

## ESTABLISHING NEW LEGAL FORMS FOR FOURTH SECTOR ORGANIZATIONS

July 17, 2008 | NYU School of Law

*Over the past few decades, the boundaries between the public (government), private (business), and social (non-profit/non-governmental) sectors have been blurring, while a Fourth Sector of organizations has been emerging. What is the broader systemic and global context in which this activity is emerging, and why is it important to create a more conducive regulatory environment for it?*

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### Participants:

- Enrique Balaguer, Executive Director, RealBenefits, Inc.
- Allen Bromberger, Attorney, Perlman and Perlman LLP
- Robert Chender, Attorney, Seward & Kissel LLP
- Colleen Ebinger, Director, Public Innovators at Root Cause
- Andrew Greenblatt, Partner, Criterion Ventures
- Todd Johnson, Attorney, Jones Day
- Andrew Kassoy, Co-Founder, B-Lab
- Marjorie Kelly, Co-Founder, Corporation 20/20
- Jay Koppelman, Partner, Marks Paneth & Shron LLP
- Robin Krause, Attorney, Patterson Belknap Webb & Tyler LLP
- Terry Mollner, Founder, Chair, and Executive Director, Trusteeship Institute, Inc.
- Rachel Mosher-Williams, Assistant Director, Non-Profit Sector and Philanthropy Program, The Aspen Institute
- Michael Pirson, Ph.D., Lecturer, Harvard Extension School, Research Fellow, Hauser Center, Harvard University
- Kris Prendergast, President, Social Enterprise Alliance
- David Roll, Managing Partner, Lex Mundi Pro Bono Foundation
- Heerad Sabeti, Convening Trustee, Fourth Sector Network
- Jeff Trexler, Wilson Professor of Social Entrepreneurship, Pace University
- Shann Turnbull, Ph.D., Researcher/Lecturer, International Institute for Self-governance
- Allen White, Director, Corporation 20/20
- Alissa Mickels, JD Candidate in 2009, UC Hastings College of the Law
- Jonathan Y. Ng, Associate, White & Case LLP

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### Meeting Summary

On July 17, 2008, the Fourth Sector Network, in partnership with the Social Enterprise Alliance and Corporation 20/20, brought together a group of attorneys, legal scholars, social entrepreneurs, policy analysts and business leaders for a roundtable discussion on legal issues surrounding Fourth Sector organizations. The meeting was organized into two parts: (1) examining the problems: impacts of current laws on Fourth Sector organizations; and (2) exploring solutions: from adaptations of existing laws to new hybrid structures.

## Part One:

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### **Examining the Problems: Impacts of Current Laws on Fourth Sector Organizations**

*As the Fourth Sector expands, organizations are encountering limitations imposed by existing legal and tax structures. What are all the existing legal authorities that affect Fourth Sector activity? What trade-offs do Fourth Sector organizations have to face within the current regulatory environment? We will explore several fact patterns involving actual or hypothetical social ventures and will examine whether the propositions are plausible under existing law.*

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Allen Bromberger welcomed participants and outlined the agenda for the day. Some participants expressed concern regarding ground rules for discussion in terms of sharing proprietary information and ideas for an emerging legal field. Discussion ensued about the importance of open communication while balancing the need to protect ideas shared by individuals. The group agreed that appropriate attribution should be given if anyone's ideas were discussed outside of this meeting.

Heerad Sabeti gave a PowerPoint presentation entitled "Patterns of Organizational Change" to set the context for the meeting (click [here](#) to view the presentation). First, he discussed how individuals were the drivers of change and how their actions are enabled and constrained by organizational structures; and organizations are, in turn, enabled and constrained by the support ecosystem that surrounds them—e.g. capital markets, regulation, technical assistance, standards, etc. As individual needs and values change, new organizational structures are called for that enable desirable behaviors on the part of their stakeholders, and those new organizations require a support ecosystem that is tuned to their needs. Next, he discussed how during the past few decades, some for-profit companies have been migrating towards an expanded bottom line that includes social and environmental purposes while some not-for-profit and governmental organizations have been migrating towards the market. These two trends point to the convergence of organizations toward a new, Fourth Sector of the economy. The traditional support ecosystems for the private, public and social sectors, however, are not adequately supportive of Fourth Sector activities. In order for the Fourth Sector to develop and expand, more appropriate support infrastructure needs to be developed, including new legal forms, tax policy and other regulation.

