an impact report. If the prepayment derived from a reorientation of the venture away from mission and towards profit, repaid SeedIIT purchasers could do nothing to nudge the enterprise back towards mission. Investors and entrepreneurs seeking greater assurances may wish to modify the standard form to tailor it to their needs.

43. Perhaps most importantly, while common equity ordinarily enjoys an unlimited upside, the return on preferred stock is "fixed." *See* KLEIN & COFFEE, *supra* note 15, at 306.

and part of the capital structure of many large, established firms.[44] Each instance adds debt-like features of various kinds into an equity product to strike a deal offering investors their desired blend of risk and return.

The most basic element of these preferred stock deals is a liquidation preference. On liquidation,[45] preferred shareholders receive their share of company assets before common stockholders. Of course, debtholders have even higher priority and will be paid before any shareholders—common or preferred alike. But if assets remain, following satisfaction of creditors, a liquidation preference gives preferred shareholders an advantage and limits the preferred shareholders' downside risk.

What preferred shareholders will receive as their liquidation preference can vary tremendously. Preferred shareholders might secure the right only to return of their initial investment prior to the payout to common shareholders. Or, they might negotiate for return of this sum multiplied by an agreed-upon factor—even a multiple of what common shareholders would receive from the deal. In the participating preferred variant, preferred shareholders are paid out at their contracted-for, higher rate and then are able to double-dip and share the distribution provided to common shareholders too.[46]

In addition to their privileged position at dissolution, preferred shares frequently include an advantage in dividend payments. Again, the basic preference is in terms of timing. Preferred dividends are paid first—before any dividends may be paid to common. In addition to this priority, preferred dividends often carry a preference in amount, which can be structured in any number of ways. For example, preferred shares may entitle their holders to payment of a particular dollar amount, to a payment pegged a certain increment above the payments to be received by other classes of stock, or to a multiple of such other dividends. Preferred dividends can be structured to be paid only at liquidation—but to be tracked and perhaps compounded over time—or to be paid midstream upon declaration by directors. Of course, dividends can only be paid out of profits and at the discretion of a corporation's directors. When a company has midstream profits to distribute, though, preferred dividends ensure preferred shareholders receive a portion of those first.

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44. *See* KLEIN & COFFEE, *supra* note 15, at 305 (noting that "many variations of preferred stock" have emerged to suit different contexts).

45. In preferred shares negotiated by venture capital funds, liquidation often is deemed to include not only dissolution and liquidation of assets but also a sale of the investee company, after which the preference will be applied in distributing sale proceeds. *See* D. Gordon Smith, *The Exit Structure of Venture Capital*, 53 UCLA L. REV. 315, 347 (2005).

46. *See* KLEIN & COFFEE, *supra* note 15, at 309–10 (describing the operation of participating preferred stock).

Classic preferred shares do not afford their holders voting rights, unless the issuer fails to make dividend payments.[47] But, in many uses of preferred shares, including in the venture capital markets, voting rights are a standard part of the deal.[48] Voting rights matter in director elections as well as in fundamental transactions. As noted earlier, benefit corporation statutes apply supermajority shareholder votes to gate corporate decisions with the potential to undermine public benefit purposes: amending the corporate charter, merger, sale of all or substantially all assets, and dissolution.

If voting rights are granted to preferred shareholders, their potency will depend on the makeup of the company's share ownership overall—including the relative number of common shares—and the extent to and manner in which default voting rules are changed by their participation.[49] Depending on the relative size of the preferred and common shareholder groups, and how director voting is conducted, preferred shareholders may or may not be at an advantage in an election for the company's board of directors. For example, in a corporation that issues preferred shares with one-share-one-vote rights equal to its common shares and pools all shareholder votes when approving fundamental transactions, whether preferred shareholders' sway will be intense or illusory will depend on the relative number of preferred and common shares outstanding.

Whether or not preferred shareholders are granted voting rights as a matter of course, standard corporation law does provide them voting rights to protect against at least some decisions or transactions that would disturb the bargain underlying their investment. For example, Delaware statutorily requires each class of shares to approve amendments to the corporate charter that "would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely."[50] This preferred shareholder veto over charter amendments that impact their

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47. *See id.* at 306 ("[I]f preferred stock dividends are not paid, the preferred shareholders may become entitled to representation on the Board of Directors.").

