Stanford SOCIAL INNOVATION REVIEW

For Love or Lucre

By Jim Fruchterman

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A VETERAN SOCIAL ENTREPRENEUR PROVIDES A GUIDE TO THOSE WHO ARE THINKING THROUGH THE THORNY QUESTION OF WHETHER TO CREATE A NONPROFIT, A FOR-PROFIT, OR SOMETHING IN BETWEEN.

By Jim Fruchterman

Illustration by Yarek Waszul

Social entrepreneurs who want to start a new venture quickly confront an important question: What type of legal structure should I create? Should I start a traditional nonprofit, a for-profit, or something in between? This is not a simple question to answer, and it is in some ways becoming more difficult with the proliferation of new legal structures like the B corporation that are intended to allow entrepreneurs to meet financial, social, and environmental bottom lines.

I have started successful and unsuccessful for-profit and nonprofit ventures. My goal in writing this article is to help other social entrepreneurs navigate these waters. I am not, however, a lawyer, and I cannot offer legal advice about creating a venture. Rather, I want to guide you through the issues that you need to consider before you even begin to think about choosing an attorney or getting help structuring your social venture.

The first thing to remember is that the legal structure is simply a tool for accomplishing your goals. Deciding structure first may lock you into a direction that won't get you where you want to go. It is important to take the time to explore your idea first; then answering the legal structure question will be easier.

Selecting a legal structure is not a question of moral purity. I am structure agnostic: I believe that for-profit and nonprofit structures can both be good vehicles for improving society. You should look seriously at both as part of your toolkit as you're creating your new social venture.

If personal wealth is a primary motivation and changing the world for the better is a nice benefit but not fundamental, it is pretty clear that you should create a for-profit structure. Being a for-profit typically gives you more flexibility and control, especially if you're the sole or controlling shareholder. This flexibility gives you the freedom to completely change your business if you spot a new and more lucrative opportunity. And you can still create an ethical and responsible for-profit. If giving away money or providing services at below cost and feeling good about it is your primary or only motivation, then your answer is similarly easy. The U.S. 501(c)(3) nonprofit structure was created to serve this purpose. If your ideas fall somewhere between making lots of money and giving most of it away, there are many ways to structure a venture to accomplish these goals.

Before looking at what type of legal structure to create, you need to explore the four issues that will illuminate your ultimate decision: what your motivation is for starting the venture, what market you are targeting, how you plan to raise capital, and what type of control you want over the venture.

MOTIVATION

Most new ventures fail. If you are going to take on the risks and responsibilities of a new venture, you need to be motivated to succeed. That is why it is important first to understand your motivation for starting a new social venture and your definition of success. Social entrepreneurs are typically driven by the goal of making positive change in society, but other factors may also influence your motivation. Almost all ventures change dramatically during their formative periods. It's certain that several things that you know for sure right now about your venture are wrong. You just don't know which ones. In the face of that uncertainty, what is going to remain constant and guide you in making the hard decisions?

How fundamental is the social mission? Assuming that your motivations are not purely financial, you need to understand how essential the social mission is to the success of your venture. Is your primary goal social change? Are you willing to pass up lucrative financial opportunities that would take the venture away from social change? How will you prioritize the social bottom line if the venture is in peril? Does your venture exist if the social impact is removed or minimized?

What are your personal financial objectives for this venture? Many entrepreneurs make financial sacrifices in the course of creating a start-up. These sacrifices are often justified to oneself or to one's family by the promise of an eventual financial payoff. As you approach a social venture, you need to be clear what your financial parameters are. How much of your own money are you willing to invest in the venture, either in the form of cash or in forgone wages (compared with your market value)? Even successful social ventures that reach financial sustainability (break even on an ongoing basis) may never recoup the initial investment. Can you (or the investors) live with that possibility? It's possible to make a decent living running a social venture, but you are not likely to get rich. Is that okay?

How do you define success? Success does not need to be defined as personal riches. For many entrepreneurs, the drive to succeed is about proving oneself and making a difference. External forces, however, can shape what becomes your organization's definition of success. If you take on a venture capitalist as a partner there will be intense pressure to define success in terms of delivering the required returns to your investors. If you take on a foundation as a partner, they will define success by social impact. Families and society often define success in terms of material attainment, and you may encounter strong social pressure to focus on personal riches rather than on social good.

