Preventing Private Inurement in Tranched Social Enterprises

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INTRODUCTION

Recently, there has been a significant amount of interest in so-called "social enterprises." While there is no precise definition of a social enterprise, "[t]he working definition . . . is that a social enterprise is one organized and operated for the dual purpose of engaging in profit-making activity and furthering a social good."[1] Thus, a social enterprise is thought to occupy a borderland between two sectors of society: the business sector and the charitable or social sector.

The social enterprise movement has been accompanied by what might best be called a social enterprise legal reform movement. Legal reformers take the position that social enterprises are overly constrained by a regulatory environment that puts enterprises in one of two boxes: either the enterprise is a for-profit business or it is a non-profit charity.[2] In response to this perceived limitation of current law,

[1] Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 5 (2010). *See also* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 337 (2009) (discussing "so-called hybrid social enterprises, which combine the soul of nonprofit organizations with the discipline and business savvy of for-profits"). Generally, social enterprises are differentiated from businesses who seek to use some (or all) of their profits from one activity to advance a separate social good. *See, e.g.*, Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 91–92 (2010) (distinguishing a for-profit social enterprise in which commercial activities directly affect mission from an enterprise in which commercial activities merely provide a source of revenue to support the mission). For a more functionally limited definition that is arguably more useful, see Ofer Eldar, *The Role of Social Enterprise and Hybrid Organizations* 1 (Yale Law & Economics Research Paper No. 485, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2379012 ("The common characteristic of social enterprises is that they have a transactional relationship with their beneficiaries.").

[2] *See, e.g.*, J. Haskell Murray & Edward I. Hwang, *Purpose With Profit: Governance, Enforcement, Capital-Raising and Capital Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 7 (2011) (citing Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective*, PERLMAN & PERLMAN LLP, http://www.pearlmanandpearlman.com/publications/articles/2008/socialenterprise.pdf) ("Even with the help of the most experienced attorneys skilled in structuring such arrangements, the lack of a convenient legal form, designed to accommodate the dual goals of profit and charity, remains the 'single greatest challenge' of social enterprises."). *See also* Kelley, *supra* note 1 at 340–44 (arguing that social entrepreneurs believe that "outmoded law and inappropriate old-style legal entities hamstring their socially transformative plans"); Anthony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?* 34 SEATTLE U. L. REV. 1351, 1362 (2011) ("The push for new forms reflects dissatisfaction with the seemingly binary nature of existing options."); Susannah Camic Tahk, *Crossing the Tax Code's For-Profit/Nonprofit Border*, 118 PENN. STATE L. REV. 489, 491–92 (2014) ("Tax law patrols the nonprofit border carefully [and the laws] view sectorial border-crossings with suspicion."); Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233, 233 (2006) ("[Social entrepreneurs must] work within a tax regime that is sometimes not flexible enough to accommodate these new ideas and new methods.").

social enterprise legal reformers seek to create a third "hybrid" legal form to facilitate social enterprise. They seek to create a legal or regulatory environment better suited to the dual social and financial purposes of social enterprises. If success can be measured by changes to the law, these legal reformers have been surprisingly successful.[3] Many states have enacted laws to provide new business entity designations for social enterprises, and such new business-form statutes include benefit corporations, L3Cs, flexible purpose corporations, benefit LLCs, and others.[4]

A significant focus of social enterprise legal reformers is "deregulatory," in the sense that the new business forms are intended to free social enterprises from a variety of laws that constrain the "traditional" non-profit sector.[5] High on the list of legal regimes that are perceived to be overly restrictive is the federal law of charities[6] contained in the Internal Revenue Code.[7] These federal tax laws permit charitable organizations to earn money tax-free and to receive tax-deductible contributions.[8] These benefits are accompanied by a list of restrictions.[9] Prominent among the restrictions is the requirement that tax-exempt charitable organizations operate as non-profits. That is, under the so-called "no inurement" rule, tax-exempt organizations are prohibited from distributing any net earnings or other "excess benefit" to shareholders or any other person who is in a position to control the organization (so-called "disqualified persons").[10] This no-inurement rule does not prevent tax-exempt

[3] *See* Brian Galle, *Social Enterprise: Who Needs It?*, 54 B.C. L. REV. 2025, 2025 (2013) ("Social enterprise lawmaking is a growth industry."). As Robert T. Esposito has pointed out, "These entities have consistently received bipartisan political support." Robert T. Esposito, *The Social Enterprise Revolution in Corporate Law: A Primer on Emerging Corporate Entities in Europe and the United States and the Case for the Benefit Corporation*, 4 WM. & MARY BUS. L. REV. 639, 648 (2013).

[4] Anne Field, *Benefit Corporations, L3Cs and All the Rest: Making Sense of Those Confusing Choices*, FORBES (May 25, 2012, 9:58 AM), http://www.forbes.com/sites/annefield/2012/05/25/benefit-corporations-l3cs-and-all-the-rest-making-sense-of-those-confusing-choices/.

[5] *See* Wexler, *supra* note 2, at 233 ("This article is a call to action to the exempt organization legal community to help . . . change the law to accommodate new approaches to philanthropy.").

[6] This Article is primarily concerned with organizations described in Section 501(c)(3) of the Internal Revenue Code, which I generally refer to as "charities."

[7] Social enterprise legal reformers sometimes argue that the new laws are necessary to avoid state corporate law as well, although many commentators point out that this concern is probably exaggerated.

[8] *See* I.R.C. §§ 501(a), 501(c)(3), & 170 .

[9] *See* I.R.C. § 501(c)(3).

[10] *See* discussion *infra* at Section II(A).

charities from engaging in income-generating activities, or even from making substantial profits year after year. But it does prevent them from having owners who share in those profits, and social enterprise legal reformers point out that this prohibition can make it difficult to raise sufficient capital to engage in some socially beneficial activities, especially if a social enterprise has the potential to both make money and do good.[11]

The new social enterprise legal forms take two very different approaches to the "deregulatory" goals. Some, like Benefit Corporations, seek to completely avoid federal charity law. Benefit Corporations do not expect to have donors making tax-deductible contributions to them and they do not generally seek money from organizations that have received such contributions. Instead, they hope to find investors who are willing to accept a potentially lower financial return in order to advance a social purpose.[12] As long as they do not take any money from tax-exempt charities, the federal law of charities does not apply to them, and they have accomplished the deregulatory impulse. From the perspective of federal tax law, they are exactly the same as any other for-profit corporate entity.

Other social enterprise legal forms do not completely avoid the federal law of charities because they seek to combine charitable funds with profit-driven investors. The most notable of these new forms is the L3C, but lawyers have been experimenting for years with mechanisms for combining charitable and for-profit funds in "hybrid" business entities that make use of separate "tranches" of business and

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[11] *See* Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 685 (2012) ("Desperately in need of capital, a social entrepreneur therefore dreams about a legal vehicle that not only allows private ownership and investment, but one that also may receive private foundation grants and charitable contributions. Currently, there is no such legal entity."). In *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 354 (2009), Thomas Kelley writes:

> Social entrepreneurs' difficulty raising start-up or expansion capital has driven many away from the nonprofit sector, but their capitalization problems are not entirely solved by choosing to launch as for-profit ventures. As an initial matter, for-profit social entrepreneurs generally cut themselves off from the sources that traditionally have funded socially beneficial activities—private foundations and governments.

See also Murray & Hwang, *supra* note 2, at 17 ("The obstacle in raising capital is sometimes said to be the most significant challenge for social entrepreneurs who turn to existing for-profit forms."); Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 106 (2010) ("'[C]haritable forms' limited funding streams—from donations, debt-financing, and earned revenue—are precisely what have turned the interest of many social entrepreneurs to blended enterprise.").

[12] *See, e.g.*, J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Statutes*, 2 AM. U. BUS. L. REV. 1 (2012).

social investors. In this article, I call these hybrid entities "tranched social enterprises" whether they are L3Cs, LLCs, partnerships, or even simple contractual joint venture arrangements.[13] Because these business forms seek to use charitable funds, they do not avoid the law that applies to tax-exempt charities. Social enterprise legal reformers focusing on "hybrid" entities, like the L3C, pursue the deregulatory goal by seeking to change the law to make hybrids more accessible, but they do not generally explicitly argue that the law should be changed to free such entities from the no-inurement rule.[14] The point of these organizations is that they are permitted to have investors who receive the profits from the enterprise's activities, but to the degree to which they have charitable donors or investors, the law of private inurement still applies to those charities, creating potential restrictions on the enterprise's use of the charity's money.

But there is a problem with the scholarship on all of these new social enterprise business forms. It tends to treat the deregulatory impulse as primarily an attempt to clear away unnecessary confusion in the law. This scholarship often acknowledges that the no-inurement rule is important to prevent diversion of funds intended for social purposes into the pockets of investors or other stakeholders.[15] But no

[13] Christopher C. Archer, Comment, *Private Benefit for the Public Good: Promoting Foundation Investment in the 'Fourth Sector' to Provide More Efficient and Effective Social Missions*, 84 TEMP. L. REV. 159, 160–61 (2011) ("[T]he L3C blueprint uses a PRI to leverage a market return for profit-seeking investors in a tranched, that is, multi-layered, investment strategy."); Thomas Kelley, *supra* note 1, at 373–74 (describing a "tiered investment strategy" with three "tiered investment tranches" including a "social outcomes" tier that would not receive any significant financial return, an "intermediate tier" that would provide a lower-than-market return, and a "market-rate tier" that would "attract capital from private-sector investors such as venture capitalists and financial institutions"); Lloyd Hitoshi Mayer & Joseph R. Ganahl, *Taxing Social Enterprise*, 66 STAN. L. REV. 387, 418–19 (2014) ("L3C advocates promote L3Cs as being particularly amenable to a tranched finance structure whereby private foundations make high-risk, low-return PRI infusions into the L3C, thereby attracting socially minded and traditional market members who make lower-risk and higher-return investments."); Katz & Page, *supra* note 2, at 1363–64 (describing three tranches: a "program-related" tranche that would "ideally take the riskiest position in the capital structure and receive no or lower returns," a "mezzanine" tranche "designed for investors willing to accept a lower return because of their contribution to social welfare," and a "top tranche" that "might be at the risk-adjusted market rate of return").

[14] *See, e.g.*, Wexler, *supra* note 2, at 244 ("Ultimately, though, the hybrid entity that [a hypothetical social entrepreneur] dreams about, an entity that could receive grants and also have investors, does not exist under U.S. law.").

[15] *See, e.g.*, Archer, *supra* note 13, at 161 ("One of the primary issues in using this strategy is whether a foundation's participation in the L3C's tranched investment structure violates fundamental rules regarding nonprofit operations, thereby threatening the foundation's exempt status."); Carter G. Bishop, *The Low-Profit LLC*

scholarly article to date has systematically addressed the application of the no inurement rule in the social enterprise context.[16] This problem is exacerbated by the fact that there is a surprising lack of certainty about how this most basic principle of the federal law of charities—the no inurement rule—applies to tranched social enterprises.

This Article provides the first detailed examination of the impact of the no-inurement regime in the context of tranched social enterprises.[17] It argues that the no inurement regime should absolutely prohibit people who are so-called "disqualified persons" from profiting from investments in social enterprises if the charity they control is a donor or investor. This reading of the no inurement rule is justified for the same reasons it is justified in the charitable context: because the interests of "independent" decision-makers are better aligned with the charitable or social goals of an organization—goals which are supported by donors to charitable organizations and the government who has provided tax subsidies to support these goals. A tranched

(L3C): Program-Related Investment by Proxy or Perversion?, 63 ARK. L. REV. 243, 245 (2010) ("Of course, no matter how PRI status is achieved, that status does not sanction private inurement"); *Id.* at 265 ("The tranche-investment notion potentially violates the private-inurement restriction."); J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273 (2010); Daniel S. Kleinberger & J. William Callison, *When the Law is Understood—L3C No* 3 (William Mitchell C.L. Legal Stud. Res. Paper Series, Working Paper No. 2010-07, 2010) ("Tranched investing runs the risk of exporting these privileges to benefit non-charitable businesses, managers, and investors."); Daniel S. Kleinberger, *A Myth Deconstructed: The 'Emperor's New Clothes' on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879 (2010); Murray & Hwang, *supra* note 2, at 50 ("We believe, however, that . . . the IRS will not look favorably on this type of arrangement."); Dana Brakman Reiser & Steven A. Dean, *Hunting Stag with FLY Paper: A Hybrid Financial Instrument for Social Enterprise*, 54 B.C. L. REV. 1495, 1524 (2013) ("[S]ocial investors need assurances that their willingness to sacrifice financial returns will not merely provide a windfall to entrepreneurs."); Wexler, *supra* note 2, at 244 ("To be credible, those entities would have to contain strict prohibitions on any excess benefits to insiders.").

[16] The most extensive scholarly treatments to date are Archer, *supra* note 13; and Brewer, *supra* note 11, at 697–706.

[17] There are also state law doctrines that affect tranched social enterprises, such as the state law duty of loyalty. *See* Ellen Aprill, *Reconciling Nonprofit Self-Dealing Rules*, Volume 48 A.B.A. REAL PROP. TR. & EST. L. J., (forthcoming Winter 2014) (manuscript at 5) ("The challenge of ensuring that nonprofit officers and directors (or trustees) do not violate their duty of loyalty, including by engaging in self-dealing, represents a key problem of nonprofit organizations."). Although, "the duty of loyalty owed by trustees of charitable trusts and directors of charitable corporations under state law is now largely eclipsed by federal tax laws that effectively regulate fiduciary behavior." Johnny Rex Buckles, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries under United States Tax Law*, 99 KY. L. J. 645, 646 (2011). This Article addresses only the federal law of charities.

social enterprise should not be permitted to avoid the no inurement regime simply because it has moved those funds one step away from the direct control of the charity that collected them. This may seem like an excessively modest proposal, but it is by no means the consensus view among social enterprise legal reformers.

There is an additional benefit to clarifying the meaning of the no-inurement regime in the tranched social enterprise context. The social enterprise legal reform movement arguably has not only "deregulatory" goals, but also "regulatory" ones. In order to be successful, social enterprises need to make credible claims to various stakeholders—investors, customers, workers and others—that they are really different from ordinary businesses . . . that they are really pursuing their social goals.[18] The new legal forms seek to provide various stakeholders with credible means of detecting and enforcing the particular balance of social and financial good that the enterprise will pursue. So, for example, benefit corporation statutes generally require benefit corporations to have their social impact measured against some third-party standard and they may give certain stakeholders the right to sue the corporation for failing to pursue its social goals or for failing to balance social with financial goals. This "regulatory" impulse seeks to provide new legal mechanisms to adjudicate between competing visions of the proper balance between social and financial goals.

This Article argues that the federal law of charities provides another mechanism to assist social enterprises to make credible commitments to their stakeholders about the balance of social and financial goals. It is not an argument that starting fresh with new mechanisms, as we are doing with benefit corporations, is a bad idea. But it is an argument that—at least with respect to the core concerns of the law of charities, which is preventing misappropriation of charitable funds—the extension of charity law to social enterprises provides a better solution, even for "mixed-purpose" investors. In other words, even if one wants to make a financial investment in a social enterprise rather than a charitable contribution, he would be better off investing in a tranched social enterprise under a clarified extension of the no-inurement regime than he would be in a social enterprise that avoided the law of charities entirely. That is because an independent charitable tranche provides the best oversight of a for-

[18] *See, e.g.*, Eldar, *supra* note 1, at 20–21 ("Standard economic theory is very suspicious of subsidizing corporations. There is a general concern that subsidies fail to achieve their purpose and may be expropriated by those who control the organization.").

profit enterprise, and any individual investor or donor can free-ride on the decisions independent charities make about how to structure their sharing of power.

Finally, however, I would be remiss if I did not acknowledge that there is a lot of uncertainty in the law of charities that is not justified by the desire to prevent the diversion of charitable funds away from their proper purposes. Thus, social enterprise legal reformers are by no means wrong when they call for simplification of the law to facilitate social entrepreneurship. For example, the law of private benefit—often confused or conflated with the law of private inurement[19]—is very poorly defined and arguably is a significant barrier to tranched social enterprises, even when these enterprises observe the inurement laws. The law of charitable "joint ventures" is unclear and creates impediments to social enterprises that are arguably not fully justified by concerns about diversion of charitable dollars. The law of private foundations' program-related investments is complicated and uncertain as well, again inhibiting social enterprises without a clear justification. Thus, while this Article defends the clear extension of the law of inurement to the social enterprise context in a restrictive way, it also argues that these other doctrines should be clarified and potentially liberalized. That is because they arguably prevent tranched social enterprises from employing the full range of possible commitment devices and thus are overly restrictive.[20]

This Article proceeds in four sections. First, it describes "tranched" social enterprises and the "subsidy problem" that they create. Second, it describes the "private inurement regime" and applies it in the tranched social enterprise context. Third, it argue that the best interpretation of the private inurement regime is a simple rule prohibiting investing by persons who are disqualified persons with respect to any charitable investor. This section uses the so-called "agency theory" to argue that the no-inurement rule is fully justified when charitable funds are being used. But it also argues that tranched social investments have benefits for social investors even when they are investing with funds that carry no tax benefit. For these investors—the same people who may be tempted to invest in business forms that avoid the federal law of tax-exempt organizations altogether—a tranched investment structure is better because it enables them to free-ride on

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[19] *See* Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 29 (2006) ("These doctrines are often incorrectly used interchangeably.").

