Stanford Social Innovation Review

Spring 2011 Volume 9, Number 2

Stanford SOCIAL INNOVATION REVIEW

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$12.95 U.S. | $14.95 Canada

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Published by the Stanford Center on Philanthropy and Civil Society

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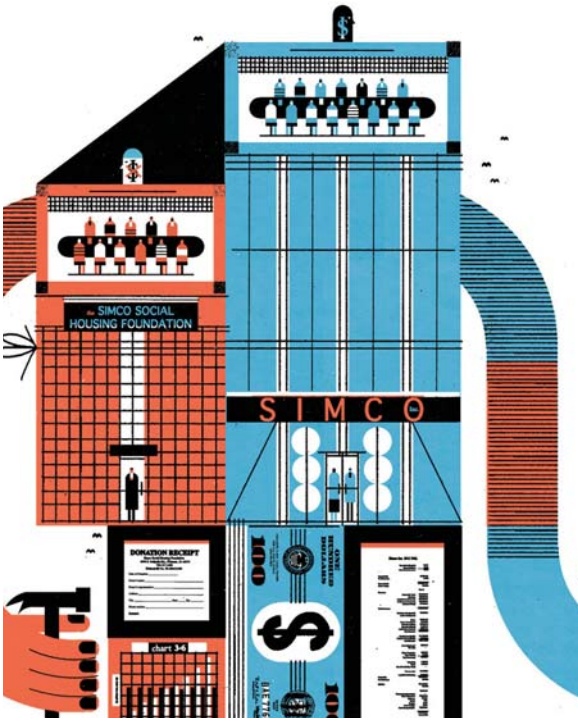

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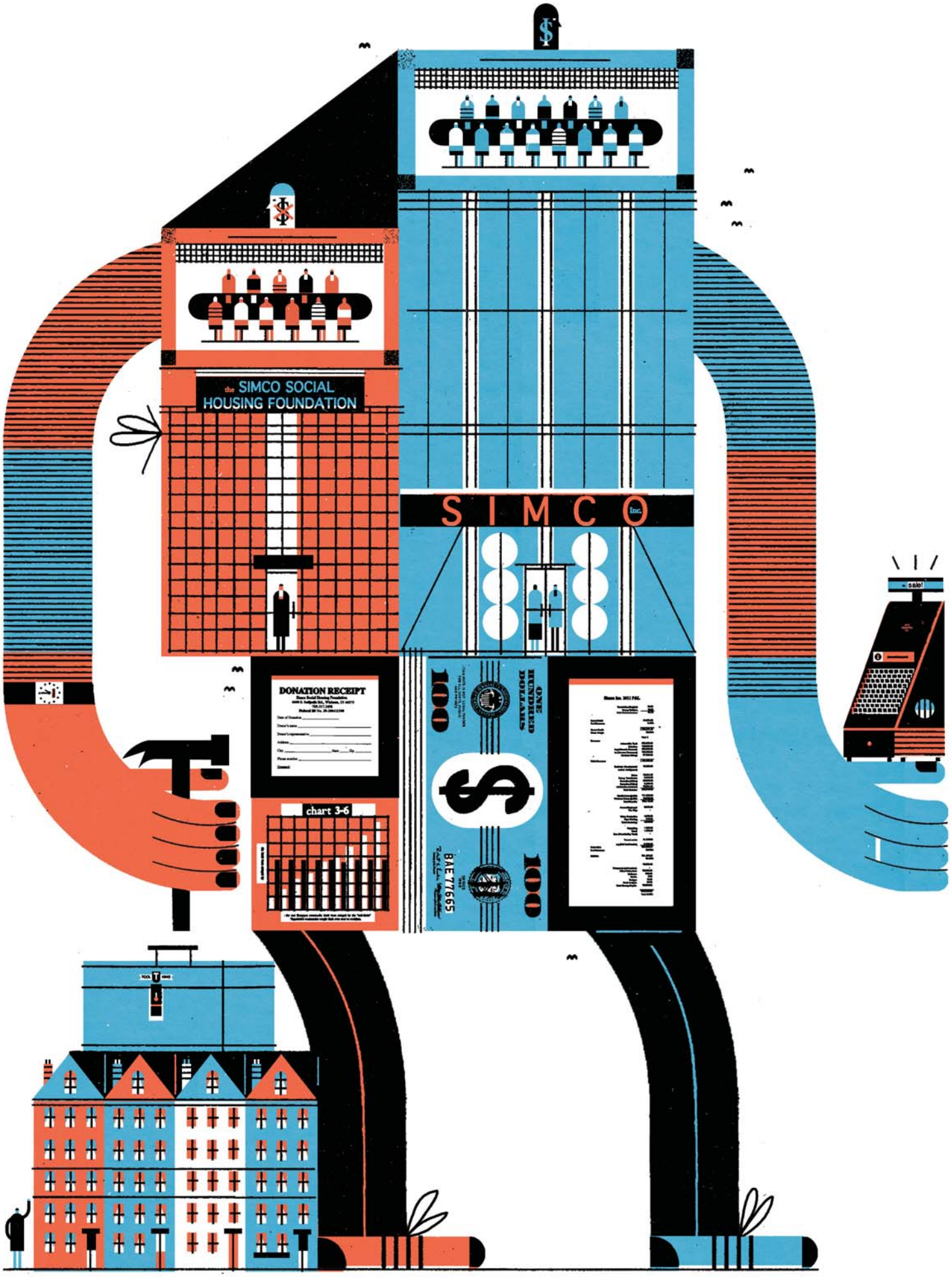
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A NEW TYPE OF HYBRID

