

## ARTICLES

### NONPROFIT DISPLACEMENT AND THE PURSUIT OF CHARITY THROUGH PUBLIC BENEFIT CORPORATIONS

by  
Alicia E. Plerhoples\*

*Nonprofits dominate the charitable sector. Until recently, this statement was tautological. Charity is increasingly being conducted through for-profit entities, raising concerns about the marketization of the charitable sector. This Article examines for-profit charity conducted through the public benefit corporation, a new corporate form that allows its owners to blend mission and profit in a single entity. Proponents of public benefit corporations intended it as an alternative to a for-profit corporation and largely ignored its impact on the charitable sector. While public benefit corporations are ripe for conducting charity because they can pursue dual missions, they lack the transparency and accountability mechanisms of charitable organizations.*

*This Article chronicles the supply and demand for public benefit corporations that conduct charity (i.e., “charitable public benefit corporations”) and hypothesizes the micro and macro level harms caused by them. At the micro level, the harm is fraud or “greenwashing,” i.e., deceiving unwitting stockholders, customers, or other stakeholders into*

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\* Alicia E. Plerhoples, Professor of Law, Georgetown University Law Center. For helpful comments and suggestions, I thank Jane Aiken, Susan Bennett, Felix Chang, Kent Greenfield, Joan MacLeod Heminway, David Millon, Robert B. Thompson, Paul Tremblay, and Anne Tucker. I am grateful to Meaghan Jerrett, Andrew Lang, Maia Tucker, and Cindy Woods for helpful research assistance. This Article benefited from participants' comments at the American Constitution Society's Junior Scholars Public Law Workshop, the National Business Law Scholars Conference, the Law & Entrepreneurship Association's Annual Meeting, and the Southeastern Association of Law Schools Annual Conference.

*investing or spending their time and money in the negligent or fraudulent enterprise. At the macro level, the more pernicious harm is that “market-based charity” injects individualistic and autocratic business values and methods into charitable work. Proposals have been made to mitigate these harms, but none are satisfactory, making additional measures necessary.*

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INTRODUCTION

Charity is increasingly being conducted through for-profit entities, raising concerns about the privatization and marketization of the charitable sector. This Article examines for-profit charity conducted through the public benefit corporation, a new corporate form that allows its owners to blend mission and profit in a single entity.<sup>1</sup> State legislatures

<sup>1</sup> DEL. CODE ANN. tit. 8, § 362(a) (2017) (Public benefit corporations are

enacted public benefit corporation legislation to alleviate a problem that they perceived with traditional corporations—that of short-term profit maximization to the detriment of societal stakeholders.<sup>2</sup> The public benefit corporation was envisioned as an alternative to a traditional corporation, not to a charitable organization. Although public benefit corporations can pursue a charitable mission,<sup>3</sup> the public benefit corporation’s potential impact on the charitable sector has largely been ignored or discounted. As an example, when the flexible purpose corporation—a hybrid corporate form similar to the public benefit corporation—was introduced in the California Senate, several nonprofit groups opposed the bill. They argued that the creation of a new hybrid form to pursue charitable purposes “could produce harmful unintended consequences for the non-profit sector, including ‘siphoning off much-needed resources from effective existing nonprofits.’”<sup>4</sup> The bill’s author and sponsor responded that this concern was “misplaced because this bill is intended to provide an alternative to the standard for-profit corporation, not an alternative to the nonprofit corporation.”<sup>5</sup>

In contrast to this attempt to dichotomize for-profits and nonprofits, Justice Alito recognized the fluidity of the organizational choice spectrum in the *Hobby Lobby* majority opinion:

Not all corporations that decline to organize as nonprofits do so in order to maximize profit. For example, organizations with religious and charitable aims might organize as for-profit corporations because of the potential advantages of that corporate form, such as the freedom to participate in lobbying for legislation or campaigning for political candidates who promote their religious or charitable goals.<sup>6</sup>

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“intended to produce a public benefit or public benefits and to operate in a responsible and sustainable manner.”).

<sup>2</sup> S.B. 47, 147th Gen. Assemb., Reg. Sess. (Del. 2013) (“A public benefit corporation is a for-profit entity which is managed not only for the pecuniary interests of its stockholders but also for the benefit of other persons, entities, communities or interests.”).

<sup>3</sup> DEL. CODE ANN. tit. 8, § 362(b) (2017). A public benefit corporation must state a specific public benefit in its certificate of incorporation, which can be a charitable public benefit. *Id.* § 362(a).

<sup>4</sup> *Flexible Purpose Corporations: Hearing on S.B. 201 Before the Cal. Assemb. Comm. on Judiciary*, 2011–2012 Sess. 12 (Cal. 2011) [hereinafter *Hearing on S.B. 201*]; see also BETSY SCHMIDT, *NONPROFIT LAW: THE LIFE CYCLE OF A CHARITABLE ORGANIZATION* 539 (2011) (asking “[i]s this new [social enterprise] movement a threat to the nonprofit sector?”).

<sup>5</sup> *Hearing on S.B. 201*, *supra* note 4.

<sup>6</sup> *Burwell v. Hobby Lobby Stores, Inc.*, 134 S. Ct. 2751, 2771 (2014) (holding that the Affordable Care Act’s contraceptive mandate violates the Religious Freedom Restoration Act, which protects for-profit closely held corporations as well as individuals). Justice Alito further stated:

Because profit-driven firms may opt into a hybrid corporate form to pursue charitable, environmental, and social ends, it should come as no surprise that mission-driven firms that could otherwise organize as charitable organizations<sup>7</sup> will opt into the public benefit corporation form to pursue financial ends.

Nonetheless, an organization that is organized as (or converts to) a public benefit corporation when it could have otherwise been organized as a charitable organization engenders suspicion. The concern is that a public benefit corporation, which could have otherwise been formed as a tax-exempt nonprofit corporation, will shirk on quality of the product or service produced because it is not constrained by the nonprofit nondistribution constraint.<sup>8</sup> Public benefit corporations are for-profit corporations with shareholders to whom dividends or other distributions can be made.<sup>9</sup> Public benefit corporations are also subject to weaker accountability mechanisms, and logic follows that they are thus formed in order to exploit these weaker accountability mechanisms, allowing public benefit corporations to engage in “greenwashing”—i.e., an organization’s false but difficult-to-prove claim to customers and the public that it is producing some public benefit.<sup>10</sup> Public benefit corporations thus emerge as villains, as an organizational form which has no use other than to deceive.

This Article analyzes the public benefit corporation as an alternative

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While it is certainly true that a central objective of for-profit corporations is to make money, modern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so. For-profit corporations, with ownership approval, support a wide variety of charitable causes, and it is not at all uncommon for such corporations to further humanitarian and other altruistic objectives.

*Id.*

<sup>7</sup> Not all nonprofits are charitable organizations. Charitable organizations are 501(c)(3) tax-exempt organizations that have an exempt or charitable purpose. Charitable organizations can be further sub-classified as private foundations or public charities. Public charities rely on donations and grants from the public or the government, and also on fees for services the charity provides. Private foundations are funded by a single donor or handful of donors. SCHMIDT, *supra* note 4, at 6–8.

<sup>8</sup> All nonprofits are prohibited from distributing profits to private shareholders or individuals. Charitable organizations are regulated by section 501(c)(3) of the Internal Revenue Code, which states that 501(c)(3) organizations are those which “no part of the net earnings of which inures to the benefit of any private shareholder or individual.” I.R.C. § 501(c)(3) (2012); Treas. Reg. § 1.501(c)(3)–1 (as amended 2016).

<sup>9</sup> See *Frequently Asked Questions*, B LAB, <http://benefitcorp.net/faq> (last visited May 14, 2017).

<sup>10</sup> See Miriam A. Cherry, *The Law and Economics of Corporate Social Responsibility and Greenwashing*, 14 U.C. DAVIS BUS. L.J. 281, 284–86 (2014) (describing the term “greenwashing”); Alicia E. Plerhoples, *Social Enterprise as Commitment: A Roadmap*, 48 WASH. U. J.L. & POL’Y. 89, 96 (2015) [hereinafter Plerhoples, *Social Enterprise as Commitment*] (describing the term “greenwashing”).



to the charitable organization and assesses the potential harms when a for-profit entity is used to conduct charity. These harms are larger than fraud or greenwashing, and also include the privatization and marketization of the charitable sector.<sup>11</sup> This Article builds upon the original descriptive research presented in *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In? (90 Days Out)*.<sup>12</sup> My research showed that 34.5% of public benefit corporations that formed in Delaware within the first 90 days have exempt purposes within the meaning of section 501(c)(3) of the Internal Revenue Code, and likely could have incorporated as a nonprofit corporation and sought federal tax-exempt recognition.<sup>13</sup>

This Article proceeds as follows. Part I introduces the public benefit corporation and builds a supply-side theory of why early proponents created, and state legislatures adopted, the public benefit corporation. This Part argues that it was an intervention in corporate law with the express purpose of counteracting the perceived problem of shareholder wealth maximization. Proponents of the public benefit corporation did not intend it as an alternative to a charitable organization. Part II describes the organizational choice spectrum, which ranges from profit-driven corporations to donative nonprofits with public benefit corporations, social enterprises, social businesses, and commercial nonprofits lying between these two extremes. This Part argues that the spectrum is fluid and not dichotomous. Part III builds a demand-side theory for public benefit corporations. It hypothesizes the normative reasons that an entrepreneur would choose the public benefit corporation form instead of a charitable organization. Many of these reasons rest on the perceived failings of the charitable organization, and the perceived ability of the public benefit corporation to overcome such failings.

Part IV identifies the potential harms raised by allowing public benefit corporations to conduct charitable activities. At the micro level, using a for-profit entity to conduct charity may result in increased fraud or “greenwashing,” i.e., deceiving unwitting stockholders, customers, or other stakeholders into investing or spending their time and money in the negligent or fraudulent enterprise. Because the public benefit corporation lacks the accountability mechanisms of the charitable organization, fraud may be more pervasive for public benefit corporations. At the macro level, using a for-profit entity to conduct charity will change the character of charity. Donative charity will be replaced by “market-based charity,” which injects individualistic and

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<sup>11</sup> See *infra* Part IV.

<sup>12</sup> Alicia E. Plerhoples, *Delaware Public Benefit Corporations 90 Days Out: Who's Opting In?*, 14 U.C. DAVIS BUS. L.J. 247 (2014) [hereinafter Plerhoples, *90 Days Out*].

<sup>13</sup> *Id.* at 268.

autocratic business ideals into charitable work. Part V analyzes two possible solutions to the problems of greenwashing and market-based charity, and ultimately rejects both as insufficient.

## I. SUPPLY-SIDE THEORY: LEGISLATING A FOR-PROFIT ALTERNATIVE

### A. *The Public Benefit Corporation*

Proponents of the public benefit corporation and other hybrid entities similar to it (such as the benefit corporation, benefit limited liability company, and social purpose corporation) were primarily concerned with supplying an alternative to a for-profit corporation, and not a charitable organization.<sup>14</sup> The benefit corporation was the primary precursor to the Delaware public benefit corporation.<sup>15</sup> Model benefit corporation legislation was first enacted in Maryland in 2010 and drafted by William Clark, Jr., a Philadelphia lawyer<sup>16</sup> working with B Lab, a nonprofit organization that certifies B Corporations, lobbies for benefit corporation legislation, and assists businesses with assessing their social impact.<sup>17</sup> According to Clark and his colleague Babson, the benefit corporation has three key requirements.<sup>18</sup> First, the benefit corporation “has a corporate purpose to create a material positive impact on society and the environment.”<sup>19</sup> This is the “general public benefit” that benefit

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<sup>14</sup> See *infra* note 34 and accompanying text.

<sup>15</sup> The benefit corporation and *public* benefit corporation are not to be confused. State law governs the internal affairs of a corporation and states have enacted different statutes with different legal requirements to facilitate mission-driven corporations. More than half of U.S. states have adopted the benefit corporation. *State by State Status of Legislation*, B LAB, <http://benefitcorp.net/policymakers/state-by-state-status> (last visited May 15, 2017). California, Washington, and Florida have adopted the social purpose corporation. CAL. CORP. CODE § 2517 (West 2016); WASH. REV. CODE § 23B.25.005 (2016); FLA. STAT. ANN. § 607.504 (West 2014). Three states have adopted the public benefit corporation, including Delaware, Colorado, and Minnesota. DEL. CODE ANN. tit. 8, § 362 (2017); COLO. REV. STAT. § 7-101-503 (2016); MINN. STAT. § 304A.102 (2015).

<sup>16</sup> William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 817 (2012) (citing Clark as the drafter of all enacted benefit corporation legislation as of 2011).

<sup>17</sup> *About B Lab*, B LAB, <https://www.bcorporation.net/what-are-b-corps/about-b-lab> (last visited May 15, 2017).

<sup>18</sup> See Clark & Babson, *supra* note 16, at 818–19.

<sup>19</sup> *Id.* at 818; MODEL BENEFIT CORP. LEGISLATION § 102 (2016), [http://benefitcorp.net/sites/default/files/Model%20Benefit%20Corp%20Legislation\\_9\\_16.pdf](http://benefitcorp.net/sites/default/files/Model%20Benefit%20Corp%20Legislation_9_16.pdf).

As comments to the Model Legislation explain, “the concept of general public benefit requires consideration of *all of the effects* of the business on society and the environment.” This legal requirement has been criticized as vague and impractical, and an exacerbation of the “dual mission-management” problem because it requires directors to promote a ‘material positive impact’ across

corporations aim to provide. Second, directors of a benefit corporation are required to consider the interests of non-shareholder stakeholders in addition to shareholders when making decisions.<sup>20</sup> This requirement expands directors' fiduciary duties and embraces so-called "stakeholder governance."<sup>21</sup> "Stakeholder governance management is a management model through which corporate directors assess the financial and non-financial returns to stakeholders (and not only shareholders) of the corporation."<sup>22</sup> Third, to assess the benefit corporation's performance in satisfying its general public benefit—and derivatively, the board's performance in considering all stakeholders—the benefit corporation must annually report "its overall social and environmental performance using a comprehensive, credible, independent, and transparent third-party standard."<sup>23</sup> This assessment is presented in a benefit report that the benefit corporation must provide to its shareholders and the public.<sup>24</sup>

The public benefit corporation adopts some of the Model Benefit Corporation Legislation's rules, but also contains significant deviations.<sup>25</sup> Similar to the Model's requirement that benefit corporations create a

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multiple factors "taken as a whole."

Plerhoples, *Social Enterprise as Commitment*, *supra* note 10, at 110 (quoting MODEL BENEFIT CORP. LEGISLATION § 102 cmt. (emphasis added)).

<sup>20</sup> Clark & Babson, *supra* note 16, at 818–19. Directors of a benefit corporation must consider the following corporate stakeholders:

- (i) the shareholders of the benefit corporation;
- (ii) the employees and work force of the benefit corporation, its subsidiaries, and its suppliers;
- (iii) the interests of customers as beneficiaries of the general public benefit or specific public benefit purposes of the benefit corporation;
- (iv) community and societal factors, including those of each community in which offices or facilities of the benefit corporation, its subsidiaries, or its suppliers are located;
- (v) the local and global environment;
- (vi) the short-term and long-term interests of the benefit corporation, including benefits that may accrue to the benefit corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the benefit corporation; and
- (vii) the ability of the benefit corporation to accomplish its general public benefit purpose and any specific public benefit purpose . . . .

MODEL BENEFIT CORP. LEGISLATION § 301(a).

<sup>21</sup> For discussion of stakeholder governance, see RAJENDRA S. SISODIA ET AL., *FIRMS OF ENDEARMENT: HOW WORLD-CLASS COMPANIES PROFIT FROM PASSION AND PURPOSE 2* (2007) (coining the term "stakeholder relationship management").

<sup>22</sup> Plerhoples, *90 Days Out*, *supra* note 12, at 252 n.17.

<sup>23</sup> Clark & Babson, *supra* note 16, at 819.

<sup>24</sup> MODEL BENEFIT CORP. LEGISLATION § 401.

