THE DISTINCTIVE ROLE OF SOCIAL ENTERPRISE

OFER ELDAR*

Social enterprises, such as microfinance institutions, fair trade firms, and work integration social enterprises, pose a challenge to the traditional tenets of corporate law. On the one hand, they do not necessarily maximize profits, and on the other, contrary to nonprofit theory, they often distribute profits to their owners. The proliferation of social enterprises has led commentators to question both the profit maximization norm and the non-distribution constraint as essential elements of for-profit and nonprofit corporate law respectively. In this article, I present a theory of social enterprise that is consistent with the prevailing theories of corporate law. Social enterprises, I argue, perform a distinctive role, which I call the measurement function of social enterprise. More specifically, social enterprises that have a commitment to transact with their beneficiaries as patrons (e.g., customers, such as poor borrowers, or providers of input, such as disadvantaged employees) have incentives to measure or gather information on the attributes of their beneficiaries. This information enables social enterprises to enter into transactions with their patron-beneficiaries and allocate subsidies to them efficiently. The measurement function makes social enterprises efficient vehicles for channeling subsidies to certain categories of beneficiaries. In particular, social enterprises tend to be more efficient than other alternative mechanisms which bear a similar structure, but have a distinctly different function, such as corporate social responsibility initiatives and corporate charity. The measurement function can thus serve as the basis for informing legal policy, especially the design of a new social enterprise legal form.

* Wagner Fellow, NYU Center for Law & Business, and J.S.D. Candidate, Yale Law School. I am grateful to Henry Hansmann for numerous valuable comments, conversations and insights. Thanks also to Bill Allen, Ian Ayres, Ryan Bubb, Richard Brooks, Kevin Davis, Ana Demel, Marcel Kahan, Michael Klausner, Sharon Oster, David Yermack, and the participants in the seminar on organizational law at Yale Law School, the Yale Legal Scholarship Forum, the corporate governance luncheon at NYU Stern School of Business and the corporate law policy seminar at NYU School of Law for helpful suggestions. All errors are mine. Email: ofer.eldar@yale.edu.

Table of Contents

THE DISTINCTIVE ROLE OF SOCIAL ENTERPRISE

Ofer Eldar

I. INTRODUCTION

In recent years, there has been a widespread growth of social enterprise. Examples of social enterprises include microfinance institutions ("MFIs"), community development finance institutions ("CDFIs"), businesses that sell fair trade products ("Fair Trade Social Enterprises" or "FTSEs"), businesses that employ disadvantaged workers ("Work Integration Social Enterprises" or "WISEs") and low-cost retailers and service providers ("low-cost sellers"). Social enterprise is no longer the domain of a small set of specialized firms. Multinational corporations, such as Starbucks, Coca Cola and Deutsche Bank, are increasingly engaged in it. Major universities such as Harvard, Oxford, and Yale have dedicated centers to the study of social enterprise, and several countries, including the United States, have established governmental agencies to encourage and facilitate its growth.[1] There is a growing belief that social enterprise constitutes a novel form of producing social wealth.

The concept of social enterprise is generally defined as including virtually any form of organization that pursues both market or for-profit activities and social purposes.[2] This definition is not particularly informative, mainly because it fails to explain what "social" means. Even strictly profit-maximizing firms have a social purpose, such as providing employment or enhancing consumers' welfare. Even if strictly profit-maximizing firms are excluded, this definition remains extremely wide and indiscriminate in scope. It includes essentially any form of hybrid enterprise that combines some for-profit and nonprofit motives, including corporate social responsibility ("CSR") initiatives, corporate charity, stakeholder models of the corporation under which managers may maximize the welfare of all stakeholders of the firm (including the firm's employees and creditors), and commercial nonprofits, such as hospitals and universities.

Defining social enterprise as any enterprise that combines for-profit and social motives poses a challenge to the traditional tenets of corporation law: the profit-maximization norm and the non-distribution constraint. The profit-maximization norm requires for-profit corporations to maximize shareholders' profits and not engage in social activities unless they enhance, at least indirectly, shareholders' profits.[3] Firms that do not maximize profits and pursue social missions instead will face difficulties in attracting capital and may therefore be unsustainable; furthermore, if managers of such firms had the authority to use surplus to benefit non-shareholders, they would be likely to pursue policies that benefit themselves as opposed to third-

[1] See the website of the U.S. Office of Social Innovation and Civic Participation at http://www.whitehouse.gov/administration/eop/sicp (last visited Feb. 5, 2012).