[20] For a discussion of the range of commitment devices used by non-profits to bind social enterprises to their social missions, see Eldar, *supra* note 1, at 41–47.

the monitoring and enforcing efforts of the controllers of the charitable tranche. Finally, it briefly describes the aspects of the federal law of charities that are not as well justified as the inurement rule, and makes some modest proposals about how they could be clarified and liberalized.

I. INTRODUCTION TO TRANCHED INVESTING

Imagine that you are a social entrepreneur. That is, you want to further a social good, and are willing to think creatively about how to do it.[21] Previously, while working in Mozambique, you discovered that poor people in poor countries cook primarily on charcoal cookstoves. Cooking on charcoal cookstoves is bad for poor people because these cookstoves are unhealthy and unsafe.[22] In addition, cooking on charcoal cookstoves is bad for the environment because burning charcoal produces CO_2 and other pollutants and because charcoal is made from wood, which is harvested from local forests. Cutting down trees to make charcoal produces deforestation, which speeds global warming.

Instead of using charcoal-burning cookstoves, poor people could use cleaner-burning, safer, non-deforesting ethanol-burning cookstoves. In your opinion, a sweeping shift from charcoal to ethanol would help the environment and improve the lives of poor people simultaneously—a win-win. But ethanol cookstoves are more expensive than charcoal cookstoves, even though ethanol is unlikely to be more costly than charcoal.

Because an ethanol revolution would have both distributive effects (helping poor people) and produce global public goods (reducing CO_2 emissions), it is the kind of thing that philanthropists may well be interested in. Because the existence of an ethanol market where none previously existed has the potential to make someone a lot of money, it is the kind of thing capitalists may well be interested in.[23]

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[21] *See* Katz & Page, *supra* note 1, at 59 (defining a "social entrepreneur" as "an ambitious person who seeks social change on a large scale, characteristically through earned income strategies").

[22] *See, e.g.*, John M. Broder, *Developing Nations to Get Cleaner Burning Stoves*, N.Y. TIMES, Sept. 21, 2010, http://www.nytimes.com/2010/09/21/science/earth/21stove.html ("Every year, according to the United Nations, smoke from these stoves kills 1.9 million people, mostly women and children, from lung and heart diseases and low birth weight.").

[23] An estimated 800 million people cook with charcoal in Africa alone and ethanol can be produced cheaply. *See* Brian Merchant, *Charcoal Kills 2 Million People & Vast Swaths of Forest Every Year.* Brian Merchant, *Can Biofuel Stop the Carnage?*, TREEHUGGER (May 16, 2012), www.treehugger.com/renewable-energy/africa-cooking-charcoal-kills-millions.html ("Some 80% of Africans still rely on solid-based fuels like wood,

And, in fact, philanthropists and capitalists may be mutually interdependent on each other for success in reaching their respective goals. Without the philanthropists providing some sort of subsidy for the purchase of cookstoves, the ethanol cookstove revolution might not get off the ground. But without a stable supply of ethanol, it will not be sustainable. Without a subsidy, poor women in Mozambique will continue to cook with charcoal; without a reliable market, you may well find them cooking with charcoal on the fancy ethanol stoves some charity gave them—another failed development project.

Being an entrepreneurial type, you create the Ethanol Cookstove for Poor People Project (the "Cookstove Project" or "the Project") to catalyze the social change that you think will benefit both poor people and the environment. The Cookstove Project must raise "charitable" funds to subsidize the production or acquisition of ethanol cookstoves. But it also must ensure that sufficient funds can be raised to capitalize the creation of a stable ethanol supply market, and so the Cookstove Project may also want to raise for-profit investment funds. Thus, the Cookstove Project is a sort of "hybrid" that seeks to use both the power of capitalists and philanthropists (and, possibly, mixtures of the two) to advance the social good. Capitalists, philanthropists and mixtures each require a different bundle of rights and expectations for their respective investments, and so the Cookstove Project needs to accommodate multiple investment "tranches."

How should you organize the Cookstove Project, and what restrictions might you encounter if you organize it as a tranched social enterprise?

A. At Least Two Purposes: Social and Financial

As described above, the Cookstove Project has potentially at least two distinct types of benefits: (i) on the one hand, it has "social" benefits, since it has the potential to increase health among poor people and slow global warming; (ii) on the other hand it has "financial" benefits because it has the potential to make money for investors in an ethanol supply chain. It also has at least two challenges to meeting its objectives: (i) cookstoves are too expensive for poor people to buy without some kind of subsidy; and (ii) creating a reliable regional ethanol supply chain is a large and capital-intensive enterprise. Thus, the Cookstove Project has to find funds for two

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dung, and especially charcoal for cooking.").

activities: providing subsidized stoves to poor people and creating and operating an ethanol supply chain. Both challenges have to be met for either benefit to accrue, and both benefits accrue once the two challenges have been met.

One could imagine a situation in which the potential financial benefit is sufficiently large and certain that it would justify the provision of the subsidy by investors, even if those investors were merely seeking a financial return. In other words, you could imagine an investor thinking to herself, "Let's give away ethanol cookstoves for free instead of charging what they cost to make; we can make up these initial losses through ethanol sales later on." It is not uncommon when businesses seek to build a customer base for them to give something away for free. This phenomenon is so familiar to us in the twenty-first century that some have predicted that it will become the dominant business model.[24] If the probability of profit is certain enough to justify the initial investment, then the project can proceed in a traditional, for-profit structure. Social benefits will accrue as an extra benefit from the investors seeking a financial return.

One could also imagine a situation in which the social goals are so compelling that a non-profit charity could raise sufficient capital from donors to fully fund the Cookstove Project. In that case, donors would provide not just the money to buy free cookstoves for poor people, but also sufficient capital to get the ethanol supply chain up and running. The non-profit charity that was created to operate the Project would then receive all of the profits from the provision of ethanol and it could use that money to expand its operations to other parts of the world, or to make ethanol cheaper, or to research other ways to benefit the health of poor people or reduce carbon emissions. There might be some limitations on the organization to make sure that the operation of this profitable business does not violate any laws,[25] but these challenges are really quite manageable, especially if the non-profit charity is willing to pay taxes on the income it makes from its ethanol business.[26]

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[24] *See* CHRIS ANDERSON, FREE: HOW TODAY'S SMARTEST BUSINESSES PROFIT BY GIVING SOMETHING FOR NOTHING (2010). But, obviously, the sales strategy of giving away something for free or selling it below cost in the hope of inducing profitable transactions on other products—generally called a "loss leader"—was common before the 21st Century.

[25] Among other things, the so-called "commerciality doctrine" may constrain some of the ways the organization conducts its business. *See generally* BRUCE HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS §§ 4.7, 4.11 (10th ed. 2011) (discussing the Commensurate Test and Commerciality Doctrine respectively).

[26] Tax-exempt organizations pay tax on income from an "unrelated trade or

Finally, one could imagine a world in which two completely separate entities engage in the two distinct activities. A charitable non-profit solicits donations to subsidize the purchase of ethanol stoves or give them away. Simultaneously, a commercial for-profit business raises the investment capital to create and operate an ethanol supply business. There is no legal impediment to these two entities each pursuing its own distinct purpose, each making use of its own distinct source of funding.[27]

But, if one could imagine a world like the three described above, it is at least as easy to imagine a world that is not like those three. For example, for an investor seeking a purely financial return, the predicted return from the distribution of ethanol might not be large enough, or assured enough, to justify an initial investment in giving away free ethanol cookstoves. For a charity, the potential social benefit of helping people cook on cleaner, more environmentally friendly stoves might not be compelling enough to convince *enough* donors to give *enough* money to both give away free stoves and build and operate an ethanol supply chain. That is a lot of upfront costs for a social benefit that is hard to measure and might not be as beneficial as it initially seems. Finally, there might be good reasons not to pursue the Cookstove Project through two distinct unrelated entities. The organizations might want to coordinate with each other, since each one's success is dependent on the other. From the charity's perspective, some choices the ethanol distributor might make may be extremely relevant to its social mission. For example, it turns out that the environmental benefits of ethanol are greatly diminished if farmers clear-cut forests to provide land to grow the crop that is distilled into ethanol.[28] The charity may want to influence the ethanol supplier's policies to ensure that deforestation does not occur, and the only way to do so may be to have some sort of ongoing control over, or influence on, the ethanol supplier. From the ethanol supplier's perspective, some choices of the charity may be extremely relevant. It may be that a myriad of business considerations go into the question of where it is feasible to distribute ethanol cost effectively, and so the ethanol supplier may want to influence where free stoves are distributed (and when, and how quickly, and with what instructions,

business" under I.R.C. §§ 511–14.

27 *See, e.g.*, ROBERT J. DESIDERIO, PLANNING TAX-EXEMPT ORGANIZATIONS §12.02[4] (2009).

28 *See, e.g.*, Sabrina Valle, *Losing Forests to Fuel Cars*, WASH. POST (July 31, 2007), http://www.washingtonpost.com/wpdyn/content/article/2007/07/30/AR2007073001484.html

etc.).

B. Blending Different Types of Capital

The Cookstove Project is an example of a social enterprise that seeks initial funding from at least two sources. First, because it is conceived as a way to improve the lives of very poor people while simultaneously slowing global warming, it is hoping to find donors who want to support it for altruistic purposes. Let us call the funds received by the Cookstove Project from these sources "charitable funds." It is worth pointing out that these funds may come from several sources. They may be from altruistic individuals who want to improve the world. They may come from existing charitable entities with environmental or sustainable-development missions. These existing charitable entities may be so-called "private foundations" or they may be so-called "public charities."[29] Funds may come from business corporations seeking to be, or appear, responsible or philanthropic. Funds may even come from governments seeking to advance environmental or sustainable-development goals.

In their purest form, charitable funds would come as "donations" or "grants," in which the contributing person parts with his money and does not expect any sort of financial remuneration. In this case, the only return received by the contributing person is the amelioration of poverty or illness and the benefits to the environment.[30] If the funds were contributions from individuals or businesses, the donors may receive a tax deduction for making the contribution. If they come from charities, the donors to the charity may have received a tax deduction when they made the contribution to the donor charity. If they came from a government, there was no tax deduction because governments do not pay taxes. But, in any case, charitable funds are funds that are provided *at least potentially* under circumstances in which a donor could have received a government subsidy in the form of a charitable contribution deduction.[31]

[29] A "private foundation" is a subcategory of 501(c)(3) organizations to which some greater legal restrictions apply. *See* I.R.C. §§ 509, 4940–46.

[30] Of course, there may be many personal non-financial benefits of donating to charity. These are sometimes collectively called "warm glow," although they may include status, building goodwill, developing personal alliances or connections, and others. *See, e.g.*, Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1222 (2010).

[31] It is not entirely uncontroversial to describe the tax provisions related to charities as "subsidies," but, it has become the norm to do so. *See, e.g.*, Miranda Perry Fleischer, *Equality of Opportunity and The Charitable Tax Subsidies*, 91 B.U. L. REV. 601, 608–09 (2011) ("Although a few scholars believe that exemption and deductibility are necessary for measurement reasons, the more accepted view is that these provisions serve as subsidies that contribute to the size and success of the charitable sector.").

Second, because the Cookstove Project has the potential to generate revenue, and even substantial profits, it hopes to find investors who are motivated by the promise of financial returns on their investment. Again, these funds may come from a variety of sources. They may come from individuals, or investment funds, or businesses, or even charitable organizations or governments. All these sources use financial investments to make money that they use to advance their interests. To the degree to which the motivation of these sources is to make money, they may want to make as much money as they could with investments of comparable risk profiles available in the market generally. In other words, if these sources are seeking a "pure" investment, they are seeking a financial return that is the same or greater than the return they could expect to receive from other investments made with no specific charitable purpose. Let us call funds received in which a contributing person seeks a return equal to the return she could receive on any other investment "market-rate investment funds."

But, of course, people and institutions do not always have *purely* charitable or *purely* financial motives. Sometimes their motives are *mixed*. Funds may come from people or institutions primarily seeking to advance the social purpose of the organization, but with some desire for a financial return as well.[32] Or, funds may come from people or institutions primarily seeking a financial return, but who care very deeply about the social purpose of the organization. Thus, charitable funds may come in an impure form, in which the donor seeks to receive some kind of financial return, and investment funds may come in an impure form in which an investor seeks to ensure some social good along with her financial return. The *impure* form of both of the categories described above is funds provided with some expectation of financial return, but not an expectation that the return will be as high as could be obtained in the market generally.[33] Let us call this third

[32] What is true for people who contribute *capital* to a social enterprise is also true for the founders, managers, and employees who provide *labor* to the enterprise. Those who provide labor may do so wholly for charitable reasons (in which case they are probably "volunteers"), wholly for financial reasons (in which case they presumably seek the highest compensation they can obtain), or for some mixed charitable and financial reasons (in which case they may accept "below-market" compensation in exchange for their services. This issue is treated in some depth in Benjamin M. Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819 (2012), in which I argue that there is a range of possible compensation structures, and people often misunderstand how much is permitted in non-profit organizations.

[33] Much of the literature on social enterprise is premised on the idea that many investors are seeking both a financial and a social return. The existence of a market for socially responsible investments estimated at 3.3 trillion dollars suggests that

category "below-market investment funds."[34] Again, these funds may come from a variety of sources, as people or institutions may have numerous reasons for wanting some financial return even if their motives are largely altruistic, and they may have numerous reasons to demand a social return even if their motives are largely profit-oriented.[35]

Given the fact that many investors have mixed motives when investing in a social enterprise, it is worth thinking of investors as existing along a spectrum. The farthest left pole represents purely charitable capital. The farthest right pole represents purely profit-driven capital. Many investors in social enterprises fall somewhere between the two poles, and those investors are potentially willing to accept a below-market return on their investments.

A significant portion of the innovation among legal reformers is to provide a legal entity that accommodates these below-market investors. For example, the "benefit corporation" statutes are designed to free corporate directors from a duty to maximize profits for their shareholders while providing some mechanism for investors to monitor some aspects of the social benefit of the corporation. But entities like the benefit corporation are designed for social enterprises with a *single class* of investors. The problems benefit corporations attempt to solve are those associated with a dual mission, not those associated with two or more actual classes of investors with different

investors are not solely concerned with financial returns. *See* U.S.S.I.F. FOUNDATION, REPORT ON SUSTAINABLE AND RESPONSIBLE INVESTING TRENDS IN THE UNITED STATES (2012), *available at* http://www.ussif.org/files/Publications/12_Trends_Exec_Summary.pdf.

[34] Among other things, some argue that seeking a financial return may be one strategy used to hold social enterprises accountable to their funders. *See, e.g.*, MATTHEW BISHOP & MICHAEL GREEN, PHILANTHROCAPITALISM: HOW THE RICH CAN SAVE THE WORLD (2008). For a thoughtful critique of the rhetoric of philanthrocapitalism, see Garry W. Jenkins, *Who's Afraid of Philanthrocapitalism?*, 61 CASE W. RES. L. REV. 753 (2011).

[35] When funds are provided in a "mixed" form, the question of whether the investor has received any sort of charitable subsidy from the government depends on the charitable status of the investor. Thus, if you yourself are not a charity, the only way to get a tax deduction for contributing funds that provide a financial return to the investor is to donate them to a charity, and then have the charity receive the return on the investment. Some commentators think this structure of the subsidy is either inefficient or unfair. *See* Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2065 (2007); M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 607 (2009); Gautam Jagannath, *Using Nonprofits to Serve Charitable Goals of Social Businesses in the United States: Circumventing the Lack of Recognition of the Social Business Model in the Federal Tax Code*, 32 PACE L. REV. 239, 242 (2012) ("[I]f social business truly act charitably then they should be conferred some tax advantages as well.").

interests.[36]

If you seek to accommodate at least two classes of investors who lie in different places along the charitable-to-market spectrum, then you need different "tranches" of investments. You need the possibility for your investors to receive different returns on their investments. For simplicity's sake, in this Article, we will assume that there are two tranches. The charitable tranche is closer to the charitable pole, although it does not need to be "purely" charitable, and we will in fact assume that it is not purely charitable;[37] the market tranche is closer to the profit-driven pole, even though its investors need not be "purely" market driven. Ideally, the Cookstove Project would find a form of organization that could tailor its investment options to investors at very different places on the charitable-to-market-rate scale. That is what a tranched investment strategy seeks to do. It seeks to provide different investment options for investors who value social return and financial return differently. Because the Cookstove Project has strong appeal to philanthropists and strong appeal to capitalists, it seeks to provide a mechanism by which philanthropists can invest in it in exchange for a lower return and capitalists in exchange for a higher return so the Project can access both sources of capital.

Thus, a "tranched investment strategy" is necessary if social enterprises want to access capital from multiple sources, each of whom seeks a different balance of social and financial ends. For several years, scholars have been describing the ability to provide a tranched investment strategy as a significant benefit to social enterprises seeking capital.[38]

C. Tranched Investing

As discussed above, numerous legal scholars have referenced the desire of social entrepreneurs to be able to make use of a tranched investment strategy.[39] It has most often been associated with the new business form created for social enterprises called the Low-Profit

[36] As Brian Galle points out, basic agency-cost theory suggests that dual-purpose entities (like those that seek both a social and a financial bottom line) are likely to generate monitoring costs so high as to make these entities inefficient except under certain circumstances. *See* Galle, *supra* note 3, at 2031–33. This is especially true if the dual-purpose entities have a single class of dual-purpose investors. This Article argues that these costs are somewhat mitigated if there are at least two classes of investors and if the law protects against private inurement by the charitable investors, as it would in a non-profit structure.