By Allen R. Bromberger | *Illustration by Raymond Biesinger*

MUCH TO THE CHAGRIN OF SOCIAL ENTREPRENEURS, U.S. law does not currently recognize any single legal entity that can simultaneously accept tax-deductible donated capital (charitable contributions and grants); invested capital (equity investment for which investors seek a market rate of return); and quasi-invested capital (such as loans or program-related investments [PRI] from foundations that are structured as investments but in which the funder has a strong philanthropic motive and neither expects nor demands a market rate of return). As a consequence, social entrepreneurs are typically forced to choose between for-profit and nonprofit models that require them to compromise their social vision and restrict their ability to finance and operate their ventures in a way that meets the founders' own needs as well as those of their investors, customers, employees, and other stakeholders.

Some entrepreneurs, however (especially the most intrepid ones), have found ways to combine the best of the for-profit and nonprofit models. They have done this by creating a hybrid structure: separate nonprofit and for-profit organizations that are bound together through governance or legal agreements. Hybrids, of course, are not new. They have been around for decades (consider Children's Television Workshop, owners of the Sesame Street characters). For the most part, hybrids have been created by an existing nonprofit or for-profit to meet a new objective that could not be met under its existing legal structure. A for-profit corporation might create a nonprofit foundation to manage its philanthropic work. Or a nonprofit museum might create a for-profit retailer to sell posters, jewelry, and other merchandise.

Social entrepreneurs have taken the hybrid model to a new level, crafting it into what is in effect a single structure that can operate as both a for-profit and a nonprofit.

In recent years, however, social entrepreneurs have taken the hybrid model to a new level, crafting it into what is in effect a single structure that can operate as both a for-profit and a nonprofit. Social entrepreneurs are now creating complex hybrid structures from the start, ones that use contracts to intimately tie together the nonprofit and for-profit organizations. I call these new entities *contract hybrids*, to distinguish them from the hybrids of the past.

NEVER THE TWAIN SHALL MEET

To understand what a contract hybrid is and how it works, one must first understand that the entire legal and regulatory structure that governs U.S. businesses and nonprofits is designed to ensure that the charitable sector and the business sector stay fundamentally distinct. In a nutshell, charity is supposed to be all about mission and not about money, whereas for-profit businesses are supposed to be all about money and not about mission. As a result, business and charities are regulated and operated according to fundamentally different principles, and any crossing of the lines is viewed with skepticism by regulators and the public.