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MARKET

Entrepreneurs must understand their market. Just about every social question and issue you may address can be recast into market questions, such as: Who is the customer? What is the value proposition? And who is the competition? Understanding your customers, their environment, and their needs is crucial to any social venture. Determining how to best serve your customers will shape your decision of how to structure your venture.

Who are your customers? One of the most important questions you need to answer as a social entrepreneur is who your customers will be. What is the need your venture is going to fill? What community are you serving? How are you going to access expertise about the needs of your customers? What activities are the customers doing now that will influence the use of your product or service? Are the users of your product or service the same as the people who pay for it? Will you need to find a new payer for your idea to work (for example, funders to directly purchase goods or services for the actual beneficiaries)?

Who or what is the competition? Notwithstanding the frequent claim of start-up entrepreneurs that they have no competitors, even if there isn't something precisely like your proposed product or service, there are other ways potential customers are spending their money or time to meet their needs. For example, if for-profit business competitors are exploiting a community, a nonprofit venture may be given the benefit of the doubt and have the opportunity to enter the market. Or if the nonprofit sector is not being responsive to a community's needs, a business approach that treats people like customers might be more successful in making change. The organizations filling the existing need may even become a distribution channel for your new solution.

What is your value proposition? You must understand how you are going to differentiate your product or service from the competition. Are you presenting an incremental value proposition (my product is 10 percent better or 10 percent less expensive) or a revolutionary value proposition (it's 10 times better or a tenth the cost of the existing option)? If you plan to offer a product or service that the for-profit sector already provides, be prepared for the Internal Revenue Service (IRS) to ask why they should issue you a tax exemption letter. Providing something below cost makes getting your nonprofit exempt status easier, but that may not mesh with your business plan and would generally require fundraising to close the gap between revenues and costs. On the other hand, a revolutionary value proposition might create the opportunity for high profitability and great scale, potentially making a for-profit structure appealing.

What is the market size and how profitable could you be serving that market? How much money can be or is being spent a year on addressing the need your organization is going to meet? It is easier to build a for-profit business when the market size is in the tens of millions or billions of dollars than if it is only $500,000 per year. Profitability is also important. Businesses with low profit margins are generally tougher to sustain because they can be quite sensitive to revenue fluctuations. If you know you're going to lose 10 percent on every sales dollar, it is clear that you should consider a nonprofit rather than a for-profit structure.

CAPITAL

Capital requirements often play an important role in the decision to be a for-profit or a nonprofit. If you aren't plausibly going to be able to pay back the money to investors or lenders with an additional return, the only for-profit investor you may be able to get is yourself. If you can't raise or don't have the capital you need, then you need to look seriously at the nonprofit structure, or reworking your business plan to start more slowly with less money.

How much money do you need to get your venture launched? Is it possible to start the venture with less than the amount you imagine and get to your destination more gradually, or does your business plan require accomplishing certain costly objectives before you can launch? Once you have a handle on the amount and timing of your funding needs, you need to seek out your options for finding that capital. If you need only $100,000 to get your venture off the ground you have many options. If, however, you need tens of millions of dollars, your degree of flexibility is vastly reduced.

How much money will you need to keep the business growing? How will your capital needs change over the first two, five, and 10 years? Unless you are lucky enough to hit upon a model that allows you to bootstrap your venture, it will take additional outside capital to bring your venture to profitability (as a for-profit) or sustainability (as a nonprofit). And profitability or sustainability does not necessarily end the need for capital. If you want to expand to new markets or scale up the organization, you will likely need more funding.

Will you have assets you could borrow against? Debt is a practical option for nonprofit and for-profit ventures that have or plan to acquire assets that can be used as security for the repayment of the loan. Ventures with substantial assets, such as those in the housing and microcredit sectors, have an easier time obtaining loans. Smaller working capital loans are available for those ventures with accounts receivable to borrow against. One significant difference between being a for-profit and a nonprofit is that foundations are more likely to make loans at below-market interest rates to quality nonprofits. These loans have to meet the requirements for a program-related investment (PRI), where the loan advances the charitable purpose of the foundation and income is not a significant purpose of the loan (typically satisfied with a below-market interest rate).