[37] *See supra* note 34.

[38] *See supra* note 13.

[39] *See supra* note 13.

Limited Liability Company ("L3C"),[40] but there is nothing preventing one from using a tranched investment strategy with a traditional LLC or any type of partnership, limited partnership, or even an old-school business corporation.[41]

Every tranched investment strategy shares one characteristic: it seeks to decrease the risk and/or increase the return for one set of investors by increasing the risk or decreasing the return for another set of investors. Imagine a two-tranche investment in the Cookstove Project. Instead of separating the provision of free stoves and the operation of the ethanol supply chain, a single entity would do both. But that entity would be funded by two different types of investors.

A "senior" tranche would be made up of market-rate or quasi-market rate investors who have the right to payment of profits from the operations before any profits are paid to the "junior" tranche. This senior market tranche presumably would be made up of equity investors,[42] which may include the social entrepreneur and his family, an independent angel investor, or multiple independent individual investors (perhaps through some sort of crowdfunding).[43] Let's call the senior market rate tranche of investors the "Subsidized Tranche," since it receives a potentially higher return than the other tranche.

The "junior" tranche would be made up of below-market investors. This junior tranche could be made up of socially conscious investors who are willing to risk very low or no return on their investment because they care deeply about the social purpose of the project. It could also be made up of a charity or charities that want to

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[40] *See, e.g.*, Bishop, *supra* note 15; Callison & Vestal, *supra* note 15; Matt F. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291 (2010); Kleinberger, *supra* note 15; Murray & Hwang, *supra* note 2; Dana Brakman Reiser, *Governing and Financing the Blended Enterprise*, 85 CHI. KENT L. REV. 619, 628 (2010).

[41] *See, e.g.*, Brewer, *supra* note 11 (generally discussing the usefulness of various business forms for tranched social enterprises and advocating a contract hybrid using multiple LLCs).

[42] Most other scholarly articles on tranched structures assume that the subsidizing tranche will be made up of a loan, not an equity interest. *See, e.g.*, Brewer, *supra* note 11. But in order to explore the legal issues in greater depth and scope, it is useful to imagine that both the subsidized tranche and the subsidizing tranche are both equity-type investments, in that they are receiving a return on their investment based on the net income of the venture.

[43] Among social entrepreneurs, there is some hopeful optimism that small-scale social investors may fund social enterprises through investments when they would not have funded the same projects with pure donations. There have been incremental changes to a variety of laws to make such investing a legal possibility. *See* Jenna Wortham, *Law Opens Financing of Startups to Crowds*, N.Y. TIMES, Sept. 22, 2013, http://www.nytimes.com/2013/09/23/technology/law-opens-financing-of-start-ups-to-crowds.html?pagewanted=all&_r=0.

make below-market investments. As discussed below, the distinction between these two options is extremely important from a legal and regulatory perspective.[44] For the present, we will assume that the investor in the junior below-market tranche is a charitable entity called the Earth Charity, which is devoted to slowing global warming.

Whatever the nature of the Earth Charity's investment or donation to the Cookstove Project, the fundamental characteristic of this junior tranche is that any financial return paid to the Earth Charity will be paid only after a return has been paid to the Subsidized Tranche (making it more risky), or it will be paid at a lower rate than the return paid to the Subsidized Tranche (making it less potentially profitable), or both. Let us call this tranche of investors the "Subsidizing Tranche," since it will receive a potentially lower or more risky return than the Subsidized Tranche. Thus, there are two tranches: (i) a Subsidized Tranche made up of private investors seeking a market or quasi-market return on their investment who hold an equity interest; and (ii) a Subsidizing Tranche made up only of the Earth Charity, a charitable organization with an interest that is subordinate and provides a below-market return on its investment. While this structure is a simplification of the tranched investment strategies proposed by prior commentators, it contains the basic elements discussed by those commentators.[45]

To be clear, the benefit that flows to social enterprises with a tranched investment structure is not the benefit of tax exemption itself. These entities are not non-profit tax-exempt organizations under current law. While some commentators have begun to advocate for these types of entities to be afforded tax benefits,[46] Lloyd Mayer and

[44] When no tax-exempt organization is involved in the transaction, the laws that apply to tax exempt organizations do not apply, and so there are fewer legal issues, but also less protection for below-market investors seeking a social return. *See infra* text accompanying note 71..

[45] *See* Reiser, *supra* note 40, at 628 (calling the charitable tranche, the "equity tranche," the market investment tranche the "senior tranche," and the below-market investment tranche the "mezzanine tranche"). *See also* Archer, *supra* note 13, at 174–75 (describing a structure in which a private foundation takes on the highest risk and an expected low return, a "socially responsible investor" takes on "moderate risk" and an expected slightly higher return, and "a profit sector investor" takes "the lowest risk" and an expected highest, but still moderate, return); Bishop, *supra* note 15, at 263 ("[T]he foundation tranche [is] allocated a high-risk L3C investment slice but with a below-market return for such a risk. Having laid off the high risk and low return to the foundation, the L3C may then market the low-risk, but above-average market returns to attract commercial investors, all in the name of charity.").

[46] *See* Mayer & Ganahl, *supra* note 13, at 390 ("[T]here have already been calls for these forms to receive some or all of the tax benefits enjoyed by charities."). *See also id.* at 391 ("[S]ome commentators have supported the extension of the tax benefits

Joseph Ganahl have made a compelling case that such benefits should not be directly available to such entities.[47] But because of the tranche structure, some of the benefits that are afforded to tax-exempt charities can be passed along to social enterprises in the form of a subsidizing investment. In effect, the tranched structure allows a tax-exempt charitable organization to receive tax benefits, in the form of tax-deductible contributions or tax-free income, and then use those benefits to reduce the cost of capital for the social enterprise in which it invests.

The Subsidizing Tranche could be structured in a variety of ways reflecting a variety of potential financial returns on the charity's investment. At one extreme, the Subsidizing Tranche could be a grant or donation. A grant's defining characteristic is that the donor receives no financial return on its investment at all. Its sole return is social, in the sense that it advances its social or charitable mission. Obviously, in that case, the Subsidizing Tranche's investment provides a lower financial return because the financial return is zero. In the middle of the spectrum, the Subsidizing Tranche could be structured as a loan. A loan pays a fixed return as a percentage of the amount of money provided. If the Subsidizing Tranche was structured as a loan, it would pay a fixed return that was less than the entity could receive if it tried to obtain a loan from a purely financial investor. The rate may still be high compared to interest rates on relatively safe investments, because market interest rates are determined based on predictions about how certain one is that a borrower will be able to pay back the principal and pay the interest. On the other end of the spectrum, the investment could be structured as an equity interest in the Cookstove Project. The defining characteristic of an equity interest is that it pays a return that is not a fixed percentage of the amount borrowed, but a percentage of the profits of the venture. In this scenario, the Subsidizing Tranche would receive a return on its investment either only after the Subsidized Tranche received a return of some amount on its investment, or as a smaller percentage of the profits relative to the amount of capital provided, or both. For the purposes of this Article, we will assume that the Earth Charity takes a subordinate equity interest in the Cookstove Project that pays a smaller return on its capital investment than the Subsidized Tranche.

historically enjoyed by nonprofit entities to other types of entities that pursue the public good.").

[47] *See* Mayer & Ganahl, *supra* note 13, at 391 ("Our conclusion is that the bare fact that hybrids have public-benefitting goals in addition to profit-seeking goals does not provide sufficient grounds for giving hybrids these tax benefits for four reasons, each of which arises from the difficulty of defining and policing 'public benefit.'").

Because academic commentary has largely associated tranched investing with the L3C, most of the legal analysis of tranched investing has focused on the special rules that apply to so-called "program-related investments" ("PRIs"). This focus is buttressed by a (perhaps unfounded) belief that the most likely providers of social investments are or will be private foundations.[48] Private foundations are a subcategory of 501(c)(3) organizations, and they are subject to a series of restrictions that other 501(c)(3) organizations do not face. For example, private foundations are prohibited from making certain risky investments[49] and are required to distribute at least five percent of their assets in grants every year.[50] If an investment qualifies as a PRI, the private foundation is free from the prohibition on risky investments[51] and can count the full amount invested as part of its five percent minimum distribution in the year in which the investment is made.[52] Determining whether an investment in a social enterprise qualifies as a PRI may be a complicated matter,[53] and one significant goal of social enterprise legal reformers has been to streamline that process, presumably to unlock some potential investments currently hampered by the restrictions on private foundations.[54] This is a worthy task. But the PRI rules apply *only* to private foundations, and so investments by charities that are not private foundations do not need to comply with them.[55]

[48] *See, e.g.*, Maximilian Martin & Arthur Wood, *Unfreezing the Foundation Asset Landscape to Create a Liquid Social Capital Market*, TOTAL IMPACT ADVISORS 105, http://www.totalimpactadvisors.com/sites/totalimpactadvisors.drupalgardens.com/files/library_items/Copy%20of%20SSRN-%20Unfreezing%20Capital%20Markets.pdf ("[C]haritable foundations emerge as a potentially major source of capital.") (2008).

[49] *See* I.R.C. § 4944.

[50] *See id.* at § 4942.

[51] *See id.* at § 4944(c).

[52] *See* Treas. Reg. § 53.4942(a)-2(c)(3)(ii)(d)(1983). For a general introduction of PRI issues in a social enterprise context, see Murray & Hwang, *supra* note 2, at 24–26.

[53] As Brian Galle points out, "The details are boring for most readers." Galle, *supra* note 3, at 2042.

[54] *See, e.g.*, Brewer, *supra* note 11, at 682 ("[B]oth the proponents and opponents generally recognize that PRIs are underutilized"); Martin & Wood, *supra* note 48, at 105 ("[C]haritable foundations emerge as a potentially major source of capital.").

[55] *See* I.R.C. § 4944(c) (exception for program-related investments from jeopardy investment rule, which applies only to private foundations); *but see* James P. Joseph, *Program-Related Investments and You—Perfect Together*, 20 TAX'N OF EXEMPTS 10, 11 (2010) (arguing that non-private foundations should use the PRI rules when making mission-related investments because "the PRI rules offer useful guidance on how to structure an investment by a public charity to ensure that the investment qualifies as a charitable activity that will not be subject to UBIT or constitute private benefit that jeopardizes the public charity's tax-exempt status").

But there are potential legal impediments to a tranched investment strategy other than the PRI rules. These impediments apply to all 501(c)(3) organizations, not just private foundations, and are conceptually more foundational than the specific PRI rules. The focus on private foundations and PRI rules has resulted in a general lack of treatment of the foundational issues associated with tranched investments, and even when these legal issues are addressed, the discussion is unnecessarily distracted by concerns that apply only to private foundations and their specific rules.[56] For that reason, this Article addresses the non-PRI legal issues. In order to do so, it assumes that the Earth Charity is a public charity rather than a private foundation, and so none of the donors/investors in the Cookstove Project are private foundations.

D. The Subsidy Problem

A reader is likely to have one of two instinctive responses to my description of a tranched investment strategy—one positive and one skeptical. Really one should have both reactions simultaneously. On the one hand, a reader should be outraged. After all, a tranched investment strategy means that a federally recognized tax-exempt charity will provide funds to a for-profit business enterprise with the expectation that it may not receive any of its money back.[57] Even worse, the charity fully understands that other private investors may receive a return on their investment, even when the charity does not. Furthermore, even if both the charitable investor and the private investors receive a financial return on their investment, the private investors will receive a higher rate of return than the charity. Charitable donors presumably contributed the charity's investment and trusted the charity to observe its duty to use those funds to advance the organization's tax-exempt purpose. Perhaps even more importantly, the government granted tax benefits both to the donors

[56] An excellent article addressing the private foundation rules in detail is Brewer, *supra* note 11, at 715–19 (describing a "contract hybrid" structure that enables a community grocery to access both equity capital from private investors and a below-market loan from two tax-exempt foundations). *See also* Archer, *supra* note 13, at 174–75 (describing a three-tranche structure in which (i) a charitable foundation takes a lowest-priority interest with a 1 percent return; (ii) a "socially responsible investor" takes a middle tranche with a 3 percent return; and (iii) a "profit-sector investor" makes a 50 percent capital investment with the lowest risk but with a "market competitive six percent rate of return").

[57] In the private foundation context, investments that are too risky or that promise too low returns may be subject to penalizing excise taxes under section 4944 of the Code, unless those investments constitute "program related investments." *See* I.R.C. § 4944(c). No comparable explicit penalty regime exists for public charities.

of the charity (tax deductible contributions) and to the charity itself (tax exemption on investment earnings) for the purpose of encouraging the pursuit of the organization's charitable purpose.[58] Those tax benefits were not given to enrich private investors. A tranched investment strategy appears to potentially create a situation in which the charity is subsidizing the profits earned by the private investors, and that seems deeply troubling.[59] In this Article, the term "subsidy problem" is used to refer to the concern that private investors in a tranched investment strategy may be diverting charitable funds to enhance their profits.[60]

On the other hand, one might think that the structure is not troubling at all. After all, there is no reason why the traditional non-profit sector should have a monopoly on producing social goods. The idea that the business community should not address its peculiar genius to the problems that face the world, and that one good way to do that would be for it to partner with the non-profit sector, seems completely plain. Whether such partnerships are called "border-crossings"[61] or "hybrids"[62] or just "social enterprises," some commentators believe that these entities have the potential to increase the social good.[63] Furthermore, the idea that these hybrid social enterprises would combine a subsidized investment by a charity with investors who want a return financial return of some sort should not be surprising.[64] The best way to access large quantities of capital for

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[58] *See, e.g.*, Galle, *supra* note 3, at 2042 (pointing out that tax-exemption creates a higher return for charitable investors whose profits are free from federal tax).

[59] In *When the Law is Understood—L3C No* (William Mitchell Legal Studies Research Paper No. 2010-07, 2010), Daniel S. Kleinberger and J. William Callison provide an example of an "outraged" reaction:

> Foundations have the privileges of tax-exempt status and the ability to receive deductible contributions. Tranched investing runs the risk of exporting these privileges to benefit non-charitable businesses, managers, and investors. Tax law has a term for this sort of private benefit—private inurement—and transactions that create private inurement cause large and potentially debilitating problems for charitable organizations. Properly constructed, a tranched investment arrangement might well survive IRS scrutiny, but it is dangerous to advocate tranched investing by foundations as a generic, easily designed, and readily-available device for social progress.

See also Bishop, *supra* note 15, at 265; Callison & Vestal, *supra* note 15, at 292.

[60] *See supra* note 15.

[61] *See* Tahk, *supra* note 2, at 492.

[62] *See* Reiser & Dean, *supra* note 15.

[63] *See, e.g.*, Tahk, *supra* note 2, at 494 ("[F]ederal tax law not only should accept the reality that organizations cross sectorial borders, but should also consider how to direct those crossings in ways that produce social benefit.").

[64] Among other things, governments often partner with the business community

scaling a potentially expensive or capital-intensive project is to offer a competitive financial return to providers of that capital.[65]

But whichever instinctive reaction a reader has, it is clear that a tranched investment strategy has a potential dilemma at its heart. The tranches are premised on the idea that some investors are willing to take a lower return or greater risk in order to facilitate the social benefit that the enterprise seeks to advance. They want to provide a subsidy to further the enterprise's social mission. But there is always the potential for this subsidy to be diverted from the social mission and used to enrich the market-rate investors. That is because there is no obvious method for evaluating whether the market-rate investors are receiving a market-rate return on their investment or an *above*-market return. That is not to say that no measurement is possible.[66] But it is hard to imagine a one-size-fits-all measurement system that could provide the basis for government regulation of the whole sector.

If one thinks there is at least some value in both reactions, then one may want to explore a legal or regulatory regime that permits tranched social enterprises but imposes some restrictions on how they are structured. In fact, the federal tax code contains exactly such a regulatory regime. The next section discusses the federal tax regime that regulates tranched social enterprises, and explores whether it strikes the proper balance between protecting donors and the government against abusive misdirection of charitable contributions (and the tax benefits that accompany them) and encouraging (or refraining from discouraging) capital formation for socially beneficial enterprises.

II. THE PRIVATE INUREMENT LEGAL REGIME

Tax laws regulate tranched investment structures for social enterprises, but only if one of the investors is a recognized tax-exempt organization. If the structure involves a tax-exempt organization (as the Cookstove Project does), the solution to the "subsidy problem" has at least two distinct components. First, tax-exempt philanthropic investors are bound by the "private inurement doctrine" and certain ancillary laws that support the private inurement doctrine such as the

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to provide social goods by providing direct tax subsidies for certain activities, like the provision of low-income housing, or by contracting directly with for-profit firms to provide those goods.

[65] *See, e.g.*, Arthur Wood, *New Legal Structures to Address the Social Capital Famine*, 35 VT. L. REV. 45 (2010).

[66] *See* discussion *infra* note 100.

penalties imposed by the Tax Code on "excess benefit transactions."[67] These laws apply generally to prevent the people who exert control over a charitable organization from diverting its funds into their own pockets. In this Article, I generally call this set of laws the "Private Inurement Regime."