48. *See id.* at 305.

49. Corporations have wide discretion to structure the voting rights of their shareholder groups, and may choose to weight voting toward or away from preferred shareholders, or among classes of common as seen in founder-protective dual-class common structures. *See* COX & HAZEN, supra note 17, § 18.5; *see also* COLIN MAYER, FIRM COMMITMENT: WHY THE CORPORATION IS FAILING US AND HOW TO RESTORE TRUST IN IT 106–07 (2013) (describing the use of such structures by Google and other U.S. media firms as well as a number of firms in Continental Europe).

50. DEL. CODE ANN. tit. 8, § 242(b)(2) (2014).

rights cannot be varied by individual corporations and backstops their contractual protections, but it is of quite limited application.[51]

Beyond matters that directly and detrimentally impact the preferred shares, whether a preferred shareholder vote will be available and potent will depend on the terms of the particular issue of preferred shares, the present circumstances (like an arrears in dividends), and the preferred shares' position in the overall corporate capital structure. Sometimes, preferred shareholders will be able to impact or control such decisions; at other times, they will be legally or practically powerless.

Preferred shares are also amenable to a conversion feature.[52] Upon a triggering event, preferred shares may be converted into common stock—either at the holder's election or automatically. Depending on how its other elements are structured, convertible preferred shares should work like convertible debt to further enhance holders' upside. Consider a preferred stock with a right to enhanced dividends and a right to a prioritized, but limited, distribution on dissolution, perhaps intended to pay out a multiple of preferred shareholders' initial investment. If the company makes unexpectedly large profits and is sold or dissolved, triggering liquidation, preferred shareholders might receive their full contractual payment but miss out on the remaining large residual value that common shareholders will receive. In such circumstances, the option to convert to common offers preferred shareholders access to this improved upside and greater gains. Of course, it is possible for an even better deal to be baked into the preferred contract, in which case mandating conversion would actually reduce the investment's upside potential. For example, if preferred shares are entitled to participate in a distribution to common in addition to receiving their liquidation preference, mandatory conversion will limit preferred shareholders' gains to equal those of common shareholders.

Redemption rights also sometimes figure in preferred shares.[53] Redemption rights entitle the holder to demand that the company buy back the shares to which they attach, at a set price. Either party can negotiate for redemption rights, and those rights can be designed to fall in only after a waiting period or to be triggered by particular events. When held by investors, redemption rights act as a put and provide them an obvious path to exit, at least once they are in effect, but also provide leverage for investors to encourage a company's managers to behave as they wish. If preferred shareholders' exercising their redemption rights would make the

51. *See* COX & HAZEN, *supra* note 17, § 18.11.

52. *See* KLEIN & COFFEE, *supra* note 15, at 311.

53. *See* Smith, *supra* note 45, at 348–50 (describing an array of mechanisms providing for a "repurchase of shares by the company").

company vulnerable by draining it of significant cash, directors will cross them at their peril.

Preferred shares are, essentially, creatures of contract, and parties to them can select from among these many permutations in their negotiations for investment.[54] This system also means that companies and potential investors can negotiate individually tailored contractual provisions to suit their needs. For example, VC firms' preferred share investments may include contractual rights to appoint specific directors and for these director representatives to approve major financial or personnel decisions by the company. Such provisions provide VC funds holding preferred shares with significant control over investee companies' present actions and future choices.

Social enterprises could use the malleable features of preferred stock to structure an investment vehicle to respond to the assurance game faced by their founders and investors. Social entrepreneurs wary of ceding control to investors could be made comfortable with taking them on by the use of preferred shares with no voting rights. The preferences that enhance convertible shares' upside, especially if structured to be payable only at liquidation, can provide comfort to investors leery of bankrolling entrepreneurs' blended mission ideas without the ability to share in a financial upside if one should materialize. Preferred shares can also be affordable and patient capital, as they come with no promise of return of investors' principal, no dividends issue until directors declare them, and their promised preferences can increase the per-share price investors will pay.