<sup>25</sup> For a complete analysis and comparison of the difference between the benefit corporation and public benefit corporation, see Plerhoples, *90 Days Out*, *supra* note 12, at 254–55.

“material positive impact on society and the environment,”<sup>26</sup> the public benefit corporation must “operate in a responsible and sustainable manner.”<sup>27</sup> The fiduciary duty of public benefit corporation directors is similar to that of benefit corporation directors. Both corporate forms adopt stakeholder governance. Directors of public benefit corporations must manage the corporation “in a manner that *balances* [(i)] stockholders’ pecuniary interests, [(ii)] the best interests of those materially affected by the corporation’s conduct, and [(iii)] the public benefit or public benefits identified in its certificate of incorporation.”<sup>28</sup> Unlike the benefit corporation, however, the public benefit corporation must specify a specific public benefit in its charter.<sup>29</sup> Finally, Delaware requires a public benefit corporation to assess or report its social and environmental performance to its shareholders biennially in a benefit report.<sup>30</sup> However, a third-party standard does not have to be used in that assessment; the corporation can apply its own standards of reporting.<sup>31</sup> Furthermore, the report need not be made public.<sup>32</sup>

### B. *Shareholder Wealth Maximization*

Advocates of the benefit corporation and the public benefit corporation make it clear that the new hybrid corporate forms were created with the intention of rectifying the perceived problem of the shareholder wealth maximization norm in corporate law. This is in stark contrast to the creation of another hybrid entity, the low-profit limited liability company (L3C), which is a limited liability company “with a primary motivation to achieve a charitable goal.”<sup>33</sup> Little has been said about the benefit corporation’s potential as an alternative to a charitable organization. Unlike the L3C, advocacy for the benefit corporation is always couched in terms of its ability to improve for-profit business, with little or no mention of its effect on charitable organizations.<sup>34</sup>

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<sup>26</sup> MODEL BENEFIT CORP. LEGISLATION § 102.

<sup>27</sup> DEL. CODE ANN. tit. 8, § 362(a) (2017).

<sup>28</sup> *Id.* (emphasis added).

<sup>29</sup> *Id.* Benefit corporations do not have to specify a specific public benefit. MODEL BENEFIT CORP. LEGISLATION § 201(b).

<sup>30</sup> DEL. CODE ANN. tit. 8, § 366(b).

<sup>31</sup> Adoption of a third-party standard is optional. *Id.* § 366(c) (3).

<sup>32</sup> *Id.*

<sup>33</sup> Elizabeth Schmidt, *Vermont’s Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. LAW REV. 163, 163 (2010). The L3C was created to facilitate program-related investments from private foundations. *Id.*

<sup>34</sup> A review of state legislative hearings on the benefit corporation reveals testimony discussing the benefit corporation as an alternative to a for-profit business. *E.g.*, NYS BILL AND VETO JACKETS, N.Y. STATE ARCHIVES ch. 599 at 8 (2011), [http://digitalcollections.archives.nysed.gov/index.php/Detail/Object/Show/object\\_id/21316](http://digitalcollections.archives.nysed.gov/index.php/Detail/Object/Show/object_id/21316) (“Benefit corporations have the potential to be the corporate entity that can offer entrepreneurs and investors the option to build and invest in businesses

Clark and Babson vigorously assert the need for the benefit corporation on the ground that modern corporate law requires corporate directors to maximize shareholders' financial interests.<sup>35</sup> Clark and Babson present cases such as *Dodge v. Ford Motor Co.* and *eBay Domestic Holdings, Inc. v. Newmark* to assert that shareholder wealth maximization is positive law, despite corporate scholars who have argued otherwise.<sup>36</sup> In

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that meet higher standards of corporate purpose, accountability and transparency.”); YVETTE M. ALEXANDER, COUNCIL OF THE D.C., COMM. ON PUB. SERVS. & CONSUMER AFFAIRS, REPORT ON BILL 19-0584: THE “BENEFITS CORPORATION ACT OF 2012” 1 (2012), <http://dcclims1.dccouncil.us/images/00001/20130220145728.pdf> (“The benefit corporation entity structure addresses the unique needs of for-profit business [sic] that want to use their business to solve social problems while maintaining a for-profit status.”); CONF. COMM. 26-20, REG. SESS., at 1 (Haw. 2011), [http://www.capitol.hawaii.gov/session2011/CommReports/SB298\\_CD1\\_CCR20\\_PDF](http://www.capitol.hawaii.gov/session2011/CommReports/SB298_CD1_CCR20_PDF) (“Under general principles of corporate organization, the directors of a corporation have a singular and enforceable duty to maximize shareholder profits. Your Committee on Conference finds that this duty may prevent entrepreneurs and investors from achieving their own goals of establishing and investing in private enterprises that serve social or environmental purposes in addition to pursuing profits. . . . Authorizing the formation of sustainable benefit corporations in this State will help to diversify Hawaii’s economy by attracting entrepreneurship and investment in innovative businesses and emerging industries.”); S. COMMERCE & HUMAN RES. COMM., IDAHO LEGISLATURE, MINUTES (2015) (testimony about Senate Bill 1076), [https://legislature.idaho.gov/wp-content/uploads/sessioninfo/2015/standingcommittees/150305\\_schr\\_0130PM-Minutes.pdf](https://legislature.idaho.gov/wp-content/uploads/sessioninfo/2015/standingcommittees/150305_schr_0130PM-Minutes.pdf) (“Benefit corporations deregulate the purpose of a corporation by allowing the free market and not government to decide on how the business operates.”); S. TRANSCRIPT, 97th Gen. Assemb., at 116 (Ill. 2012) (third reading of Senate Bill 2897, statement of Senator Frerichs), <http://ilga.gov/senate/transcripts/strans97/09700098.pdf> (“The proposed bill expands corporate purpose for [profit-seeking corporations] to allow owners to consider society and environment, in addition to profit.”); H. TRANSCRIPTION DEB., 97th Gen. Assemb., at 14–15 (Ill. 2012) (third reading of Senate Bill 2897, statement of Representative Feigenholz), <http://ilga.gov/house/transcripts/htrans97/09700134.pdf> (“Senate Bill 2897 establishes benefit corporations in Illinois and addresses concerns by entrepreneurs who wish to raise growth capital but fear of losing control.”). However, in one instance, testimony regarding the benefit corporation does reveal it as an alternative vehicle for charitable and social activities in “taking the burden off of the government and freeing up public resources.” COMMERCE COMM., JOINT FAVORABLE REPORT FOR SB-23, at 1 (Conn. 2014), <https://www.cga.ct.gov/2014/JFR/S/2014SB-00023-R00CE-JFR.htm> (providing a rationale and summaries of responses and support for the bill) (“The bill allows market-driven solutions to address troubling social issues, in turn taking the burden off of the government and freeing up public resources.”).

<sup>35</sup> Clark & Babson, *supra* note 16, at 825–28.

<sup>36</sup> *Id.* at 825–27 (citing *Dodge v. Ford Motor Co.*, 170 N.W. 668 (Mich. 1919) and *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1 (Del. Ch. 2010)). Clark and Babson also cite to the scholarship of two prominent corporate law scholars, Stephen Bainbridge and Jonathan Macey, both of whom have asserted that shareholder wealth maximization is positive law. *See id.* at 826 (citing STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 410–13 (2002) and Jonathan R. Macey, *A Close Read of an Excellent Commentary on Dodge v. Ford*, 3 VA. L. & BUS. REV. 177, 190

*Dodge v. Ford*, the Michigan Supreme Court stated that “[a] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end.”<sup>37</sup> *Dodge v. Ford* is frequently called “bad law” because (i) the holding did not turn on the shareholder wealth maximization norm, making the oft-quoted statement above judicial dicta, and (ii) no Delaware court has ever cited the holding of *Dodge v. Ford*—a Michigan case—as authority on corporate purpose.<sup>38</sup> Despite the lack of authority of *Dodge v. Ford*, Clark and Babson cite to a more recent and relevant Delaware case as evidence that the shareholder wealth maximization norm is positive law: *eBay Domestic Holdings, Inc. v. Newmark*.<sup>39</sup> In *eBay Domestic Holdings, Inc. v. Newmark*, minority stockholder eBay sued two directors of craigslist, the online classifieds company, for breach of fiduciary duty in adopting a rights plan, or “poison pill” that would dilute eBay’s shares.<sup>40</sup> The directors (who were also the founders of craigslist) defended its adoption of the poison pill as a means to preserving its “corporate culture”—they did not wish to monetize craigslist as eBay had monetized its own online selling site.<sup>41</sup> The Delaware Chancery Court ordered rescission of the poison pill and affirmed the shareholder wealth maximization norm as positive law:

As an abstract matter, there is nothing inappropriate about an organization seeking to aid local, national, and global communities by providing a website for online classifieds that is largely devoid of monetized elements. . . . The corporate form in which craigslist operates, however, is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment. Jim and Craig opted to form craigslist, Inc. as a for-profit Delaware corporation and voluntarily accepted millions of dollars from eBay as part of a transaction whereby eBay became a stockholder. Having chosen a

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(2008)). Nonetheless, other prominent corporate law scholars reject the proposition that shareholder wealth maximization is positive law. See, e.g., LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* 25 (2012) (arguing that corporate law has never dictated that corporate managers must pursue shareholder value to the exclusion of other interests).

<sup>37</sup> *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919).

<sup>38</sup> See, e.g., Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, 3 VA. L. & BUS. REV. 163, 166 (2008); see also David G. Yosifon, *The Law of Corporate Purpose*, 10 BERKELEY BUS. L.J. 181, 188 (2013) (“*Dodge* has been cited only 68 times by subsequent state and federal courts. It has been cited just three times, and never for the crucial issue of corporate purpose, in Delaware cases. It is a decision about Michigan corporate law, and Michigan corporate law is not even very important in Michigan. Ford Motor Company itself is today a Delaware corporation.”).

<sup>39</sup> 16 A.3d 1 (Del. Ch. 2010).

<sup>40</sup> *Id.* at 6–7, 33.

<sup>41</sup> *Id.* 6–8.

for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form. Those standards include acting to promote the value of the corporation for the benefit of its stockholders.<sup>42</sup>

The court held that a poison pill cannot be used to defend “corporate culture” because corporate culture is not a legitimate corporate purpose when not tied to shareholder value creation.<sup>43</sup> The court rejected the craigslist directors’ assertion of a “corporate culture” that openly rejects profitability: “Directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors’ fiduciary duties under Delaware law.”<sup>44</sup>

This case—though an anomaly—makes clear that at least some Delaware courts espouse the shareholder wealth maximization norm as the central purpose of a corporation. Given this legal uncertainty, corporate managers generally couch their decisions benefitting non-shareholder stakeholders in terms of shareholder value. The benefit corporation thus creates a corporate form that corporate managers and shareholders can opt into to openly pursue stakeholder value.<sup>45</sup>

B Lab, the primary promoter of benefit corporation legislation takes up Clark and Babson’s position,<sup>46</sup> as did Delaware Governor Jack Markell when he signed the statutory amendment to the Delaware General Corporation Law to create the public benefit corporation.<sup>47</sup> Markell called the public benefit corporation a means to “harness the power of private enterprise to create public benefit,” noting that it will “combat the plague of short termism that we have seen over the last five years [that] can undermine a shared and durable prosperity.”<sup>48</sup>

Similarly, Leo Strine, Jr., Chief Justice of the Delaware Supreme Court and former Chancellor of the Delaware Chancery Court,<sup>49</sup> wrote an

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<sup>42</sup> *Id.* at 34.

<sup>43</sup> *Id.* at 33 (“Promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders.”).

<sup>44</sup> *Id.* at 35.

<sup>45</sup> Clark & Babson, *supra* note 16, at 832.

<sup>46</sup> *Benefit Corporations Are Necessary*, B LAB, <http://benefitcorp.net/attorneys/benefit-corporations-are-necessary> (last visited May 15, 2017) (arguing that corporate law requires directors to adhere to shareholder primacy and that the business judgment rule, which gives directors wide discretion in corporate decisionmaking, does not grant such deference to not pursue shareholder value).

<sup>47</sup> Jack Markell, *A New Kind of Corporation to Harness the Power of Private Enterprise for Public Benefit*, HUFFINGTON POST (July 22, 2013), [http://www.huffingtonpost.com/gov-jack-markell/publicbenefit-corporation\\_b\\_3635752.html](http://www.huffingtonpost.com/gov-jack-markell/publicbenefit-corporation_b_3635752.html).

<sup>48</sup> *Id.*

<sup>49</sup> The Delaware Chancery Court is the most influential and reputable court—state or federal—when it comes to adjudicating corporate law matters. *See* LEWIS S.

essay in the Harvard Business Law Review asserting that even if shareholder wealth maximization is not positive law (although Strine himself believes it is), both the market for corporate control and the accountability structure of corporations incentivize corporate managers to adhere to shareholder primacy.<sup>50</sup> Strine argues that takeovers are a part of the normal “corporate life cycle” and “in the important context of change of control transactions, the only constituency whose best interests must be considered is stockholders.”<sup>51</sup> Additionally, the “accountability structure” of corporations gives rights only to stockholders, and not other stakeholders.<sup>52</sup> With this context set out, Strine then launches into praise for the Delaware public benefit corporation statute:

In the liberal tradition of incremental, achievable reform rather than radical renovation, the benefit corporation is a modest evolution that builds on the American tradition of corporate law. But that evolution is potentially important because, if it gains broader market acceptance, the benefit corporation model puts some actual power behind the idea that corporations should be governed not simply for the best interests of stockholders, but also for the best interests of the corporation’s employees, consumers, and communities, and society generally.<sup>53</sup>

Strine and others view the public benefit corporation as holding potential—even if merely incremental—to provide founders and corporate managers with a means of rejecting the shareholder wealth maximization norm and reforming bad corporate behavior.<sup>54</sup>

### *C. Ignoring Nonprofit Impact*

Couching the benefit corporation in terms of corporate law reform ignores its potential use as an alternative to a charitable organization. At the end of 2015, there were approximately 2,600 benefit corporations formed in the United States, with more than 400 public benefit corporations incorporated in Delaware alone.<sup>55</sup> In *90 Days Out*, my

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BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE 5–7 (2007) (describing the history, influence, and reputation of the Delaware Chancery Court).

<sup>50</sup> Leo E. Strine, Jr., *Making It Easier for Directors to “Do the Right Thing”?*, 4 HARV. BUS. L. REV. 235, 237–40 (2014). “In the end, American corporate law makes corporate managers accountable to only one constituency—stockholders—and that accountability has been tightened because of market developments concentrating voting power in institutional investors and information technology innovations easing communication and joint action among stockholders.” *Id.* at 241–42.

<sup>51</sup> *Id.* at 238.

<sup>52</sup> *Id.* at 238–40.

<sup>53</sup> *Id.* at 242.

<sup>54</sup> See *id.* at 235 n.1, 242.

<sup>55</sup> J. Haskell Murray, *The Social Enterprise Law Market*, 75 MD. L. REV. 541, 588 (2016) (Appendix A lists the number of benefit corporations and L3Cs active in each state); E-mail from April M. Wright, Corps. Adm’r, Del. Sec’y of State, Div. of Corps.,



research found that 19 of the 55 public benefit corporations (or 34.5%) formed in Delaware within the first three months could have alternatively incorporated as a nonprofit corporation and sought federal 501(c)(3) tax exemption.<sup>56</sup> Although my findings were limited by the small population size, it is clear that some portion of public benefit corporations provide charitable services. For example, Arist Medical Education Corporation operates a medical and nursing school.<sup>57</sup> According to the certificate of incorporation of Good Life Alliance Public Benefit Corporation, it provides educational and cultural activities to youth in underserved communities.<sup>58</sup> OjoOido.com Public Benefit Corporation is dedicated to improving the academic lives of Latino youth through a blended learning curriculum.<sup>59</sup> HandUp is a direct giving platform through which donors can give money directly to those in need in their neighborhoods.<sup>60</sup> Regardless of the original intentions of its

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to author (Dec. 9, 2015) (on file with author) (providing a list of public benefit corporations incorporated in Delaware as of October 31, 2015).