The group then discussed a broad range of unique challenges facing Fourth Sector organizations. A handout was circulated entitled, "Unique Problems and Issues Related to Fourth Sector Organizations" (click [here](#) to view the document). These include access to finance, measuring success and performance, exit of stakeholders, how to attract and retain talent, establishing trust of stakeholders and society, maintaining the integrity of the organization's missions, values and principles, determining equitable distribution of benefits, deciding what to do with profits and preventing inclusive participation from degrading operational efficacy.

Terry Mollner raised the issue of minority shareholder rights within Fourth Sector organizations. For example, how might minority shareholders be able to challenge investment decisions of the Directors? The underlying issue concerns what is the appropriate standard of review—the reasonableness test or the shareholder primacy doctrine—to apply to a corporation giving away

its assets in the form of philanthropy. The problem with the reasonableness test is that the threshold of what is reasonable has changed through time depending on economic and political circumstances. Jeff Trexler explained that what is “reasonable” has varied greatly from decade to decade since the 1930’s. Thus, he concluded, we must consider what factors will transcend economic downturns and booms. There was then debate about whether there should be an estoppel theory applied to Fourth Sector organizations precluding shareholders from bringing claims against Directors, specifically regarding investment decisions in philanthropy because philanthropy is part of the mission of such organizations. Because there is a lack of jurisprudence regarding Fourth Sector corporate legal issues, one solution raised to address minority shareholder rights was to expressly address them in the organization’s by-laws. State courts, however, use a standard of review that trumps by-laws.

Todd Johnson then raised the sub-issue of how do you get venture capitalists to invest if the Directors do not have a fiduciary duty to maximize profit for shareholders. He said you can come up with a redemption right for the founders. For example, if the Directors approve a “terminal” transaction, the founders have a right to veto that transaction if they are willing to buy out the minority shareholders. He said you must allow a long period of time for redemption to occur so the market has a chance to value it. Johnson has structured companies with these redemption rights in the past, and he said no lawsuits can arise so long as Directors have acted reasonably.

Next, the group discussed creating strategic hybrid legal models for organizations with eleemosynary purposes. This includes not-for-profits setting up for-profit companies and vice-versa. Enrique Balaguer asked what kinds of social enterprises exist right now. He stressed that it is important to figure out what corporate structure best fits your organization’s mission versus trying to fit your organization’s mission into a certain type of corporate structure. In the end, the key issue is determining how you are going to raise risk capital. Another challenge raised was that designing a financial structure that fits your social objective now can become problematic later after your organization grows. Thus, one size does not fit all. Pura Vida, a social venture which started out with a good financial model but now has too much debt, was mentioned as an example of an organization encountering this problem. The structure that hospitals use was discussed, but it was quickly determined that the hospital structure is not replicable because hospitals are treated differently by the law and can do things other corporations cannot such as issue bonds to raise capital. Bromberger said there are many ways to protect individual interests by using contracts instead of dealing with corporate structures. It was discussed, however, that instead of using contracts to address singular issues that arise, the focus should remain on the governance of the entity over the long-run because in the end, the ultimate question eleemosynary organizations are going to encounter is: *how important is your social objective?* In particular, how do you maintain your social mission while continuing to grow and raise capital? Who should decide this and to whom should you be accountable? Someone then suggested that a special class of shares could be created or provide super-voting stock for the founders to enable them to take advantage of equity much later down the line. Mollner said you will still encounter problems with minority shareholder rights and discussed what happened within Ben & Jerry’s as an example. At the end of that portion of the discussion, the group concluded that no matter what approach is best, there will always remain some external restraints in terms of what the courts will allow. Further, many people are trying many different things, and we will not know what works well until a few more years.