[2] For examples, see Gregory J. Dees, *Enterprising Nonprofits*, Harv. Bus. Rev. 55 (January-February 1998); Kim Alter, *Social Enterprise Models and Their Mission and Money Relationships*, *in* ALEX NICHOLLS ED., SOCIAL ENTREPENERSHIP: NEW MODELS OF SUSTAINABLE SOCIAL CHANGE (Oxford University Press, 2006), at 205; CARLO BORZAGA & JACQUES DEFOURNY EDS., THE EMERGENCE OF SOCIAL ENTERPRISE (Routledge 2001).

[3] See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 Geo. L.J. 439 (2001); Jonathan Macey & Geoffrey Miller, *Corporate Stakeholders: A Contractual Perspective*, 43 U. Toronto L.J. 401 (1993); Oliver Hart, *An Economist's View of Fiduciary Duty*, 43 U. Toronto L.J. 299 (1993).

party stakeholders.[4] Thus, designing firms that pursue both for-profit and social mission is generally inconsistent with profit-maximization.

By contrast, nonprofits are subject to the non-distribution constraint, which prohibits the managers of a firm from distributing the firms' earnings to themselves. The non-distribution constraint ensures that managers entrusted with subsidies or donated funds will not expropriate such funds.[5] The nonprofit form serves as a commitment device by giving subsidy-providers, e.g., the donors in the case of a charity, some assurance that managers will use the subsidies for their intended purpose, e.g., by providing relief to the poor.[6] As I explain below, social enterprises are similar to donative nonprofits because they are entrusted with a subsidy which they are supposed to use for the benefit of third-party beneficiaries. The subsidy can take many forms, including not only donations or grants, but also implicit subsidies in the form of investments at below-market returns or premiums paid by consumers for products. However, unlike donative organizations, social enterprises receive a significant portion of their income from the sale of products or services and in many cases they are incorporated as for-profits, hence can distribute profits to their owners.

Accordingly, the structure and function of social enterprise is arguably inconsistent with prevailing theory, which seems to predict that such enterprises will either be unsustainable because they do not maximize profits or untrustworthy when they are not subject to the non-distribution constraint. However, as stated above, certain forms of social enterprise, such as MFIs and FTSEs, appear to have an increasing impact and influence. This suggests that social enterprise constitutes an efficient form of organization. Some commentators have recently questioned the validity of profit-maximization and the non-distribution constraint as the prevailing theories of corporate law.[7] There is therefore a need for a theory of the role of social enterprise that identifies its structural attributes and explains its function. The purpose of this article is to develop such a theory. The theory I offer is generally consistent with both the profit-maximization norm and the non-distribution constraint.

In particular, I argue that social enterprises have a distinctive role, which I term the *measurement* role of social enterprise. In a nutshell, social enterprises, such as MFIs or FTSEs, are subsidized commercial (for-profit or nonprofit) enterprises with a commitment to transacting with certain classes of beneficiaries. The beneficiaries are patrons of the firm: for example, poor

---

[4] Hansmann & Kraakman, *id*., at 444. This is partly due of the difficulty of verifying what policies in fact benefit third-party stakeholders.

[5] Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 Yale L.J. 835 (1980); Edward L. Glaeser & Andrei Shleifer, *Not-For-Profit Entrepreneurs*, 81(1) J. of Pub. Econ. 99 (2001).

[6] Donors face a contract failure because even if they entered into a contract requiring the firm to use the donation in a specified way, the donors are likely to have difficulty in verifying and monitoring the quality of services provided by the firm, given the separation between the payer for the services (i.e., the donors) and the recipient of the services (e.g., the poor in developing countries); see Hansmann, *id.*, at 846-848.