Will tax structure affect your business significantly? Nonprofits often have the benefit of being exempt from income and property taxes. But what if your venture is unlikely to have much income or property? Being exempt from taxes won't make a big difference to your choice of structure then. If, however, the amount of income or property taxes would have a big impact on the viability of a venture, choosing a nonprofit form could make a significant difference in the venture's long-term success. If your main practical source of capital is philanthropy, then becoming tax-exempt will make it much easier to raise capital in the form of grants. Government often creates programs where only nonprofit organizations are eligible to apply. If a government funding stream is essential to the viability of your venture, then that's a strong case to organize as a nonprofit.

CONTROL

For-profit and nonprofit structures have very different control and governance regimes, so it is important to determine how much control you need to have over your venture. Nonprofit structures are generally less flexible than for-profits, because of the requirements to qualify for nonprofit status.

How important are confidentiality and secrecy to you and your venture? Privately held for-profits can be very secretive about their business information: tax returns are confidential, salaries are confidential, profits are confidential, and business plans are confidential. For some entrepreneurs, this is a privacy question. For others, control of this information is part of gaining a competitive advantage. Nonprofits, however, are legally required to operate with a much greater degree of transparency. All but the smallest U.S. nonprofits have to file a detailed tax return every year that is public information, disclosing assets, income, expenses, and top employee salaries. Moreover, this information is often freely available on the Internet or from organizations like GuideStar.

Can you run and fund your venture yourself? If you completely control the venture, you have a great deal of flexibility to run the organization the way you want. You may choose to run at break-even, never pay a dividend, or even give away your profits to a separate charity. As soon as you start sharing control with others, you create the possibility of a split. You may believe that parents, siblings, spouse, life partner, close friends, or mentors are good partners, but many ventures have split these personal relationships. Disputes over money are often at the root of these splits. Thinking these shared control issues through at the beginning reduces the chance of a schism forming.

Will you need to share control with investors? Typically, the ultimate authority in a venture is vested in a board of directors. The investors may or may not hold a majority of the board, but once you have a return-oriented investor, your degree of flexibility is reduced. In most cases, you have a very serious obligation to your investors to keep their best interests in mind. This is a legal obligation known as a fiduciary duty, and it requires you to place your obligation to your investors above your own interests. There is a growing movement in the United States to incorporate larger stakeholder interests in corporate structures and provide the board with some protection if it chooses to balance the interests of the shareholders with another valid social interest such as the environment. But this doesn't obscure the complications from accepting capital from investors or lenders who have a legitimate expectation of being repaid with returns based on risk.

Will you need or want to share control with the public interest? When you operate a nonprofit, the board is acting primarily in stewardship for the public interest. As an entrepreneur, you need to recognize that as you move from sole control to shared control, you are placing your fate and the fate of your venture in the hands of others. Founders are often ejected from their ventures by boards whose primary obligations are to the venture itself, investors, or society. When choosing partners, investors, or board members for your venture, you need to choose people who share your vision for your venture, and who can be trusted with stewarding what may become your life's work.

SELECTING THE BEST STRUCTURE

After answering the previous questions you are ready to think about what type of legal structure you want to create for your organization. Once you begin to consider a particular legal structure seriously, you will want to consult a lawyer, but first it is useful to consider all of the various options. What follows is an overview of five basic organizational structures, looking at both their advantages and disadvantages, along with examples of organizations that have adopted those structures. These particular structures are from the United States, but their analogues exist in many other countries.

| **For-Profit** | Social ventures can take on standard for-profit structures, such as a C corporation, limited liability company (LLC), or sole proprietorship. One of the principal advantages of a for-profit is that it can tap the large pool of investment capital. Because the social mission is not part of the legal structure, however, it is up to the board of directors and entrepreneur to make sure that the company fulfills its social obligations. The decision about what type of for-profit to create is often driven by tax considerations. Venture capitalists are almost always interested in investing in C corporations, even though profits can be taxed at the corporation level and again as dividends at the investor level. Some individual investors prefer LLCs because they are a pass-through for tax purposes and therefore do not have double taxation.