As Dan Pallotta points out in his book *Uncharitable*, this divergence is not rooted in any law of economics or even politics. Rather, it is the result of historical accident. It is essentially the view propounded by the Puritans who settled in the United States in the 17th century. They believed that business and commercial activity was a sin, albeit a necessary one. To atone, one did charitable work, which had to be kept clean of any taint of commerciality. Although we have progressed in our thinking since then, Congress, the Internal Revenue Service (IRS), state regulators, the general public, and even nonprofit leaders remain locked into this outmoded mental model.

Creating a hybrid entity that can serve both charitable goals and business objectives simultaneously may sound simple, but from a legal perspective it is actually quite complicated. For-profit businesses have as their primary objective the pursuit of profit for the benefit of their owners. The directors and managers of a for-profit business have a fiduciary duty to maximize shareholder return, and if pursuit of a social mission interferes with that primary duty, the directors and officers can face legal jeopardy.

Nonprofits, on the other hand, have as their primary objective the accomplishment of a social or public mission. Nonprofit directors and managers must run the enterprise to further public rather than private interests. If they confer private benefits on individuals (other than reasonable compensation for services rendered, itself a touchy subject), they may face legal liability. And they generally cannot engage in profit-sharing arrangements with private investors or businesses. To put it another way, businesses and nonprofits are fundamentally single-purpose entities. Although the law allows them to stretch toward each other, a complete synthesis is not possible, and the further each model is stretched, the more legally uncertain the venture becomes.

The three most popular stretched models today are the B corporation, benefit corporation, and low-profit limited liability company (L3C). The B corporation is a brand, certified by B Lab (itself a nonprofit), rather than a legal form in the eyes of the IRS. To be certified a B corporation, the owners and managers of the organization voluntarily submit themselves to a rigorous battery of questions and tests that measure their commitment to social values and socially and environmentally responsible practices. B Lab makes the results of these tests public, so that consumers can find out what these companies stand for and how their claims of social responsibility are put into practice. B Lab promotes B corporations as a group, which gives them a marketing advantage and provides further incentive for them to justify social mission as a business strategy.

The benefit corporation, which is officially recognized in Maryland (and Vermont beginning April 2011) and is under consideration in several other states, is often confused with the B corporation but is actually distinct. Whereas the B corporation is essentially a brand, a benefit corporation is a legally distinct type of business corporation that is committed to accomplishing one or more social or public purposes. A benefit corporation must specify in its charter that it is formed to pursue a social purpose, it must have at least one "benefit" member on its board whose sole duty is to protect mission rather than profit, it must be certified by an independent third party as complying with standards promulgated by the certifying agency, and it must produce an annual report that explains what it has done during the prior year to accomplish its social mission. In return, the directors of the benefit corporation are protected from liability for decisions that further the social mission, even if they impair profitability.

The L3C, which has been legally recognized in several states and is under consideration in several others, is essentially a limited liability company (LLC) whose purpose is limited to "low profit" activities that further a charitable purpose, and the generation of income is not a significant purpose of the venture. The L3C was originally designed to be a special purpose vehicle to which private foundations could more easily make PRIs. Practitioners argue whether or not the L3C has any utility at all in this regard (because foundations can already make PRIs in for-profits), but the brand has caught on and many people now regard it as a way to signal their intent to place mission at a level that is equal to or greater than profit, while still enjoying the advantages of a business structure (the ability to accept private investment and enter into a broad range of business relationships). The B corporation, benefit corporation, and L3C do not qualify for tax-exempt status; they are all firmly in the for-profit sphere.