<sup>56</sup> Plerhoples, *90 Days Out*, *supra* note 12, at 268 (“Admittedly, whether a public benefit corporation could have alternatively incorporated as a nonprofit corporation and received recognition of tax exempt status from the Internal Revenue Service (‘IRS’) is subjective and speculative, because the alternative cannot be tested and the lack of publicly available information on many of the public benefit corporations makes it difficult to conduct a comprehensive legal analysis of whether the entity could be a 501(c)(3) tax exempt organization. When an organization applies for tax exemption, the IRS does not simply look at the stated mission of the organization but instead applies a two-part organizational and operational test. The two-part test cannot be applied without more detailed information about each public benefit corporation. Therefore, this analysis is not comprehensive; it is based solely on the stated missions of the public benefit corporation (where such information was available) and whether that mission would qualify as one of the exempt purposes listed in Section 501(c)(3). I included only entities with missions that would clearly fall within the scope of exempt purposes of Section 501(c)(3).”). Notably, since my original study, it has gotten easier to apply and qualify for tax exemption. The IRS adopted Form 1023-EZ on July 1, 2014. Form 1023 is a three-page form for organizations with gross receipts less than \$50,000 or \$250,000 in assets. I.R.S. News Release IR-2014-77 (July 1, 2014). The new form has been criticized as paving the way for fraud because the information gathered on the form does not make it possible for an IRS examiner to thoroughly vet an organization or even apply the organizational and operational test. Patricia Cohen, *I.R.S. Shortcut to Tax-Exempt Status Is Under Fire*, N.Y. TIMES (Apr. 8, 2015), <https://nyti.ms/1NbqpGh>; Michael Wyland, *Widespread Form 1023-EZ Abuse Reported by IRS*, NONPROFIT Q. (Jan. 8, 2016), <https://nonprofitquarterly.org/2016/01/08/widespread-form-1023-ez-abuse-reported-by-irs/>.

<sup>57</sup> See ARIST MEDICAL EDUC. CORP., <http://www.arist.com/> (last visited May 15, 2017); Doug Lederman, *Blurring the Nonprofit/For-Profit Divide*, INSIDE HIGHER ED (Feb. 23, 2015), <https://www.insidehighered.com/news/2015/02/23/nonprofit-university-becomes-benefit-corporation-further-blurring-profit-divide>.

<sup>58</sup> Certificate of Incorporation of Good Life Alliance PBC, filed with State of Del., Sec’y of State (Oct. 31, 2013) (on file with author).

<sup>59</sup> See OjoOIDO, <http://www.ojooido.com/> (last visited May 15, 2017).

<sup>60</sup> See HANDUP, <https://handup.us/> (last visited May 15, 2017).

sponsors, the public benefit corporation statute has altered the landscape of entity selection, offering not just an alternative to for-profit corporations but also an alternative to charitable organizations.

## II. ORGANIZATIONAL CHOICE: A SPECTRUM, NOT A DICHOTOMY

### A. *Historically Blurred Lines*

Organizational entities can be placed on a spectrum ranging from profit motive to charitable impact. One might think of the for-profit sector and the charitable sector as distinct spheres, existing on opposite sides of an organizational choice spectrum. On one side of the spectrum lies the for-profit corporation, which earns a profit and whose directors owe a duty of care and loyalty to the corporation, and ultimately its stockholders.<sup>61</sup> On the other side of the spectrum lies the donative public charity, which is typically organized as a nonprofit corporation under state law; sustains itself financially through donations; and pursues charitable, religious, educational, scientific or other exempt purposes with federal tax-exempt recognition.<sup>62</sup> “While this protected tax status is perhaps the most obvious feature of most nonprofit entities, it is not their defining characteristic. The hallmark of the [nonprofit] form is the nondistribution constraint: Simply put, what makes a nonprofit a nonprofit is the inability to distribute profits.”<sup>63</sup> Under long-standing charitable laws, nonprofit corporations are prohibited from distributing profits.<sup>64</sup> They have no shareholders. In return, nonprofit corporations do not pay federal income tax and if the tax-exempt organization is further classified as a charitable organization, i.e., a private foundation or public charity under Internal Revenue Code section 501(c)(3), it can receive donations that are tax-deductible to the donor.<sup>65</sup>

And yet, for-profit corporations and charitable organizations have never represented an absolute dichotomy. Each has always participated in the other’s activities. At least since the New Jersey Supreme Court’s 1953 decision in *A.P. Smith Manufacturing, Co. v. Barlow*, allowing a corporation’s donation to Princeton University, for-profit corporations have legally engaged in corporate philanthropy.<sup>66</sup> Additionally, the tax

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<sup>61</sup> See *supra* Part I.

<sup>62</sup> See SCHMIDT, *supra* note 4, at 7.

<sup>63</sup> Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1263 (2011).

<sup>64</sup> SCHMIDT, *supra* note 4, at 7.

<sup>65</sup> *Id.*

<sup>66</sup> *A.P. Smith Mfg., Co. v. Barlow*, 98 A.2d 581, 590 (N.J. 1953) (validating a for-profit company’s donation to a nonprofit made voluntarily under the belief that it would advance the public good and further the donor company’s standing within its community); see also *Kahn v. Sullivan*, 594 A.2d 48, 51 (Del. 1991); *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405 (Del. Ch. 1969); *Kelly v. Bell*, 254 A.2d 62, 75 (Del. Ch. 1969).

code facilitates corporate charitable contributions by granting corporations a business deduction of up to ten percent of the business's taxable income.<sup>67</sup> Many current state corporate statutes prescriptively allow corporations to make charitable contributions.<sup>68</sup> Corporations justify their philanthropy on the basis that it benefits the corporation, for example, by enhancing the corporation's public image or standing in the community, thereby increasing shareholder value.<sup>69</sup>

Just as corporations have historically engaged in philanthropy, charitable organizations have similarly engaged in commerce. Prior to 1950, "there was no statutory limitation on the amount of business activity an exempt organization could conduct, as long as the earnings from the business were used for exempt purposes."<sup>70</sup> Charitable organizations engaged in commercial activities on the basis of the "destination of income" test upheld by the U.S. Supreme Court in 1924 in *Trinidad v. Sagrada Orden de Predicadores*.<sup>71</sup> In *Trinidad*, the Court held that the destination and not the source of the income was the test for exemption from income tax.<sup>72</sup> A charitable organization could engage in for-profit commercial activities and have no obligation to pay federal taxes on the income from those activities if the income was used to further the charitable organization's exempt purpose.<sup>73</sup> For example, a charitable organization could house and operate a bakery in direct competition with a for-profit bakery; as long as the charitable organizations used the bakery's income to help the homeless or some other charitable class, the income would be exempt from federal income

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<sup>67</sup> I.R.C. § 170(b)(2)(A) (2012).

<sup>68</sup> Delaware, California, and New York each authorize corporations to make donations. New York and California expressly authorize corporate charitable contributions regardless of the "corporate benefit." CAL. CORP. CODE § 207(e) (West 2016); N.Y. BUS. CORP. LAW § 202(a)(12) (McKinney 2017). Delaware authorizes donations, but the statute is silent as to whether the contribution must be made for the benefit of the corporation. DEL. CODE ANN. tit. 8, § 122(9) (2017); *see also*, D.C. CODE ANN. § 29-303.02(13) (West 2017).

<sup>69</sup> *See* Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2446 (2009).

<sup>70</sup> BRUCE R. HOPKINS, *THE TAX LAW OF UNRELATED BUSINESS FOR NONPROFIT ORGANIZATIONS* 15 (2005).

<sup>71</sup> 263 U.S. 578 (1924) (establishing the "destination of income test" and holding that the income and interest derived from real estate and investments owned by an organization organized and operated exclusively for religious, charitable and educational purposes was not taxable because the income was used exclusively for religious, charitable, and educational purposes). For a brief legal history regarding statutory laws and jurisprudence on the commercial activities of tax-exempt organizations, *see* John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 495–514 (2002).

<sup>72</sup> *Trinidad*, 263 U.S. at 581.

<sup>73</sup> *Id.* at 580–82.

tax. Subsequently, the Court expanded the destination of income test to allow organizations to avoid federal taxation even if they did not conduct any charitable activities directly.<sup>74</sup> These were so-called “feeder” organizations, sanctioned by the Second Circuit in *Roche’s Beach, Inc. v. Commissioner of Internal Revenue*.<sup>75</sup> In *Roche’s Beach*, Edward Roche started a business—formed as a corporation—prior to his death. Upon his death, all of the profits and income of the business were bequeathed to create, capitalize, and operate a charitable foundation with the exempt purpose of “relief of destitute women and children.”<sup>76</sup> The business filed and paid taxes after Roche’s death, and subsequently requested a tax refund from the Internal Revenue Service (IRS), claiming that it was exempt from federal taxes because all of its income was donated (and would continue to be donated) to the charitable foundation per Roche’s will.<sup>77</sup> The IRS denied the refund claim and the Board of Tax Appeals upheld the denial.<sup>78</sup> The Second Circuit applied the destination of income test to reverse the Board of Tax Appeals:

To gain exemption under [the Revenue Act of 1928], the petitioner must be a corporation “organized and operated exclusively for charitable purposes no part of the net earnings of which inures to the benefit of any private shareholder or individual.” This does not mean that to come within the exemption a corporation may not conduct business activities for profit. The destination of the income is more significant than its source.<sup>79</sup>

*Roche* allowed a “feeder” corporation to engage solely in commercial activities and be exempt from income tax so long as it distributed its profits to a charitable organization. The approval of feeder corporations saw its peak in 1950 when a particularly egregious case came before the Third Circuit.<sup>80</sup> In 1947, NYU School of Law acquired C.F. Mueller Company, the prominent pasta maker.<sup>81</sup> Upon completion of the acquisition, C.F. Mueller Company’s new charter stated that its purpose was charitable and provided for all of its profits and assets to be distributed to NYU School of Law.<sup>82</sup> Notably, C.F. Mueller Company grounded “its claim to exemption on its own charter and purposes rather than those of New York University.”<sup>83</sup> The Third Circuit reversed the Tax Court’s decision and relied on numerous cases, starting with the *Roche’s*

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<sup>74</sup> See *Roche’s Beach, Inc. v. Comm’r*, 96 F.2d 776, 778–79 (2d Cir. 1938).

<sup>75</sup> *Id.* at 779.

<sup>76</sup> *Id.* at 776–77.

<sup>77</sup> *Id.* at 777.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 778.

<sup>80</sup> *C.F. Mueller Co. v. Comm’r*, 190 F.2d 120 (3d Cir. 1951).

<sup>81</sup> *Id.* at 120–21.

<sup>82</sup> *Id.* at 121.

<sup>83</sup> *Id.*

*Beach* decision, which hold that “the exclusive purpose required by the [tax] statute is met when the only object of the organization involved originally was and continues to be religious, scientific, charitable or educational, *without regard to the method of procuring the funds necessary to effectuate the objective.*”<sup>84</sup> Thus, a pasta company was allowed to continue as a charitable organization because its profits were distributed to a charitable organization.

Congress put an end to what it viewed as charitable organizations unfairly competing with for-profit business when it passed the Revenue Act of 1950, which expressly prohibited “feeder” organizations from tax exemption<sup>85</sup> and introduced the unrelated business income tax.<sup>86</sup> The unrelated business income tax, or UBIT, is assessed on the commercial activities of a tax-exempt organization where those activities constitute (i) a trade or business that is (ii) regularly carried on, (iii) that is unrelated to the organization’s exempt purpose, and (iv) does not satisfy an exception.<sup>87</sup> UBIT essentially levels the playing field, taxing charitable organizations conducting commercial activities at the same corporate tax rate as for-profit corporations.

Despite UBIT, the tax code currently allows public charities<sup>88</sup> (but not private foundations) to continue to compete with for-profit firms by engaging in commercial activities, both related and unrelated to their exempt purposes.<sup>89</sup> First, the tax code allows public charities to engage in a “substantial” amount of commercial activities if those activities are related to the organization’s exempt purpose.<sup>90</sup> Hospitals, universities, and museums prove useful examples. Museums and other service-provider public charities typically rely on a specific tax exemption that allows them to derive their revenue primarily from membership fees and gross receipts from commercial activities related to their exempt

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<sup>84</sup> *Id.* (emphasis added).

<sup>85</sup> Revenue Act of 1950, Pub. L. No. 81-814, § 301, 64 Stat. 906, 908, 947–48 (codified as amended at I.R.C. § 502 (2012)); see S. REP. NO. 81-2375, at 26 (1950).

<sup>86</sup> Revenue Act § 301, 64 Stat. at 948–49; see S. REP. NO. 81-2375, at 27. Legislative history shows that unfair competition was the primary reason for enacting the unrelated business income tax. H.R. REP. NO. 81-2319, at 36 (1950); S. REP. NO. 81-2375, at 28–31.

<sup>87</sup> I.R.C. § 513(a); see Treas. Reg. § 1.513-1 (1983).

<sup>88</sup> The tax code applies different UBIT rules to public charities and private foundations. Private foundations are effectively prohibited from conducting commercial activities through an excise tax on their excess business holdings. I.R.C. § 4943(a)(1).

<sup>89</sup> For a legal history reflecting the uncertainty of how the commerciality doctrine and the UBIT would be applied after its enactment, see Colombo, *supra* note 71, at 500–01.

<sup>90</sup> See I.R.C. § 513(a).

purpose.<sup>91</sup>

Second, the tax code allows public charities to conduct commercial activities that are unrelated to their exempt purposes, so long as such activity is insubstantial and does not lend a “commercial hue” to the organization.<sup>92</sup> As will be discussed in Part III, neither the tax code nor the IRS has defined “insubstantial.”

In sum, the line between for-profit corporations and charitable organizations has always been blurred, and is likely to become even more so as (i) for-profit firms increasingly engage in charitable activities and advertise their social impact to appeal to increasingly socially-conscious consumers, (ii) nonprofits continue to engage in commercial activities to fund their charitable programs, and (iii) (as is discussed below) new for-profit forms, such as the public benefit corporation, are purposefully created to blend profit and charitable motives.

### *B. Statutory Convergence of Purposes*

For an entrepreneur pursuing both profit and charitable motives, new hybrid forms, including the public benefit corporation, expanded the organizational choice spectrum. The purposes of a public benefit corporation and a charitable organization have converged, although the two are not absolute substitutes. A Delaware public benefit corporation must produce a “public benefit.”<sup>93</sup> The Delaware General Corporation Law defines a “public benefit” as “a positive effect (or reduction of negative effects) on 1 or more categories of persons, entities, communities or interests (other than stockholders in their capacities as stockholders). . . .”<sup>94</sup> Under Delaware law, the certificate of incorporation must state a specific public benefit that the corporation intends to pursue.<sup>95</sup> A specific public benefit can be “effects of an artistic, charitable, cultural, economic, educational, environmental, literary, medical, religious, scientific or technological nature.”<sup>96</sup> This specific public benefit reflects purposes similar to the exempt purposes of a charitable organization. The exempt purposes of a charitable organization include “religious, charitable, scientific, testing for public safety, literary, or educational purposes,” among other purposes.<sup>97</sup> The convergence between a public benefit corporation’s “specific public benefit” and a charitable organization’s “exempt purposes” is not coincidental.

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<sup>91</sup> See I.R.C. § 509(a)(2); Treas. Reg. § 1.509(a)-2 (as amended in 1973).

<sup>92</sup> This is the commerciality doctrine. See *infra* notes 151–156 and accompanying text.

<sup>93</sup> See DEL. CODE ANN. tit. 8, § 363(a) (2017).

<sup>94</sup> *Id.* § 362(b).

<sup>95</sup> *Id.* § 362(a)(1).

<sup>96</sup> *Id.* § 362(b).

<sup>97</sup> I.R.C. § 501(c)(3) (2012); Treas. Reg. § 1.501(c)(3)-1T (as amended 2016).