Investors in social enterprises that are tax-exempt charitable organizations are also bound by a second set of rules. These rules seek to prevent a diversion of funds or energy away from the organization's charitable mission, but apply whether or not the potential beneficiaries of the diversion are in a position to control the charity. This second set of rules includes the so-called "private benefit doctrine" as well as the IRS's "joint venture rules," which are derived from the private benefit doctrine. I call this second set of laws and rules the "Private Benefit Regime."[68] The essential difference between the two regimes is that the Private Inurement Regime applies only when some person who exerts control over a charitable entity obtains some private benefit from that charity or its funds. Whereas the Private Benefit Regime applies even when the person who obtains a private benefit from the charity or its funds does not exert control over the charity.[69]

Note that the current legal regime applies *only* if the philanthropic investor is an exempt organization.[70] Thus, there is a second very different legal regime that applies if none of the philanthropic investors are tax-exempt organizations. If *private* philanthropic investors want to make a below-market investment in a tranched social enterprise, they are not subject to the private inurement rules, the joint venture rules, or the special rules for private foundations.[71]

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[67] *See* I.R.C. § 4958.

[68] There is a third separate regime that applies only to so-called private foundations, that includes the "program related investment" restrictions, among other things.

[69] Despite the fact that these regimes are fundamentally different, "These doctrines are often incorrectly used interchangeably." *See* Nicholas A. Mirkay, *Relinquish Control! Why the IRS Should Change its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 29 (2006) (citing *Distinguishing Between Private Benefit and Inurement*, TAX-EXEMPT ADVISOR (CCH), Dec. 11, 2000, at 9).

[70] Evelyn Brody, *Business Activities of Nonprofit Organizations: Legal Boundary Problems*, *in* JOSEPH J. CORDES & C. EUGENE STEURLE, NONPROFITS & BUSINESS 90 (2009) ("Keep in mind, though, that the tax system's benefits are limited and, because favorable tax treatment is essentially elective, and organization may simply forego tax-favored status if it wishes to avoid the strings that come attached.").

[71] This is because application of federal law to charities only applies when those charities seek tax-exempt status under I.R.C. § 501(a).

This section deals with the laws that apply when the investors in the Subsidizing Tranche are charitable entities. Remember, legal reformers have consistently stated that one prominent goal of social entrepreneurs is to be able to access capital from both charitable sources and regular capital markets,[72] and so it is accordingly important to deal extensively with the law that applies to such mixtures of capital.

A. Private Inurement

The first and most obvious legal solution to the subsidy problem is the prohibition on "private inurement" that applies to exempt organizations. Section 501(c)(3) of the Code mandates that "no part of the net earnings of [a qualifying organization] inures to the benefit of any private shareholder or individual[.]"[73] This provision is the basis of the so-called "nondistribution constraint."[74] It is what distinguishes *non*-profit organizations from *for*-profit organizations.[75] And, it is this prohibition that prevents 501(c)(3) organizations from directly accessing capital from equity investors, since the IRS has held that a 501(c)(3) organization with shareholders who are entitled to a portion of its profits is *per se* engaged in private inurement.[76] This *per se* inurement originates in the plain language of the statute, which emphasizes "net earnings" flowing to "private shareholders." Thus, direct equity ownership of a 501(c)(3) organization is impossible because of the private inurement doctrine.[77]

But, in addition to preventing 501(c)(3) organizations from directly accessing equity capital, the private inurement prohibition potentially affects investments by 501(c)(3) organizations in a venture that itself has equity investors. That is because the most common meaning of "private inurement" is much broader than the transfer of

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[72] *See supra* note 11.

[73] *See* § 501(c)(3) ("[N]o part of the net earnings of which inures to the benefit of any private shareholder or individual.").

[74] *See, e.g.*, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

[75] *See* BRUCE HOPKINS, THE LAW OF NONPROFIT ORGANIZATIONS 505 (10th ed. 2011) ("[I]ndeed, [the doctrine of private inurement] is the fundamental defining principle of law that distinguishes *nonprofit organizations* from *for-profit organizations*.") (emphasis added).

[76] *Id.* at 523 ("With the emphasis of the federal tax law, in the private inurement area, on *net earnings* and the reference to *private shareholders*, the most literal and obvious form of private inurement is the parceling out of an exempt organization's net income to those akin to shareholders.").

[77] This is true even if the equity ownership is in the form of so-called "participating debt," in which a debt-like instrument permits the lender to receive a return measured by net income. *See* Brewer, *supra* note 11, at 696.

net income directly to equity owners, since the "inurement prohibition serves to prevent anyone in a position to do so from siphoning off any of a charity's income or assets for personal use."[78] Thus, in general, private inurement involves (1) one or more insiders[79]—people who are in a position to control the charity—and (2) some *excessive* benefit flowing to those people—something more than just reasonable compensation for their provision of property or services to the charity.[80]

If private inurement involves a 501(c)(3) organization "siphoning off" funds to insiders, then a 501(c)(3) organization's investment in a social enterprise could constitute private inurement if one or more insiders owned the social enterprise, and if the investment constituted an excessive benefit. Several commentators have explained why the private inurement rules (among others) prevent social enterprises from operating as tax-exempt organizations,[81] and some have mentioned that the private inurement doctrine may be a problem for tranched investing in social enterprises,[82] but none have analyzed in any depth how the rules impact such an investment.[83]

[78] I.R.S. Gen. Couns. Mem. 39862 (1991). *See also* John D. Colombo, *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1067 (2006) ("The [private inurement] prohibition refers to 'siphoning off' the income or assets of the exempt organization via non-arm's-length transactions with 'insiders.'") (internal citations omitted).

[79] *See, e.g.*, United Cancer Council, Inc. v. Comm'r, 165 F.3d 1173, 1176 (7th Cir. 1999) ("The term 'any private shareholder or individual' in the inurement clause of section 501(c)(3) of the Internal Revenue Code has been interpreted to mean an insider of the charity."); Treas. Reg. § 1.501(a)–1(c)(1982) (defining "private shareholder or individual" as "persons having a personal and private interest in the activities of the organization").

[80] *See, e.g.*, I.R.S. EXEMPT ORGANIZATIONS HANDBOOK (IRM 7751) § 342.1(3) ("[T]he prohibition of inurement, in its simplest terms, means that a private shareholder or individual cannot pocket the organization's funds except as reasonable payment for goods or services.").

[81] *See* Brewer, *supra* note 11, at 697–98 (briefly describing the law); *Id.* at 708 ("[T]he prohibitions on private inurement . . . prohibit tax-exempt status for an organization that issues equity-like debt to insiders.").

[82] *See, e.g., supra* note 15; Bishop, *supra* note 15, at 264–65 ("[T]he tranche-investment notion potentially violates the private inurement restriction" but "these questions are yet unanswered, and general guidance is sought from related authorities.").

[83] Brewer does not address any potential private inurement in his "contract hybrid" tranched investment model because he assumes that the charitable tranche is wholly independent from the market tranche, and so no "insiders" in the charity are also investors in the social enterprise, negating the possibility of private inurement. *See* Brewer, *supra* note 11, at 716–18. Archer likewise does not address the private inurement rules because he also assumes that "[t]he private investors in the L3C's market tranche will normally be considered 'outsiders' because they lack direct influence over the foundation's affairs." Archer, *supra* note 13, at 190.

Because the private inurement doctrine demands not just an excess benefit, but also an "insider," it would only impact a hybrid social enterprise if the investors in the Subsidized (market-level or quasi-market-level) Tranche were related to insiders in the charitable organization that made the subsidizing (below-market or purely charitable) investment. For example, in the Cookstove Project, which has a Subsidized Tranche of equity owners and a Subsidizing Tranche comprised of the Earth Charity, private inurement could exist only if the owners of the Subsidized Tranche (or their relatives) had some sort of influence or control over the Earth Charity. If any of the investors in the Subsidized Tranche were the founder of the Earth Charity, or a board member, or the executive director, or the husband of the executive director, or even potentially a substantial contributor to it, there would be the possibility of private inurement. Private inurement law, however, is relatively undefined, and it is not entirely clear either what type of relationship constitutes influence or control or what type of benefit constitutes inurement.

B. Excess Benefit Transactions

While the inurement doctrine is somewhat imprecise, it has been bolstered and supplemented by more detailed statutory schemes that arguably serve the same purpose: preventing insiders from enriching themselves at the expense of the charity.[84] The first more detailed statutory scheme was enacted in 1969, and applied only to that subcategory of 501(c)(3) organizations called "private foundations."[85] In 1996 Congress supplemented the private foundation rules with a statutory scheme that provides penalties for so-called "excess benefit transactions" between insiders and all non-private-foundation 501(c)(3) organizations (generally called "public charities").[86] These penalties are called "intermediate sanctions" because they are intended to permit the government to sanction charities for transactions that excessively benefit insiders without revoking the organization's tax-exempt status, which was formerly the IRS's only remedy under the private inurement doctrine.[87] However, they cover

[84] *See* Colombo, *supra* note 78, at 1068 ("Today, the private inurement limitation largely has been supplanted by I.R.C. § 4958 . . . which provides statutory remedies short of loss of tax exemption for these siphoning transactions.").

[85] *See* I.R.C. § 4941. In 1969, Congress enacted a statutory regime to punish Private Foundations and their leadership if they engaged in "self-dealing" transactions. *Id.* A self-dealing transaction is a transaction between a Foundation and a disqualified person. *Id.*

[86] *See id.* at § 4958.

[87] Hopkins, *supra* note 75, at 548.

essentially the same ground as the inurement rule: situations in which the charity enriches certain insiders by providing them an excessive financial benefit.

The strength of the excess benefit transactions rules is that they attempt to provide more precision and detail to the law of private inurement, even though significant ambiguity remains. For example, the statute defines the type of relationship at issue (a "disqualified person") as anyone who was or is "in a position to exercise substantial influence over the affairs of the organization."[88] It defines the "excess benefit" as one in which "the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit."[89] All of the law of excess benefit transactions flows from these two deceptively simple formulations.

One starts the analysis only if there is some benefit, since there can be no excess benefit transaction without a benefit. In the case of the Cookstove Project, investors in the Subsidized Tranche are providing capital in exchange for the right to a portion of the profits of the venture. Receiving a payment in exchange for the provision of start-up capital is exactly the kind of benefit that warrants excess benefit transaction analysis. But, remember, the Cookstove Project itself is not a tax-exempt organization. Federal tax law does not prevent insiders in the Cookstove Project from benefitting financially from its operations, even if those benefits are "excessive."[90] Rather, it is the Earth Charity—the investor in the Subsidizing Tranche—that is subject to the rules, and so it is the Earth Charity that we must focus on in our analysis. The Earth Charity is providing a benefit to the Cookstove Project in the form of start-up capital, and so there is an obvious benefit flowing from the Earth Charity to the Cookstove Project.

Once we determine that there is a benefit, we must determine if it is flowing to any disqualified persons. If there are no disqualified persons, there is no application of the excess benefit transaction rules. There are two ways to analyze the question of whether there are any disqualified persons. First, since the Cookstove Project is itself a legal

[88] § 4958(f)(1)(A). The term "disqualified person" also includes a family member of a person who exercises substantial control, an entity controlled by a person who exercises substantial control, and a few other miscellaneous categories of person. *See* § 4958(f)(1)(B)–(F).

[89] *Id.* at § 4958(c)(1)(A).

[90] If the insiders are directors, state fiduciary duty law might prevent such excessive benefits. Similarly, state corporation laws prevent corporate waste, which may extend to excessive payments to insiders under certain circumstances.

entity, it is a "person" who could be a "disqualified person." The statute defines disqualified person to include "a 35-percent controlled entity,"[91] which it defines as a corporation, partnership or trust in which disqualified persons control more than 35 percent of the voting power, profits interest, or beneficial interest respectively.[92] Thus, if 35 percent or more of the Cookstove Project is controlled by disqualified persons, then the Cookstove Project itself is a disqualified person. Thus, we need to determine which individuals are disqualified persons with respect to the Earth Charity in order to determine whether the Cookstove Project itself is a disqualified person with respect to the Earth Charity.

In addition to the statute, regulations provide detail about what kind of individuals qualify as disqualified persons, and, unsurprisingly, the types of persons in this category are generally the same people identified in the private inurement context: voting members of the charity's governing body, senior officers of the charity and family members of disqualified persons.[93] Further, the regulations specify that certain people *might* be disqualified persons, depending on an analysis of all the facts and circumstances. These people include the founder of the charity, substantial contributors to the charity, and people who control a discrete aspect of the charity.[94] So, if directors, senior officers, founders, or senior employees of the Earth Charity, or a family member of any of those people, own 35 percent of the Cookstove Project, then the Cookstove Project may well be a disqualified person. Remember, disqualified persons are determined based on their relationship to the Earth Charity, not to the Cookstove Project. If the owners of 35 percent or more of the Cookstove Project are disqualified persons with respect to the Earth Charity, then the Cookstove Project is itself a disqualified person. But relationships with the Cookstrove Project other than ownership (like management or other indices of influence) do not make the Cookstove Project itself a

[91] *Id.* at § 4958(f)(1)(C).

[92] *Id.* at § 4958(f)(3)(A); Treas. Reg. § 53.4958-3(b)(2)(2002).

[93] *See* Treas. Reg. § 53.4958-3(c)(2002) (including persons serving the function of president, C.E.O., C.O.O., treasurer and C.F.O. "regardless of title").

[94] *See* Treas. Reg. § 53.4958-3(e) (2002). The examples in the Regulations suggest that in the hospital context, the question of whether a doctor is a "department head" may be the factor that determines whether she is a disqualified person or not. *Compare* Treas. Reg. § 53.4958-3(g), ex. 10 (doctor who is not a department head is not a disqualified person) *with* Treas. Reg. § 53.4958-3(g), ex. 11 (doctor who is a department head is a disqualified person). *See also* I.R.S. Priv. Ltr. Rul. 2013-36020 (Sept. 6, 2013) (finding that a doctor who is not a department head is not a disqualified person).

disqualified person.[95] There is a potential excess benefit transaction issue if the entrepreneur or others are disqualified persons with respect to the Earth Charity—by being directors or officers *of the Earth Charity*—and own at least 35 percent of the Cookstove Project.

Finally, even if the Earth Charity provided a financial benefit to the Cookstove Project (in the form of an equity investment) and the Cookstove Project was a disqualified person, there is still no excess benefit transaction unless the benefit received is excessive.[96] Section 501(c)(3) organizations provide benefits to disqualified persons all the time with no implication of impropriety, much less illegality. For example, 501(c)(3) organizations may pay compensation to employees who perform services for the organization.[97] They may also pay interest to persons who provide capital to the organization in the form of debt. These payments are not problematic because the value of the capital or services provided is equal to the value of the compensation paid by the charity and so the benefit is not "excess." A benefit is only excess if a disqualified person receives more in a transaction with the 501(c)(3) organization than he could have obtained in a market transaction between unrelated persons. For example, if a person gets paid more salary than he should be paid, that could be an excess benefit transaction; if a person loans money to the 501(c)(3) organization and gets paid an *above*-market interest rate, that could be an excess benefit transaction; if a person borrows money from the organization and pays a below-market interest rate, that could be an excess benefit transaction; and if a charity sells its operation to a disqualified person for less than it is worth, that could be an excess benefit transaction.[98]

In the case of the Cookstove Project, the Earth Charity provided capital in the form of a below-market equity investment. The fact that the investment is "below market" seems to provide evidence that the Cookstove Project received a benefit (start-up capital) that "exceeds the value of the consideration" (below-market dividends or profits)

[95] There is some potential confusion in this issue. As discussed *infra* in the text accompanying notes 113 and 114, both the IRS and some commentators have taken the position that control of a subsidiary or joint venture could render a person a disqualified person with respect to a charity that is a member of the joint venture, even if the alleged disqualified person exerted no influence directly over the charity. For reasons discussed *infra*, this approach is overly inclusive.

[96] I.R.C. § 4958(c)(1)(A) ("[I]f the value of the economic benefit provided exceeds the value of the consideration . . . received for providing such benefit . . .").

[97] *See, e.g.*, World Family Corp. v. Comm'r, 81 T.C. 958, 969 (1983) ("[T]he law places no duty on individuals operating charitable organizations to donate their services; they are entitled to reasonable compensation for their efforts.").

[98] Caracci v. Comm'r, 118 T.C. 379 (2002), *rev'd* 456 F. 3d 444 (5th Cir. 2006).

paid to it for that benefit.[99] Thus, with respect to the Cookstove Project as an entity, it appears that the transaction is an excess benefit transaction. If the Cookstove Project as an entity is a disqualified person, the provision of a below-market investment tranche appears to be an excess-benefit transaction, and penalties would presumably apply. Remember, the Cookstove Project is a disqualified person if it is a "35-percent controlled entity," which means that disqualified persons own at least 35 percent of the entity. That seems like a pretty straightforward prohibition on permitting individuals who control the Earth Charity from owning more than 35 percent of the Cookstove Project.

Even if the Cookstove Project itself is not a disqualified person because disqualified persons do not own 35 percent of the Cookstove Project, it is possible that there is an excess benefit transaction if *any* of the investors in the Cookstove Project are disqualified persons with respect to the Earth Charity. That is because when the Earth Charity provides funds to the Cookstove Project, those funds in effect belong to the investors in the Subsidized Tranche, or at least accrue to their benefit. Thus, the provision of start-up capital to the Cookstove Project is potentially a benefit to the investors in the Subsidized Tranche of the Cookstove Project in addition to being a financial benefit to the Cookstove Project itself.