THE HYBRID

Standing in contrast to these stretched models is the hybrid. It is based on the principle that a single entity—be it an L3C, a 501(c)(3), a benefit corporation, or a traditional for-profit—cannot by itself do everything that a social venture needs to do. Instead, the hybrid uses a series of contracts and agreements to combine one or more independent businesses and nonprofits into a flexible structure that allows them to conduct a wide range of activities and generate synergies that cannot be done with a single legal entity. The two (or more) entities that generally make up a hybrid are distinct for legal purposes, and each is responsible for compliance with the laws and regulations that govern it, but when properly structured, the legally distinct entities can behave much like a single entity. For these reasons, a hybrid is often a better solution than a single legal entity that tries to incorporate a wide range of activities.

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Hybrids, as mentioned before, are nothing new. For decades, nonprofits such as the National Geographic Society have created for-profit subsidiaries and entered into strategic relationships with for-profit companies to exploit their assets in the marketplace. Catholic Charities USA, the American Health Assistance Foundation, the National Center on Family Homelessness, Community Teamwork, the DC Central Kitchen, and the United Spinal Association are all examples of charities that over the past 10 years have created LLCs to carry out profit-making activity.

Hospitals, universities, and museums also routinely engage in commercial transactions and collaborations with for-profit companies, including joint ventures that serve the mission of the nonprofit and the financial interests of the businesses. Nonprofits contract with for-profits all the time, and it is now common to see businesses associate themselves with nonprofits using a variety of cause marketing techniques, including corporate sponsorships and commercial co-ventures. These arrangements are fairly well understood and have been approved by the IRS on numerous occasions.

Most existing hybrids are structured either as parent-subsidiary relationships, where the charity owns the business, or as "one-off" arrangements where the charity and the for-profit collaborate to achieve a particular project or activity. There are variations on these models (such as the corporate foundation and the joint venture), but the parent-subsidiary model essentially uses governance as the mechanism of control and is intended to ensure a high degree of integration over time. One-off arrangements use contracts as the mechanism of control but are limited in scope and the degree of integration between nonprofit and for-profit is usually limited.

What makes the contract hybrid different is the degree to which the goals, objectives, and strategies of the nonprofit and the business are coordinated to serve mutual interests. Rather than a one-off deal where a nonprofit licenses property to a for-profit company, or a company provides marketing dollars to benefit a specific charity event, the purpose of the contract hybrid is to create an ongoing, symbiotic relationship between a nonprofit and a for-profit to accomplish mission and business objectives on a long-term basis.

Some might describe the distinction between a traditional hybrid and a contract hybrid as a matter of degree, but from a legal point of view it is more than that. It allows synergies that simply aren't possible with the other models, because both the nonprofit and the business are free to pursue their activities in a way that is most likely to be successful within the legal, financial, and regulatory framework that applies to it, without being bogged down in the limitations and regulatory burdens of the other party. Yet they are tied together in a way that allows the whole structure to leverage the strengths of each organization.

UP CLOSE

To understand what makes a contract hybrid special, it is useful to take a close look at one example. (These are real organizations, but for privacy their names have been changed.) The Appalachian Economic Development Corporation (AEDC) is a nonprofit that provides assistance to the chronically unemployed in the economically distressed region of Appalachia. In order to create jobs, stimulate the regional economy, and generate revenues to support its operations, the organization decided to use mail-order catalogs to market and sell products made by local residents. Because AEDC had little experience in this area, it entered into an agreement with the North American Catalog Company, a for-profit C corporation, to handle marketing, sales, and distribution. Under the contract, North American Catalog is paid a percentage of sales, with incentives when sales reach certain milestones. AEDC, in consultation with North American Catalog, selects the products to be sold, which must meet standards and guidelines set forth in the agreement.

AEDC assists the local residents with business advice and support, including low-interest loans provided by North American Catalog (the company lends money to AEDC, which in turn lends it to the residents). The loans allow the residents to expand their production and management capacities to meet the higher demand for their products that the catalogs create.