The latter is especially true when preferred shares are made convertible, as we would recommend for the same reasons convertibility is so valuable in FLY Paper or other convertible debt vehicles. The ability to convert to common stock—and thereby obtain greater control and access to residual earnings—would mitigate investors' concerns about the commitments of entrepreneurs and fellow investors. Again, selecting the trigger point for convertibility will be key. As in FLY Paper, a contingency that allows preferred shareholders to share in any gains from the entrepreneur's sale of her own stake would limit the entrepreneur's potential gains from defection. Or, contingencies could be structured to trigger conversion rights in response to other events, such as failure to achieve specific mission-related goals or to retain external certifications

54. *See id.* at 319–20 ("[V]enture capitalists use negative contractual covenants . . . and liquidation rights to limit the ability of entrepreneurs to act opportunistically. . . . prohibit[ing] the portfolio company from engaging in business combinations (for example, mergers) and other important transactions without prior approval from the venture investors, thus cutting off the means by which common stockholders have traditionally taken advantage of preferred stock.").

of good practice, but doing so will still raise concerns about the precision of any such metric.

Investors with significant bargaining power might also secure features to make a preferred share product more appealing. Those desiring more control than preferred shares typically offer could negotiate for voting rights, particularly if their numbers or weight would provide them a veto right over fundamental transactions that could put the benefit corporation's social mission at risk. These rights could be made part of the initial preferred share bargain, or to fall in on the occurrence or failure of future events—like meeting metrics tied to social or financial metrics, or a combination of both. Investors can bargain for preferred shares to include contractual rights to weigh in on corporate decisions directly, through notice or even veto rights over particular corporate actions, or bargain for put rights to increase their leverage.

Social entrepreneurs concerned about empowering preferred shareholders in this way can also use typical preferred stock features to hedge their bets on investors' commitments. For example, those suspicious of investors' motives could negotiate the right to redeem investors' shares. The cost of buying back the preferred shares may be one entrepreneurs and other benefit corporation stakeholders are willing to pay if necessary to remove a preferred class with the potential to undermine its values. An exchange of control rights for redemption might be an even bargain, or redemption rights might be sought by entrepreneurs with greater negotiating power.

The above discussion highlights a variety of dimensions along which debt and equity differ and many ways in which they can be remarkably similar. Because so many of the characteristics of hybrid debt and equity instruments are the idiosyncratic product of negotiation between investors and entrepreneurs, the line between them can be blurry. For instance, although debt ordinarily gives rise to a tax deduction while equity does not, even that distinction may be illusory. At least some hybrid instruments labeled stock entitle issuers to interest deductions.[55]

C. Taking Contract Further

While preferred stock and convertible debt are well-known hybrid investment vehicles, they are only the tip of the creative finance iceberg. Both rely on contract to tweak a standard investment into one that will attract capital and that suits issuing entities' needs. But contracting power extends far beyond these standard riffs and can be deployed to create a

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55. *See* KLEIN & COFFEE, *supra* note 15, at 305 (noting that "MIPS (Monthly Income Preferred Securities)" were designed to provide issuers with an interest deduction).

potentially infinite range of investment choices. The range of alternatives described below offer a vision of social enterprise finance unconstrained by convention. Whether or not one offers a blueprint for safely fueling benefit corporations, they show that the possibilities neither begin nor end with debt and equity.

At one end of the spectrum, in terms of complexity, Professor Heminway has identified the use of "unequity" by early (pre-JOBS Act) crowdfunding sites.[56] She defines unequity as a "financial interest that provides for profit sharing or revenue sharing on a short-term basis, with no accompanying governance rights."[57] This product, like all investment products, responds to interests of both issuers and investors. Companies issuing unequity investments avoid a potential financial drain, an attractive feature if they are uncertain their venture will generate the predictable cash flow needed to service traditional debt. Unequity also avoids the unappealing relinquishment of control and value that equity investment can require. Why empower a crowd of owners or give up the potential downstream upside using standard equity if investors will purchase unequity interests? Convertible debt and preferred stock do not avoid these concerns altogether and still run the risk of locking investors into a long-term relationship with investors that they may prefer to avoid. Unequity is a very attractive prospect for issuers: it delays the company's obligation to pay until and unless revenues—or even profits—materialize, removes investors from the capital structure after a brief period, and affords them no input in governance in the meantime.