But, just because a benefit flows to the Cookstove Project does not necessarily mean that the benefit flows through to the investors in the subsidized tranche. Remember, the purpose of the subsidy is to enable the Cookstove Project to provide a social good-health for poor people and lower greenhouse gas emissions for the environment. If the subsidy provided by the Earth Charity is somehow "used up" by the social good provided, then there is a plausible case to be made that the benefit flowing to the Subsidized Tranche investors is not excessive at all. It is just a regular market-rate return on their capital. In fact, this premise is the basis of the whole structure. A charity provides a benefit to a social enterprise to permit it to do good. The return paid to its

[99] There is no IRS guidance specifically about charitable investments in the subsidizing tranche of a social enterprise, but there is a fact mentioned in a recent ruling addressing so-called "ancillary joint ventures" (discussed *infra* in section IV(B)) that pertains to the discussion here. In Revenue Ruling 2004-51, the IRS ruled that an ancillary joint venture will not negatively impact a participating charity's tax-exempt status, so long as "[the partners'] ownership interests . . . are proportional to their respective capital contributions, and all returns of capital, allocations and distributions by [the partnership] are proportional to [the partners'] ownership interests." Rev. Rul. 2004-51, 2004-1 C.B. 974. Thus, in the case of a tranched investment strategy, in which the ownership interests are *not* proportional, it is not clear what the IRS would conclude.

for-profit investors is not "above market;" it is no more than "at market" in the sense that it is comparable to what those investors could receive in comparable investments if some of the risk associated with the social return were removed. On the other hand, it is not clear how one could measure whether the subsidy is "used up" or not, at least not if you are the IRS trying to administer a regulatory regime consistently.[100]

If it was too difficult to measure whether the benefit is "used up," one could try to measure directly whether the return provided to market-rate investors is excessive. In order to do that, one would have to determine what an unsubsidized market-rate return would be.[101] But measuring an unsubsidized return is very difficult or impossible. Remember, a market return is some combination of projected return and risk. If one's return on investment is a share of the profits of the venture, one cannot know what a "market" return would be unless one knows what other options were available in the market, what his projected returns looked like, and what his projected risk was. As any business appraiser will tell you, these things defy full measurement.[102] And, of course, the fact that the returns *were subsidized* by the charitable tranche's investment seems like at least preliminary evidence that the

[100] When private foundations make grants to for-profit enterprises, they are subject to an information collecting regime called "expenditure responsibility," which is one attempt to determine if a benefit provided by a tax-exempt entity is "used up" or not. *See* I.R.C. § 4945(d)(4) (1969). Unfortunately, the expenditure responsibility regime is difficult to adapt to a tranched investment context, since it requires even in the program-related investment context that the grant recipient "use all the funds received from the private foundation . . . only for the purposes of the investment." Treas. Reg. § 53.4945-5(b)(4)(i) (1972). This requirement that all funds provided under an equity-type investment be "used up" creates significant legal uncertainty, since there is no method that has been clearly accepted by the IRS for doing so. For a general discussion of the difficulties involved in measuring social benefit. see Linda M. Lampkin & Harry P. Hatry, *Measuring the Nonprofit Bottom Line*, in JOSEPH J. CORDES & C. EUGENE STEURLE, NONPROFITS AND BUSINESS ch. 9 (2009).

[101] The excess benefit transaction rules provide a mechanism by which a taxpayer who follows a series of procedural steps can create a rebuttable presumption that the benefit it is providing is not "excessive." *See* Treas. Reg. § 53.4958-6 (2002). However, one of the conditions necessary to create the presumption is that "the authorized body obtained and relied upon appropriate data as to comparability prior to making its determination [of how much to pay for the benefit]." Treas. Reg. § 53.4958-6(a)(2) (2002). But this presumption fits very uneasily with a situation in which a charity is making an equity investment in a social venture. It is generally used to ensure that compensation paid to executives is not excessive, and while it also applies to transfers of funds in exchange for property or the use of property, it is difficult (although not impossible) to analogize a transfer of capital in exchange for an interest in future profits of a firm for a transfer of money in exchange for a property interest. In any case, it seems unlikely for the reasons discussed in the text that comparability data would be readily available.

[102] *See generally* DAVID LARO & SHANNON P. PRATT, BUSINESS VALUATION AND FEDERAL TAXES: PROCEDURE, LAW AND PERSPECTIVE 172–76 (2nd ed. 2011).

returns provided to the market-rate investors are *above* market rate.[103]

The challenge in measuring return is exacerbated because we chose for our hypothetical a return that is "equity-like" as opposed to "debt-like." In general, a debt-like return is one in which an investor receives a return that is a fixed percentage of her capital contribution. So, for example, in exchange for $100,000, an investor may receive a right to the return of that $100,000 plus a fixed 5 percent per year until the principal is repaid. In contrast, an equity-like investment is not fixed with regard to the amount invested, but varies depending on the profitability of the venture. So, for example, in exchange for an investment of $100,000, an investor may receive a right to one percent of the profits of the venture. Most detailed discussions of tranched investment structures assume that the charity's Subsidizing Tranche would be debt-like.[104] This may be partially because it seems easier to measure whether a debt-like instrument is "below market" or not because the availability of information about the credit market gives the illusion that it is easy to find a "market" interest rate. Whereas an appropriate equity-like return is a challenge to even conceive. It is important, however, to note that the challenges associated with identifying a "market" return in an equity-like instrument infect debt-like instruments as well. In both cases, a market return is a function of risk, and a comparable rate cannot be identified without an accurate assessment of risk in the venture at issue.[105] Obviously, assessing risk in a venture is an imprecise science (to say the least).[106]

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[103] It is worth pointing out that the Code expressly provides:

> [T]o the extent provided in regulations prescribed by the Secretary, the term 'excess benefit transaction' includes any transaction in which the amount of any economic benefit provided to or for the use of a disqualified person is determined in whole or in part by the revenues of 1 or more activities of the organization . . .

I.R.C. § 4948(c)(4) (1978). That provision presumably exists for the same reason that paying a share of the profits of a tax-exempt organization is *per se* private inurement, as discussed *supra* at note 76. Whether this provision could apply to the proposed Cookstove Project's structure would depend on whether the Cookstove Project could be considered an "activit[y] of the organization." But, in any case, since the Secretary has so far refrained from promulgating any regulations pertaining to the provision, it currently has no effect. *See* Treas. Reg. § 53.4958-5(2002) [Reserved].

[104] *See supra* note 45.

[105] *See, e.g.*, Lowry Hospital Ass'n v. Comm'r, 66 T.C. 850 (1976) (holding that loans from a tax-exempt organization were "below-market" even though they were "roughly equivalent to the interest rate it was receiving . . . on passbook deposits from the local bank" because the loans "represented substantially greater risk").

[106] *See* Laro & Pratt, *supra* note 102.

At bottom it seems that the best we can do is acknowledge that a compelling case could be made that a subsidizing investment from the Earth Charity to the Cookstove Project creates an excess benefit transaction, and that evidence showing that the benefit was *not* excessive would be hard to find or develop. The case is strongest if the Cookstove Project is a disqualified person on account of 35 percent of its shareholders being disqualified persons. The case is weaker, but not by any means insignificant, if the Cookstove Project itself avoids being a disqualified person itself, but disqualified persons are nonetheless investors in the subsidized tranche. In that case there is some risk at least that the IRS will successfully argue that an excess benefit flows to such disqualified person investors, especially if no compelling method is devised to show that the subsidy is "used up" for the social purpose of the Project. Perhaps the most we can say is that there is a significant risk that the IRS will interpret the excess benefit rules to mean that the fact that the Earth Charity is providing a subsidizing investment in itself constitutes an excess benefit flowing to investors in the Subsidized Tranche. The fact that an argument could be made that the benefit is not excessive, while plausible, does not remove that risk. Thus, the excess-benefit transaction rules presumably significantly inhibit investment in the Subsidized Tranche by disqualified persons.[107]

On the other hand, if no disqualified person is an investor in the subsidized tranche, the organization should be able to rely on its own internal assessment that the subsidizing tranche advances its charitable purpose.[108] It should not be overly chilled by a concern that the IRS will disagree with it about the social value of the social enterprise. Remember, the central premise of the entire charitable sector is the idea that the non-distribution constraint is the primary check on misdirection of funds by charities.[109] This central premise should not

[107] It is very hard to quantify how much in the way of potential investments are being inhibited by uncertainty in the law, but the penalties can get very large. For example, in Caracci v. Comm'r, 118 T.C. 379 (2002), *rev'd*, 456 F. 3d 444 (5th Cir. 2006), the total liability arising out of the imposition of excise taxes on the directors of a relatively small tax-exempt nursing home amounted to $69,702,390.

[108] *See* Archer, *supra* note 13, at 191 ("To avoid violating the inurement restriction, a foundation must only ensure that no individuals with personal or professional ties to the foundation take part in the market tranche of the L3C.").

[109] In *The Role of Social Enterprise and Hybrid Organizations* 40 (Yale Law & Economics Research Paper No. 485, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2379012, Ofer Eldar writes:

> [C]ontrary to some recent claims that the non-distribution constraint has lost its force as a commitment device because for-profits are increasingly engaged in the pursuit of social goals, it remains a key

be ignored when non-profits invest in tranched social enterprises. So long as the charities and the profit-makers are independent, the non-distribution constraint should still have force to prevent a diversion of funds away from social goals.

III. REFORMING THE PRIVATE INUREMENT REGIME

Some social enterprise legal reformers have asserted that private inurement would be a significant problem for hybrid social enterprises without analyzing why;[110] at least one other has dismissed the private inurement doctrine as inapplicable because he assumed that "[t]he private investors in the L3C's market tranche will normally be considered 'outsiders' because they lack direct influence over the foundation's affairs."[111] Whether they will normally be considered outsiders or not, it is at least clear that a tranched investment structure in which they are *not* outsiders will be potentially problematic under current law. It is probably fair to say that under current law any charity making a subsidizing investment in a social enterprise should assure itself that none of the investors in the subsidized tranche are disqualified persons with respect to it.[112]

But there is significant ambiguity under current law about the scope of the private inurement regime. On the one hand, there are hints in IRS guidance that the IRS believes that a person can be a disqualified person with respect to a charity *solely* because of her control over an entity that seeks to advance that charity's tax exempt purpose,[113] and at least one commentator thinks the IRS should

component of the commitment devices associated with for-profit social enterprises. The assumption is that organizations which are subject to a non-distribution constraint can be trusted to monitor for-profits.

110 *See* Bishop, *supra* note 15, at 265–67; Daniel Kleinberger, *supra* note 15, at 893.

111 Archer, *supra* note 13, at 190.

112 This position is by no means a consensus among lawyers who advise tranched social enterprises or other joint ventures between charities and for-profit entities. As Ellen Aprill has commented (in the private foundation context), "private practitioners tell me that there is confusion about indirect self-dealing, that the regulations regarding indirect self-dealing add to the confusion, and that one area of particular uncertainty is joint investment by disqualified persons and private foundations in various investment vehicles." *See* Aprill, *supra* note 17, at 20.

113 *See* Treas. Reg. § 53.4958-3(g), ex. 7 (2002) (stating that a management company that manages a hospital that is the subject of a whole hospital joint venture between a charity and a for-profit entity "is a disqualified person with respect to [the charity]" even if the management company is otherwise wholly unrelated to the charity solely because the management company has "ultimate responsibility for supervising the management of the hospital"). But note that this example, by its terms, applies only to a whole venture joint venture in the hospital context, and is therefore ambiguous about whether the same analysis applies in an ancillary joint venture context or in an investment, loan, or grant that does not constitute a joint venture.

embrace this expansive reading of the private inurement regime.[114] In other words, the director of the Cookstove Project could be a disqualified person with respect to the Earth Charity because she controls the Cookstove Project, even if she is completely unconnected to the Earth Charity. This expansive reading of the private inurement regime would dramatically increase the scope of the doctrine beyond merely preventing charitable insiders from benefiting from the charity's subsidizing investments.

On the other hand, there is also ambiguity about whether an equity interest in the Cookstove Project necessarily constitutes an "excess benefit" with respect to the Earth Charity when the Earth Charity makes a subsidizing investment in the Cookstove Project. If the Earth Charity could show that a subsidizing equity investment does not result in an above-market return for the market-tranche investors—for example, by showing that the "subsidy" is entirely "used up"—then there is no private inurement. The question of whether the benefit flowing to the market-tranche investors is an "excess benefit" or not is equally pronounced if the Subsidizing Tranche is a below-market loan or a grant.

I propose that the IRS issue guidance that makes clear what seems like simple good advice under current law: that the existence of a Subsidizing Tranche in a tranched social enterprise creates the presumption that the subsidized tranche is receiving an excess benefit. Therefore, the private inurement regime requires that any charity providing funds to the subsidizing tranche must be independent from the Subsidized Tranche. In other words, the subsidized tranche cannot contain any investors who are disqualified persons with respect to any charitable investor in the subsidizing tranche. But it should also make clear that a person who is completely independent of all charitable investors does not become a disqualified person merely because of her involvement with, or control over, the social enterprise. In other words, just because the charity is investing in a social enterprise does not mean that all the persons who control the social enterprise are disqualified persons with respect to the charity.

[114] Nicholas Mirkay characterizes IRS guidance as expressing "a long-held view . . . that a person or entity can become a disqualified person by entering into a contractual arrangement with an exempt organization if the contract provides such person or entity with the ability to control a portion of the exempt organization's income with no effective limitations or restrictions on possible private inurement." Mirkay, *supra* note 69, at 77–78. He argues that this expansive reading of the private inurement doctrine under certain circumstances would permit the IRS to police transactions between charities and for-profit partners when they engage in ventures together, whether they are social enterprises or not. *See id.* at 71–84.

Under this proposed guidance, there would be no problem with a social entrepreneur creating the Cookstove Project to help poor people, slow global warming, *and* make money. She could be an investor in the market tranche receiving a market return on her investment. She could find a charity or charities, like the Earth Charity, to invest at a lower return (or higher risk) in a subsidizing tranche of the project, so long as she was not a disqualified person with respect to this charity or charities. She could not be its founder, the sister of its president, a member of the board of directors, or a major contributor. But as long as she met this simple requirement, she would be free to profit from the Cookstove Project. This principle would apply not only to the entrepreneur investing in the market tranche, but also to her compensation. As long as she was not a disqualified person with respect to the Earth Charity, she could be paid a share of the profits of the enterprise for her services.

This may seem like simple good advice, but it has at least two significant implications. First, it means that an entrepreneur who wishes to invest in the social enterprise *cannot* also control any charity that invests in the charitable tranche.[115] Much of the literature on social enterprises has assumed that a founder or entrepreneur will own an equity interest in the project,[116] and so it is likely that the private inurement legal regime prevents social enterprise entrepreneurs from controlling the charities that fund their ventures.[117] In other words, social entrepreneurs seeking charitable investments must find "independent" charities interested in funding them. But it also means that tranched social enterprises can be used to provide a profit-related financial return to project managers or entrepreneurs. This responds to a rising tide of criticism of the effect of tax-exempt organizations law on incentives in the non-profit sector.[118]

[115] This limitation may constrain some "philanthrocapitalists" who wish to exercise "muscular philanthropy" in which the charitable funder exercises significant control over the social enterprise. *See* Jenkins, *supra* note 34. But it is only a limitation if disqualified person with respect to the charity also want to be investors.

[116] *See, e.g.*, Brewer, *supra* note 11, at 708.

[117] *See* Tahk, *supra* note 2, at 517 ("Additionally, with the contract hybrid structure, the individuals controlling the exempt entity may not benefit financially from the for-profit business . . . . Correspondingly, investors in the for-profit need to be comfortable pursuing a shared mission with an exempt organization they do not control.").

[118] *See, e.g.*, Anup Malani & Eric Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2065 (2007); M. Todd Henderson & Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 109 COLUM. L. REV. 571, 607 (2009) ("[T]he government should eliminate tax discrimination between producers of altruism.").

This section argues that this proposal is not only expedient as a simplification of existing law, but is theoretically justified.

A. *Evaluating a Strengthened Private Inurement Regime*

If the private inurement regime could provide clear boundaries within which tranched social enterprises could operate, one still must evaluate whether those restrictions are beneficial or detrimental. There is a compelling argument that the private inurement regime is at the heart of all regulation of charitable non-profits, and so an evaluation of the value of clear enforcement of the private inurement regime in the social enterprise context is really an evaluation of whether there is value in importing the law of charities into the law of social enterprises, at least under certain circumstances. Remember, this importation of the law of charities into the law of social enterprises occurs only when a social enterprise seeks capital from charitable sources. It is not triggered when a social enterprise seeks capital from non-charitable sources, even if those sources seek a social return and are willing to invest in a subsidizing tranche. Thus, an evaluation of whether the private inurement regime is beneficial or not is a question of whether (1) it is beneficial to impose the private inurement regime on funds that have been donated to charity in a context in which the donor received a tax deduction for the donation (and the charity received a tax exemption for profits made from the investment of those funds), and (2) whether it is beneficial to be able to donate to, or invest in, social enterprises that are bound by a no-inurement requirement. I argue that both things are beneficial.

The question of whether the private inurement regime is beneficial is in some ways the same as the question of whether it is beneficial to require that charitable entities be non-profits. As discussed above, the private inurement regime is just another word for the requirement that a charity be a non-profit: it is what distinguishes a *non*-profit organization from a *for*-profit one.[119] As many others and I have noted, the dominant argument for why "non-profitness" is beneficial—and therefore why it is valuable for the government to enforce the inurement regime—has been Henry Hansmann's theory of "contract failure."[120]

[119] *See supra* note 75 and accompanying text.

[120] *See, e.g.*, Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 845 (1980); Henry Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 506 (1981).