[7] For examples, see Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 Va. L. Rev. 2017 (2007); M. Todd Henderson and Anup Malani, *Corporate Philanthropy and the Market for Altruism*, 111 Colum. L. Rev. 571 (2009). Henderson, Malani and Posner claim that for-profits may have a comparative advantage over nonprofits in providing altruistic goods, and that the non-distribution constraint is not essential for ensuring that donations are not expropriated by corporate managers. Similar claims have been made by entrepreneurs; see MICHAEL KINSLEY ED., CREATIVE CAPITALISM: A CONVERSATION WITH BILL GATES, WARREN BUFFET AND OTHER ECONOMIC LEADERS (Simon and Schuster 2009); MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM (Public Affairs 2008); DAN PALLOTTA, UNCHARITABLE: HOW RESTRAINTS ON NONPROFITS UNDERMINE THEIR POTENTIAL (Tuft University Press 2008).

borrowers in the case of MFIs or CDFIs, small producers in the case of FTSEs, and workers in the case of WISEs. The transaction with the beneficiaries as patrons underlies the measurement role. As social enterprises are committed to transacting with their beneficiaries, their sustainability is dependent in part on their beneficiaries' performance – either as providers of input or as customers. Thus, social enterprises have incentives to measure and gather information on the abilities and preferences of their beneficiaries. The information generated by the measurement role enables social enterprises to enter into transactions with their beneficiaries and allocate them subsidies efficiently.[8] The measurement role of social enterprises makes them relatively efficient vehicles for allocating subsidies to beneficiaries,[9] and thus provides an efficiency rationale for social enterprise.

Before discussing the theory in detail, it should be noted that from a policy perspective, understanding the structure and function of social enterprises is critical for developing policy to foster their growth and development. First, as more for-profits increasingly emphasize their social pursuits, largely as a marketing strategy and to enhance their reputations, it is critical to identify those organizations which have the incentives to pursue social goals effectively. Social enterprises may be better trusted to channel subsidies to beneficiaries than other forms of hybrid enterprise, such as CSR and corporate charity.[10] Second, recent Delaware case law casts doubts on the ability of social enterprises formed as for-profits to commit to a social purpose.[11] Many jurisdictions have introduced a legal form, such as the L3C and the For-Benefit Corporation, to enable social enterprises to adopt a commitment device.[12] Most of these statutes define social or hybrid enterprise differently from the others,[13] and more importantly, most of these statutes are rarely used. They have played only a marginal role in the evolution of social enterprise, in large part because of the lack of a clear theoretical framework that explains its underlying structure and function. Third, understanding the function of subsidized funds which constitute an essential

[8] There is another residual category of social enterprises, which I call, "external beneficiary social enterprises" ("EBSEs") that do not transact with the beneficiaries, but rather are committed to producing public goods. I discuss EBSEs in section IV(A).

[9] To be sure, I do not argue that social enterprises necessarily maximize aggregate welfare. Rather, given the availability of subsidies, social enterprises may serve as efficient vehicles for utilizing them.

[10] While some have criticized the effectiveness of CSR (see Milton Friedman, *The Social Responsibility of Business Is To Increase Its Profits*, N.Y. Times, Sep. 13, 1970; Aneel Karnani, *The Case Against Corporate Social Responsibility*, Wall. St. J., Aug. 23, 2010), others have argued that for-profits should engage in corporate social responsibility (see Michael E. Porter & Mark R. Kramer, *Strategy and Society: the Link between Competitive Advantage and Corporate Social Responsibility*, Harv. Bus. Rev. 78 (2006); Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. Rev. 733 (2005)).

[11] *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1. (Del. Ch. 2010); see David Wishnick, *Comment, Corporate Purposes in a Free Enterprise System: A Comment on eBay v. Newmark*, 121 Yale L.J. (forthcoming 2012).

[12] For reviews of the new legal forms, see Thomas A. Kelley III, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 Tul. L. Rev. 337 (2009); Matthew NC. Doeringer, *Fostering Social Enterprise: A Historical and International Analysis*, 20 Duke J. Comp. & Int'l L. 291 (2010); Dana B. Reiser, *Blended Enterprise and The Dual Mission Dilemma*, 35 Vt. L. Rev. 105 (2010); Fabrizio Cafaggi and Paola Iamiceli, *New Frontiers in the Legal Structure and Legislation of Social Enterprises in Europe: A Comparative Analysis*, EUI Working Papers LAW 2008/16, *available at* http://cadmus.eui.eu/handle/1814/8927 (last visited Feb. 5, 2012).