The greater puzzle of unequity lies in its appeal to investors. Unequity purchasers buy a time-limited and highly contingent share of the financial benefits accruing to the company they support but feel neither the need to take a residual interest nor a governance role as equity would. Moreover, they do not even demand a promise of return of their invested principal as would debt products. In fact, at least in the context Professor Heminway describes, many unequity interests offer little or no realistic opportunity for investors to achieve a financial return on their investment.[58]

Unequity investors are investing for something more than financial return—they seek to be a part of the efforts of the company they are supporting. They receive some nonfinancial, but real, benefit from the

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56. *See* Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 ENTREPRENEURIAL BUS. L.J. 335, 360–61 (2012) (defining "unequity").

57. *Id.* at 360.

58. *See* Joan MacLeod Heminway, *How Congress Killed Investment Crowdfunding: A Tale of Political Pressure, Hasty Decisions, and Inexpert Judgments That Begs for a Happy Ending*, 102 KY. L.J. 865, 878 (2014) ("[T]he typical unequity offering is not intended to (and may not) result in pecuniary gain to the investor.").

company's success, which combines with their sometimes nominal financial rights to make their participation worthwhile.[59] In some crowdfunding examples Professor Heminway describes, early adopters of unequity offered investors altruistic benefits. These issuers—and the platforms that matched them with investors—self-identified as social enterprises, and investment paid off in "altruism (funding a better world) and meaningfulness (the emotional satisfaction of having an individual impact)" as well as money.[60] Other unequity issuers provided investors with tangible, but nonfinancial benefits, such as a product prototype or the ability to participate as an extra in a video project.[61]

While entrepreneurs of all stripes might be drawn to unequity's combination of a limited pull on cash flow, protection of entrepreneur's upside, and little control by investors, only companies with a nonfinancial appeal for investors will be able to sell it. Some benefit corporations may well occupy this unique niche. Like investors in early stage crowdfunding projects, investors motivated to support a benefit corporation's social commitments may find unequity attractive. If they view their investment as a substitute or near-substitute for a charitable contribution, which offers a negative return other than as a potential tax deduction,[62] unequity's potential for revenue or profit sharing may compare favorably.

For investors seeking assurance that entrepreneurs will remain committed to the pursuit of the "stag" of a double-bottom line, however, unequity will be an unsatisfying solution. Other than its brief lifespan, unequity offers investors little protection from a defecting entrepreneur or her management team. Unequity investors must either trust the benefit corporation's management for other reasons or not care if the social benefit fails to be generated. Benefit corporations may have highly committed and trusting potential investors or passionate believers willing to contribute without regard to financial return. Unequity can be a useful way to tap these resources, perhaps to participate as part of a bootstrapping campaign, as friends and family of the entrepreneur, or in a small seed-stage investment. However, it seems unlikely to succeed in enabling benefit corporations to scale by providing access to a large pool of investors unconnected to the organization or its management and for whom financial return is a real concern.

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59. *See id.* at 878.

60. Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and The Securities Act of 1933*, 78 TENN. L. REV. 879, 897 (2011).

61. *See* Heminway, *supra* note 58, at 878; Heminway & Hoffman, *supra* note 60, at 896.

62. *See* I.R.C. §§ 170, 2055, 2522 (authorizing income, estate and gift tax deductions, respectively, for charitable contributions).

Of course, profit- or revenue-sharing interests can be constructed to provide greater financial returns to investors. And, benefit corporations with substantial capital requirements will likely need to so sweeten the deal to appeal to a larger market of potential investors. At the other end of the complexity spectrum from unequity, researchers at Santa Clara University designed the "Demand Dividend" framework to serve just this purpose.[63] Intentionally a profit-sharing—rather than merely revenue-sharing—vehicle, it will appeal to the needs of more mature benefit corporations and dedicated impact investors.

The Demand Dividend has four key elements. The first ties payments to investors to profits earned by the issuing company. A Demand Dividend investor receives 25%–50% of cash flow from operations, but only if the company is generating operating profits.[64] Entrepreneurs and managers will appreciate that if the company does not net a profit, payments need not be made. Even more appealing may be the vehicle's second feature. No payments whatsoever need be made during its honeymoon period of 10 to 24 months.[65] This element ensures invested capital's patience.