This theory, which is sometimes called the "agency theory,"[121] argues that the non-distribution constraint facilitates transactions in which a "patron" seeks to give a producer money in exchange for the production of some good under circumstances in which it is very expensive (or impossible) for the patron to monitor the quality of the good.[122] The quintessential example of such a situation is when the patron seeks to provide money that will be used to provide a good that benefits a person whom the patron does not know and will never meet, such as when a wealthy donor gives money to a charity to benefit the poor in a far-away land.[123] In that circumstance, the donor has very little information about whether the charity provided a high-quality benefit, or if the benefit was even provided at all. Because it would be so expensive for the donor to get evidence of the quality of the good provided to the poor, there is an incentive—absent any legal intervention—for the provider of the benefit to skimp on quality and put any savings in his pocket.[124]

The government therefore intervenes to provide some certainty to the donor that such expropriation is not occurring. But it is very difficult or impossible for the government (or anyone else) to certify the quality of the goods provided directly, since measurement of social goods are so variable. So, a substitution is performed. Rather than monitoring and enforcing a certain quality of goods, the non-distribution constraint monitors and enforces the financial benefits going from the charity to insiders in the charity, on the theory that so long as no excessive benefits are flowing from the charity to the people who control it, the patron/donor can be relatively assured that those benefits are being used in good faith to provide the social goods intended by the donor at as high a quality as possible.[125] In other words, the presumption at the core of the non-distribution constraint is that

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[121] *See* Leff, *supra* note 32, at 823 (explaining why the term "agency theory" is possibly not the best term to use, but that it has become accepted).

[122] *See* Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980)

[123] *See id.*

[124] As Brian Galle points out, "Since Hansmann first wrote in the early 1980s, scholars have penned a considerable new literature on the exchange of 'credence' goods, or goods whose quality must largely be taken on faith by the purchaser, ranging from legal services to organic foods." *See* Galle, *supra* note 3, at 2036.

[125] But, of course, even when non-profit directors are acting in good faith, they may well make decisions that are inefficient. *See, e.g.*, Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Form*, 40 N.Y.L. SCH. L. REV. 457, 464 (1996) ("[W]hile the nondistribution constraint might convince the patron that the nonprofit is more trustworthy than a for-profit in situations of opportunistic behavior, the nonprofit could be even less trustworthy in avoiding inefficient expenditures.").

the best way to ensure that benefits are being provided as efficiently as possible is to constrain the ability of insiders to enrich themselves by skimping on the benefits provided or diverting funds away from charitable benefits toward themselves.[126]

The existence of non-profit firms is made possible by the government's willingness to enforce the non-distribution constraint in situations in which patrons/donors and producers agree that the non-distribution constraint is the most efficient legal regime to govern their transaction. But this standard explanation does not explain why tax benefits—like charitable contribution deduction and exemption from corporate tax—should be available *only* to non-profit firms. Some social enterprise advocates (though not by any means most) have identified this apparent unfairness as a justification for extending tax benefits to social enterprises that are not constrained by the non-distribution constraint.[127] Where a government subsidy is provided to a charitable enterprise, however, the government's interest in advancing the social purpose that the subsidy seeks to advance justifies limiting the tax benefit to firms that are subject to the non-distribution constraint.[128] Several commentators argue that tax benefits should be available only to non-profit firms precisely because it is so difficult for the government to measure social benefit.[129]

But even if the private inurement regime is justified in the charitable context, the question remains under which circumstances there is a justification for importing it into the social enterprise context. The first answer is that there is a justification for importing

[126] This "best" is of course relative, since the non-distribution constraint is only the most efficient means because the quality of the goods provided cannot efficiently be observed, either by the patron or by the government. In most non-charitable situations, we assume that a patron can observe the quality of goods, and that in those cases it is more efficient to permit the provider of goods to enrich herself by reducing costs. In fact, in most firms we assume that the key to efficient provision of goods comes from a combination of competition and the ability of providers to enrich themselves by increasing efficiency.

[127] Malani & Posner, *supra* note 118, at 2065 (arguing that tax benefits should be available to for-profit firms if they operate for "charitable" purposes); Henderson & Malani, *supra* note 118, at 607 ("[T]he government should eliminate tax discrimination between producers of altruism."); DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL (2008).

[128] *See* Leff, *supra* note 32, at 854–68.

[129] *See, e.g.*, James Hines Jr., Jill R. Horwitz &Austin Nichols, *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1183 (2010) ("[A]s a realistic matter, it is almost impossible to administer a system that ties tax benefits to public benefit provision levels."); Mayer & Ganahl, *supra* note 13, at 391 (finding that hybrids should not have tax benefits because of "four reasons, each of which arises from the difficulty of defining and policing 'public benefit'").

the private inurement regime into the social enterprise context when a charity is passing on its charitable tax benefits by making a grant to, or making a subsidizing investment in, a social enterprise. For example, when the Earth Charity makes a subsidizing investment in the Cookstove Project, the Earth Charity's tax benefits are in effect transferred to the Cookstove Project. If insiders of the Earth Charity were able to divert those tax benefits to *themselves* on account of their control over the Earth Charity and their investor status in the Cookstove Project, then we might worry that the government's tax benefits were being abused. Because the Cookstove Project (and its donors) received a tax benefit from the government (in the form of deductible contributions and exemption of income), the government has an interest in preventing those funds from being diverted from their social purposes to the financial benefit of the very people tasked with protecting the social mission of those funds. Once the government has provided a tax benefit to encourage or facilitate some charitable purpose, it is reasonable for it to require that benefit to be used subject to the inurement regime. As I discuss in greater detail elsewhere,[130] the inurement regime may be the most efficient way for the government to ensure that its investment in social benefits be used for those benefits. When the private inurement rule is applied to prohibit people who control the Earth Charity from profiting from the Cookstove Project, this independence of the Earth Charity's directors and managers removes any direct financial incentives to divert the Cookstove Project from its social purposes to its financial profitability. In addition, once their ability to profit financially from the Cookstove Project is removed, their independence reduces the likelihood that the Subsidizing Tranche will excessively subsidize the Subsidized Tranche, since their only remaining incentive is for the Cookstove Project to succeed in its social mission. The alignment of their interests with the social mission of the organization directly benefits the government by preventing a diversion of the tax benefits provided by it.

In addition, in situations in which a charity is making its investment with charitable funds, the inurement requirement serves to protect not just the government, but also a second class of interested persons. In addition to protecting the government (or the taxpayer, which is essentially the same thing), the inurement regime also protects people who donated to the Earth Charity. Whether they made their donation with knowledge of the Cookstove Project or not, they donated with the understanding that the Earth Charity was bound by

[130] *See supra* note 128

the non-distribution rule, and so a diversion of charitable assets into the pockets of the directors of the Cookstove Project would be a breach of their reasonable expectations. In other words, the existence of the inurement regime creates reasonable expectations among those persons who choose to donate to charities. They chose tax-exempt non-profits on the promise by the government that it would police the non-distribution constraint with the private inurement regime, and their choice of entity is "efficient" only if that expectation is respected. Those people presumably made a calculation that providing funds in that way was the most efficient way to provide the social benefit they wished to support, and it would be a betrayal of those reasonable expectations for the government to refrain from enforcing the inurement rule on investments made with those donated charitable funds.

Where no charitable funds are involved, the case for enforcing the inurement regime is much weaker. Many social enterprises do not involve charitable funds, and indeed under current law the inurement regime does not apply to those organizations.[131] Therefore, if no charitable funds are needed, a social enterprise can avoid the inurement regime, and no independent (non-investor) party is necessary to the structure. But even in cases in which a social enterprise does not need the tax benefits provided to charities, if the private inurement regime provided clear rules about diversions of funds, there might be a benefit for social enterprises to subject themselves to it.

Social enterprises may seek to constrain themselves under a clarified and strengthened private inurement regime because of the *regulatory* goal of social enterprise legal reformers. Social enterprise legal reformers seek to free social enterprises from the restrictions contained in current law, but they also seek a credible means to communicate to their various stakeholders that they are genuinely valuing social goals.[132] If the private inurement regime was clarified,

[131] For example, a benefit corporation is a for-profit entity with no expectations that it will be affiliated in any way with a charitable non-profit. Therefore, the private inurement regime does not apply to it. *See supra* note 71. Ofer Eldar points out that *all* the organizations that meet his somewhat narrower definition of what constitutes a social enterprise use nonprofit organizations to monitor the commitment devices used by the social enterprises. *See* Eldar, *supra* note 1, at 41 ("The essence of commitment devices is that a nonprofit is responsible for identifying a class of patron-beneficiaries . . . and verifying the transactions with them.").

[132] *See, e.g.*, Reiser, *supra* note 40, at 619 ("[The hybrid form] must . . . offer credible commitments to enforce such enterprise's dual missions."); Reiser & Dean, *supra* note 15 at 1524 ("Social investors need assurance that their willingness to sacrifice financial returns will not merely provide a windfall to entrepreneurs.").

and it was clear that it required that an *independent* charity to assess the social impact of a social enterprise's social purposes—and nothing more—then stakeholders, including other social investors, could rely on this independent assessment in making their own investment decisions.

In other words, if the private inurement regime was clarified, *non-charitable* investors in the Cookstove Project might benefit from the imposition of the private inurement regime as much or more than the Earth Charity was benefiting from it. Imagine you are a private person who wishes to invest non-charitable dollars in a social enterprise, but you care about the social mission as well as the financial mission of the enterprise. If there is a subsidizing tranche of charitable funds, and a subsidized tranche of market-rate investors, you fall potentially between the two. You wish to be a subsidizing investor, but you are not operating with charitable funds; you have not received any tax benefit in the form of a deduction for a donation or tax-free income.

Now imagine that you have the choice of investing in a social enterprise that has a true charitable tranche (like the Cookstove Project) or a social enterprise that has no true charitable tranche (let's call it the Cheap Stove Project). Imagine that you are looking at a website that enables individuals to make below-market investments in social enterprises, a crowd-source website like Kickstarter (which accepts donations) or Crowdfunder (which accepts investments),[133] and you are trying to decide whether to invest in the Cheap Stove Project or the Cookstove Project. The Cookstove Project now has three tranches: the subsidizing charitable tranche, the subsidized market-rate tranche and a second subsidizing tranche made up of socially-minded individual investors like you. The Cheap Stove Project is also a social enterprise, but it seeks to raise funds from two sources: a tranche of market-rate investors and a tranche of subsidizing individuals (not charities). Because the Cheap Stove Project has no charitable tranche, it is not subject to the no-inurement rule. You may welcome this structure because it frees the Cheap Stove Project from the burden of regulation that accompanies tax-deductible charitable dollars.[134]

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[133] *See* Chance Barnett, *Top 10 Crowdfunding Sites For Fundraising*, FORBES (May 8, 2013, 9:00 AM), http://www.forbes.com/sites/chancebarnett/2013/05/08/top-10-crowdfunding-sites-for-fundraising/; *see also* KICKSTARTER, https://www.kickstarter.com/ (last visited Oct. 14, 2014); CROWDFUNDER, https://www.crowdfunder.com (discussing various crown-sourcing websites) (last visited Oct. 14, 2014).

[134] This is the "de-regulatory impulse" discussed *supra* in the Introduction to this Article.

But, what at first seems like a burden of the Cookstove Project—that it has a charitable investor and therefore is subject to the no-inurement rule—actually gives you a significant benefit.[135] First, you know that the enterprise has an investor that has more resources than you have to evaluate the terms of the subsidizing investment, and potentially to monitor the investment to make sure that it is used to advance the social purpose. From an agency-cost point of view, the existence of a larger institutional investor is a huge benefit to you, because you can free-ride on its analysis, contracting, and monitoring. But their efforts only reduce your agency costs if you feel confident that they share your interests. If their interests diverge from yours, then there is no value in free-riding on their supervision over your mutual agent.

The private inurement regime is potentially your best assurance (although it is obviously far from complete) that the charitable investor shares your interest in the social mission of the firm. That is because removing the ability of the charitable investor to divert funds to her own pocket decreases the chances that she will do so. So, as a social investor, the existence of a charitable tranche that is bound by the private inurement rule means that the government will protect your reasonable expectation that the charitable investor will not divert funds to her pocket.

There are two huge caveats to the argument above. The first is that the charitable tranche protects your interest only if your interest is in the social mission of the enterprise. Remember, the Cookstove Project has two purposes: social and financial. You are investing in both. If you are more worried about the Cookstove Project failing to provide sufficient financial benefits than you are about the Cookstove Project providing sufficient financial returns, then the existence of an independent charitable investor gets you nothing. But in that case, the existence of market-rate financial investors should provide the assurances you want. As long as you are comfortable with the differences between your investment and theirs, their desire to profit may provide some assurance that the financial mission of the enterprise will not be ignored, though the gap between the terms of your deal and of theirs is very important to that calculation.

The second major caveat, though, is that this analysis does not apply to situations in which you have developed a better system to monitor and enforce the social mission of the enterprise. If you can

[135] This is the "regulatory impulse" discussed *supra* in the Introduction to this Article.

make a contract with the Cookstove Project in which social benefit is quantified with sufficient clarity and precision that your monitoring and enforcement costs are *not* higher than the costs associated with the private inurement regime, then that private system is more efficient than the importation of the private inurement regime.[136] In that case, you should invest in the Cheap Stoves Project and not the Cookstove Project. But in the absence of that situation, which I suspect is less common than some commentators might wish, the existence of a charitable tranche that is clearly subject to the private inurement regime—and therefore is made up of independent people—can be very useful to an individual contemplating making a subsidizing investment in a social enterprise.[137] The application of the private inurement rule enables the Cookstove Project to make a credible commitment to potential investors that a board of independent persons (the Earth Charity) has made an independent evaluation of the terms of the subsidizing investment and has decided that it is worthwhile from the perspective of the Cookstove Project's social mission.

Basically, the benefits of enforcing a clarified private inurement regime on a social enterprise with a tranche of investors or donors using charitable funds are threefold. If we think of the Cookstove Project, we can see that the first benefit of enforcing the private inurement regime is that doing so protects the reasonable

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[136] Also, if your social goals are very well expressed by third-party verifiers of social benefit, like the non-profit B-Lab. *See* BCORPORATION.NET, http://www.bcorporation.net/ (last visited Oct. 8, 2014). You may be able to cheaply rely on them to monitor social benefit. But that solution only works if they are diligent in their monitoring, and if your social goals are the same as those factors that B Lab measures.

[137] Brian Galle does an excellent job of identifying some situations in which the social good provided by the social enterprise is relatively easily identified, measured, and monitored. For example, a firm operating in an industry that "kills dolphins, poisons the water, sells 'conflict diamonds,' [or] hired developing-world workers at pennies per hour" may have to "sell its products at a discount, pay out higher rates of return to investors, pay managers a premium, or all of the above." Galle, *supra* note 3, at 2037. He cleverly calls the problem these firms face "cold glow" and discusses mechanisms these firms use to "warm" these cold glow effects. *Id.* He points out that some of the innovations in social enterprise legal forms may be addressed to more efficiently warming cold glow. But these cold glow firms are just a subset of the more general category of firms who pursue social goods that are (relatively) easily quantified, monitored, and enforced. In situations in which social goods are easily quantified, measured and enforced, so-called "agency theory" would predict that patrons and producers of such social goods might not choose the non-profit form, and no subsidized charitable dollars would be needed to spur pursuit of them. Agency theory predicts that the non-profit form is embraced to overcome problems associated with quantifying, measuring and enforcing commitments regarding social goods. These firms providing easily quantified social goods may be housed in traditional for-profit corporations, or new social enterprise entities, like benefit corporations.

expectations of those people who donated to the Earth Charity. They chose to contribute their funds subject to a legal regime that prevented managers or other insiders in the Earth Charity from diverting those donated funds to themselves, and they presumably did so because they thought that was the most efficient way to advance their social mission. Second, enforcing the private inurement regime advances the government's interest (also called the taxpayers' interests) by preventing money that has been subsidized with tax benefits from being diverted into the pockets of the managers of the Earth Charity. The government provided these tax benefits to the Earth Charity under an understanding that the private inurement regime would apply, and we should assume that it did so because of its own agency-cost analysis. Permitting the Earth Charity to use its funds to enrich managers of the Earth Charity through the Cookstove Project would violate the reasonable expectation under which the government operated when it chose to provide tax subsidies only to organizations bound by the private inurement regime.

The third benefit, however, may be the most important. By enforcing the private inurement regime against the Cookstove Project *only* when it has a subsidizing tranche of charitable funds, the law creates a mechanism for the Cookstove Project to create a signal to those social investors who are not using charitable funds. It enables the Cookstove Project to say, in effect, *there are some social investors just like you who think this is a good project, and none of them stand to get personally rich from it.* If other investors want to free-ride on the judgment of those independent charitable investors, they are free to do so. On the other hand, if there is no tranche of charitable funds, the Cookstove Project is clearly communicating the opposite: that there is no tranche of social investors who are legally required to be independent. No regulatory effort is being made in any way to ensure the independence of any social investors. If that is not important to the Cookstove Project, it can opt out of receiving charitable dollars. If it is important to the Cookstove Project, it can opt in. The regulatory regime permits the Cookstove Project to *choose* how to signal the market. It provides an opportunity that may well be valuable, but not a requirement if the Cookstove Project decides it is not valuable. It can always choose to forego charitable dollars.[138]

[138] Remember, it can even accept donations for its project without accepting charitable dollars. Arguably, the only limitation is that the donor cannot make the donation on a tax-deductible basis, and the social enterprise cannot earn its income tax-free.