AEDC promotes the products (sold exclusively by North American Catalog) on its website and licenses its mailing lists and logo to the company, which can use the lists and logo only for catalogs that include products created by the residents. North American Catalog agrees to spend a certain amount of money on marketing and to distribute a certain number of catalogs each quarter. It also agrees to use local printers and designers so long as they can produce work of acceptable quality at an acceptable price. These arrangements are not just for a single season or for one or two products but cover a wide range of products over five years, with an option by either side to extend it another five years.

The agreement allows AEDC to withdraw without penalty if it determines that the arrangement is not in its best interest or would jeopardize its tax-exempt status. North American Catalog can terminate the agreement if sales don't meet certain minimums, if it has a change in control, or if a certain percentage of the products selected by the nonprofit don't meet the negotiated guidelines.

Sales are about $13 million per year, with North American Catalog earning about $1 million after expenses, AEDC earning about $400,000, and the local residents collectively earning about $3 million. More important, a large percentage of the expenditures are made within the Appalachian region, pumping between $7 million and $8 million into the local economy every year, creating jobs and increasing the local tax base. None of the parties could have done this on their own: it required a collaborative effort and a carefully crafted set of agreements to make it work. It required a contract hybrid.

PRINCIPLES OF CONTRACT HYBRIDS

Six basic principles govern the creation of contract hybrids. First, the nonprofit and the business must be legally independent of each other, with independent majorities on each board to minimize conflicts of interest and assure that each entity has the ability to comply with the laws, regulations, and best practices that apply to it. It is not uncommon for each entity to have its own accountants and lawyers to preserve this independence.

Second, the entities are tied together using a variety of contractual arrangements. These include contracts for goods or services,

financing agreements, shared service agreements, intellectual property licenses, fiscal sponsorships, participation agreements, nondisclosure agreements, grant agreements, and leases.

Third, each of these contractual agreements is negotiated at arm's length. For example, in the case of AEDC and North American Catalog, the sales, marketing, and distribution agreement was not a standard contract. Various provisions had to be customized and each side had to make concessions so that each party could fulfill its part of the bargain on commercially reasonable terms without either side taking unfair advantage of the other. This is one reason why many contract hybrids have separate boards of directors, lawyers, and accountants to ensure that each entity looks out for its own best interests, and that its advisors and decision makers don't have conflicted loyalties.

Fourth, if the assets of the nonprofit are to be used by the for-profit, the nonprofit must receive fair value in exchange. For example, if a nonprofit has developed a product or service that the for-profit wants to use, the nonprofit has to ensure that the benefit to the investors in the for-profit is incidental, meaning that the benefit to the outside investors is not out of proportion to the overall venture or the size of their investments, and the arrangement is structured so that its primary purpose is to accomplish mission (or benefit the nonprofit) rather than to enrich the investors.

Fifth, any payments from the for-profit to the nonprofit should be taken as a marketing or other business expense by the for-profit rather than as a charitable contribution whenever possible. For example, the Sugar Bowl, a 501(c)(3) organization that hosts a nationally televised college football game, receives a significant payment each year from Allstate Insurance Company in exchange for naming its game the "Allstate Sugar Bowl," and for providing prominent visibility for Allstate's name and logos. Because this is a "qualified corporate sponsorship," an arrangement whereby a company makes "donations" to a charity in exchange for recognition and the right to use the charity's name and logo for promotional purposes, these payments are treated as contributions on the nonprofit's tax return rather than taxable advertising income. These payments are treated as a business expense by Allstate rather than a charitable contribution because they serve a business purpose.

Last, all transactions and arrangements should be fully documented, everything should be reviewed and approved by the boards independently, and there should be special provisions in the documents to protect both the business and the nonprofit against allegations that either is being used to unfair advantage by the other.

There are downsides to the contract hybrid model: Because there are so many formalities to be observed, overhead may go up; and the structure can be complex and hard to understand, which may impair the venture's ability to attract philanthropic and private capital. But those problems can often be solved by putting clear policies and procedures in place that minimize the need for improvisation and the concomitant risks of noncompliance. Furthermore, if done properly, the structure can be explained in a relatively simple manner. The greatest problem, ironically, is that most nonprofit and business lawyers are not yet familiar with these structures, so they often advise their clients to stay away from them because of perceived risk.