[13] Most forms are defined by reference to the social purpose of the enterprise. For example, the L3C is generally defined as a Limited Liability Company that significantly furthers the accomplishment of one or more charitable or educational purposes, and no significant purpose of the company is the production of income or the appreciation of property; see 11 V.S.A. § 3001(27) for the Vermont L3C Act. The Vermont For-Benefit Corporations Act further requires that the "general public benefit" of the corporation be measured by a "third-party standard" and that termination of a benefit corporation status be approved by a majority of at least two-thirds of the shareholders; see 11A V.S.A. §12.03.

element of social enterprises and when subsidies tend to be effective is essential for designing an efficient subsidy policy for social enterprises.

II. A THEORY OF THE STRUCTURE AND FUNCTION OF SOCIAL ENTERPRISE

I define social enterprise as a subsidized commercial enterprise (for-profit or nonprofit) with a commitment to channeling subsidies for the benefit of beneficiaries who are patrons of the enterprise ("patron-beneficiaries"), typically customers or providers of input. This definition may be broken down into four main elements: (a) a commercial enterprise,[14] (2) a subsidy (direct or implicit), (3) a transaction with a beneficiary, and (4) a commitment device. Each of these elements is common to the main forms of social enterprise referred to above, such as MFI, FTSE or WISE. I will focus in particular on the transaction with the beneficiary and the commitment device as the key elements of social enterprise. Given the relative structural complexity of social enterprises, I introduce the theory by reference to a specific example. Thus, I first discuss WISEs and then proceed to develop a general theory, which I apply to other forms of social enterprise.

A. AN ILLUSTRATIVE EXAMPLE: THE GREYSTON BAKERY AND OTHER WORK INTEGRATION SOCIAL ENTERPRISES

I use WISEs as an illustrative example to explain the structural and functional elements of social enterprises. I focus especially on a specific firm, the Greyston Bakery. WISEs are businesses that employ disadvantaged employees who suffer from systemic hardship in finding employment. Disadvantaged employees may include people with disabilities, migrants and people from an ethnic minority, people with a criminal record or other social problem, such as drug addiction, and members of low-income communities who lack education or an employment record.[15] WISEs have enjoyed a steady growth in recent decades, especially in Europe, [16] though there are many notable WISEs in the U.S. as well.[17] WISEs usually produce and sell products or services which require a large number of low-skilled employees, especially in industries such as food, catering, custodial services, and recycling. The Greyston bakery as of 2007 is a $6 million business, which specializes in gourmet cookies and baked ice cream ingredients. The bakery hires employees that live in Yonkers, New York, who usually have little or no education and

[14] I emphasize that I make references to "enterprise" rather than organizations or entities. An enterprise may comprise an entity or several entities, but may also be a segment of an organization that includes various types of enterprises.

[15] See JERR BOSCHEE, SOCIAL ENTERPRISE SOURCE BOOK (Encore! Press 2001).

[16] The growth in Europe seems to be due to problems of systemic unemployment and European legislation which allocates subsidies to firms that employ certain groups of excluded people; see MARTHE NYSEENS ED., SOCIAL ENTERPRISE AT THE CROSSROADS OF MARKET, PUBLIC POLICIES AND CIVIL SOCIETY (Routledge 2006); Jacques Defourney & Marthe Nyssens eds., *Social Enterprise in Europe: Recent Trends and Developments*, EMES WP no. 08/01, *available at* http://www.emes.net/index.php?id=49 (last visited Feb. 5, 2012); Borzaga & Defourny eds., *supra* note 2; Giulia Galera, Social *Enterprises and the Integration of Disadvantaged Workers*, *in* LEONARDO BECCHETTI & CARLO BORZAGA EDS., THE ECONOMICS OF SOCIAL RESPONSIBILITY: THE WORLD OF SOCIAL ENTERPRISES (Routledge 2011).

[17] See Boschee, *supra* note 15.

employment record.[18] The Greyston bakery is a for-profit firm that is wholly owned by a nonprofit, the Greyston Foundation.