IV. PRIVATE BENEFIT LEGAL REGIME

If the private inurement regime is justified because it provides a mechanism to satisfy the "regulatory" goals of the social enterprise legal reform movement, the same cannot necessarily be said of the rest of the rules that the IRS potentially imposes on social enterprises. Social enterprise legal reformers are not wrong when they say that the federal laws that apply to social enterprises are confusing and potentially prevent charities from investing in socially beneficial social enterprises.[139] Other scholars have addressed the so-called "program-related investment" rules that apply only to private foundations,[140] and so I do not address those rules here, but none has yet adequately addressed the second major regulatory regime that applies to all charities, the "private benefit regime." The private benefit doctrine is far more ambiguous and therefore potentially far more restrictive than the private inurement doctrine, and it therefore has the potential to severely restrict the workability of tranched investment strategies if it is not properly cabined. And there is no doubt that from the IRS's perspective, a tranched social enterprise "is ripe for private benefit analysis."[141]

This section, introduces the private benefit regime and argues that—unlike the private inurement regime, which is essential to combatting malfeasance by unscrupulous social entrepreneurs and to properly aligning incentives—the private benefit regime should be narrowed to apply only in certain clearly-defined situations. In the case of the Private Benefit Regime, that means liberalizing the law to make clear that (1) the mere fact that a subsidizing investment may confer an "excess benefit" on market-tranche investors does not constitute a violation of the private benefit doctrine, and (2) an investment in a social enterprise that constituted a relatively small share of a charity's total operational budget (or an ancillary joint venture) does not require that the charity maintain ongoing formal control over the organization. Instead, a wide range of commitment mechanisms that the charity deems sufficient to ensure that the investment is used to advance the charity's tax-exempt purpose are permissible.

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139 *See, e,g.*, Archer, *supra* note 13.

140 *See, e.g.*, Bishop, *supra* note 15.

141 Archer, *supra* note 13, at 188.

A. Private Benefit Doctrine

The private benefit doctrine is an ill-defined legal constraint on the activities of exempt organizations. Law professor John Colombo has pointed out that the IRS used the doctrine to constrain a wide range of disparate activities without giving any a precise description of its scope.[142] Unlike the private inurement doctrine, there is no direct statutory source for the private benefit doctrine. Instead, it is rooted in the Treasury Regulations, which interpret the requirement in IRC § 501(c)(3) that a charitable organization be "organized and operated exclusively for" a charitable purpose.[143] In describing what charitable purposes qualify, the regulations state that an organization is not operated for a charitable purpose unless "it serves a public rather than a private interest."[144]

The regulations go on to explain that "it is necessary for an organization to establish that it is not organized or operated *for the benefit of private interests* such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."[145] Because of its focus on persons who influence the organization ("the creator or his family, shareholders"), this sounds very much like a sort of re-stating of the private inurement doctrine.[146] But unlike the private inurement doctrine, the private benefit doctrine has been held to apply even when the benefited party is not an insider to the charity at all.[147] In other words, the list of "designated individuals" is illustrative only, and an organization can fail to have a "public purpose" if it excessively benefits any person, even if that person exercises *no* influence or control over the organization.

The second big difference between the private inurement doctrine and the private benefit doctrine is that the private inurement doctrine is an absolute ban. If *any* excessive benefits are paid to

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[142] Colombo, *supra* note 78, at 1064 ("Despite the IRS's broad invocation of private benefit as a policing tool, however (or perhaps *precisely because* of its broad invocation of it), no one really can define the doctrine.") (emphasis added).

[143] I.R.C. § 501(c)(3).

[144] Treas. Reg. § 1.501(c)(3)–1(d)(1)(ii) (2008) (emphasis added).

[145] *Id.* (emphasis added).

[146] *See* Colombo, *supra* note 78, at 1068 ("On first glance, the language in the regulation cited above would seem to be little more than an augmented explanation of the statutory private inurement limitation.").

[147] *See* United Cancer Council, Inc v. Comm'r, 165 F.3d 1173, 1180 (1999) ("[A] violation of [the charity's duty of care] which involved the dissipation of the charity's assets might . . . support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity.").

disqualified persons, then a charity can lose its exempt status or owe excess benefit transaction penalties. The private benefit doctrine, however, is a clarification of the requirement that a charity have exempt purposes and is derived from a regulation that states that a charity has a public rather than a private purpose.[148] Therefore, for a private benefit to disqualify a charity for exempt status, it must be substantial enough that it overwhelms the charity's public purpose.[149]

But it is not at all clear how substantial a private benefit has to be to disqualify an organization from tax-exempt status. The Supreme Court has stated that "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."[150] Thus, apparently, the question of how substantial a private benefit must be is not strictly quantitative. In other words, it is not sufficient to measure the activities that advance the organization's charitable purpose and compare them to those that advance the private benefit to ensure that some acceptable ratio of charitable activities is met. However, it is also not clear what the right measure should be. The IRS has taken the position that a private benefit must be "insubstantial"[151] and that insubstantiality should be measured both "qualitatively" and "quantitatively."[152] But the reality is there is no identifiable standard by

[148] Treasury Regulation § 1.501(c)(3)–1(e)(1) states:

> An organization may meet the requirements of section 501(c)(3) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business.

[149] *See* Colombo, *supra* note 78, at 1072–73 (explaining that in General Council Memorandum (GCM) 39598 (1987) the IRS took the position that the private benefit doctrine differs from the private inurement doctrine both because it applies to any economic arrangement with persons other than the charitable class (and not just insiders), and because it involves a comparative weighing of private versus public benefit (as opposed to any amount of inurement resulting in loss of exemption)).

[150] Better Bus. Bureau of Washington, DC. Inc. v. United States, 326 U.S. 279, 283 (1945).

[151] *See* I.R.S. Gen. Couns. Mem. 39,598, 1987 GCM LEXIS, at *14–15 (Jan. 23, 1987) ("An organization is not described in section 501(c)(3) if it serves a private interest more than incidentally . . . . If, however, the private benefit is only incidental to the exempt purposes served, and not substantial, it will not result in a loss of exempt status.").

[152] I.R.S. Gen. Couns. Mem. 39,598, 1987 GCM LEXIS, at *15 states:

> A private benefit is considered incidental only if it is incidental in both a qualitative and a quantitative sense. In order to be incidental in a qualitative sense, the benefit must be a necessary concomitant of the activity which benefits the public at large, i.e., the activity can be accomplished only by benefitting certain private individuals.

which to measure private benefit.

Law professor John Colombo has pointed out that in the uncertainty over the law of private benefit, there are two primary ways in which it might be applied in the future. One way it could be employed would be as a general check on economic transactions with unrelated third parties. In this reading, the private benefit doctrine applies to any economic transaction in which charitable assets are improperly diverted to someone other than the charitable beneficiaries. As noted above, Judge Posner suggested in *United Cancer Council* that negligent improper diversions of charitable assets to private persons (breaches of the directors' duties of care) might constitute violations of the private benefit doctrine.[153] Under this analysis, the private benefit doctrine would function similarly to the private inurement doctrine, but without any requirement that that benefited party be an insider. This interpretation of the private benefit doctrine creates significant risk to investors since it can exist in any organization no matter the quantity of legitimate tax-exempt activities conducted.[154] In addition, there is no way to protect against this application of the private benefit doctrine by providing benefits only to "independent" persons because there is no requirement that the benefited person be a disqualified person or an insider. It is plausible that the measure of what constitutes a private benefit would be exported from the private inurement regime, and any "excess benefit transaction" would constitute a violation, even when the transaction was between the organization and a truly unrelated third party.

Obviously, if this analysis applied, a charity that invests in a "subsidizing tranche" in a social enterprise could easily have a private benefit problem. As discussed above, it is very difficult to measure a "market rate" return on capital, especially if the capital investment results in an "equity-like return." Therefore, the use of a tranched investment structure in the Cookstove Project likely constitutes at least *prima facie* evidence of an excessive benefit flowing to the subsidized

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153 *See supra* note 147.

154 Theoretically, at least, there is no reason why the private benefit doctrine should be confined to situations in which a person receives an excessive benefit. Because the private benefit doctrine is really just an elaboration of the requirement that a charity have a proper tax-exempt purpose, provision of a substantial enough private benefit should result in revocation of tax-exempt status even if the benefit is not excessive. There is a plausible argument that the IRS has addressed this issue by treating excessive private benefits as "qualitatively substantial" even if they are not "quantitatively substantial." Obviously a doctrine that potentially applies notwithstanding the fact that no insiders have been benefited *and* notwithstanding the fact that no excessive benefit has been identified is potentially a very broad doctrine. The doctrine's application relies entirely on the "substantiality" of the private benefit.

tranche. Under the Private Inurement regime, the Cookstove Project can protect itself from the adverse legal effects of that purported excessive benefit by preventing disqualified persons from investing in the subsidized tranche. But because the private benefit doctrine has no "insider" requirement, an interpretation that made any possibly excessive benefit problematic would make tranche investing virtually impossible.

The other way Professor Colombo thinks the private benefit doctrine could be employed by the IRS in the future would be to restrict the doctrine to those situations in which some non-charitable purpose has overwhelmed the charitable purpose of the organization so that the organization no longer really serves its charitable goals. This approach would involve a comparison of charitable activities with private benefit activities, such that a sufficient quantity of genuinely charitable activities would protect an organization from violation of the private benefit doctrine.[155] Thus, this approach is unlikely to present a problem when the transaction in question is merely ancillary to the primary activities of the charity. Under this analysis, if the amount of the Earth Charity's investment in the Cookstove Project is small in relation to its overall activities, then this form of the private benefit doctrine is unlikely to be problematic. Unfortunately, an investor could not be assured that the IRS will interpret the private benefit doctrine in this "quantitative" way. Quite the contrary, there is reason to believe that the IRS does not view the private benefit doctrine as one that is overcome if the quantity of private benefit is less than some fixed proportion of the overall activities of the charity.[156]

B. Joint Venture Analysis

In addition to standing alone, the private benefit doctrine serves as the basis for the IRS's guidance on joint ventures between exempt organizations and for-profit partners.[157] In its joint venture analysis,

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[155] Because of its comparative approach, this interpretation of the private benefit doctrine has echoes in other doctrines that constrain exempt organizations, like the "commerciality doctrine" and the "commensurate in scope" doctrine. *See generally* BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS (10th ed. 2011).

[156] *See supra* note 151.

[157] The IRS's interpretation of what constitutes a joint venture such that its joint venture analysis would apply is quite broad. *See, e.g.*, MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX EXEMPT ORGANIZATIONS 292 (3rd ed. 2007) ("The term 'joint venture' in this context includes a partnership as well as any other arrangement that accomplishes a comparable sharing or redistribution of benefits and burdens."). It is not clear that *every* tranched social enterprise would constitute a joint venture for the IRS's purposes, but it is likely that one like the Cookstove Project, in which the Earth Charity and private investors each had equity-type interests in an LLC, would.

the IRS has replicated the ambiguity inherent in the private benefit doctrine.[158] Just as it is unclear whether the private benefit doctrine is *only* a means of ensuring that the organization has a sufficiently substantial charitable purpose to justify tax exemption *or also* a mechanism by which the IRS to monitors the organization's economic transactions with outsiders, so too the IRS's joint venture doctrine potentially serves both functions.[159] It is not clear from the IRS's guidance on joint ventures whether its joint venture analysis is solely a way to ensure that an exempt organization involved in a joint venture with a non-exempt partner continues to pursue its charitable purpose, or whether it is also a means to ensure that the charitable partner does not provide excessive benefits to its for-profit partner.[160]

That ambiguity comes from the fact that the IRS's guidance breaks joint ventures into two distinct categories: whole venture joint ventures[161] and ancillary joint ventures. A whole venture joint venture is one in which a charity conducts *all* of its tax-exempt activities through the joint venture. In that case, obviously, since participating in the joint venture is all that the charity does, it must adequately advance the charity's tax-exempt purpose to justify exemption. The IRS has been relatively clear that it believes that a whole-venture joint venture potentially calls into question the charity's tax-exempt status

Regardless of whether the specific enterprise constitutes a joint venture, the IRS's guidance on joint ventures gives some insight into its evolving interpretation of the private benefit doctrine's application.

[158] The author of the leading treatise on the topic describes the IRS's approach to joint ventures with exempt organizations as "prohibitively restrictive" and governed by "inscrutable laws." *Id.* at xviii.

[159] In *Relinquish Control! Why the IRS Should Change its Stance on Exempt Organizations in Ancillary Joint Ventures*, 6 NEV. L.J. 21, 31 (2006), Nicholas A. Mirkay writes:

> It is this broad scope of the private benefit doctrine, which encompasses and examines all of an organization's activities (i.e., exempt activities, transactions with insiders and/or with unrelated disinterested persons), that has resulted in an aggressive expansion and application of the doctrine by the IRS in the context of joint ventures.

[160] Historically, it has certainly been the case that the IRS was concerned with the potential for joint ventures to result in private benefit or private inurement as well as whether they would divert the organization from its tax-exempt purposes. In service of this goal, "the IRS will look at relative capital contributions and risks of the various joint ventures to determine whether capital contributions are proportionate to the sharing of profits and losses, among other indicators." Sanders, *supra* note 157, at 293. Remember, in a tranched social enterprise, capital contributions are *not* proportionate to profits and losses, but instead the charitable tranche provides *more* capital in exchange for *less* profits. Under the IRS's historical analysis, at least, this situation would raise red flags.

[161] IRS guidance actually only refers to a "whole hospital" joint venture, since that was the situation it addressed, and some commentators have adopted the term "whole entity" joint venture. *See id.* at 25–26.

unless the charity exercises formal meaningful control over the joint venture.[162]

In an ancillary joint venture, on the other hand, the charity conducts other activities that justify its tax-exempt status, and the joint venture is a relatively small part of the charity's activities. In this case, if the activities are "incidental" to the charity's other tax-exempt activities, then they should not call into question the charity's tax-exempt status even if they do not advance the charity's exempt purpose. This is because, as discussed above, a charity is permitted to engage in some activities that do not advance its tax-exempt purpose, so long as these activities are incidental in relation to the charity's overall activities.[163] However, the IRS's guidance on ancillary joint ventures is much more ambiguous than its guidance on whole venture joint ventures. The IRS has communicated that in the case of ancillary joint ventures, it does not hold the charity to the same control standard that applies in the whole venture context.[164] It would be logical to conclude that an ancillary joint venture does not require control, because ancillary activities, whether they provide a public benefit or not, are sufficiently insubstantial that they cannot prevent the organization from primarily advancing its tax-exempt purpose.[165] But the rule with regards to ancillary joint ventures is surprisingly underdeveloped.[166] The IRS has arguably signaled that, at least sometimes, it is necessary for the charity to exercise ongoing control over an ancillary joint venture.[167] Or, possibly, the IRS could take the

[162] *See* Redlands Surgical Servs. v. Comm'r, 113 T.C. 47 (1999), *aff'd per curiam*, 242 F.3d 904 (9th Cir. 2001); Rev. Rul. 98-15, 1998-1 C.B. 718. *See also* St. David's Health Care System v. United States, 349 F.3d 232 (5th Cir. 2003) (affirming the control test, vacating, and remanding to resolve a genuine issue of material fact about whether St. David's exercised sufficient control over the joint venture).

[163] *See supra* discussion accompanying notes 148–152.

[164] *See* Rev. Rul. 2004-51, 2004-22 I.R.B. 974. (holding that "[the whole venture] continues to qualify for exemption under § 501(c)(3) when it contributes a portion of its assets to and conducts a portion of its activities through [an ancillary joint venture]").

[165] Paul Streckfus has described this interpretation of Rev. Rul. 2004-51 as "the majority view." Paul Streckfus, *Ancillary Joint Ventures May Involve Exemption Risk*, 47 EXEMPT ORG. TAX REV. 327, 327 (2005). He writes:

> The majority view is that the only risk posed by an ancillary joint venture to an EO is that its distributive share of joint venture income may be subject to the unrelated business income tax, but—and here's the good news—participation in such a venture poses no threat to exempt status.

[166] *See* Sanders, *supra* note 157.

[167] *See* Mirkay, *supra* note 19, at 59 ("[A]n IRS representative unofficially issued a poignant reminder—Revenue Ruling 98-15 is 'still on the books' and 'Revenue Ruling 2004-51 does nothing to modify Revenue Ruling 98-15.'"). Mayer and Ganahl, among others, adopt this interpretation of the IRS's position that Rev. Rul. 2004-51 ruled:

position that a joint venture is not "insubstantial" even though it constitutes only a small part of what a charity does.[168]

In any case, if the joint venture is substantial enough, the IRS demands that the charity must "control" the joint venture. In a "whole hospital" joint venture, the charity must have ongoing formal control. In the case of an ancillary joint venture, the control standard may be more permissive, and may require not formal control, but only effective control over the parts of the joint venture relevant to the charity's tax-exempt purpose. In the case of the Cookstove Project, it may be sufficient for the charity to be able to control certain key choices in the distribution of cookstoves, like the criteria for receiving one, but it may also be important for the charity to retain ongoing control over sources of ethanol, given the evidence that clear-cutting forests to produce ethanol has adverse environmental effects. But some form of control might be required, and if the social enterprise did not want to cede overall formal control to the charity, guidance on what type of control would be sufficient does not clearly exist.[169]

> [I]n a situation where only an insubstantial part of a tax-exempt organization's activities are housed in a partnership, it will be sufficient for the tax-exempt organization to only appoint half of the partnership's governing body if the tax-exempt organization has other means of controlling the substance of the partnership's activities to ensure those activities further the tax-exempt organization's exempt purpose.