Proponents of hybrid corporate forms such as the public benefit corporation looked to the charitable sector for inspiration as they created for-profit forms that could pursue social missions, even as they ignored the impact on the charitable sector.<sup>98</sup>

And yet, the statutory definitions of “specific public benefit” and “exempt purpose” do not overlap in their entirety. A Delaware public benefit corporation can pursue a specific public benefit that would not qualify as an exempt purpose. Likewise, benefit corporations that follow the Model legislation must create a general public benefit (i.e., “a material positive impact on society”)<sup>99</sup> but are not required to pursue a specific public benefit. Therefore, not all benefit corporations pursue charitable activities.

[A] benefit corporation is not required to engage in or promote charitable activities (although it may designate such a specific purpose if it so chooses). If the corporation consciously conducts its operations in a manner that is socially and environmentally responsible, it would qualify as a benefit corporation regardless of whether it also contributes to or promotes charitable causes.<sup>100</sup>

The lack of complete overlap between the statutory definitions of “specific public benefit” and “exempt purpose,” as well as the model legislation’s optional specific public benefit is consistent with my findings in *90 Days Out* that only a portion of Delaware public benefit corporations could have been organized as charitable organizations, and not all of them.

The overlap of statutory purposes facilitates public benefit corporations’ ability to operate in the charitable sector, even if it is not itself a charitable organization.

### *C. Interchangeable Entities in the Pursuit of Profit and Mission*

Where a founder wishes to pursue both profit and charitable objectives, the charitable organization and public benefit corporation are somewhat interchangeable. Most charitable organizations are organized at the state level as nonprofit corporations.<sup>101</sup> At a minimum, both are corporations with all the attributes that the corporate form provides, including limited liability, deduction for their business expenses (this is

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<sup>98</sup> For example, under the California Corporate Flexibility Act of 2011, a flexible purpose corporation must pursue a “special purpose,” whose definition includes “one or more charitable or public purpose activities that a nonprofit public benefit corporation is authorized to carry out.” CAL. CORP. CODE §§ 2513, 2602(b)(2)(A) (West 2016).

<sup>99</sup> MODEL BENEFIT CORP. LEGISLATION § 102 (2016).

<sup>100</sup> Clark & Babson, *supra* note 16, at 842.

<sup>101</sup> See NAT’L CTR. FOR CHARITABLE STATISTICS, NUMBER OF REG. NONPROFIT ORG. BY STATE, 2012, <http://nccsweb.urban.org/PubApps/reports.php?rid=2>.

true of public charities that pay unrelated business income tax), internal governance and management structure subject to state law, and fiduciary duties owed by directors and officers to the corporation. These corporate forms facilitate a founder's goals and are somewhat interchangeable if the founder has both profit and altruistic motives. To illustrate this argument, an example is useful.

### *1. Maria's Algorithm*

Maria has created an algorithm that accurately assesses a person's creditworthiness by data-mining their online persona, including email and social networking sites. Maria wants to break up the consumer lending industry and provide loans to people whose FICO credit scores are low, but who are rated as creditworthy using Maria's new algorithm. Credit ratings using Maria's new algorithm could make affordable consumer credit available to low-income persons and persons without credit histories, such as formerly incarcerated and homeless persons, and undocumented immigrants. Maria has both a profit and an altruistic motive for creating the algorithm. Maria's goals are to make money for herself and to provide affordable consumer credit to those who are left out of or exploited by traditional consumer credit markets. Maria wants the organization she forms to serve both purposes. Maria could form a public charity (organized as a nonprofit corporation at the state level), a public benefit corporation, or a corporation. Maria can accomplish her goals in any of these forms, with some trade-offs.

#### *a. Public Charity*

Maria could create a public charity that is organized as a nonprofit corporation at the state level. The public charity would be organized and operated exclusively for the exempt purpose of the "[r]elief of the poor and distressed or of the underprivileged."<sup>102</sup> As previously stated, the significant advantages of the public charity are (i) tax exemption from federal (and often state and local) income tax, and (ii) donor's tax deductibility of charitable contributions, which encourages donors to donate. The public charity that Maria forms could directly act as a consumer lender or license the algorithm to other lenders such as community banks. This entity choice clearly captures Maria's charitable motives, and it can also further Maria's profit motive. Because of the nondistribution constraint, the nonprofit cannot distribute any profits to Maria. However, there are other means of extracting money from a public charity: Money can be extracted in exchange for goods or services. Thus, Maria could be the public charity's executive director, thereby controlling the organization's operations and collecting a salary. She could also serve as the chair of the board and control the organization's direction and long-term strategy. Maria could retain personal ownership

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<sup>102</sup> Treas. Reg. § 1-501(c)(3)-1(d)(2).



of the algorithm and license the algorithm to the public charity and collect royalty payments. Maria would have to be careful to avoid private inurement,<sup>103</sup> conflicts of interests,<sup>104</sup> excess benefit transactions,<sup>105</sup> or breaches of duty of care and loyalty.<sup>106</sup> Nonetheless, Maria could create a charitable organization that provides her with a steady stream of income, and significant income if the organization does well.<sup>107</sup>

*b. Public Benefit Corporation*

Maria could create a public benefit corporation and articulate the same purpose as she would if she had chosen the public charity, i.e., “relief of the poor, the distressed, or the underprivileged.” However, the public benefit corporation is not particularly restrictive in defining what constitutes a “public benefit.”<sup>108</sup> In addition to charitable purposes, the public benefit corporation statute includes economic and technological purposes as appropriate public benefits,<sup>109</sup> two purposes that also articulate Maria’s goals. Therefore, Maria could articulate broader public benefit than the exempt purposes of a public charity.

To control the public benefit corporation, Maria could be the sole or

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<sup>103</sup> *Id.* § 501(c)(3)–1(c)(2) (“An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.”); see also Trevor A. Brown, Note, *Religious Nonprofits and the Commercial Manner Test*, 99 YALE L.J. 1631, 1633 (1990) (“The second requirement for tax exemption under section 501(c)(3), the ban against private inurement, prohibits enrichment of those persons closely associated with a nonprofit organization. Reasonable payment for goods or services is not private inurement and does not disqualify an organization from receiving section 501(c)(3) status on the grounds that it serves private interests. Salaries; other cash compensation such as dividends, royalties, or ‘debt repayment’; and in-kind compensation are evaluated by a reasonableness standard. Where the total of these benefits exceeds reasonable compensation for services rendered, private inurement or purpose to enrich private individuals is inferred.”).

<sup>104</sup> MODEL NONPROFIT CORP. ACT § 8.60 (AM. BAR ASS’N 2008) (stating the standards for conflicts of interests); see also James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 236–37 (2003) (describing how to evaluate conflicts of interest).

<sup>105</sup> I.R.C. § 4958(c); Treas. Reg. § 53.4958–1(c).

<sup>106</sup> MODEL NONPROFIT CORP. ACT § 8.30 (stating the fiduciary duties of care and loyalty for nonprofit board directors); see also Fishman, *supra* note 104, at 232–35 (describing the duties of care and loyalty for nonprofit board directors).

<sup>107</sup> Salaries of CEOs of large nonprofits (typically presidents of universities, museum curators, and hospital administrators) can top \$1 to \$1.8 million annually, although median salary hovers around \$200,000 to \$250,000. Note, however, that these figures are only salary and not total compensation, which includes benefits and retirement packages. CHARITY NAVIGATOR, 2013 CHARITY CEO COMPENSATION STUDY 6 (2013), [http://www.charitynavigator.org/\\_\\_asset\\_\\_/studies/2013\\_CEO\\_Compensation\\_Study\\_Final.pdf](http://www.charitynavigator.org/__asset__/studies/2013_CEO_Compensation_Study_Final.pdf).

<sup>108</sup> See *supra* notes 93–94.

<sup>109</sup> DEL. CODE ANN. tit. 8, § 362(b) (2017).

majority shareholder, or she could give herself one class of super-voting shares that has the right to multiple votes while granting other investors a separate class of shares with single votes. Maria could further control the public benefit corporation by being the only director (when the corporation is small) and naming herself president of the board of the directors (as the corporation grows). She could also earn a salary as chief executive.

To pursue a charitable mission in a for-profit form, Maria could attract impact investors who share her mission-driven vision. Impact investors seek to “actively plac[e] capital in enterprises that generate social or environmental goods, services, or ancillary benefits such as creating good jobs, with expected financial returns ranging from the highly concessionary to above market.”<sup>110</sup> The size of the impact investing market is difficult to measure. However, J.P. Morgan and the Global Impact Investing Network (GIIN) estimate that the impact investing market is \$60 billion.<sup>111</sup> At the other end of the spectrum, the World Economic Forum estimates \$25 billion as a “conservative” estimate of the market size.<sup>112</sup> In the middle, Impact Economy prepared a primer for the UK Cabinet Office in 2013 in which they placed the “still nascent” impact investing market at \$36 billion.<sup>113</sup> With impact investors rather than traditional investors as the public benefit corporation’s primary shareholders and with the fiduciary protection that the public benefit corporation provides, Maria can use the public benefit corporation to pursue charitable objectives in addition to shareholder value, possibly even at the expense of shareholder value should the public benefit corporation choose to prioritize its charitable objectives.

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<sup>110</sup> Paul Brest & Kelly Born, *When Can Impact Investing Create Real Impact?*, STAN. SOC. INNOVATION REV., Fall 2013, at 22, 24.

<sup>111</sup> J.P. MORGAN & GLOB. IMPACT INVESTING NETWORK, EYES ON THE HORIZON: THE IMPACT INVESTOR SURVEY 5 (2015), <https://www.jpmorganchase.com/corporate/Corporate-Responsibility/document/impact-investor-survey-2015.pdf>. J.P. Morgan and GIIN’s estimate is cited repeatedly by other organizations; see Anne Field, *Impact Investing Grows, But There’s Still a Dearth of Deals*, FORBES (May 5, 2015), <http://www.forbes.com/sites/annefield/2015/05/05/impact-investing-grows-but-theres-still-a-dearth-of-deals/>; Michael Etzel, *Philanthropy’s New Frontier—Impact Investing*, IMPACT INDIA, Fall 2015, at 42, 42; Brian Trelstad, *Making Sense of the Many Kinds of Impact Investing*, HARV. BUS. REV. (Jan. 28, 2016), <https://hbr.org/2016/01/making-sense-of-the-many-kinds-of-impact-investing>.

<sup>112</sup> WORLD ECON. FORUM, FROM THE MARGINS TO THE MAINSTREAM: ASSESSMENT OF THE IMPACT INVESTMENT SECTOR AND OPPORTUNITIES TO ENGAGE MAINSTREAM INVESTORS 10 (2013), [http://www3.weforum.org/docs/WEF\\_IL\\_FromMarginsMainstream\\_Report\\_2013.pdf](http://www3.weforum.org/docs/WEF_IL_FromMarginsMainstream_Report_2013.pdf).

<sup>113</sup> MAXIMILLIAN MARTIN, STATUS OF THE SOCIAL IMPACT INVESTING MARKET: A PRIMER 5 (2013), [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/212511/Status\\_of\\_the\\_Social\\_Impact\\_Investing\\_Market\\_-\\_A\\_Primer.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/212511/Status_of_the_Social_Impact_Investing_Market_-_A_Primer.pdf).

*c. Corporation*

Maria could create a for-profit corporation, but her ability to pursue a charitable mission is more limited than the public charity or public benefit corporation options. Through a corporation, Maria could undoubtedly realize her profit motives. The ownership structure of the corporation could be similar to that of the public benefit corporation. Maria could pursue her charitable motives in the corporate form as well, particularly while she remains the sole owner of the corporation, or if the corporation has stockholders who share her charitable vision. However, as the corporation takes on traditional investors who seek market rates of returns, the ability to pursue the mission at the expense of shareholder value becomes limited, as illustrated by the *eBay* case.<sup>114</sup> To increase corporate profit, Maria may feel pressured to charge high interest rates instead of making the consumer credit affordable, or apply the algorithm more widely to all borrowers rather than targeting atypical, disadvantaged borrowers who have little or no credit history.

*2. Limits to Interchangeability*

Instances where the organizational forms are not fungible are at the margins. For example, if Maria's motives are mostly profit-driven and only slightly charitable, the public charity is not compatible. As an extreme example, Maria will find it impossible to use the public charity to become as financially well-off as Mark Zuckerberg or Bill Gates. These men made their billions in the for-profit social media and tech industries and then turned to philanthropy.

Similarly, if Maria's motives are mostly mission-driven and only slightly profit-driven, the corporate form is not compatible. Once Maria seeks outside investment from shareholders who seek a market rate of return, Maria would have trouble dedicating the profits of her for-profit corporation entirely to serve charitable purposes. In sum, while the charitable organization and public benefit corporation are interchangeable for founders with dual-mission motives, there are trade-offs to be made along the organizational choice spectrum, and limits at the margins.

### III. DEMAND-SIDE THEORY: REJECTING THE CHARITABLE ORGANIZATION

The public benefit corporation does not offer a solution at the margins. It falls in the middle of the organizational spectrum, offering founders the ability to blend profit and charitable objectives. In rejecting the charitable organization, founders with dual motives may perceive public benefit corporations as the best alternative to accommodate their

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<sup>114</sup> See *supra* Part I.

dual motives. That is, founders may conduct a cost-benefit analysis, see that the costs of maintaining tax exemption quickly accumulate,<sup>115</sup> and choose a hybrid form like the public benefit corporation as an alternative. This Part builds a demand-side theory for the public benefit corporation and theorizes the factors attributable to choosing the public benefit corporation form over a charitable organization.

#### A. *Psychic and Financial Rewards*

One of the benefits of working in the charitable sector is the psychic reward the altruistic nonprofit founder, board director, manager, or employee feels while supporting or providing charitable activities.<sup>116</sup> Actors within a public benefit corporation that provides charitable activities may feel the same “warm glow” and receive the same accolades that were previously reserved for charitable actors.<sup>117</sup> Outside observers may perceive the charitable work in which a public benefit corporation is engaged, and such perceptions are likely to provide psychic rewards to actors within the public benefit corporation.

This public perception can lead to financial benefits as well. The charitable work of a public benefit corporation or a social enterprise is typically highlighted through significant advertising as business savvy social entrepreneurs put the charitable work front and center to attract customers.<sup>118</sup> As an example, consider the buy-one-give-one business model used by TOMS Shoes.<sup>119</sup> Although TOMS is not organized as a public benefit corporation, no customer has ever purchased a pair of over-priced shoes from TOMS without knowing that with her purchase another pair will be made and donated to a disadvantaged child.<sup>120</sup> Such businesses make it known to the world that they are “doing good” and

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<sup>115</sup> See Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 879 (1980) (noting that the nonprofit form is chosen when the benefits of the nondistribution constraint exceeds the costs created by the relative disadvantages of a nonprofit).

<sup>116</sup> Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1222–24 (2010) (noting that both the charity’s employees and donors receive intangible benefits in the form of “good feelings” from engaging with the charity). *Contra* Rodrigues, *supra* note 63, at 1322 (arguing that the donative nonprofit form creates a “unique warm-glow identity that a for-profit cannot”).

<sup>117</sup> Galle, *supra* note 116, at 1224–25 (arguing that allowing for-profits to receive charitable deductions would lower the “warm glow” benefits for both for-profit and nonprofit charitable enterprise employees and donors).

<sup>118</sup> See Christopher Marquis & Andrew Park, *Inside the Buy-One Give-One Model*, STAN. SOC. INNOVATION REV., Winter 2014, at 28, 28 (conducting research that shows that the buy-one give-one model of social entrepreneurship is effective for its “simple yet effective marketing message” and recommending that social entrepreneurs create effective advertising around their charitable or social missions).