First, it is clear that the Greyston bakery is a commercial enterprise. A commercial enterprise is any enterprise that receives a significant portion of its income from prices charged for its products or services, so that its solvency and profitability are dependent on such income. Greyston is a for-profit, though I emphasize again that a commercial enterprise may also be a nonprofit organization. For example, Gulf Coast Enterprises ("GCE"), a business that provides custodial services, food services, and other administrative services, is a nonprofit. As of 2009, GCE was a $46 million business with 1,243 employees, 894 of them with disabilities, including people with behavioral disorders (such as mental illness or substance abuse) or a developmental or physical disability.[19] Both Greyston and GCE are commercial enterprises because their solvency and profitability are dependent on earned income.[20]

Second, although social enterprises rely on earned income, they are also recipients of a subsidy. Social enterprises serve as vehicles for channeling subsidies to their beneficiaries, in this case, the employees of the bakery. Although subsidies may be used by social enterprises to make direct disbursals to the firm's beneficiaries (e.g., special training for employees),[21] the primary role of the subsidies is to fund the costs associated with employing disadvantaged workers, i.e., the costs of gathering information on beneficiaries' attributes; I discuss these costs in the next section.

The subsidy itself may be any contribution of capital – monetary or other type of capital – which is intended to be utilized for the benefit of a specified class of beneficiaries, and is provided for no consideration or for a below-market consideration.[22] The subsidy may be provided by different sources. WISEs may receive government subsidies conditioned on the employment of individuals that belong to a disadvantaged group.[23] In addition, WISEs may receive preferential treatment in making purchases or tender decisions by public authorities.[24] The subsidy may flow from patrons of the firm. The Greyston bakery has received subsidies in various forms. As stated above, its owner, the Greyston Foundation, provided the seed capital, which may be viewed as an ongoing subsidy of the firm's capital costs. Although the profits of the bakery are currently equivalent to other commercial bakeries, in the first years of its establishment, the Foundation accepted below-market returns, i.e., the difference between commercial returns and actual returns constituted the subsidy. The Foundation also continues to subsidize the costs of various services, such as training, housing and childcare, to the bakery's employees. The subsidy to the bakery also flows from its consumers. The Greyston bakery has been receiving favorable trade terms from the ice cream company, Ben & Jerry's, for example,

---

[18] Boschee, *id.*, at 78-83; Michael Barker, et al., *A Case Study on Greyston Bakery: The Do-Goodie Product Launch* (May 15, 2009) (on file with the author; hereinafter, *The Do-Goodie Product*); Michael Barker et al., *Greyston Bakery: The Costs and Benefits of an Open Hiring Policy* (May 15, 2009) (on file with the author; hereinafter, *Open Hiring Policy*).

[19] Boschee, *id.*, at 90-96.

[20] I discuss below the choice of organizational form in greater detail in the context of commitment devices.

[21] Although a disbursal is a subsidy in itself, I will use the word "disbursal" to refer to the actual transfer to the beneficiary in order to differentiate it from the subsidy received by the organization.

[22] i.e., a consideration whose monetary value is less than the opportunity costs of investing that capital.

[23] For example, the Work Opportunity Tax Credit ("WOTC") provides businesses with a tax credit for hiring individuals from targeted groups, including, persons with disabilities, ex-offenders and certain welfare recipients; see Francine J. Lipman, *Enabling Work for People with Disabilities: A Post-Integrationist Revision of Underutilized Tax Incentives*, 53 Am. U. L. Rev. 393 (2003).

[24] Laurent Gardin, *A Variety of Resource Mixes inside Social Enterprises*, in Nyssens ed., *supra* note 16, at 111.

greater willingness to adjust the terms of transactions if performance is not adequate or timely. The bakery also recently started marketing its social mission to attract premiums from consumers by introducing the "Do-Goodie" brownies.[25] Finally, the managers of the firm, who care deeply about its mission, invest special effort in training its employees and attending to their needs.