ADVANTAGES:

- Well-known structure that doesn't need to be explained
- Relatively easy to raise money as equity or debt
- Can tap U.S. Small Business Administration grants, loans, and technical assistance
- Easy to sell or shut down (as long as you pay your creditors)
- Can convert to a nonprofit more easily than a nonprofit can convert to a for-profit
- Extensive precedents on best practices for managing for-profits

DISADVANTAGES:

- The social bottom line is not built into the structure, but is instead dependent on the leadership
- Income and property subject to tax
- Governance is primarily focused on serving the shareholders, creating a strong fiduciary duty to act in the shareholders' best interests by making money for them
- Cannot accept foundation grants or nontaxable contributions

EXAMPLES:

- Compartamos Banco is a Mexican microcredit bank that converted from a nonprofit to a for-profit, and then went public.
- D.light design is a privately held company that sells affordable solar-powered LED lights in the developing world. It has received investments from a variety of Silicon Valley venture capitalists.
- Grameenphone offers affordable cell phone service to Bangladesh. The founder raised angel capital in New York City before signing partners Grameen Bank and the Norwegian telecom company Telenor. Grameenphone's initial public offering in Bangladesh was oversubscribed and the country's largest to date.
- Whole Foods Market Inc. is a publicly held company that contributes 5 percent of its profits to charity.

| **For-Profit with a Social Overlay** | These ventures take the for-profit structure and make significant tweaks toward the social objectives. There are numerous ways of doing this. Some of these structures have been in place for decades, such as cooperatives (which can be for-profit or nonprofit) and employee-owned firms. Other structures are new, such as benefit corporations (enacted in Maryland) and low-profit limited liability companies, or L3Cs (now legal in several states). Other for-profit options include socially controlled stock structures in which a community has a controlling interest in the company though a preferential class of stock, non-stock companies, and the flexible purpose corporation (under consideration in California).

ADVANTAGES:

- Same advantages as standard for-profit
- Ensures some level of commitment to the social objectives of the organization through the governance structure
- Additional options for raising capital (for example, it is easier for foundations to invest in an L3C through a PRI)
- Marketing benefits from having a social orientation

DISADVANTAGES:

- Control can be more diffuse (for some social entrepreneurs, this is considered an advantage)
- The social overlay may not hold through adversity or legal challenges
- Investors may not want to invest in these forms without strong social motivations
- Exit options may be more constrained than a standard for-profit

EXAMPLES:

- Equal Exchange (a cooperative) sells fairly traded and organic coffee, tea, chocolate, and snacks from farmers around the world.
- Impact Makers (a non-stock company) is a management consulting company that donates all of its profits to charity.
- Maine's Own Organic Milk Company (an L3C) was created by family farmers and investors to sell the farmers' organic milk.
- Seventh Generation (a B corporation) manufactures nontoxic cleaning products and donates 10 percent of its profits to charity.

| **Hybrid** | Rather than being limited to choosing either a for-profit or a nonprofit structure, some organizations take advantage of both by creating governance structures and contracts that bind a for-profit and nonprofit together in a hybrid structure. Sometimes the for-profit creates the nonprofit. For example, the for-profit brokerage firm Charles Schwab & Company created Schwab Charitable, an affiliated nonprofit that handles the donor-advised fund operations. In other instances, the nonprofit creates the for-profit. Typically, this is to pursue an activity that looks more like a business.

ADVANTAGES:

- The nonprofit and the for-profit entities each retain the advantages that are unique to those legal structures
- Creating a subsidiary can protect the nonprofit status of the

parent by removing the unrelated income (if it becomes too large relative to the parent's size)
- The subsidiary shields the parent from liabilities arising from the subsidiary's activities
- The for-profit subsidiary can be sold at the nonprofit's discretion

DISADVANTAGES:
- Once assets are in the nonprofit, they are locked into the nonprofit sector and cannot be transferred back to the for-profit
- Shutting down the nonprofit affiliate requires its net assets to be transferred to another nonprofit
- Care needs to be taken that benefits flow from the for-profit to the nonprofit (and not the reverse) and that charitable restrictions are respected
- If the for-profit is the main source of funding for the nonprofit, it can be difficult to diversify the funding base of the nonprofit
- Additional overhead for two organizations