The third element is structured to provide solace to investors who may languish without a return for a considerable time. Demand Dividend instruments promise investors a fixed payoff amount that is a multiple of the initial investment.[66] Payments out of profits are counted toward this payoff to the extent they are made, and the company must satisfy any remaining amounts due to pay off in full by the end of the instrument's term. This feature will not only compensate the investor for the risk they undertake and the patience they must show, but also should motivate investors to "extinguish the obligation."[67] Once the payoff amount has been reached, the investor loses the right to a share of profits as earned and that portion becomes available for reinvestment in growth or distributions to other investors—including entrepreneurs. Of course, the payoff element is a double-edged sword for entrepreneurs. It is a way to remove investors' claim on their company's profits, but it is also an obligation to pay, which may loom large and frightening to entrepreneurs unsure if they will be able to meet it when the time comes.

The fourth and final element serves an explicit matchmaking function. "A cash flow focused financial forecast is attached to any

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63. *See* MILLER CENTER FOR ENTREPRENEURSHIP, SANTA CLARA UNIVERSITY, DEMAND DIVIDEND: CREATING RELIABLE RETURNS IN IMPACT INVESTMENT (2015), https://static1.squarespace.com/static/55036eefe4b0fe6c8e833e4a/t/56428004e4b024d1dbe1a775/1447198724492/Demand-Dividend-Description-2015.pdf [https://perma.cc/2JST-F2FG].

64. *See id.* at 3.

65. *See id.*

66. *See id.*

67. *Id.*

Demand Dividend term sheet. This forecast, equal to the length of the debt term, ensures alignment of investor and entrepreneur expectations . . . ."[68] Hashing out a forecast forces investors and entrepreneurs to think through carefully how their obligations and returns will shake out. A deal should be concluded only if the expectations are ones both can live with. Of course, forecasts can be wrong, and if profits do not stream in as anticipated, the parties might renegotiate or replace it.[69]

The Demand Dividend provides a design superior to unequity for reaching investors with at least some concern for generating a financial return. Its use of transparency as a protection for investors concerned about entrepreneurial defection, though, limits its appeal to those who can understand and negotiate such disclosures. The creators had impact investors in mind, and these sophisticated, repeat players in the social capital markets do seem its most likely users. A long-term commitment to invest for impact will enable them to develop expertise in evaluating forecasts. It will also afford them the ability to fund a portfolio of Demand Dividend instruments—exclusively or together with other investment vehicles—that can tolerate the variable payment and residual risk the Demand Dividend envisions.

Benefit corporations may be especially well-suited to use Demand Dividends. After all, transparency is the bedrock for this organizational form. Benefit corporations under statutes adopting the Model Benefit Corporation Legislation approach must issue periodic benefit reports self-assessing their performance with respect to a third-party standard,[70] an assessment which also lies at the core of what it means to be a benefit corporation.[71] Delaware PBCs do not require use of a third-party standard but do still require periodic reporting to shareholders.[72] Of course, benefit reports do not include a cash flow forecast, and Professor Murray's early research indicates few benefit corporations are actually producing required reports.[73] Expertise developed from creating these benefit reports and applying metrics generally may help benefit corporations in providing the transparency required to create a Demand Dividend, but the link is far from certain.

68. *Id.*

69. *See id.* at 6.

70. *See* MODEL BENEFIT CORP. LEGIS. § 401 (2016).

71. *See id.* §§ 102, 201(a) (2016) (requiring a benefit corporation to have a purpose of creating a general public benefit, defined as "A material positive impact on society and the 98 environment, taken as a whole, *assessed against a third-party standard*, from the business 99 and operations of a benefit corporation") (emphasis added).

72. *See* DEL. CODE ANN. tit. 8, § 366 (2013).

73. *See* J. Haskell Murray, *An Early Report on Benefit Reports*, 118 W. VA. L. REV. 25, 34–35 (2015).

Well-known tech incubator Y Combinator developed its own framework for an investment product tailored for startups.[74] Somewhere between the simplicity of unequity and the sophistication of the demand dividend, its standard agreement for future equity (or "safe") is a contract under which investors provide capital in exchange for a promised right to purchase equity in the future.[75] Safe investors do not receive any current interest in the company to which they contribute capital;[76] nor do they receive rights to midstream payments of revenues or profits, even if the company earns them.[77]

Instead, their investment is protected by the contractual right to purchase future rights, and those future rights will be equity.[78] If the company ultimately issues stock, safe investors' interest will convert into shares of that stock.[79] On a liquidity event, they may choose either the return of their invested capital or conversion to common to participate in the transaction.[80] And if the company dissolves, the safe contract entitles them to return of their invested capital prior to any distribution to common stockholders.[81] Thus, safe investors receive an attractive combination of both downside protection and upside potential.