1. The Transaction with the Beneficiary and the Measurement Function

In this section, I explain how the transaction with their patron-beneficiaries, i.e., the workers, allows WISEs to perform their measurement role. In the first subsection, I explain why commercial firms that seek to maximize profits generally avoid transacting with disadvantaged employees. I argue that information problems relating to workers' abilities and efforts make it costly for such firms to employ disadvantaged workers. Second, I explain why donative enterprises, such as charities or government agencies, are likely to be inefficient in providing assistance to such workers. Again, the problem is information problems relating to workers' attributes. By donative enterprises, I refer to enterprises that engage in making disbursals (e.g., cash grants or training) to "external beneficiaries" (i.e., beneficiaries who are not patrons of the enterprise) and fund themselves by raising donations rather than selling goods or services. Donative enterprises are generally formed as nonprofits, but they may also be government agencies.[26] Third, I discuss how WISEs, such as the Greyston bakery, address information problems relating to workers' attributes by fulfilling their measurement role.

Before embarking on the analysis, it is helpful to make some assumptions concerning workers' attributes. I will make the simplifying assumption that workers have three levels of abilities. First, they may have fully competitive ("FC") abilities. FC abilities denote the required level of abilities necessary to enter into transactions with commercial firms ("commercial transactions"). Workers, however, may lack sufficient abilities to obtain employment with commercial firms, and therefore commercial firms will not hire them. Workers who lack certain skills have less than FC abilities with respect to certain jobs. A donative enterprise may provide a disbursal to such a worker-beneficiary (i.e., a "donative transaction") to enable him to reach the competitive level at which he will be able to find employment. Let's further assume that such worker-beneficiaries belong to two groups. One group has BC (denoting, "below competitive") abilities where BC<FC. This group would need a disbursal, for example, training or technical assistance, in order to reach the competitive level. The other group's abilities are quantified at NC (denoting, "not competitive"), where BC>NC. The NCs are generally unable to work at a competitive level even if they receive a disbursal, such as technical assistance.

a. Information Problems in Commercial Transactions

Commercial firms have traditionally avoided employing disadvantaged workers. As a result, such workers suffer from severe and systemic unemployment. In the case of the Greyston bakery, we are concerned with workers in a poor neighborhood who have little employment record and a poor educational background. The problem is that disadvantaged workers remain

[25] Ben & Jerry's are committed to buying their supplies from the bakery; see Barker, et al., *The Do-Goodie Product*, *supra* note 18.

[26] Government agencies are functionally equivalent to charities because they are primarily engaged in making disbursals to beneficiaries, and they are essentially funded by a form of grant, i.e., an allocation of funds from the government.

unemployed even when they have FC abilities. Although workers from a disadvantaged background may lack certain skills and training, with respect to many jobs, especially low-skill jobs, it is fair to assume that many of them possess FC abilities. Information problems, however, make it costly for commercial firms to identify and hire those employees with FC abilities that belong to a disadvantaged group.[27] To be sure, information problems, such as adverse selection and moral hazard, exist in principle in any hiring decision.[28] Employers have difficulty in observing employees' abilities, and there is therefore a risk of adverse selection, namely that the firm will hire employees with insufficient abilities. In the case of low-skill jobs, the major difficulty is observing soft skills, such as discipline, attentiveness and commitment.

If firms cannot observe employees' abilities ex ante they have to adjust the terms they extend to their employees, for example, by reducing their starting salaries. The problem is that if offered less favorable terms, persons with high abilities (FC and above), who have higher opportunity costs, may choose to exit the market altogether, for example, by starting their own business or even accepting welfare benefits. If capable workers exit the market, commercial firms will then further adjust their terms to reflect the higher risk of inadequate performance, which again drives capable employees away from the market. As the proportion of capable workers decreases, this process eventually leads to rationing and potentially a collapse of the market, a situation in which all commercial firms decline to hire employees in that market.

In addition, firms face a moral hazard with respect to observing their employees' efforts. Firms are usually able to monitor some aspects of employees' efforts that are easily observable, such as arrival to work on time. But genuine efforts to increase production are difficult to observe. Employees thus have incentives to shirk and exert less effort than required under their employment contract.[29] If firms cannot observe their employees' abilities and efforts, they have to decrease the wages offered to employees to reflect their lower productivity. At lower wages, employees have less incentive to exert effort, and employees with greater abilities and higher opportunity costs may leave their jobs. Lower wages may therefore decrease the firm's productivity, leading again to a further reduction in wages, and ultimately rationing.