Next, the discussion turned to charities. Balaguer discussed how an organization in which he was involved started as a project of a 501(c)(3) entity. They were classified as a 509 supporting organization, which still did not address issues of raising capital. His project was still audited by the IRS for selling software, and he concluded that if he could do things over, he would organize his project as a for-profit entity because it reduces the level of complexity that a not-for-profit faces. The group then discussed the tax effects of not-for-profits owning for-profit corporations. If a not-for-profit owned a limited liability company, then the profit could be tax-free so long as the company's purpose was related to the not-for-profit's purpose. If a not-for-profit owned a corporation, then the profit is taxed at the entity level. Bromberger said that investments should focus on carrying out the organization's charitable purpose rather than maximizing returns like in a traditional for-profit organization. Thus, perhaps a foundation should be created to accumulate capital to make strategic investments in companies that are value-driven. The Rockefeller Foundation was mentioned as putting together a campaign on mission-related investments and Kellogg launched a small fund of \$100 million that was being deployed in a conservative way, seeking a 6 percent return on its investments. Mollner mentioned that the Calvert Foundation faces an issue with the IRS definition of "charitable." Bromberger said that you can use a 501(c)(3) as a vehicle to support social enterprise, which avoids a lot of the tension between making money versus pursuing a social mission by focusing solely on the mission. The 501(c)(3) becomes a revolving loan fund. You can have models in which not-for-profits generate profits and re-distribute it to social causes. No one is paid from the profits and all of it stays within the charity. For not-for-profit shareholders of for-profit companies, Bromberger said that the safest model is for the charity to own 51 percent of the not-for-profit. Trexler said that ultimately, we are talking about steering social entrepreneurs away from for-profit venture capital funds, so there is a need to create an alternative source of capital.

The discussion then focused on giving away profit that is generated, for example, in the form of grants as gifts. The issue here involves association with certain sponsors and maintaining your organization's brand. Allen White talked about how there is a time dimension to investing in which the person who keeps reaping financial gain in perpetuity presents a challenge in which old money is rewarded. He wants to know how we can bring in "fresh" money and how to reward new investments. Shann Turnbull believes that "For-Benefit" companies should put time limits on equity investors so you can get new investors. Allen White suggested you can write in redemption rights into the by-laws for companies to buy out investors. Johnson said that capital markets understand the time element of return. What he thinks is missing is any way to value the time element of social return. He said we can't measure social return very well.

Reference: A brief summary of US law affecting Fourth Sector organizations was created as a discussion draft in advance of the meeting (click [here](#) to download).

## Part Two:

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### Exploring Solutions: From Adaptations of Existing Laws to New Hybrid Structures

*What alternative approaches or legal forms might meet the needs of social ventures better than existing structures? If a new legal form makes sense, what would it look like? What trade-offs would be required to create a form that offers unique benefits to social ventures while still staying within appropriate boundaries of public policy? What is the interplay between the structure of the entity under state law and its treatment under federal, state and local tax law? Is there an acceptable “archetype” that can be adapted to a wide range of activities in a way that is similar to today’s corporation, LLC or trust? If so, what would its key attributes be? Participants will consider some existing proposals, including models that exist outside of the US, in order to draw conclusions about the potential for alternatives that could receive legal recognition and enforceability under US law.*

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After the lunch break, Alissa Mickels opened the second part of the meeting with a presentation about the “International Approaches to Enabling Fourth Sector Activity” (click [here](#) to view the presentation). She discussed the various terminology associated with the Fourth Sector movement in various countries. She also provided an overview of some state laws in Hawaii and Minnesota that have been proposed to enable Fourth Sector activity. If passed, these state laws would create new legal entities, new legal structures and new tax incentives. Pointing to international solutions, Mickels discussed the ecosystems and law in Belgium, Spain and Canada as examples.