EXAMPLES:
- Hewlett-Packard Company Foundation is the nonprofit foundation affiliated with Hewlett-Packard Co. Although corporate foundations are formally separate from the corporation, often there is de facto control by the corporation.
- Greyston Foundation is a Buddhist charity. Greyston Bakery is a wholly owned affiliate that employs disadvantaged people who make the brownies for Ben & Jerry's ice cream.
- The nonprofit Mozilla Foundation, makers of the Firefox Web browser, created the for-profit Mozilla Corp. to handle sales and distribution of the browser. It did this when Google started paying Mozilla tens of millions of dollars as part of an advertising agreement, putting the nonprofit status of the foundation at risk.

| **Nonprofit with a Mission-Related Enterprise** | These are typically tax-exempt nonprofits that have earned income that is clearly related to the social mission. Many types of nonprofits earn income from the sale of products or services, including theaters, museums, colleges, and thrift stores. Any income earned from the enterprise must be used by the organization to further its mission. In contrast to a for-profit, the income cannot be distributed to investors or shareholders (although it can repay loans).

ADVANTAGES:
- No taxation on mission-related income
- Ability to raise philanthropic money to fill the gap between the costs of providing the product or service and the revenues
- Opportunities for creating a selling advantage based on the charitable nature of the enterprise

DISADVANTAGES:
- Two bottom lines means that sometimes there are tradeoffs
- Access to capital limited to traditional nonprofit resources, such as philanthropists and debt

EXAMPLES:
- Benetech operates almost exclusively mission-related enterprises with a mixed-income structure. Revenues from product and services are usually not enough to pay for the full cost of operating the enterprises, so grants and donations fill the gap.
- TransFair is the main fair trade certification organization in the United States that collects certification fees from the supply chain of fair trade commodities like coffee, bananas, and cocoa, which pay for the majority of the organization's budget.
- Goodwill is a national network of local nonprofits that operates recycling, product sales, and employment training services.

| **Nonprofit** | The social mission of traditional nonprofits is clear and unambiguous. They raise all of their money through donations of money, products, or time, and do not have any earned-income enterprises. Examples of traditional nonprofits include 501(c)(3) charities and 501(c)(3) foundations.

ADVANTAGES:
- No conflict between the venture and the social objectives
- People receive a tax deduction for donations that are used to directly help the disadvantaged, or in the case of foundations, used to help other charities in the form of grants

DISADVANTAGE:
- Dependent on traditional fundraising to operate the organization

EXAMPLES:
- The Robin Hood Foundation receives donations from thousands of people each year that are consolidated and given as grants to nonprofits to help alleviate poverty in New York City.
- Mercy Corps receives grants, donations, material aid, and government funds that it uses to fund disaster relief efforts and economic development projects.
- Music in the Schools Foundation pays for music classes in the low-income Ravenswood School District in East Palo Alto, Calif.

CONCLUSION

The world is facing big problems. More and more people are turning their attention to solving those problems. The old models of traditional for-profits and charities no longer are sufficient tools for meeting these challenges. The future is far more likely to be dominated by businesses that are tracking more than their financial bottom line, and nonprofits that see enterprise as a fundamental part of large-scale social change.

Policymakers are responding to the changing times by embracing new forms of social action that fall between the two poles of traditional business and traditional charity. Expect to see new organizational forms exhibiting these increasingly hybrid characteristics. I believe that the new generations of business and social leaders will fundamentally reject what they see as a false dichotomy of the past, and adopt new structures that can transparently deliver more social benefits. Both business and the social sector are going to change in these directions, and society will be the better for the change. ■

The idea for this paper came during a meeting hosted by the Social Enterprise Alliance and the Aspen Institute in 2007, just before the alliance's annual Social Enterprise Summit. I want to thank the social enterprise and legal leaders who made that such an inspirational gathering. I also want to thank Jeff Rauenhorst, Joan Mellea, and Barbara Morrison for their assistance in researching and drafting this essay. Finally, I'd especially like to thank Joshua Mintz, vice president and general counsel of the John D. & Catherine T. MacArthur Foundation, and Robert Wexler, partner at the law firm Adler & Colvin, for their assistance with the final draft.