<sup>119</sup> See *id.*

<sup>120</sup> See *id.* at 28, 30, 33 (discussing the success of TOMS Shoes and the simplicity of TOMS Shoes’ messaging around its charitable operations).

their customers purchase their products precisely because of the social and environmental impact claimed, even if the claims cannot be substantiated. Scholars of social enterprise have previously noted that the main benefit of new hybrid corporate forms such as the public benefit corporation has been branding.<sup>121</sup> By adopting the benefit corporation form, a start-up signals its intent to pursue social and environmental value and thereby gains immediate legitimacy in the public eye, a benefit previously reserved for charitable organizations.<sup>122</sup>

Moreover, actors within public benefit corporations may obtain greater benefits than those in charitable organizations. Managers and employees of a charitable organization often rely on the “warm glow” of their charitable deeds to make up for poor compensation in the nonprofit sector.<sup>123</sup> The IRS requires that charitable organizations pay only “reasonable” compensation, and the IRS can deny or revoke tax-exempt status of a charitable organization that pays excessive compensation on the basis of private inurement.<sup>124</sup> Charity Navigator

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<sup>121</sup> See Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 622 (2011) (arguing that social entrepreneurs pick hybrid entity forms in order to create a brand, but noting that “[w]hether the benefit corporation form can effectively function as such a brand . . . depends on whether it is a credible proxy for truly dual mission entities”); J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 45 (2012) (noting that “public branding” in the form of sanctioned hybrid corporate forms can confer significant benefits on social enterprise).

<sup>122</sup> To be fair, outside observers or customers of social enterprises are not likely to be good monitors of social enterprises because they do not pay attention to *actual* social and environmental metrics but instead rely on advertised claims. However, typical customers of commercial nonprofits or donors of donative nonprofits are not likely to be good monitors either—they rely on nonprofit laws such as the nondistribution constraint and oversight of executive compensation to restrict nonprofit abuse. See Hansmann, *supra* note 115, at 865 (explaining that customers patronize commercial nonprofits such as nursing homes “in the expectation that such institutions will be less likely than proprietary institutions to take advantage of the discretion that must necessarily be granted to them”).

<sup>123</sup> See generally Femida Handy & Eliakim Katz, *The Wage Differential Between Nonprofit Institutions and Corporations: Getting More by Paying Less?*, 26 J. COMP. ECON. 246 (1998) (presenting research that nonprofits pay employees and managers less than for-profit firms). See also Peter Frumkin & Elizabeth K. Keating, *The Price of Doing Good: Executive Compensation in Nonprofit Organizations* 8 (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 8, 2001), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=292253](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=292253) (citing compensation studies that have found that nonprofit compensation is lower than comparable for-profit organizations).

<sup>124</sup> See I.R.C. § 162(a) (2012) (limiting a corporation’s deduction of salary as a business expense to “reasonable allowance for salaries or other compensation”); see also *Enter. Ry. Equip. Co. v. United States*, 161 F. Supp. 590, 595 (Ct. Cl. 1958) (applying the reasonableness requirement of § 162 to exempt organizations). Payment of excessive compensation can result in the denial or revocation of tax-exempt status on the basis of private inurement. See I.R.C. § 501(c)(3) (requiring that

conducts an annual study of nonprofit executive compensation. Of the approximately 4,000 public charities studied in 2013, only nine paid their chief executive officers over \$1 million with the highest compensation topping out at \$1.8 million.<sup>125</sup> Executive compensation in the for-profit world can be quite higher in absolute terms.<sup>126</sup> The oft-used motto of social enterprise—“doing well and doing good”—reflects the idea that financial rewards are greater in the social enterprise sector than in the charitable sector. “Doing well” means receiving monetary rewards above those received by managers and employees of a charitable organization.

### *B. Competition for Impact Investments*

Social entrepreneurs may also use public benefit corporations instead of a charitable organization in order to gain better access to capital. In response to the concerns of nonprofit groups opposing the California flexible purpose corporation (a hybrid form similar to the public benefit corporation), the author and sponsor of the bill stated that FPCs “will not divert resources from non-profits . . . primarily because foundations, charities or individuals will not be permitted to receive favorable tax treatment in connection with donations to FPCs, who instead must avail themselves of the mainstream capital markets.”<sup>127</sup>

Nonetheless, it is clear that hybrid forms such as the public benefit corporation have capital-raising advantages over a stand-alone<sup>128</sup>

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exempt organizations have “no part of the net earnings of which inures to the benefit of any private shareholder or individual”); *Mabee Petroleum Corp. v. United States*, 203 F.2d 872, 876 (5th Cir. 1953) (finding that unreasonable salaries may cause the organization to lose its exempt status based on inurement).

<sup>125</sup> CHARITY NAVIGATOR, *supra* note 107, at 9.

<sup>126</sup> See, e.g., James B. Stewart, *Accounting for Dimon's Big Jump in Pay*, N.Y. TIMES (Jan. 31, 2014), <https://nyti.ms/1be7OVi> (discussing how the compensation and management development committee of JP Morgan Chase's board arrived at recommending a \$20 million compensation package in 2013 for its chief executive Jamie Dimon).

<sup>127</sup> *Hearing on S.B. 201*, *supra* note 4 (omission in original) (quoting statement of S.B. 201's author and sponsor).

<sup>128</sup> Public charities can take advantage of the impact investing market through forming for-profit affiliates. A public charity can own, wholly or partially, for-profit subsidiaries. I.R.S. Priv. Ltr. Rul. 90-16-072 (Apr. 20, 1990). Tax-exempt organizations can also enter into joint ventures with for-profit entities. For a discussion of I.R.S. private letter rulings on joint ventures, see JODY BLAZEK, TAX PLANNING AND COMPLIANCE FOR TAX-EXEMPT ORGANIZATIONS: RULES, CHECKLISTS, PROCEDURES 598–604 (4th ed. 2004). A public benefit corporation could be used to house the commercial activities of a public charity and capture such impact investments, particularly because the public benefit corporation's “public benefit” purpose aligns with exempt purposes. However, creating and managing for-profit subsidiaries or affiliates is administratively complex and burdensome for a small public charity. Julie Battilana et al., *In Search of the Hybrid Ideal*, STAN. SOC. INNOVATION REV., Summer 2012, at 51, 52–53 (discussing the creation of two separate legal entities—one for-profit and one nonprofit—to accomplish a dual mission, but noting the

charitable organization. Charitable organizations rely on capital from donors and grantors (with no expectation of private return), debt financing, or fees charged for goods and services.<sup>129</sup> Charitable organizations have an “access to capital” problem; they exist at the pleasure of donors and grant-makers, or the sale of their goods and services.<sup>130</sup> What investments charitable organizations do offer take the form of debt.

While it remains true that tax deductions are not available to investors in public benefit corporations, hybrid firms nonetheless have a wide array of capital-raising methods, some of which do and will siphon resources from charitable organizations. Philanthropists, private foundations, and other institutions which would have donated funds to charitable causes can turn to impact investing to accomplish a charitable mission while earning a return.<sup>131</sup> According to GIIN, impact investments are “[i]nvestments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return.”<sup>132</sup> Impact investments are characterized by

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administrative complexity of such an arrangement).

<sup>129</sup> Hansmann, *supra* note 115, at 877.

<sup>130</sup> *Id.* (“Donations may reflect merely the whims of contributors.”).

<sup>131</sup> See, e.g., J.P. MORGAN ET AL., *IMPACT INVESTMENTS: AN EMERGING ASSET CLASS 5* (2010), <https://assets.rockefellerfoundation.org/app/uploads/20101129131310/Impact-Investments-An-Emerging-Asset-Class.pdf> (“In a world where government resources and charitable donations are insufficient to address the world’s social problems, impact investing offers a new alternative for channeling large-scale private capital for social benefit. With increasing numbers of investors rejecting the notion that they face a binary choice between investing for maximum risk-adjusted returns or donating for social purpose, the impact investment market is now at a significant turning point as it enters the mainstream.”).

<sup>132</sup> GLOB. IMPACT INVESTING NETWORK, *IMPACT INVESTING: A GUIDE TO THIS DYNAMIC MARKET 2*, [https://thegiin.org/assets/documents/GIIN\\_impact\\_investing\\_guide.pdf](https://thegiin.org/assets/documents/GIIN_impact_investing_guide.pdf). Several other definitions of impact investing exist. Paul Brest and Kelly Born define impact investing as “actively placing capital in enterprises that generate social or environmental goods, services, or ancillary benefits such as creating good jobs, with expected financial returns ranging from the highly concessionary to above market.” Brest & Born, *supra* note 110, at 24. The World Economic Forum Mainstream Impact Investing Working Group defines impact investing as “an investment approach that intentionally seeks to create both financial return and positive social or environmental impact that is actively measured.” WORLD ECON. FORUM, *supra* note 112, at 7. The Monitor Institute defines impact investing as “[a]ctively placing capital in businesses and funds that generate social and/or environmental good and at least return nominal principal to the investor.” JESSICA FREIREICH & KATHERINE FULTON, MONITOR INST., *INVESTING FOR SOCIAL AND ENVIRONMENTAL IMPACT 11* (2009), [http://monitorinstitute.com/downloads/what-we-think/impact-investing/Impact\\_Investing.pdf](http://monitorinstitute.com/downloads/what-we-think/impact-investing/Impact_Investing.pdf). The G8’s Social Impact Investment Taskforce defines impact investments as “those that intentionally target specific social objectives along with a financial return and measure the achievement of both.” SOC. IMPACT INV. TASKFORCE, *IMPACT INVESTMENT: THE INVISIBLE HEART OF MARKETS 1* (2014), <http://>

four attributes. First, the impact investor invests with the intention to create a social or environmental impact.<sup>133</sup> Second, impact investments are made with the expectation of a financial return and not donations.<sup>134</sup> Third, the rate of return of an impact investment varies from concessionary, or below market, rates to risk-adjusted above market rates.<sup>135</sup> Fourth, impact investment requires a “commitment of the investor to measure and report the social and environmental performance and progress of underlying investments, ensuring transparency and accountability.”<sup>136</sup>

Recent changes to federal policies have facilitated impact investing, which are expected to increase the flow of capital to for-profit hybrid firms from private pension funds and private foundations. First, upon the recommendation of the Obama administration’s National Advisory Board on Impact Investing, the U.S. Department of Labor issued Interpretive Bulletin 2015-1 in October 2015, withdrawing its previous rules that under the Employee Retirement Income Security Act of 1974 (ERISA), fiduciaries could not use plan assets “to promote social, environmental, or other public policy causes at the expense of the financial interests of the plan’s participants and beneficiaries.”<sup>137</sup> Under ERISA, fiduciaries could not “subordinate”<sup>138</sup> or “sacrifice the financial interests of plan participants” in exchange for social, environmental, or

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[www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL\[3\].pdf](http://www.socialimpactinvestment.org/reports/Impact%20Investment%20Report%20FINAL[3].pdf).

<sup>133</sup> GLOB. IMPACT INVESTING NETWORK, *supra* note 132, at 3. “The word ‘intention’ differentiates these investments from socially responsible investments, which aim to avoid social or environmental harm, while still pursuing a single bottom line: profit.” MARTIN, *supra* note 113, at 5 (reporting on the status of the impact investing market to the U.K. Cabinet Office and the delegates at the G8 Forum of Social Impact Investing); see also Brest & Born, *supra* note 110, at 22 (“An impact investor seeks to produce beneficial social outcomes that would not occur but for his investment in a social enterprise.”).

<sup>134</sup> GLOB. IMPACT INVESTING NETWORK, *supra* note 132, at 3.

<sup>135</sup> *Id.*; see also Brest & Born, *supra* note 110, at 24 (explaining that impact investments “include concessionary investments, which sacrifice some financial returns to achieve social benefits, and non-concessionary investments, which expect risk-adjusted market returns or better”). For an explanation of “risk adjusted” returns, see Simon Constable, *What Are Risk-Adjusted Returns?*, WALL ST. J. (July 6, 2015), <https://www.wsj.com/articles/what-are-risk-adjusted-returns-1435758627>.

<sup>136</sup> GLOB. IMPACT INVESTING NETWORK, *supra* note 132, at 3.

<sup>137</sup> Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. 65,135 (Oct. 26, 2015) (to be codified at 29 C.F.R. pt. 2509); see also Mark E. Brossman, *Social Investing Redux: Obama Administration Changes Course*, LAW360 (Dec. 2, 2015), <https://www.srz.com/images/content/7/0/v2/70467/Law360-Social-Investing-Redux-Obama-Administration-Changes-Cours.pdf>.

<sup>138</sup> Interpretive Bulletin Relating to the Fiduciary Standard under ERISA in Considering Economically Targeted Investments, 80 Fed. Reg. at 65,136 (citing Interpretive Bulletin Relating to Investing in Economically Targeted Investments, 73 Fed. Reg. 61,734, (Oct. 17, 2008) (to be codified at 29 C.F.R. pt. 2509)).



other benefits.<sup>139</sup> The Department of Labor’s most recent interpretation of fiduciary duties now allows fiduciaries to (i) consider social, environmental, and other non-economic benefits when making investments, (ii) adopt environmental, social, and governance (ESG) factors in their investment policies, and (iii) to use ESG metrics to assess an investment.<sup>140</sup> The Department of Labor acknowledged that “[e]nvironmental, social, and governance issues may have a direct relationship on the economic value or the plans investment. In these instances, such issues are not merely collateral considerations or tie-breakers, but rather are proper components of the fiduciary’s primary analysis of the economic merits of competing investment choices.”<sup>141</sup> With these new rules, retirement plan asset managers who collectively hold trillions of investment dollars can now engage in impact investing.<sup>142</sup>

Similarly, in April 2016, the IRS issued final regulations making it “easier for private foundations to make Program-Related Investments (PRIs), which are investments—such as loans, loan guarantees, or equity investments—made primarily to accomplish a foundation’s charitable purposes, and not to generate financial returns.”<sup>143</sup> The final regulations include general principles that private foundations can use when making PRIs, including the principles that: (i) PRIs can take the form of equity investments in for-profit entities; (ii) PRIs are not limited to investments that help “economically disadvantaged individuals and deteriorated urban areas”; and (iii) “a potentially high rate of return does not automatically prevent an investment from qualifying as a PRI.”<sup>144</sup> Private foundations such as the Kresge Foundation,<sup>145</sup> W.K. Kellogg Foundation, the Case Foundation, and the Bill and Melinda Gates Foundation are setting aside millions of dollars for impact investments, either in the form of PRIs or through use of their endowment investments.<sup>146</sup>

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<sup>139</sup> *Id.*

<sup>140</sup> *Id.*

<sup>141</sup> *Id.*

<sup>142</sup> See Ronald Cohen et al., *U.S. Policy Shift Can Unleash the Power of Impact Investing*, INSTITUTIONAL INVESTOR (Nov. 14, 2015), [http://www.institutionalinvestor.com/blogarticle/3506085/blog/us-policy-shift-can-unleash-the-power-of-impact-investing.html?ArticleID=3506085#VxzK7D\\_aBaU](http://www.institutionalinvestor.com/blogarticle/3506085/blog/us-policy-shift-can-unleash-the-power-of-impact-investing.html?ArticleID=3506085#VxzK7D_aBaU).

<sup>143</sup> David Wilkinson, *Steps to Catalyze Private Foundation Impact Investing*, WHITE HOUSE: BLOG (Apr. 21, 2016), <https://www.whitehouse.gov/blog/2016/04/21/steps-catalyze-private-foundation-impact-investing>.

<sup>144</sup> Examples of Program-Related Investments, 81 Fed. Reg. 24,014, 24,015–16 (Apr. 25, 2016) (to be codified at 26 C.F.R. pt. 53).

<sup>145</sup> Alex Daniels, *New IRS Rule Likely to Make Impact Investing Easier*, CHRONICLE PHILANTHROPY (Sept. 18, 2015), <https://philanthropy.com/article/New-IRS-Rule-Likely-to-Make/233227/>; *Kresge Board Commits \$350 Million to Social Investments*, KRESGE FOUND. (Sept. 17, 2015), <http://kresge.org/news/kresge-board-commits-350-million-social-investments>.