Following Mickels’ presentation, in relation to the global corporate social responsibility (“CSR”) movement, Trexler discussed how the United States may have actually been an early player in the CSR movement. He said it was evident through Tocqueville’s writings that we learned almost 200 years ago that to produce social benefit, we had to liberate corporations. He recommended that participants take a look at The Creative Capitalism Blog ([creativecapitalismblog.com](http://creativecapitalismblog.com)).

This then led to a discussion about the academic research relating to social enterprise. David Roll asked what kind of rigorous academic literature exists addressing the best way to fulfill social needs. In other words, what is the academic case for social enterprise? Trexler said this is an ongoing debate, and that it is the job of the people in this room to amplify the argument for social enterprise. Sabeti mentioned that there exists more academic literature related to CSR than to social enterprise. Colleen Ebinger pointed out that the term “not-for-profit” was a misnomer because such organizations do make profit; they just do not pay it out. Michael Pirson added that there is not much academic literature because there is no clear theory behind the social enterprise movement. The focus here is more on human behavior as a basis for social enterprise. Generally, he said, academics are late bloomers and will take more interest once there is more interest from the public. He cited Harvard University as an example at which the university does not reward research on social enterprise or use it for tenure. The real motor, he contended, comes from civil organizations pushing for a more grounded theory. Dr. Pirson also said no matter what, our arguments for social enterprise must counter the arguments set forth by economists. Trexler added that this type of academic movement takes time. Shann Turnbull added that business schools in particular ask where’s the market for this type of research, which is why it needs

constant reinforcement from groups like this one meeting today. Jay Koppelman said that from his perspective as an accountant, business schools must produce graduates who have been indoctrinated about social enterprise issues in practical approaches. He said there exists a macro educational problem and a micro day-to-day problem of attorneys and practitioners who meet with clients who want to do good and do well.

The discussion then transitioned to how there has been a growing movement from the bottom-up driven by students and young professionals. The social movement is a bottom-up movement, and this is evident through the emergence of a variety of new organizations such as Ashoka, StartingBloc and Echoing Green, among many other groups. Mickels briefly discussed her experience at the Wisdom Conference in Paris as an example of a generation of young people who wish to do good for the world through more innovative ways. Johnson added that he sees four different silos that have emerged. First, there are the social activists who are comprised of both liberals and conservatives. Second, there are people of faith who view what they do in business as an extension of their faith. Third, there are the 40's "Cultural Creatives." Fourth, there is the "Justice Generation," which comprises people who have grown up with a sense of social justice connected to the world more so than any previous generation. These people understand that what they have inherited is messed up. Johnson mentioned Sam Goldman as an example of someone from the Justice Generation. Sam Goldman went to work at Wal-Mart, and instead of feeling like a corporate sell-out, he realized that he was in the position to change the corporate culture there. Marjorie Kelly added that she thought you could add government as a fifth silo in that the younger generation distrusts the government. This is important to address because the government is the common thread across the numerous sectors that are required to address social change. Also, she added, we should not discount government altogether because in looking at other countries, it was the government that played a large role in creating a positive ecosystem for social change to occur. Following up on that point, Johnson said he thinks the biggest driver in the United States is the Tax Code, which created this binary for-profit/not-for-profit model. This binary model is now the wrong way of promoting social enterprise, and he believes there should be some corporate structure that allows people to create what they want based on their social mission. Someone else added that the \$25 trillion under management in the equity markets are managed by people who are highly specialized in profit-maximization. Thus, if we want to direct money from where it's currently going to where we want it to go, we must do better to show investments that have worked. Social entrepreneurs focus on mission and money managers focus on profit maximization, but those two concepts do not have to be at odds with each other; they can thrive separately.

Mollner then introduced his idea of a "1 to 10 Movement." This involves encouraging companies to donate between 1-10% of their net profits to Fourth Sector Foundations ("4SF"). The 4SFs then solely invest in "Fourth Sector Investment Funds ("4SIFs"). The 4SFs raise donations and issue loans. The 4SIFs buy successful companies and convert them into 10% Fourth Sector Companies ("4SCs"). The 4SCs' primary objective is serving the common good. These companies are characterized by having a 12% cap on their return to investors, a donation of 1-10% of annual net profits to the 4SFs and a cap on return on equity is encouraged with the remaining balance invested in 4SIFs. There will always be an issue of what percentage of net profit each year should be distributed to stakeholder shares.