Mayer & Ganahl, *supra* note 13, at n.155.

[168] *See* discussion *supra* note 152.

[169] Archer argues that the "expenditure responsibility" requirements that apply to foundations making grants to, or program-related investments in, for-profit entities should constitute sufficient "control" to satisfy the IRS's control standard in social enterprise contexts. *See* Archer, *supra* note 13, at 192–96. Whether or not the expenditure responsibility rules could require the right balance of flexibility and control, if they were interpreted correctly, how one would interpret such rules in the context of an equity investment in a social enterprise remains unclear. The expenditure responsibility rules require that a foundation "establish adequate procedures . . . to see that the grant [or investment] is spent solely for the purposes for which made." I.R.C. §4945(h)(1) (2006). This requirement means that a private foundation making a program related investment must obtain an agreement that the recipient will "use all the funds received from the private foundation . . . only for the purposes of the investment and to repay any portion not used for such purposes." Treas. Reg. §53.4945-5(b)(4)(i)(1972). It is hard to conceive of how this requirement would apply to a subsidizing equity investment in a tranched social enterprise, since the investment is intended to improve the profitability or lessen the risk of the subsidized tranche. In a Private Letter Ruling that addresses equity investments by foundations in for-profit enterprises, the return-on-investment between the foundations and the market investors were proportional to their capital contributions. *See* I.R.S. P.L.R. 2006-10020 (Mar. 10, 2006). There is no guidance from the IRS that analyses a tranched structure.

As Ofer Eldar has made clear, control is only one of a number of commitment devices that social enterprises use to ensure that their activities truly advance their social missions.[170] Other such devices include certification mechanisms, in which third parties certify compliance with certain standards,[171] and contractual mechanisms, in which compliance with social benefit goals are monitored and enforced contractually.[172] Other areas of the law, such as the "expenditure responsibility" regime that applies to private foundation grants to non-public charities, envision a number of mechanisms other than direct control by which an organization would ensure that its investment is used in an appropriate manner to advance its tax-exempt purpose.[173]

The point is that in situations in which there is no private inurement because no disqualified persons stand to gain from a subsidizing investment by a charity, it is not clear why ongoing formal control is necessary. Current law is ambiguous about what is required, but there is at least a strong risk that the IRS will require some undefined quantum of formal control even when a joint venture is small in relation to a charity's overall activities. Because there are a variety of ways for a charity to make sure that its investment is not diverted from its social mission, the charity's independence should gain it significant latitude to choose the best one.

C. *Clarifying or Liberalizing the Private Benefit Regime*

Thus, one thing is very clear: the Private Benefit Regime analysis is more uncertain than the Private Inurement Regime and potentially creates a much bigger barrier to a tranche investing structure for the Cookstove Project. That is because it is impossible to avoid the potential application of the doctrine by finding an "independent" charitable investor. Without the ability to avoid loss of exemption in a certain way, some number of investments in social enterprises will be chilled.

There are several reasons why the enforcement of the private benefit regime is less compelling than the private inurement regime in the social enterprise context. The first is the simple point that the risk of diversion of assets or energy away from the social mission is decreased when the members of the subsidized tranche are not disqualified persons. The second centers around the notion that

170 Eldar, *supra* note 1, at 40–48.
171 Eldar, *supra* note 1, at 46.
172 Eldar, *supra* note 1, at 48.
173 *See* Archer, *supra* note 13, at 191–96.

confusion itself is a bad thing, since it is dangerous to enter into investments if one is unsure of the law that the IRS will apply. Finally, the effect of an overly restrictive regime is likely to be to push social enterprises into alternate structures that avoid the reach of the IRS. As discussed above, a social enterprise that does not use charitable funds can avoid tax-exempt organizations law entirely. The cost of pushing social enterprises into such structures is that they then lose the commitment and signaling benefits of the private inurement regime.

First, the reason that the no inurement regime applies only to insiders is because there is a presumption that the ability to distribute profits to oneself is a strong incentive to divert funds from the organization's charitable mission. In order for outsiders to divert charitable funds to themselves, they must first persuade insiders that such diversions are a good idea. The whole edifice of non-profit law is built on the belief that the existence of independent directors and other controllers creates at least some barrier to such diversion of funds.[174] If that belief is at all true, then the risk of diversion decreases when the benefited persons are not in positions of control over the charitable organization. Obviously, it does not reduce the risk to zero, but it nonetheless reduces the risk.

Second, if the law of non-profit organizations is meant to protect the reasonable expectations of donors and the government, then it is important for such stakeholders to understand what can be reasonably expected. As discussed above, significant disagreement exists regarding whether the private benefit regime is primarily a restriction on the *quantity* of resources that a single charitable investor can devote to a social enterprise or whether it is primarily a check on whether such investments provide *excess benefits* to for-profit investors. If the goal of non-profit law is to enable donors (and the government) to choose a legal structure that most efficiently enables them to pursue their social mission, then ambiguity about the central effect of the law almost certainly creates inefficient outcomes. How could a donor make a decision about whether to provide funds through a tax-exempt non-profit if she cannot predict what types of restrictions attach to such a contribution? Likewise, the whole point of the government providing tax benefits to organizations that abide by a specific set of rules is that

[174] John Colombo summarized this instinct nicely:

> [I]t is hard to imagine a situation in which a charity *intentionally* diverts assets at less than fair market value to an outsider. If a charity enters into an economic transaction with someone who has no influence over the charity, there is . . . simply no reason to believe that the charity would intentionally hand assets over to that person for less than full value.

Columbo, *supra* note 78, at 1084.

those rules require generalized responses. Therefore, uncertainty in the law does not benefit the government in this context either.

Finally, an overly restrictive or confusing private benefit regime decreases the utility of tax-exempt organization law as a commitment or signaling mechanism. As is discussed above, the existence of a charitable tranche in a social investment can be a powerful signal to social investors who are *not* using charitable funds. These social investors are seeking social enterprises that can make credible commitments that they are pursuing a social mission—what I have called the regulatory impulse. Because the existence of a tranche of charitable funds implicates the law of tax-exempt organizations, a tranched social enterprise can use IRS enforcement of the law to make a credible commitment that it will observe certain rules in pursuing its social mission. If those rules are unclear, its commitment is valueless to social investors. In the case of a private benefit regime that may or may not limit the quantity of funds a charitable investor can invest and may or may not provide a check on whether the IRS takes an interest in whether the charitable investment creates an "excess benefit" for the market tranche investors, the "signal" lacks enough clarity to have any effect. This can be damaging whether the social investors *under*appreciate the force of the law (and think they are making an investment in a permissive regime when really it is more restrictive) or if they *over*estimate the force of the law (thinking that the IRS is preventing certain types of abuse, for example, which are really just not covered by the private benefit regime). Thus, uncertainty in the law creates confusion that diminishes the value of the regulatory regime for a variety of stakeholders in a social enterprise. As discussed above, social investors have a choice about where to invest. If the IRS interprets the private benefit regime to prevent tranched investing, social investors can always invest in social enterprises that have no charitable capital. But, if they do so, they lose the powerful regulatory benefits of enforcement of the no inurement regime.

If lack of clarity in the private benefit doctrine prevents socially beneficial social enterprises from being created, then the IRS should clarify the doctrine. A number of proposals exist for clarifying the proper scope of the private benefit regime.[175] They share some basic characteristics and differ on others. It is probably the case that any of them would be better than none, but analyzing the proposals' effect on tranched social enterprises uncovers some relative strengths and

[175] *See, e.g.*, John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187–90 (2001); Mirkay, *supra* note 19, at 69; Sanders, *supra* note 157.

weaknesses between the proposals.

Some proposals focus on the fact that the private benefit doctrine prohibits only activities that are *substantial*, and so the doctrine should be clarified with some bright-line quantification method for measuring substantiality. Under these tests, a charity engaged in both direct charitable activities and transactions that benefit private persons would not have to worry about the transactions with private persons so long as they constituted less than some fixed percentage of their overall activities. For example, Michael Sanders proposes that an organization that invested less than ten to fifteen percent of its assets in joint ventures with for-profit entities should be safe from threat of private benefit analysis.[176] If this analysis were applied to the Earth Charity's investment in the Cookstove Project, it would mean that the Earth Charity could be free from anxiety about the private benefit transaction so long as its investments in the Cookstove Project—along with all other investments in social enterprises—constituted only a small part of its overall activities.

This solution has the benefit of clarity, since an organization can have confidence that its transaction does not risk its tax-exempt status, but it has some weaknesses as well. For example, if the Earth Charity wanted to specialize exclusively in making investments in social enterprises, it would be prevented from doing so. As soon as its aggregate investments exceeded 10 or 15 percent of its overall activity it would lose the certainty that its tax-exempt status was safe. Since there are no doubt economies of scale and scope in making investments in social enterprises, it would be unfortunate to prevent firms from specializing in such investments if there was no good justification for doing so.

Other proposals focus on the question of whether the possible private benefit activity advances the tax-exempt purpose of the charity.[177] For example, in the case of the Earth Charity's investment in the Cookstove Project, the only relevant question would be whether creating a market for propane cookstoves in developing countries advanced the Earth Charity's mission of helping poor people and reducing greenhouse gas emissions. Of course, the problem with this question is that it seems open-ended and could therefore subject the charity to risk that the IRS would disagree with them. Luckily, charities are already required to determine if revenue-generating activities are

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[176] *See* Sanders, *supra* note 157, at 223 § 4.5(c). *See also* Mirkay, *supra* note 19, at 66–67.

[177] *See* John D. Colombo, *A Framework for Analyzing Exemption and UBIT Effects of Joint Ventures*, 34 EXEMPT ORG. TAX REV. 187 (2001); *see also* Mirkay, *supra* note 19, at 65.

"connected" to the tax-exempt purposes, since the IRS requires payment of a so-called "unrelated business income tax" (UBIT) on the profits from any trade or business that is not related to their tax-exempt purpose.[178] Since the organization is already required to do an analysis of the connection between its revenue-generating activities and its tax-exempt purposes in order to comply with the UBIT rules, John Colombo argues that the private benefit regime should be collapsed into the UBIT regime.[179] He proposes that a charity should be able to be confident that it will not lose its tax-exempt status so long as its UBIT-generating activities are not excessive.[180] Thus, if the Earth Charity wanted to specialize in making subsidizing investments in social enterprises like the Cookstove Project, it could do so confidently as long as it felt confident that most investments were sufficiently connected to its tax-exempt purposes that they would not generate UBIT.

This approach has the benefit of overall clarity (because it has a fixed percentage above which an organization cannot go), but it also has the benefit of permitting social investing as long as the investment advances the charitable purposes of the organization. In these ways, it appears to be both closer to purpose of the private benefit regime, given its origin in the purposes clause of 501(c)(3), and more permissive of social enterprises.

Both Colombo's and Sanders's approaches prevent the IRS from using the private benefit regime to police "excessive" transactions with non-insiders. They do not permit the private benefit doctrine to police corporate waste or duty of care to efficiently pursue the charity's tax-exempt status, in the way that Judge Posner suggested it might in dicta in the *United Cancer Council* case.[181] But this restriction of the private benefit doctrine is exactly the strength of both proposals. If the IRS used the private benefit doctrine to police "excessive" transactions with non-insiders, it is unclear how they could do so in a way that would give any clarity to charities about when their transactions were safe from scrutiny. If the standard was the same as in the private inurement regime, then all it would do was apply the "excess benefit" portion of the standard in cases in which the recipient of a benefit is not a disqualified person. That reads the whole "disqualified person" analysis out of the law and removes any incentive charities have under current law to enter into transactions with independent persons.

[178] I.R.C. §§ 512, 513, with some exceptions.
[179] *See* Colombo, *supra* note 177, at 189.
[180] *See* Colombo, *supra* note 177, at 189.
[181] *See supra* discussion accompanying note 147.

Unless it is restricted under one of the theories proposed, the private benefit doctrine potentially allows the IRS discretion to police whether a social investment's terms are too generous. For example, in the case of the Earth Charity's investment in the Cookstove Project, imagine that the project was a huge success and the market investors doubled their money.[182] Unless there were strong, clear guidance to prevent the IRS from treating such a transaction as a private benefit transaction, the Earth Charity may reasonably worry that investments in social enterprises carried excessive risk under the private benefit regime.

But protecting against excessive benefit is exactly what the private inurement regime is designed to do, and it rests on a presumption that an independent charity is the best guarantor of social benefit. The structure of tax-exempt organizations rests on a calculated guess that a charity controlled by persons who do not stand to personally profit from the financial success of an enterprise are the best agents for its social mission.[183] At the end of the day, the appropriate question to ask of this approach is whether the IRS needs a mechanism to oversee the quality of transactions under the private benefit regime as well as the private inurement regime. This Article argues that using the private benefit regime to police the quality of transactions with private parties is not beneficial. That task should be left to the private inurement regime.

CONCLUSION

Social enterprise legal reformers have been arguing for several years that there is an untapped potential for advancing the social good if only we could get the laws right. Among other things, they have been arguing that significant social value could be created if we were to provide a clear legal mechanism for social enterprises to combine

[182] Imagine in addition that the Earth Charity failed to require that the Cookstove Project require that its ethanol producers refrain from clear-cutting forests to produce its ethanol, and that ethanol produced from clear-cutting is worse from a global-warming perspective than charcoal production.

[183] In *In Search of Private Benefit*, 58 FLA. L. REV. 1063, 1084 (2006), John D. Colombo writes:

> If a charity enters into an economic transaction with someone who has no influence over the charity, there is simply no reason to believe that the charity would intentionally hand assets over to that person for less than full value . . . . [T]he notion that one would intentionally overpay or undercharge for services outside a context in which the recipient of the economic benefit has some kind of insider connection does not comport with either basic assumptions of our tax system nor with normal human economic behavior.

social investors or donors and profit-driven investors in a single entity. These reformers want laws to facilitate the creation of tranched social enterprises that have a subsidizing tranche of charitable funds. I remain somewhat skeptical about the magnitude of the social benefit that could arise from legal reforms that facilitate this type of tranched investing in social enterprises, but I am convinced that the laws should facilitate experimentation and innovation when possible.

If experimentation has the possibility of bringing social value (whether great or incremental), then it is worthwhile to clarify the legal restrictions are necessary to preserve the value created by the current regulatory regime, and which are extraneous. Most social enterprise legal reformers (although not all) agree that it is important to preserve the private inurement regime, even when they do not elaborate on how the rule operates in the context of tranched social enterprises.[184] I have argued that the private inurement regime is indeed justified and that its application to social enterprises should be clarified and strengthened. The IRS should promulgate guidance making clear that a subsidizing tranche in a social enterprise presumptively creates an excess benefit for participants in the subsidized tranche, and so disqualified persons should not be investors in the subsidized tranche. The enforcement of this rule would preserve the reasonable expectations of donors to charitable entities and the government, and as an additional bonus, provides a potentially important signaling function that could be used by tranched social enterprises seeking to bind themselves to credible commitments with regard to social goals.

On the other hand, an expansive reading of the private benefit regime is less well justified. The lack of certainty it creates means that it cannot enforce the reasonable expectations of the charitable donors or the government and cannot provide a signaling function to potential social investors outside of the charitable context. Even if the private benefit regime were clarified, however, it would still not be justified if its clarification involved taking an expansive view of what it prohibited. This is because a private benefit doctrine that requires all tranched social enterprises be controlled by charities or that permits the IRS to substitute its own discretion about excessive benefits in the social enterprise context is simply too restrictive. The risks involved in

[184] For example, Susannah Camic Tahk acknowledges that the "elaborate rules aimed at preventing nonprofits from misusing public subsidies" are important, and that, therefore, "Congress and/or the IRS can design measures intended to stimulate cross-sector collaborations so that those measures also minimize abusive transactions." Tahk, *supra* note 2, at 539–40.

being overruled or second-guessed by the IRS would plausibly prevent the board from making decisions that maximized social welfare, and the result would be for social enterprises to choose entity structures that avoided tax-exempt investors, in order to avoid the legal constraints on those investors. The result would be to remove from social investors the option of free-riding on the higher quality decisions of charities bound by the no-inurement rule. Thus, the IRS should issue guidance properly cabining the private benefit doctrine.

The difference between private inurement and private benefit is about the regimes' relation to "independence." Under the private inurement rule, we trust independent directors to act in the best interests of the charity they oversee. We provide regulatory oversight only when those directors' independence is compromised. Under the private benefit rule, we provide regulatory oversight regardless of the role of an independent board. Thus, the private inurement regime relies on a certain "logic of independence" that is ignored by the private benefit regime. If we can trust the logic of independence to prevent abusive transfers of charitable dollars, then we can have bright-line rules in this area: no subsidizing investment of charitable dollars in a joint venture with disqualified persons. If we cannot, then, this leaves us with ambiguity, and ambiguity will prevent many transactions from occurring (or, will force them to occur completely outside of the reach of non-profit law, in which case private inurement is permitted). The ultimate question is how much work "independence" can do.

While the question of how much work "independence" can do in the regulation of social enterprises is ultimately beyond the scope of this Article, I suggest that the social enterprise field is an ideal place to begin experimentation on that very question. If we were to clarify the law so it was clear how the private inurement regime applied to tranched social enterprises (strongly) and how the private benefit regime applied (weakly), we would empower social enterprises to opt in or out of these two regimes by choosing whether to seek investments from charitable sources. Without providing unnecessary barriers to innovative structuring arrangement, we would empower a new generation of social entrepreneurs to solve the world's problems.

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