STRUCTURING A CONTRACT HYBRID

From a legal point of view, deciding whether and how to structure a contract hybrid depends on some well-understood considerations, in particular IRS rules on joint ventures, private benefit, unrelated business income tax, conflicts of interest, related party transactions, and the new IRS Form 990, each of which is discussed below.

JOINT VENTURES | Although joint ventures may be a practical option for nonprofits that want to conduct business ventures with for-profit entities, the contract hybrid may be a better choice in many cases. Unless the nonprofit has effective control over the joint venture (which many investors will resist), or the joint venture is small in comparison to the nonprofit's overall activity (which is generally true only for very large nonprofits), there are substantial risks to the nonprofit's tax-exempt status if it engages in a joint venture with a for-profit entity. By contrast, with a contract hybrid, there is no separate entity or partnership formed, and thus no joint venture in the legal sense. Instead, the contract hybrid consists of nothing more than a series of agreements that tie the parties together with respect to certain activities in which they have a common interest or in which exchanges for value are involved. Take, for example, a business that employs disabled workers. The workers need various support services, such as housing assistance and occupational therapy, that the business cannot provide. So the business enters into an agreement with a nonprofit. The nonprofit provides the needed support services and refers eligible workers to the business, and in return the business pays a referral fee to the nonprofit. The parties do not control each other, they are not obligated to look out for each other's interests, they do not jointly conduct activities, they do not share profits or losses, and each party is free to conduct its own activities as it sees fit, subject only to the agreements it has signed.

PRIVATE BENEFIT | A charity cannot qualify for 501(c)(3) tax exemption (or retain its exemption) if it confers substantial private benefits on non-tax-exempt entities or private individuals. Take, for example, a nonprofit art museum whose only activity is showing the work of new artists. The museum enters into an arrangement with a for-profit art gallery in which the works shown by the museum are sold by the gallery on a consignment basis. The artists and the gallery keep 90 percent of the sales price, and the museum receives the other 10 percent. Because the museum's sole activity directly and substantially benefits the gallery owners and the individual artists out of proportion to the benefits to the museum, and the activity that generates the benefit does not contribute to the accomplishment of the museum's tax-exempt mission, under relevant IRS authority, the museum can lose its tax-exempt status. The rule, however, is not absolute. Private parties can benefit from joint activity if the benefits are inherently unavoidable, indirect, and insubstantial. For example, a nonprofit formed to clean and maintain a lake that is used for recreational purposes by the public would not lose its tax-exempt status merely because its activity benefits the homeowners who own property on the lake.

UNRELATED BUSINESS INCOME TAX | Every 501(c)(3) organization must pay a tax on net income from unrelated business activity, called the unrelated business income tax (UBIT). The tax must be paid when the charity conducts a trade or business that is regularly carried on and that is not "substantially related" to its tax-exempt purposes. The classic example is a case involving New York University. The owner of a macaroni factory bequeathed the factory to NYU when he died. The IRS ruled that because the operation of a macaroni factory did not further the university's educational mission, the income from the factory was subject to UBIT. An activity is substantially related to a charitable purpose only if it contributes to the accomplishment of a tax-exempt purpose in an important way other than through the production of income. For example, a pharmacy within a hospital that fills prescriptions only for patients of the hospital. There are several exceptions to UBIT, the most important of which are the exceptions for so-called passive income, such as rents, royalties, and dividends. A contract hybrid can avoid liability for UBIT by following several basic rules. Whenever possible, unrelated business activities should be conducted by the for-profit entity and not the 501(c)(3). The income should flow from the for-profit to the nonprofit either as compensation for goods and services, or as passive income; or the income should flow to the nonprofit in the form of donations, such as a qualified corporate sponsorship (the payments from Allstate to the Sugar Bowl are an example of this).