Y Combinator has made public the standard terms for a variety of safe vehicles.[82] So entrepreneurs and investors need to negotiate only a single term individually: the valuation cap.[83] When and if the company issues equity, safe investors will be entitled to receive shares on the same terms—up to the cap.[84] For example, consider a $100,000 safe investment with a $5 million valuation cap.[85] In the future, the company plans to sell $1 million of preferred shares with a valuation of $10 million. The "fully-diluted outstanding capital stock immediately prior to the financing, including a 1,000,000 share option pool to be adopted in connection with

74. *See* Y Combinator, *Startup Documents*, https://www.ycombinator.com/documents/ [https://perma.cc/N5JS-QVRJ] [hereinafter Y Combinator, *Startup Documents*] (describing Y Combinator's development of the "simple agreement for future equity (safe)"); *see also* Coyle & Green, *supra* note 31, at 168–70 (describing the process of the developing the "safe").

75. *See* Y Combinator, *Safe Primer*, at 1, https://www.ycombinator.com/documents/ [hereinafter Y Combinator, *Safe Primer*] (downloadable from middle of page).

76. *See id.*

77. *See id.*

78. *See id.*

79. *See id.*

80. *See id.* at 2.

81. *See id.* at 3.

82. *See* Y Combinator, *Startup Documents*, *supra* note 74.

83. *See* Y Combinator, *Safe Primer*, *supra* note 75, at 1.

84. *See id.* at 1–2.

85. *See id.* at 6 (app. II, ex. 1). The example that follows in the text is drawn from that provided in the *Primer*.

the financing, is 11,000,000 shares."[86] In this case, the price for the standard preferred share investors will be determined by dividing the $10 million valuation by the 11,000,000 in outstanding shares, yielding a price of $0.909 per share. Safe investors' price to convert to equity will, however, be protected by the valuation cap. Their price will be just $0.4545 per share, determined using $5 million as the numerator. If the investee company issues equity at a valuation below the cap, safe investors' shares will convert at the same price at which new holders purchase the shares issued.[87]

Unlike the Demand Dividend, which is ultimately a debt instrument that carries a maturity date, obligations to make payments midstream post-honeymoon as long as profits are earned, and the potential threat of insolvency, the safe creates no debt obligation. Although, like all contracts, the safe may be renegotiated, it does not expire; thus, it can remain outstanding for as long as it takes for a share issue, liquidity event, or dissolution to occur.[88] Its designers at Y Combinator argue these same features make it preferable to convertible debt and tout its simplicity "[a]s a flexible, one-document security without numerous terms to negotiate, [which] should save startups and investors money in legal fees and reduce the time spent negotiating the terms of the investment."[89]

While not expressly targeted at social enterprises, the safe seems tailor-made for the task of providing social entrepreneurs with the resources they need by providing investors with the reassurance they seek. Like FLY Paper, the safe's conversion feature can provide comfort to potential benefit corporation investors. The right to convert, participate, or be cashed out reduces the financial incentive for entrepreneurs, managers, or existing equity holders to shift away from social mission to pursue financial gain through a liquidity event, dissolution, or share issue. Entrepreneurs will appreciate the safe's promise of freedom from obligations to make midstream payments or to submit to governance authority without even the need to negotiate low yields, long terms, or pay-in-kind rights as would FLY Paper issuers. Safe investors' willingness to contribute funds without the promise of even a concessionary financial

86. *Id.*

87. *See id.* at 2; *see also id.* at 6–7 (app. II, ex. 2).

88. *See id.* at 3.

89. *See* Y Combinator, *Startup Documents*, *supra* note 74. Following Y Combinator's lead, accelerator 500 Startups developed a simplified convertible debt instrument, the "Keep It Simple Security (KISS)." *See 500 Startups Announces 'KISS'*, 500 STARTUPS, http://500.co/kiss/ [http://perma.cc/M7BU-UTLN]. Like the safe, a KISS converts into equity on future equity issues and liquidity events, but it is a debt instrument with a limited duration. *See* Jack Wroldsen, *Crowdfunding Investment Contracts*, 11 VA. L. & BUS. REV., 14–15, 30–36 (forthcoming 2017) (comparing the KISS and safe investment contracts and reporting on their use by 5% and 31%, respectively, of 39 early crowdfunding investment campaigns studied).

yield should provide reassurance to entrepreneurs. This willingness to forego any financial return unless future events change the capital structure suggests patience at least, and passion at best. So long as cap negotiations do not undermine these assurances, the safe appears ripe for application to benefit corporations and other social enterprises.