The group then spent several minutes discussing the 1 to 10 Movement. Bromberger said that as a lawyer, he thought this model is very attractive because we can use the existing laws to implement this model instead of going through a long process of trying to change laws. Essentially, this model directs energy in a different way. Allen said this looks like a 501(c)(3) that uses the business as an engine of profit and the not-for-profit for social good. Rachel Mosher-Williams asked where the social good is happening with these organizations. Mollner said that the charitable purpose for the Fourth Sector is education. Another participant said he supports this model because it seizes the tools that make the rich richer. He said he was not sure about the 12% cap, but generally, he supports the concept.

From here, the discussion shifted to defining what the Fourth Sector means. Johnson started out by following up on an earlier point from the morning in which he has adapted provisions related to corporate citizenship and placed them into form by-laws for organizations. Basically, the idea is to incorporate values into corporate documents. Examples of this include provisions related to environmental responsibility (i.e., “The company shall endeavor to conduct business in an environmentally and socially responsible manner.”), corporate giving, fair wages, equal benefits for employees, compensation and no third-party beneficiary status. These type of legal forms will be helpful for others looking to establish similar socially conscious corporations. Johnson said the original idea to disseminate this type of information was to create a wiki. Sabeti said the legal document library on the Fourth Sector website had been completed and was ready to be populated. Bromberger asked if such corporate documents are enforceable. Johnson responded that the key is to live within the laws as they exist today, and there is no externality that affects these forms. Trexler added that this is an issue of framing. When you speak to the judge, there is an understanding that the social and profit goals are imbedded into your corporation’s brand. Johnson also added that social purpose companies can work within the existing legal structures, but they should also be explicit about their social purpose. In every communication the company sends out, it should be clear to the shareholders that it is first and foremost a social enterprise. Trexler also said there is a signal to noise problem. The court will focus on the depth of commitment to social responsibility, which fits within the fiduciary responsibility argument. Courts will begin to scrutinize the depth of your company’s commitment to social good because it was part of your business model from day one.

Bromberger elaborated on an alternative approach of setting up a not-for-profit together with a for-profit, and then arrange contractual arrangements. This way, you create a relationship between the two entities with some board overlap, but overall, there is independence. Thus, rather than locking the relationship and social mission into the organization documents, he structures it through contracts. He understands these contracts are not really going to be tested because no one is likely to breach them and sue each other; however, this approach does create a clear structure for how ownership works and how money is supposed to be exchanged.

The remainder of the meeting centered on a discussion of formalizing a Fourth Sector archetype. Sabeti led the discussion and began by identifying what he believed were the lowest common denominators shared by all Fourth Sector companies. He said the premise underlying the creation of an agreed-upon archetype is based on the fact that we need consensus on what the Fourth Sector is so we can get to a rationalized marketplace with a coherent support ecosystem. Sabeti believes this group can be a driver behind establishing the base for this archetype. There was continued discussion about whether it was worthwhile to discuss a Fourth Sector archetype. The

general consensus was that there should be some model for everyone to use. Trexler said the problem with hybrid models is that they create uncertainty. Thus, we need some standardized model that is accessible to the public. For an archetype to be established, however, it was important to the group to better define the Fourth Sector's boundaries.

The key take-aways at the end of this portion of the discussion included: (1) the need to come up with certifications of social enterprises (similar to LEED standards); (2) creating a non-proprietary repository of legal and business documents to share best practices; (3) further developing the 1 to 10 Movement introduced by Mollner.

Reference: A brief scan of proposed US and international solutions enabling Fourth Sector activity was developed as a discussion draft in advance of the meeting (click [here](#) to download).

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*For additional information about the July 17, 2008 Fourth Sector Legal Strategy Roundtable (including copies of the meeting presentations and handouts) and the Fourth Sector's development, please visit [www.fourthsector.net](http://www.fourthsector.net).*