CONFLICTS OF INTEREST | It is important that contract hybrids are structured to avoid conflicts of interest that may arise in transactions between the nonprofit and for-profit entities. It is well-established in nonprofit corporate governance that directors and officers must act solely in the interests of the organization, and not in their personal interests or the interests of another party. To ensure that this occurs, state corporate law and IRS rules require that directors and officers—indeed, anyone who is in a position to influence a nonprofit's decisions on a particular issue—disclose any personal interest they have in the transaction and recuse themselves from participating in the decision. With a contract hybrid, the directors and officers of the nonprofit may sometimes have a financial interest in transactions between the nonprofit and the for-profit entity. For example, they may be investors in the for-profit entity. This creates a conflict of interest that must be disclosed, and the director or officer may not participate in decisions related to the transaction. So long as the transactions are approved by a majority of the "disinterested" directors (those who do not have a conflict), however, the transaction can go forward and will be legal. This is another reason why a majority of the boards of the nonprofit and for-profit should be independent of each other.

RELATED PARTY TRANSACTIONS | A related party transaction is a transaction between a charity organization and one or more of its officers or directors, or anyone else within the organization who is in a position to influence the charity with respect to the transaction, or with an organization in which such a person has a substantial financial interest. An example of this is a director of a nonprofit who sells insurance to the nonprofit. The term also applies to transactions between a charity and another organization that controls it or is controlled by it, or where both are controlled by a third party. Transactions with "supporting organizations" are also covered. Finally, organizations, whether or not tax-exempt, that have entered into partnerships (including LLCs taxed as partnerships) with a charity are also treated as related parties. One needs to be careful of related party transactions because, although they are not prohibited, they must be reported to the IRS on the charity's annual Form 990, and they may be scrutinized by the IRS to determine whether or not the related party received an excess benefit.

FORM 990 | Charities are required to disclose on Form 990 whether they have invested in, contributed assets to, or otherwise participated in a joint venture. Unlike a legal joint venture, which requires the creation of a legal entity or partnership to carry out the venture, a joint venture for this purpose is defined broadly as a "joint venture *or other similar arrangement* with one or more taxable persons." It includes a broad range of arrangements in which assets, revenues, gains, and losses are shared, regardless of who controls the venture or how it is legally structured. If an organization has participated in a joint venture using this broad definition, it has to answer a follow-up question concerning whether it has a written policy or procedure meeting certain requirements. It must also be able to assert that it has taken steps to safeguard its tax exempt status. The 990 disclosure requirement has not been used as a basis for applying the rules applicable to legal joint ventures. Nevertheless, disclosure may lead to scrutiny to ensure that the arrangements are appropriate. The contract hybrid probably has to be disclosed as a "similar arrangement" even though it doesn't meet the legal definition of a joint venture. So thought must be given to how the arrangement is described.

CONCLUSION

In the absence of a legal form specifically designed to allow the pursuit of mission and profit simultaneously, practitioners are often forced to create structures that combine for-profit and nonprofit entities in ways that allow each to do what it does best. The contract hybrid is one approach that has been specifically designed to overcome the obstacles that current law imposes on partnerships and collaborations between nonprofits and for-profits.

The contract hybrid can be complicated to create and maintain, and it will not work in all situations, particularly where the rules are difficult or impossible to follow. In situations where a nonprofit or a business can accomplish its goals without the need for a hybrid legal structure (for example, where a business can accomplish its social goals by making donations, or a charity can establish a business venture using a subsidiary that does not require outside investors), those approaches may be preferable.

The concepts and techniques that form the foundation of the contract hybrid are, however, well established in law, and a number of experienced lawyers have agreed that the contract hybrid is a useful approach. Done correctly, it can offer the opportunity for charities and business to do things that they cannot do on their own. Although not the final answer, the contract hybrid represents an important step in the evolution of legal structures for social ventures. ■