There are two important notes of caution to sound about the safe, however. In the startup context in which Y Combinator conceived the safe, angel investors and venture capitalists put their capital into a portfolio of investee companies with the idea that only a fraction of those investments will yield huge gains.[90] Losing access to midstream interest payments or the ability to force repayment or renegotiation at a maturity date may not matter to these gamblers at the startup casino. The pool of investors for benefit corporations and other social enterprises, however, is not likely the kind of super-charged VC or even angel investor community that Y Combinator had in mind. Investors seeking a double-bottom line may not have as much capital to lose. That said, the safe has been used in a number of early crowdfunding issues,[91] targeting investors whose risk-tolerance is likely closer to impact investors than to venture capital funds. Moreover, a win will look different to an investor truly seeking impact—perhaps not generating huge financial returns but important or lasting social ones, along with a more moderate financial gain. For social enterprise investors, concessionary but still positive gains—rather than a bet-the-farm gamble—may be the way to sustain their investment practice.

CONCLUSION

Benefit corporation statutes have achieved a valuable expressive victory, legitimating dual-mission enterprises as specialized corporate organizations. But adopters will not reach scale by waving statute books or gubernatorial signing statements. To fuel their dreams, they need capital. Capital formation is always limited by trust, and in a dual-mission enterprise trust gets harder. Entrepreneurs have to worry about investor commitment, lest they push them to marginalize their social goals for financial gains. Impact investors want to invest their dollars for social good but will have trouble monitoring the social value being generated. Unless both parties are willing to trust each other, investment will be limited and capital-constrained benefit corporations will be limited in the social value they can create.

The tools of finance are well-suited to addressing this problem. Creative attorneys and finance professionals can alter the standard debt

90. *See, e.g.*, BREALEY ET AL., *supra* note 20, at 375 (describing the investment approach of venture capitalists).

91. *See* Wroldsen, *supra* note 89, at 14–15, 30–36.

and equity building blocks of corporate finance to reassure entrepreneurs and investors of each other's commitments. Different types of benefit corporations at different points in their life cycles may find these various funding vehicles appealing. They also offer a menu to the range of very different investors that want to use their capital to generate a combination of financial and social returns.

Endless specialization does have a downside, however. One principal advantage of the benefit corporation form lies in its standardization. Providing an operational roadmap to social entrepreneurs rich in ideas but not in resources can help avoid the unnecessary expense of reinventing the wheel each time. The same argument can be made about financing tools for benefit corporations. Standardizing one or a few key financial tools for benefit corporations and other social enterprises to adopt will help them reach a wider range of investors—including small ones—and avoid the transaction costs inherent in negotiating each deal from scratch.

This article reviews a number of financial vehicles that are a good fit for this kind of standardization and for social enterprise advocates like B Lab[92] to begin honing for launch. When financing vehicles solve the assurance game of social enterprise investment, benefit corporations and other social enterprises will be able to drink deep from pools of capital to meet their true potential.

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92. B Lab is a nonprofit, tax-exempt organization "that serves a global movement of people using business as a force for good." *About B Lab*, B LAB, https://www.bcorporation.net/what-are-b-corps/about-b-lab [https://perma.cc/R9YQ-8G72]. The Model Benefit Corporation Legislation was developed through its initiative "to align the interests of business with those of society and to help high impact businesses be built to last." *Id. See also* Brett McDonnell, *Benefit Corporations and Strategic Action Fields (or the Existential Failing of Delaware)*, 39 SEATTLE U. L. REV. 263, 281–83 (2016) (describing the role of B Lab in creating and advocating for benefit corporation legislation). B Lab also developed and runs the B corporation certification program, which licenses the B Corp mark to companies that meet its standards of "overall social and environmental performance, public transparency, and legal accountability." *Id. See generally* Michael Dorff, *Assessing the Assessment: B Lab's Effort to Measure Companies' Benevolence*, 40 SEATTLE U. L. REV. 515 (2017).