In developed labor markets, though, there are information mechanisms that mitigate the problems of adverse selection and moral hazard. First, employees may use various certification and qualification mechanisms, such as their educational and professional qualifications as well as their social background, to signal their abilities to prospective employers. Job referrals also mitigate information problems in hiring decisions. These mechanisms address the risk of adverse selection ex ante a hiring decision. With respect to moral hazard, employment contracts may be designed to include incentive schemes to encourage employees to expend greater effort, for example, wages or a bonus scheme tied to performance measures, or simply the threat of dismissal if certain performance measures are not met.

These information mechanisms are not generally available with respect to disadvantaged employees. Poor employees in disadvantaged communities may lack access to education. Disadvantaged groups often have no employment track record that they can use to signal their abilities to potential employers. Moreover, the poor have less job contacts on average, and thus

[27] TIMOTHY J. BARTIK, JOBS FOR THE POOR: CAN LABOR DEMAND POLICIES HELP? 55-58 (Russell Sage Foundation 2001).

[28] See ANDREU MAS COLELL, ET AL., MICROECONOMIC THEORY 436-445 (Oxford University Press 1995).

[29] See Chapter 14 in Mass Colell et al., *id.*

job referrals are less likely to be available.[30] Employers thus have limited means of gathering information on such employees. Moreover, the presence of a large number of workers with BC or NC abilities makes it even more difficult for firms to identify those with FC abilities; in these circumstances firms often assume that all workers have less than FC abilities. Accordingly, being a member of a disadvantaged group constitutes a form of stigma, sending a negative signal to firms that the relevant worker does not have the required skills.[31] With respect to moral hazard, ex post a hiring decision, employers may be able to design incentive schemes to encourage employees to exert greater effort. However, incentive schemes inevitably entail substantial monitoring costs when a large portion of employees have BC or NC abilities. When the number of employees with less than FC abilities is large, the transaction costs of constantly monitoring them and measuring their performance can be very high. In light of these costs, most businesses prefer to avoid hiring disadvantaged employees altogether.

b. Information Problems in Donative Transactions:

Many disadvantaged workers have either BC or NC abilities. Commercial firms would not hire such persons even if they had information on their abilities. Donative enterprises, such as a charity or a government agency, may therefore step in to provide cash payments, professional training and other assistance to such workers. The Greyston Foundation, for example, provides job training, childcare and housing for the unemployed.[32] I emphasize that my concern is with disbursals which are intended to help beneficiaries with BC abilities reach the fully competitive level, so that they can transact with commercial firms.

Donative transactions, like commercial transactions, are subject to information problems. Disbursals of cash payments are subject to the risk of adverse selection and moral hazard. Cash payments in this case are mainly intended to be used by the recipient to acquire professional training or education to enhance his earning abilities and for basic consumption and housing needs.[33] Beneficiaries have an incentive to misstate their abilities in order to receive a cash payment. Those with FC abilities may represent themselves as having BC or NC abilities. It is also practically impossible to monitor how beneficiaries use cash payments. In the case of disbursals in the form of professional training, the risk of adverse selection and moral hazard is lower, because there are fewer incentives for beneficiaries to seek such benefits unless they wish to enhance their abilities. Nonetheless, donative enterprises may be insufficiently informed about the abilities of their beneficiaries or the type of training that would enhance their employment prospects. Professional training should be given in principle only to those with BC abilities. If donative enterprises cannot identify beneficiaries' abilities they will allocate training to all disadvantaged employees, including those with FC and NC abilities. Such disbursals would be redundant because those with FC abilities do not need them, and those with NC abilities cannot perform anyway. More importantly, if the content of the training does not fit the specific needs of certain businesses the training will not enhance the employment prospects of the beneficiaries of such programs.[34] There is evidence that the effectiveness of such training programs tends to

[30] Bartik, *supra* note 27, at 57; Galera, *supra* note 16, at 106-107.
[31] Bartik, *id.*, at 57-58; Galera, *id.*
[32] Barker et al., *The Do-Goodie Product*, *supra* note 18, at 2-3; Boschee, *supra* note 15.
[33] Cash payments, though, are essential to help those with NC abilities who would not be able to obtain employment even if they receive professional training.
[34] A major criticism of training programs is that they are usually not tailored to meet labor demand needs; see Bartik, *supra* note 27; John P. Martin & David Grubb, *What Works and for Whom: A Review of OECD Countries'*

be partial at best.[35] Moreover, professional training is not useful if commercial enterprises continue to ignore disadvantaged workers, even if they reach the competitive level.