<sup>146</sup> Stephanie Strom, *In New Brand of Philanthropy, Nonprofits Invest in For-Profits*,

The growth of impact investing may harm charitable organizations, as grantors and philanthropists may prefer to invest in a charitable cause and receive a return, rather than donate to a charitable cause. Charitable organizations are unable to offer a private return on equity investment,<sup>147</sup> and therefore must structure any impact investments as debt. Moreover, much of the impact that charitable organizations strive to make does not offer a return—the work is charitable precisely because it does not make money but relies on donations to break even. As one nonprofit executive puts it:

While it sounds enticing and straightforward in theory—the perfect combination of financial acumen and social good—that attractive quality is exactly what makes impact investing so dangerous. More and more philanthropy funders are focusing on business plans instead of the traditional “number of lives saved” metrics when it comes to making funding decisions. This narrative is gaining traction at the expense of the lives the grant-seeking organization is intending to save.<sup>148</sup>

If dollars are increasingly dedicated to impact investments rather than donations, nonprofit managers and social entrepreneurs may attempt to monetize their charitable activities to compete for capital. Such monetization often works better in the for-profit form (such as through a public benefit corporation) rather than as a charitable organization because of both the nondistribution constraint and federal regulation of nonprofit commercial activities, as is explained below.

### C. *Uncertainty and Risk in Federal Regulation*

Another reason that founders may reject the charitable organization in favor of the public benefit corporation turns on a lack of clarity and inconsistent application of federal laws regulating the charitable organization. Interpretations of the tax code or treasury regulations vacillate depending on whether the regulator is the U.S. Tax Court, other federal court, or IRS.<sup>149</sup>

As an example of the lack of clarity of IRS regulations, the IRS limits the commercial activities of charitable organizations in order to deter competition with for-profit business.<sup>150</sup> Under the “commerciality

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N.Y. TIMES (Dec. 11, 2012), <https://dealbook.nytimes.com/2012/12/11/in-new-brand-of-philanthropy-nonprofits-invest-in-for-profits/> (discussing the investments of well-known nonprofit foundations in for-profit philanthropic companies).

<sup>147</sup> I.R.C. § 501(c)(3) (2012).

<sup>148</sup> Christopher Ategeka, *Why Impact Investing Is Hurting Nonprofits*, FORBES (Jan. 4, 2016), <http://www.forbes.com/sites/theyec/2016/01/04/why-impact-investing-is-hurting-nonprofits/>.

<sup>149</sup> See Colombo, *supra* note 71, at 491–92.

<sup>150</sup> See *supra* notes 85–87 and accompanying text; see also BLAZEK, *supra* note 128, at 534.

doctrine,” a charitable organization risks its tax exemption if its commercial activities are substantial or give the organization a “commercial hue.”<sup>151</sup> Even “the presence of a single non[exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes.”<sup>152</sup> And yet, what constitutes “substantial” commercial activity has never been defined by the IRS or Congress.

There are few bright-line rules in the Code or revenue rulings related to the commercial activities of a public charity.<sup>153</sup> Instead, the IRS employs “facts and circumstances” tests to determine what qualifies as a commercial activity not in furtherance of an exempt purpose.<sup>154</sup>

Among the major factors courts have considered in assessing commerciality are competition with for-profit commercial entities; extent and degree of below cost services provided; pricing policies; and reasonableness of financial reserves. Additional factors include, inter alia, whether the organization uses commercial promotional methods (e.g., advertising) and the extent to which the organization receives charitable donations.<sup>155</sup>

Excessive benefits—including executive compensation—to “insiders” of the tax-exempt organization are similarly scrutinized.<sup>156</sup> In addition to unclear and inconsistent application of the tax code, the IRS’s regulation of charitable organizations is also changing, creating an unpredictable landscape of future treatment.<sup>157</sup> Case-by-case application of the tax code

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<sup>151</sup> *Airlie Found. v. IRS*, 283 F. Supp. 2d 58, 63–64 (D.D.C. 2003) (applying the commerciality doctrine and discussing the various factors that courts use to assess commerciality).

<sup>152</sup> *Better Bus. Bureau of Wash., D.C., Inc. v. United States*, 326 U.S. 279, 283 (1945).

<sup>153</sup> Colombo, *supra* note 71, at 491 (arguing that tax policy on commercial activity by tax-exempt charitable organizations has created conflicting court decisions and little IRS guidance).

<sup>154</sup> The test to determine whether a commercial activity is sufficient to deny or revoke tax exemption partially involves whether the activity has a “commercial hue,” i.e., how similar it is to a for-profit commercial activity. *B.S.W. Grp., Inc. v. Comm’r*, 70 T.C. 352, 357–58 (1978).

<sup>155</sup> *Airlie Found.*, 283 F. Supp. at 63.

<sup>156</sup> See I.R.C. § 4958(c)(1)(A) (2012).

<sup>157</sup> See generally H. COMM. ON WAYS & MEANS, 113TH CONG., 2D SESS., TAX REFORM ACT OF 2014 (Comm. Print 2014) (discussion draft), [https://waysandmeans.house.gov/UploadedFiles/Statutory\\_Text\\_Tax\\_Reform\\_Act\\_of\\_2014\\_Discussion\\_Draft\\_022614.pdf](https://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft_022614.pdf) (proposing to allow individual deductions for charitable contributions only to the extent that such charitable contributions exceed 2% of an individual’s contribution base; proposing a 25% excise tax on nonprofit executive compensation over \$1,000,000; proposing expansion of intermediate sanctions against tax-exempt organizations; and proposing that losses from one unrelated business activity cannot be used to offset losses from another unrelated business activity).

is defended on the basis that bright-line rules would inadvertently create loopholes or unintended application of federal law. Nonetheless, the practical reality is that the lack of clarity of IRS regulations and application of those regulations makes it difficult for a founder with dual-mission motives to know whether its innovative capital-raising methods will subject the firm to penalties, including loss of tax-exempt recognition.<sup>158</sup> There are real and immediate consequences to violating charitable trust laws that are not present when conducting business through the public benefit corporation form.<sup>159</sup> This uncertainty and risk makes the charitable organization less palatable to social entrepreneurs.

Finally, the “lean startup”<sup>160</sup> strategy that founders are increasingly adopting to launch their organizations does not fit well with starting a charitable organization. “Lean startup” strategy entails getting one’s “minimal viable product” (i.e., a test product but not the perfect final product) to market as soon as possible in order to obtain consumer input and determine the viability of success quickly.<sup>161</sup> The strategy potentially involves avoiding high sunk costs, such as legal fees.<sup>162</sup> If the product fails, it should fail fast, so that the entrepreneur can learn from the failure and either adapt or move on to the next viable idea that may turn into a success.<sup>163</sup> Incorporating a firm as either a public benefit corporation or nonprofit corporation is fairly quick and simple. But applying for tax-exempt recognition from the IRS is a three-month process,<sup>164</sup> not in line

<sup>158</sup> The entrepreneur could seek a private letter ruling from the IRS for clarity, but as will be discussed below, this does not allow the entrepreneur to engage in “lean startup” strategy or pivot quickly to take advantage of new commercial opportunities as they arise.

<sup>159</sup> This may change in the future as charity regulators attempt to regulate hybrid entity forms similarly to tax-exempt organizations under charitable trust laws. See Dana Brakman Reiser, *Regulating Social Enterprise*, 14 U.C. DAVIS BUS. L.J. 231, 244 (2014); see also Robert A. Wexler, Attorney General Regulation of Hybrid Entities as Charitable Trusts 10 (2013) (unpublished manuscript) (available at <http://academiccommons.columbia.edu/catalog/ac%3A171168>). Additionally, some states require businesses claiming to donate profits to charities to register under charitable solicitation laws. See, e.g., N.Y. EXEC. LAW § 173 (McKinney 2017) (requiring commercial co-venturers in New York State to register with the New York attorney general under charitable solicitation laws).

<sup>160</sup> See generally ERIC RIES, *THE LEAN STARTUP: HOW TODAY’S ENTREPRENEURS USE CONTINUOUS INNOVATION TO CREATE RADICALLY SUCCESSFUL BUSINESSES* (2011) (detailing how to create business using the “Lean Startup Method”).

<sup>161</sup> *Id.* at 76–77, 94–97.

<sup>162</sup> *Id.* at 110 (noting that start-up founders should understand the patent law risks of testing a “minimal viable product” but also arguing that patent registration is not essential if the company only seeks to use it for defensive purposes).

<sup>163</sup> *Id.* at 149–50.

<sup>164</sup> As of April 2014, according to the IRS website, the IRS was processing tax exemption applications from June 2013, or ten months prior. However, determination letters can be provided in as early as 90 days. *Where’s My Exemption Application?*, IRS, <http://www.irs.gov/Charities&Non-Profits/Charitable->

with “lean startup” strategy. To simplify and shorten the tax-exemption application process, the IRS adopted Form 1023-EZ, a three-page form that can be processed in a couple weeks. However, only very small organizations can avail themselves of this form.<sup>165</sup>

#### D. Increased State Regulation

Founders choosing an entity option must also confront increasing state regulation aimed at curbing nonprofit abuse. In 2011, the Uniform Law Commission (ULC) finalized the Protection of Charitable Assets Act, new model legislation that, among other things (i) clarifies the power of state attorneys general to protect charitable assets and (ii) requires charities with charitable assets above \$5,000 to register and file an annual report with the state attorney general, including attachment of the charity’s annual IRS financial return (i.e., IRS Form 990).<sup>166</sup> Thus far, only Maryland has adopted the Act,<sup>167</sup> but the ULC encourages every state to adopt its model acts to ensure uniformity among “state law where uniformity is desirable and practical.”<sup>168</sup> If adopted in each state, the Act essentially requires multi-state registration and annual report filings. Additionally, the Act requires charities to give the state attorney general notice of significant events, including notice of the disposition of all or substantially all of the charity’s charitable assets prior to disposition or removal of the assets from the state in order to give the attorney general “time to review the proposed transaction and recommend changes if necessary while the assets can still be reached.”<sup>169</sup>

Another example of increasing state regulation of charities is the California Nonprofit Integrity Act of 2004,<sup>170</sup> which requires, among

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Organizations/Where%27s-My-Application (last updated Jan. 26, 2017). One shortcut for nonprofits is to obtain fiscal sponsorship arrangements, but this still entails setting up the sponsorship (which tends to be long term) before being able to access capital in the form of tax-deductible donations or grants. *See, e.g.*, PUB. COUNSEL LAW CTR., FISCAL SPONSORSHIPS: AN ALTERNATIVE TO FORMING A NONPROFIT 501(C)(3) CORPORATION 1–2 (2009), [http://www.publiccounsel.org/tools/publications/files/fiscal\\_sponsor.pdf](http://www.publiccounsel.org/tools/publications/files/fiscal_sponsor.pdf).

<sup>165</sup> To apply using Form 1023-EZ, an organization must have less than \$50,000 in gross receipts annually for three years. I.R.S. News Release, *supra* note 56.

<sup>166</sup> MODEL PROT. OF CHARITABLE ASSETS ACT 3, § 4 cmt. (UNIF. LAW COMM’N, Approved and Recommended for Enactment 2011), [http://www.uniformlaws.org/shared/docs/protection\\_of\\_charitable\\_assets/mpocaa\\_final\\_2011.pdf](http://www.uniformlaws.org/shared/docs/protection_of_charitable_assets/mpocaa_final_2011.pdf).

<sup>167</sup> *Legislative Fact Sheet—Protection of Charitable Assets Act, Model*, UNIF. LAW COMM’N, <http://www.uniformlaws.org/LegislativeFactSheet.aspx?title=Protection%20of%20Charitable%20Assets%20Act,%20Model> (last visited May 16, 2017); *see* MD. CODE ANN., BUS. REG. § 6 (LexisNexis 2016).

<sup>168</sup> *About the ULC*, UNIF. LAW COMM’N, <http://www.uniformlaws.org/Narrative.aspx?title=About%20the%20ULC> (last visited May 16, 2017).

<sup>169</sup> MODEL PROT. OF CHARITABLE ASSETS ACT § 5 cmt.

<sup>170</sup> 2004 CAL. STAT. 7158, 7161–62 (codified as amended in scattered sections of

other things, that California nonprofit corporations with gross revenues of \$2 million or more establish an audit committee and prepare annual audited financial statements.<sup>171</sup> The New York Non-Profit Revitalization Act of 2013<sup>172</sup> was adopted to create greater transparency and oversight of New York nonprofit organizations. The Act requires New York nonprofit corporations to have a conflict of interest policy,<sup>173</sup> to submit an annual financial report (unaudited or audited, depending on revenue) to the New York Attorney General,<sup>174</sup> and to have a whistleblower policy if revenues are in excess of \$1 million or the organization has 20 or more employees.<sup>175</sup> A new Oregon law mandates that Oregon nonprofits devote no more than 70% of its functional expenses to administrative expenses or fundraising; failure to satisfy this threshold results in revocation of state tax exemption and corporate excise tax deductions on its charitable contributions.<sup>176</sup> Such state regulations are attempts to make charitable organizations more accountable and their operations more transparent. Founders may forgo starting a charitable organization to avoid what they perceive as excessive state regulation. They may hope to achieve accountability through the market rather than government oversight.

Additionally, some state regulation is aimed squarely at charitable organizations' commercial activities. North Carolina now enforces sales tax against nonprofit ticket sales to entertainment and live events.<sup>177</sup> A Kansas bill would have revoked state property tax exemption from any service provider that receives 40% of its revenues from membership sales or program services, but the bill ultimately died in committee.<sup>178</sup> The push to de-incentivize commercial activities by charitable organizations may drive founders with dual missions away from creating charitable organizations.

#### IV. MICRO AND MACRO LEVEL HARMS

This Article has outlined the supply and demand theories for a public benefit corporation and the many ways in which the public benefit corporation acts as a substitute for charitable organizations despite original intentions to create an alternative to a for-profit corporation. This Part evaluates the potential for two harms caused when a public

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CAL. BUS. & PROF. CODE and CAL. GOV'T CODE).

<sup>171</sup> CAL. GOV'T CODE § 12586(e) (2016).

<sup>172</sup> 2013 N.Y. LAWS 1400.

<sup>173</sup> *Id.* at 1429–30.

<sup>174</sup> *Id.* at 1401.

<sup>175</sup> *Id.* at 1430. Additionally, the Act disallows CEOs or other employees from serving as chair of the board and heightens related-party transactions. *Id.* at 1427. The Act became effective July 1, 2014. *Id.* at 1451.

<sup>176</sup> OR. REV. STAT. § 128.760 (2013).

<sup>177</sup> N.C. GEN. STAT. § 105-164.4(a)(10) (2017).

<sup>178</sup> H.B. 2498, 2014 Leg. (Kan. 2014).

benefit corporation is used to pursue charitable activities. The first is a micro-level harm: fraud. In the social enterprise context, such fraud is often called “greenwashing,” i.e., deceiving unwitting stockholders, customers, or other stakeholders to invest or spend their time and money in an enterprise that negligently or fraudulently claims to pursue social, environmental, or charitable benefits.<sup>179</sup> The second possible harm is a macro level harm, and speaks to the very heart of charitable public benefit corporations: “market-based charity” or the injection of business strategy, methods, and ideals into charitable work.

### A. *Greenwashing*

Applying Henry Hansmann’s seminal contract failure theory to public benefit corporations explains, in part, why greenwashing is less likely in the nonprofit form and more likely for public benefit corporations that engage in charitable activities. In *The Role of the Nonprofit Enterprise*, Hansmann argued that the inability to distribute profits gives nonprofit managers less incentive to shirk on the quality of the goods or services produced at the expense of consumers.<sup>180</sup> The lack of a profit-incentive is especially important in situations where the quality of the service or product is not easily or cost-effectively observable.<sup>181</sup> In the nonprofit context, the purchaser of the good or service cannot easily discern the quality of the good or service because the purchaser is not often the same as the consumer or beneficiary of the good or service.<sup>182</sup> For example, a purchaser of charitable services makes a donation to a homeless shelter, but cannot easily observe the quality of the shelter services given to the shelter beneficiaries, the homeless. Because of this contract failure, the purchasers will prefer to donate to a nonprofit homeless shelter that is constrained by the nondistribution constraint, and not to a for-profit that could shirk on the quality of shelter services in order to enrich shareholders or insiders at the expense of beneficiaries.

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<sup>179</sup> See Plerhoples, *Social Enterprise as Commitment*, *supra* note 10, at 96 (“Although originally applied to environmental issues, greenwashing also applies to any firm’s claim that its activities or actions improve the environment or society, or address an environmental or social problem. Greenwashing involves diversion, deception, and hypocrisy. Broadly, ‘there is wrongdoing, distraction in the form of a “wash,” and at its heart, an underlying structural problem never receives proper redress.’ Notably, the actions that constitute greenwashing for a specific firm will depend on what the firm has committed to do. A firm cannot engage in greenwashing if it never committed to an underlying environmental or social action. Greenwashing is therefore a particularly acute problem for social enterprises, because they claim to create social and environmental value.” (quoting Cherry, *supra* note 10, at 286)).

<sup>180</sup> Hansmann, *supra* note 115, at 845 (originating the informational asymmetry or contract failure theory as the economic role of nonprofits).

<sup>181</sup> See *id.* at 862–63.

<sup>182</sup> *Id.*

Even for commercial nonprofits where purchasers and beneficiaries are most often the same and thus theoretically in the position to assess the quality of services received, the types of services provided “are often complex and difficult for the purchaser to evaluate.”<sup>183</sup> Examples include day care, nursing care, and education.<sup>184</sup> Hansmann refers to the nondistribution constraint as the “essential characteristic that permits nonprofit organizations to serve effectively as a response to contract failure.”<sup>185</sup> Purchasers of charitable goods and services prefer and demand the nonprofit form.

In addition to the nondistribution constraint, the myriad of federal and state regulations presented above as the reasons why social entrepreneurs might reject the charitable form are the very same attributes that increase the charitable sector’s accountability. Charitable organizations must annually disclose their charitable activities and finances to the IRS, which can penalize, or revoke the tax-exempt status of a charitable organization if it fails to be operated primarily for an exempt purpose.<sup>186</sup> The charitable activities and finances of charitable organizations are also disclosed to the public, and several watchdog groups regularly review and monitor these public disclosures for potential abuse.<sup>187</sup> Finally, many states require charities to register with the state’s attorney general office and notify the office of any significant actions that impact the charity’s assets, such as a sale of major assets, merger, or dissolution.

The potential for abuse is greater in the public benefit corporation form because the public benefit corporation lacks the nondistribution constraint and the federal or state regulation imposed on the charitable sector.<sup>188</sup> Delaware law does not require public benefit corporations to publicly disclose its ownership structure, charitable activities, finances, or to register with the attorney general. This is likely because the public benefit corporation was formed as an alternative to a for-profit corporation (which also does not have to publicly disclose its ownership

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<sup>183</sup> Henry Hansmann, *Economic Theories of Nonprofit Organizations*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 27, 30 (Walter W. Powell ed., 1987); see also Hansmann, *supra* note 115, at 872 (noting that commercial nonprofits produce services that “are more complex to evaluate than are industrial goods, which typically are highly standardized, objectively describable, and easily compared”).

<sup>184</sup> Hansmann, *supra* note 115, at 837.

<sup>185</sup> *Id.* at 873.

<sup>186</sup> Charitable organizations annually file IRS Form 990 which is also open to public inspection through a website run by Guidestar, which is itself a public charity. See GUIDESTAR, <https://www.guidestar.org/Home.aspx> (last visited May 16, 2017).

<sup>187</sup> See, e.g., CHARITY WATCH, <https://www.charitywatch.org/home> (last visited May 16, 2017); CHARITY NAVIGATOR, <http://www.charitynavigator.org/> (last visited May 16, 2017).

<sup>188</sup> See Brakman Reiser, *supra* note 159, at 239–40; Murray, *supra* note 121, at 33–34.



structure or finances unless it is a public company or falls under some other regulation) in a business-friendly state with little regard for its use as an alternative to a charitable organization.<sup>189</sup>

To illustrate the potential for fraud resulting from the use of the public benefit corporation form, consider an example. Rasmussen College provides a complex service whose quality is not easily discernible—higher education. In 2014, Rasmussen College converted to a Delaware public benefit corporation.<sup>190</sup> Just 18 months prior, the U.S. Senate Health, Education, Labor and Pensions Committee (HELP) issued an incriminating report on for-profit colleges, specifically naming Rasmussen College.<sup>191</sup> Culminating in a two-year study of Rasmussen and other for-profit colleges,

[t]he report notes that the revenues of for-profit colleges come almost entirely from federal taxpayers (to the tune of \$32 billion a year) but that the retention rate of students is low, the colleges are not held accountable for ensuring student success, the colleges have seen large increases [of] shareholder returns in recent years, the colleges spend more money on recruiting than education, and that the quality of education provided is abysmal.<sup>192</sup>

The report contains profiles and sub-reports on each of the for-profit colleges it studied, including Rasmussen College. The report condemns Rasmussen with the following facts. First, approximately 80% of Rasmussen's revenue is from federal funds.<sup>193</sup> Additionally, "[c]ompared to public colleges offering the same programs, the price of tuition is higher at Rasmussen. . . . A Bachelor's degree in Business Management from Rasmussen College costs \$68,668. The University of Minnesota costs \$56,240 for a Bachelor's in Business."<sup>194</sup> In 2009, Rasmussen also spent a great deal more on marketing and profit than it did on students.<sup>195</sup>

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<sup>189</sup> Unlike the Delaware statute governing public benefit corporations, the Model Benefit Corporation Legislation requires a benefit corporation's assessment of its social or environmental performance to be made publicly available, as well as be assessed using a third-party standard. The benefit corporation, then, is closer in its transparency and accountability to charitable organizations than the public benefit corporation. MODEL BENEFIT CORP. LEGISLATION §§ 401, 402(b) (2016).

<sup>190</sup> Alicia Plerhoples, *Whitewashing & the Public Benefit Corporation: An Example*, SOCENT LAW: BLOG (Jan. 22, 2014), <http://socentlaw.com/2014/01/whitewashing-the-public-benefit-corporation-an-example/> [hereinafter Plerhoples, *Whitewashing*].

<sup>191</sup> STAFF OF S. HEALTH, EDUC., LABOR & PENSIONS COMM., FOR PROFIT HIGHER EDUCATION: THE FAILURE TO SAFEGUARD THE FEDERAL INVESTMENT AND ENSURE STUDENT SUCCESS 632 (Comm. Print 2012), [https://www.help.senate.gov/imo/media/for\\_profit\\_report/PartII/Rasmussen.pdf](https://www.help.senate.gov/imo/media/for_profit_report/PartII/Rasmussen.pdf) [hereinafter HELP Report].

<sup>192</sup> Plerhoples, *Whitewashing*, *supra* note 190.

<sup>193</sup> *Id.*; HELP Report, *supra* note 191, at 635.

<sup>194</sup> HELP Report, *supra* note 191, at 639; Plerhoples, *Whitewashing*, *supra* note 190.

<sup>195</sup> See HELP Report, *supra* note 191, at 644 ("Rasmussen spent \$4,801 per student on instruction in 2009, compared to \$6,261 on marketing and \$9,017 on

Student retention rates at Rasmussen College were “among the lowest” of the for-profit colleges studied in the report.<sup>196</sup> The report concludes:

Like many others in the sector, Rasmussen’s enrollment increased rapidly over the past decade. Much of this growth came after the company’s 2003 acquisition by the private equity company Frontenac. Additionally, Rasmussen has received increasing amounts of Federal financial aid dollars, at least \$185 million in 2010, and realized significant increases in profit. However, the company’s programs are costly and students attending Rasmussen have some of the worst retention rates of any company examined by the committee, with more than 63 percent of students leaving with no degree. While Rasmussen has made some minor improvements, including an orientation program, and makes a greater investment in spending on instruction and student services than many for-profit colleges examined, it is unclear whether taxpayers or students are obtaining value from their investment in the company.<sup>197</sup>

This report raises questions about whether Rasmussen College undertook its conversion to a public benefit corporation to improve its student outcomes or to improve its public image so that it could continue defrauding students. As a Delaware public benefit corporation, Rasmussen directors must balance the interests of its stockholders, its students (who are “materially affected by the corporation’s conduct”), and its declared public benefit. Presumably, the interest of traditional stockholders is profit and the interest of college students is a quality education. Rasmussen directors do not have to publicly disclose how they balance these competing interests. Moreover, stockholders are the only constituents who can bring a derivative suit against Rasmussen for failure to balance these interests. Unless Rasmussen’s stockholders now consider themselves to be impact investors that care equally about financial and social returns (or the board intends to seek impact investors), the board’s responsibility going forward will be to figure out how to make the interests of both stockholders and students converge, and not focus solely on the bottom line. The feasibility of Rasmussen pursuing both financial and social returns is in question, and the public benefit corporation does not provide strong accountability and transparency mechanisms to counteract potential greenwashing.

Once an organization claims to pursue or make a charitable impact or societal contribution—even when mixed with a profit motive—it is fair to hold the organization accountable to its claims. Is the organization doing what it claims to be doing? Or is it employing the public benefit corporation form to deceive investors, stakeholders, the public, and regulators?

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profit.”).

<sup>196</sup> *Id.* at 642.

<sup>197</sup> *Id.* at 649 (emphasis added).

### B. *Market-Based Charity*

A second potential harm caused by social entrepreneurs rejecting the charitable organization in favor of a public benefit corporation is the macro-level impact that it may have on the way in which charity is conducted. Conducting charity through for-profit businesses such as public benefit corporations creates “market-based charity.” Market-based charity has two components: (i) the use of commercial markets and (ii) the use of business methods and strategy to conduct charity. First, market-based charity requires using markets, and not charity or donations, to provide public benefits, social benefits, or public goods. Many social enterprises that reject the charitable organization form do so because their operational strategy relies on the market; they sell their products directly to a charitable class instead of subsidizing the products with donations and giving the products away. For example, in the case study above, Maria’s for-profit company would make loans directly to what could be deemed a charitable class of borrowers—i.e., borrowers with bad or no credit history, including low-income, foreign, and formerly incarcerated borrowers. Maria’s company would not rely on donations but on interest rates charged to this otherwise charitable class. Another example of market-based charity are those social enterprises that employ a charitable class to produce products which are sold to consumers. For example, the tag line of Greyston Bakery, an iconic social enterprise that employs hard-to-employ people, is “we don’t hire people to bake brownies, we bake brownies to hire people.”<sup>198</sup> Thus, one component of market-based charity is a reliance on the purchase and sale of goods as the primary income stream, rather than on subsidy through donations.

Professor Garry Jenkins elaborates on the macro-level harms that arise from market-based charity which sells to or employs a charitable class. Jenkins’s critique focuses on a specific form of market-based charity, philanthrocapitalism, or the promotion by private foundations and billionaire philanthropists on market-based strategies in dictating philanthropic dollars to nonprofits.<sup>199</sup> Many of his criticisms can be applied equally to market-based charity conducted by for-profit firms. Jenkins argues that “reimagining poor individuals primarily as sellers and buyers of goods . . . privileges wealth creation over distribution, and is grounded in the idea of individual self-help as the driver of change.”<sup>200</sup>

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<sup>198</sup> Mike Brady, *On Inclusion*, GREYSTON, <http://greyston.com/about-greyston/reentry-inclusion> (last visited May 16, 2017).

<sup>199</sup> Garry W. Jenkins, *Who’s Afraid of Philanthrocapitalism*, 61 CASE W. RES. L. REV. 753, 754–55 (2010). See generally MATTHEW BISHOP & MICHAEL GREEN, PHILANTHROCAPITALISM: HOW THE RICH CAN SAVE THE WORLD (2008) (documenting and applauding the rise of philanthrocapitalism).

<sup>200</sup> Jenkins, *supra* note 199, at 803.

The ideology of market-based social change initiatives usually seeks to create individual winners within an existing economic system. Alternative views of philanthropy that promote social transformation based on, for example, instilling more communitarian or egalitarian values, may lead to different types of solutions and the promotion of different values. Another problem is that market-led interventions will likely create only small shifts in an unequal world. Without broader political, social, and cultural shifts, increased individual participation in markets is likely to reproduce existing inequalities rather than unsettle traditional hierarchies.<sup>201</sup>

Jenkins also notes that this type of market-based charity “teaches people that corporations . . . will care for societal problems, presumably obviating the need for government regulation, liberal welfare policies, progressive taxation, and the like.”<sup>202</sup> This rationale could “limit our imagination or political will to engage in collective, broad-based, bottom-up social transformation.”<sup>203</sup>

An additional problem with market-based charity that employs the charitable class is that it may depress donor giving to traditional charities. One can imagine a consumer who foregoes donating to an emergency aid relief fund after a tsunami or earthquake hits a developing country and instead buys a charm bracelet or other accessory made by poor women in that developing country. The donor-turned-consumer believes that she is contributing to the cause but the direct donation may be a more impactful charitable act.

The second component of market-based charity entails the use of business techniques, strategies, and methods within an organization “in order to improve capacity, efficiency, accountability, and effectiveness.”<sup>204</sup> Emphasis is placed on outcomes instead of outputs. The question becomes not “was this charitable product or service given?” but “how did it improve the lives of those for which it was produced or served?” The latter question is costlier, more difficult, and sometimes impossible to ascertain. What is the quantifiable benefit of saving an endangered species? Or preventing a genocide?

Additionally, market-based charity challenges the values of the charitable sector, “namely the role of nonprofit institutions in social change, the promotion of democratic values, and the building of communities and social ties through empowerment and participation.”<sup>205</sup> According to Jenkins, where the charitable sector values cooperation and collective action, “market principles would favor solutions grounded in

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<sup>201</sup> *Id.* at 805.

<sup>202</sup> *Id.* at 811.

<sup>203</sup> *Id.*

<sup>204</sup> *Id.* at 755.

<sup>205</sup> *Id.* at 759.

competition and individualism.”<sup>206</sup> Where the charitable sector values mission and democratic, bottom-up control over charitable assets, market-based charity reflects the autocratic, outcome-driven, top-down control of a single or small group of social entrepreneurs. Who is to say that a single social entrepreneur can know and meet the needs of a charitable class? One imagines a parallel Silicon Valley in which every technology company is a social enterprise aimed at solving intractable societal problems, yet has no understanding of what those problems are or how best to tackle them.

Ultimately, Jenkins acknowledges that market-based charity can be effective for some forms of charity, but cautions against the growth of market-based charity.<sup>207</sup> He warns against the wholesale adoption of market-based charity without further consideration of how to incorporate the important values that traditional charity espouses.<sup>208</sup>

## V. REFORMING CHARITABLE PUBLIC BENEFIT CORPORATIONS

### A. *Reject Reforms to the Charitable Organization*

To decrease the demand for public benefit corporations, and hence decrease the harms produced by market-based charity, one might reform the tax code or IRS regulations to create a nonprofit form that is more desirable to social entrepreneurs. This could entail creating bright line rules around the commercial activities that a charitable organization can engage in, reducing uncertainty and risk,<sup>209</sup> or creating more flexible rules to allow charitable organizations to engage in more commercial activities.<sup>210</sup> The basic structure of the charitable organization would remain intact. The charitable organization would not have owners since it would still be constrained by the nondistribution constraint, and democratic, participatory values could be retained.

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<sup>206</sup> *Id.* at 813.

<sup>207</sup> *Id.* at 805 (“This is not to say that economic and market-led charitable activity is without merit. Quite the contrary, market-based solutions to public problems may work in some settings, but they are hardly a panacea. Social transformation also requires collective action, relationship building, participation, and political change.”).

<sup>208</sup> *See id.* Philanthropists should donate “in ways that promote strong civil society, strengthen nonprofit institutions, and respect and list to the voices of communities in need.” *Id.* at 821.

<sup>209</sup> For example, the Public Citizen’s Bright Line Project works to create bright line rules regarding nonprofit organizations’ lobbying activities. BRIGHT LINES PROJECT, IRS RULEMAKING TEAM SHARED PRINCIPLES, <http://www.brightlinesproject.org/wp-content/uploads/2015/07/20150720-Shared-Principles.pdf>.

<sup>210</sup> *See, e.g.,* Dana Brakman Reiser, *Charity Law’s Essentials*, 86 NOTRE DAME L. REV. 1, 21–23 (2011) (arguing for the removal of federal treasury regulations limiting charitable organizations’ commercial and political activities).

Relaxing the rules for charitable organizations are likely to encourage more charity fraud and abuse if additional resources are not given to the IRS to police such abuse. As an example, in 2014 the IRS introduced Form 1023-EZ, a shorter tax exemption application for charities with gross annual receipts of \$50,000 or less.<sup>211</sup> The IRS sought to process tax exemption applications faster with this three-page application that asks applicants to attest that they meet the qualifications for tax exemption rather than requiring applicants to produce documentation that supports their claim for tax exemption.<sup>212</sup> The Taxpayer Advocate Service, an independent service within the IRS, investigated use of Form 1023-EZ and reported that the IRS approved 95% of Form 1023-EZ applicants.<sup>213</sup> When the IRS requested documentation from a sample of these applicants, its approval rate was only 77%.<sup>214</sup> The Taxpayer Advocate Service estimates that 20% of applicants using Form 1023-EZ do not qualify for tax exemption “despite their attestations to the contrary.”<sup>215</sup> Although it is not fair to say that these 20% of applicants plan to engage in charity fraud, it is clear that relaxed rules without additional enforcement resources heighten the potential for fraud.

Additionally, these types of reforms to charitable organizations would do little to curb the demand of social entrepreneurs and impact investors who want to create “shared value,” i.e., benefits to themselves and stakeholders.<sup>216</sup> Reforms to charitable organizations would never (and should never) go so far as to remove the nondistribution constraint and allow them to distribute profits.

### *B. Reject Federal and State Oversight*

To mitigate the harms of charitable public benefit corporations, one could propose mapping the values and accountability framework of the charitable sector onto charitable public benefit corporations through federal or state oversight.<sup>217</sup> Charitable public benefit corporations could

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<sup>211</sup> 1 NAT’L TAXPAYER ADVOCATE, 2015 ANNUAL REPORT TO CONGRESS 36 n.2, [http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2015ARC/ARC15\\_Volume1.pdf](http://www.taxpayeradvocate.irs.gov/Media/Default/Documents/2015ARC/ARC15_Volume1.pdf).

<sup>212</sup> *Id.* at 39.

<sup>213</sup> *Id.* at 40.

<sup>214</sup> *Id.*

<sup>215</sup> *Id.* at 41.

<sup>216</sup> See Michael E. Porter & Mark R. Kramer, *Creating Shared Value: How to Reinvent Capitalism—and Unleash a Wave of Innovation and Growth*, HARV. BUS. REV., Jan.–Feb. 2011, at 62, 66 (defining “shared value” as “policies and operating practices that enhance the competitiveness of a company while simultaneously advancing the economic and social conditions in the communities in which it operates”).

<sup>217</sup> *Contra* John Tyler et al., *Producing Better Mileage: Advancing the Design and Usefulness of Hybrid Vehicles for Social Business Ventures*, 33 QUINNIPIAC L. REV. 235, 301 (2015) (“There is little or no reason to regulate or oversee the formal hybrid forms

be regulated like charitable organizations.

A possible regulator of public benefit corporations is the IRS. The IRS holds charitable organizations accountable through annual financial reporting and the authority to deny or revoke tax exemption as well as penalize wrongdoing. However, public benefit corporations are not tax-exempt like charitable organizations and the IRS could not wield similar regulatory authority over public benefit corporations without congressional action. There does not seem to be any political willpower to consider federal social enterprise legislation in Congress, let alone regulatory oversight. Twice, U.S. Congressman David Cicilline introduced the Social Enterprise Ecosystem and Economic Development (SEED) Act in the U.S. House of Representatives. The SEED Act would establish the Commission on the Advancement of Social Enterprise to (1) “establish criteria for identifying social enterprises for purposes of Federal programs,” and (2) “identify opportunities for the Federal Government to more effectively engage social enterprises in creating jobs and strengthening local economies.”<sup>218</sup> Significantly, under the SEED Act, the Commission would be tasked with making recommendations to changes in the tax code to support social entrepreneurship.<sup>219</sup> Each year, the SEED Act never made it out of committee and the bill has not been re-introduced.

Even if political willpower existed in Congress to authorize IRS oversight of public benefit corporations and other social enterprise entities, the IRS lacks the necessary resources to do so<sup>220</sup> and risks wading into a political quagmire, as it did when it tried to exert authority and oversight over conservative Tea Party groups.<sup>221</sup>

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any differently than has been done for modified traditional forms and joint ventures among for-profits and charities that have been operating as hybrid enterprises for decades.”).

<sup>218</sup> Social Enterprise Ecosystem and Economic Development Act, H.R. 2043, 113th Cong. § 2 (2013); Social Enterprise Ecosystem and Economic Development Act, H.R. 6505, 112th Cong. § 2 (2012).

<sup>219</sup> *The SEED Commission Act*, CONGRESSMAN DAVID CICILLINE, [https://cicilline.house.gov/sites/cicilline.house.gov/files/The%20SEED%20Commission%20Act%20Summary\\_0.pdf](https://cicilline.house.gov/sites/cicilline.house.gov/files/The%20SEED%20Commission%20Act%20Summary_0.pdf).

<sup>220</sup> See Leandra Lederman, *The IRS, Politics, and Income Inequality*, 150 TAX NOTES 1329, 1332 (2016) (discussing the inadequate funding of the IRS and how progressives might harness economic inequality arguments to gain more funding for the IRS); see also Tyler et al., *supra* note 217, at 301. *Contra*, see generally Anup Malani & Eric A. Posner, Essay, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017 (2007) (arguing that tax exemption should be decoupled from the nonprofit form, allowing for-profit corporations to seek tax exemption for their charitable activities and proposing a user fee payable to the IRS to fund this large scale shift in administration).

<sup>221</sup> See, e.g., Zachary A. Goldfarb & Karen Tumulty, *IRS Admits Targeting Conservatives for Tax Scrutiny in 2012 Election*, WASH. POST (May 10, 2013),

A second potential regulator of public benefit corporations are state attorneys general. In *Regulating Social Enterprise*, Professor Dana Brakman Reiser explores the potential to enlist state attorneys general to hold social enterprises accountable for the dual-mission claims.<sup>222</sup> State attorneys general have enforcement authority over “protecting charitable assets, protecting consumers and investors from fraud or deception, and safeguarding the general public interest.”<sup>223</sup> The state attorneys general role could be leveraged to include enforcement of social enterprises. Nonetheless, as Brakman Reiser points out, public benefit corporations do not hold charitable assets, making state attorney general oversight on that basis untenable without state legislative action.<sup>224</sup>

State attorneys general could, however, exert authority over public benefit corporations in their role as consumer protector. State attorneys general already exert their enforcement power over for-profit businesses as well as nonprofit corporations:

[The] broad investigatory and prosecutorial powers [of attorneys general] in both the consumer protection and charitable regulation contexts could also be deployed to challenge and punish social enterprises that make misleading claims to consumers, solicit capital on terms unfair to investors, or fail to live up to the claims they make or terms they undertake.<sup>225</sup>

Brakman Reiser questions whether state attorneys general will act as enforcer in the social enterprise arena, given that their offices are often underfunded and understaffed.<sup>226</sup> But it is difficult to see how state attorneys general could escape this responsibility—failing to police public benefit corporations as state attorneys general police other businesses and nonprofits is tantamount to giving social enterprises preferential treatment, and carte blanche to engage in consumer fraud. The policing of public benefit corporations by state attorneys general is not only necessary, but also a responsibility they already hold.

State attorneys general are not complete solutions to the harms posed by charitable public benefit corporations. They cannot be the sole accountability mechanism. The roles of state attorneys general are generally limited to prosecuting fraud, misrepresentation, or illegal business practices.<sup>227</sup> Some instances of greenwashing may not rise to the

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[https://www.washingtonpost.com/business/economy/irs-admits-targeting-conservatives-for-tax-scrutiny-in-2012-election/2013/05/10/3b6a0ada-b987-11e2-92f3-f291801936b8\\_story.html](https://www.washingtonpost.com/business/economy/irs-admits-targeting-conservatives-for-tax-scrutiny-in-2012-election/2013/05/10/3b6a0ada-b987-11e2-92f3-f291801936b8_story.html); Jackie Calmes, *Senate Report Cites I.R.S. Mismanagement in Targeting of Tea Party Groups*, N.Y. TIMES (Aug. 5, 2015), <https://nyti.ms/1ImpJsq>.

<sup>222</sup> Brakman Reiser, *supra* note 159, at 240.

<sup>223</sup> *Id.*

<sup>224</sup> *Id.* at 240–43.

<sup>225</sup> *Id.* at 244.

<sup>226</sup> *Id.*

<sup>227</sup> *See id.* at 240–46.



level of fraud or illegality, and misrepresentation may be difficult to prove. For example, while the HELP Report condemned Rasmussen College, it stopped short of openly accusing the college of fraud.<sup>228</sup> Social impact is difficult to ascertain. Unlike financial accounting that relies on somewhat objective standards of monetary inputs and outputs, social accounting can include difficult-to-measure and subjective standards. Social accounting is a relatively nascent field and no single standard has emerged, or may ever emerge, as authoritative.<sup>229</sup>

Finally, even where state attorneys general can help hold charitable public benefit corporations accountable, they are an inadequate solution to the other deleterious effects of market-based charity, which include an emphasis on outcome-driven, autocratic, and individualistic business values and the loss of democratic and participatory values to solve societal problems.

### C. *Explore Stakeholder Governance for Public Benefit Corporations*

This Article has argued that the proposed solutions to mitigate both the micro-level and macro-level harms caused by the public benefit corporation remain insufficient. One possible solution not yet fully explored elsewhere is the imposition of a stakeholder governance requirement. A charitable public benefit corporation could be required to grant or donate a sufficient amount of stock to a stakeholder or group of stakeholders who would, by virtue of being stockholders, have the right to bring a derivative suit against the public benefit corporation for failing to pursue its charitable public benefit. As I explored in my prior article, *Social Enterprise as Commitment: A Roadmap*.

Who comprises the group of stakeholders would be entirely context dependent. The stakeholders . . . might be the individual, community, or nonprofit beneficiaries that the social enterprise seeks to help. Directors might also look outside of stakeholder groups to subject-matter experts, such as representatives of independent nonprofits working in the same field. . . . The shares could be donated [or sold] to a trust or nonprofit, or group of

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<sup>228</sup> The HELP report does state the following:

[Rasmussen] has experienced significant enrollment growth yet has little to show for it, as the company has some of the worst student retention rates of any company examined by the committee. At the same time that 63 percent of students are leaving without completing a degree, taxpayers are investing approximately \$185 million a year in the company.

HELP Report, *supra* note 191, at 632.

<sup>229</sup> 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, 256–57 (2012) (discussing the Research Initiative on Social Entrepreneurship’s 2004 study of social impact accounting).

nonprofits . . . .”<sup>230</sup>

This stakeholder-stockholder solution ensures that there are true impact investors backing or involved in the public benefit corporation, and not simply traditional investors seeking to use the “warm glow” of the public benefit corporation for their financial gain. The stakeholder-stockholders are in place to ensure the charitable public benefit, but because they are stockholders they will also want to ensure the financial viability and profitability of the organization.

A full analysis of a stakeholder governance mechanism lies beyond the scope of this Article. Nonetheless, the stakeholder-stockholder requirement has several advantages. Investors in a closely-held or privately-held corporation (which all public benefit corporations are currently) are in a good position to determine and ensure whether the charitable public benefit is being met. Stakeholder-stockholders will have all of the rights that accompany being a stockholder. They receive the public benefit corporation’s financial reports and benefit reports and they have the power to inspect its books and records. Additionally, when venture capitalists or angel investors invest in a company, they usually place their own people on the company’s board and require regular monitoring and reports from management. Stakeholder-stockholders of charitable public benefit corporations can do the same. Stakeholder-stockholders could require the charitable public benefit corporation to adopt and adhere to a specific set of social reporting metrics as well as, where appropriate, opt into voluntary regulatory frameworks such as the International Labor Organization’s Labor Standards or the United Nation’s Guiding Principles on Business and Human Rights. Moreover, many nonprofit/for-profit hybrids are already structured in such a manner, with a nonprofit parent that dictates the mission and a for-profit subsidiary that pursues financial gain within the perimeters of that mission.

This stakeholder-stockholder proposal also allows the public benefit corporation to compete in the market without burdensome government oversight that could disadvantage them in the marketplace. As some scholars have already noted:

To impose an additional, likely draconian, layer of regulatory

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<sup>230</sup> Plerhoples, *Social Enterprise as Commitment*, *supra* note 10, at 128–29 (“The corporation would need to maintain this two percent share ownership through additional donations of stock to the third party with each new stock issuance.”). In *Social Enterprise as Commitment*, I recommended a set of voluntary steps that social entrepreneurs could take to avoid greenwashing and mission drift. My proposal there included voluntarily granting or donating shares to a set of stakeholders. *Id.* My proposal in this Article expands upon this earlier work to recommend that the Delaware General Corporation Law be amended to require that public benefit corporations pursuing a charitable public benefit be required to grant or donate shares to designated stakeholder-stockholders who would act as a watchdog against greenwashing or mission drift.

oversight as the first approach would place hybrids at a competitive disadvantage. Why erect unnecessary barriers to solving or mitigating social problems—particularly the subset of problems that are charitable—especially when legitimate regulator and public concerns can be addressed using less onerous means?<sup>231</sup>

The stakeholder-stockholder requirement is minimally burdensome but could also have the positive effect of deterring businesses from converting to the public benefit corporation if they only wish to do so to achieve the “warm glow” advantage without delivering any charitable public benefit.

The stakeholder-stockholder requirement also helps mitigate the macro level harm of market-based charity. Granting stakeholders stock in the public benefit corporation brings participatory and democratic governance<sup>232</sup> to the public benefit corporation. This solution maps the governance structure of many public charities—at least at the board level—onto public benefit corporations. Many public charities have board directors who reflect the populations that they serve or reserve seats on the board for beneficiaries. Under the proposed requirement, stakeholders of a public benefit corporation would serve such a role at the stockholder level. They could also appoint corporate directors who represent their “communitarian and egalitarian values”<sup>233</sup> and goals, such as “promot[ing] social transformation”<sup>234</sup> and not merely “reproduce existing inequalities”<sup>235</sup> through autocratic and individualistic values. A stakeholder governance mechanism merits consideration for those public benefit corporations who pursue a charitable public benefit comparable to that of a charitable organization.<sup>236</sup>

## CONCLUSION

This Article has documented the choice of entity overlap between charitable public benefit corporations and charitable nonprofits. It has unearthed the possible harms caused by this overlap. These harms were not anticipated by the creators and sponsors of the benefit corporation. They viewed the new corporate form as an alternative to the traditional

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<sup>231</sup> Tyler et al., *supra* note 217, at 301.

<sup>232</sup> See Jenkins, *supra* note 199, at 804–06.

<sup>233</sup> *Id.*

<sup>234</sup> *Id.*

<sup>235</sup> *Id.*

<sup>236</sup> Public benefit corporations that are formed and look more like for-profit corporations than charitable organizations—such as the online retailer Etsy—need not be obligated to follow the stakeholder-stockholder requirement. Public benefit corporations like Etsy were formed to be more socially-oriented for-profit corporations, not to compete with charitable organizations for impact investment dollars or “warm glow.”

corporations, not public charities. Greenwashing and the harms caused by market-based charity cannot be mitigated through reforms to the charitable organization or with more federal or state oversight without causing further problems. Additional measures are required to ensure that charity remains charitable and retains its democratic character. One possible solution to explore is a stakeholder-stockholder requirement for charitable public benefit corporations. Requiring stakeholder voices in the governance of the charitable public benefit corporation may reduce fraud and propel transformative solutions to societal problems that are not solely market-based and take into account stakeholder concerns and values.