These information problems stem from the nature of the relationship between donative enterprises and their beneficiaries. The beneficiaries of donative enterprises are external beneficiaries. Donative enterprises do not transact with their beneficiaries. A contractual transaction enables commercial enterprises to elicit information on their patrons, especially their patrons' preferences, abilities and efforts. It shows that patrons value the benefit they receive under the contract with the firm. Employees clearly value the opportunity to work for a given salary. Performance as an employee is an indication of the employee's productivity and efforts and the relevance of his skills to the needs of the firm employing him. As donative enterprises enter into no contractual transaction with their beneficiaries, they lack a mechanism providing information on their beneficiaries' attributes, and thus need to rely on available information, to the extent that such exists, or to conduct specific studies of their beneficiaries' attributes.

It could be argued that donative enterprises may simply raise more capital to study their beneficiaries' preferences and abilities, and monitor how they use the disbursals they receive. However, doing extensive diligence on workers' attributes, monitoring how recipients of professional training make use of their newly acquired skills, and continuously adjusting professional training to the needs of commercial firms is likely to be very costly. Nonetheless, capital constraints do not seem to be the fundamental problem, which is that donative enterprises tend to have modest incentives to use capital to fund such studies and costly monitoring projects. As they receive their funding from donors, donative enterprises are generally designed to serve their donor-customers by disbursing donated funds to beneficiaries on their behalf. They have fewer incentives to spend on conducting costly reviews of the effects of their own disbursals, because if it emerges that disbursals are being used inefficiently, donors may be reluctant to make additional donations to the organization. Thus, donative enterprises tend to report information on the amount rather than the effectiveness of their disbursals. In the absence of clear information on effectiveness, the amount of disbursals is often the critical factor in attracting additional funding from donors.[36] In fact, donative enterprises may have an incentive not to report information on the effect of their programs, or to report information that exaggerates or even misstates the effectiveness of their activities.

c. The Measurement Function of WISEs:

WISEs resolve information problems in both commercial and donative transactions by engaging in information-gathering on their patron-beneficiaries. I term this type of information gathering, the *measurement* function of social enterprises. With respect to commercial transactions, WISEs are committed to hiring and training disadvantaged employees. Unlike commercial enterprises, WISEs are recipients of a subsidy. The subsidy – whatever its source – is used to fund the higher costs of acquiring information on the firm's employees. With respect

---

Experiences With Active Labour Market Policies, Working Paper 2001:14 (OECD 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=348621; IEG, *Using Training to Build Capacity for Development: An Evaluation of the World Bank's Project-Based and WBI Training* (World Bank 2008), at 36-38.

[35] See James Heckman et al., *The Economics and Econometrics of Active Labor Market Programs*, *in* Orley Ashenfelter & David Card, Handbook of Labor Economics, Volume 3B 1865 (North Holland 1999); Bartik, *id.*, at 88-110; IEG, *id.*, at 36-38.

[36] Donative enterprises are usually evaluated by donors and other external agencies, such as Charity Navigator, primarily on the basis of the quantity of disbursals they make to beneficiaries.

to donative transactions, WISEs have better tools and incentives to gather information on their employee-beneficiaries. As WISEs are financially dependent on the performance of their employee-beneficiaries, they have incentives to gather information on their abilities and performance. The contractual transaction with the employees can be utilized to elicit information on their attributes. If the beneficiaries are unable to perform the contract, the WISE will not be sustainable. Where beneficiaries have BC abilities, WISEs have incentives to ensure that they are provided with the appropriate training to be able to perform the contract. WISEs have no incentive to provide training to employees with FC or NC abilities; such training would not improve such employees' performance, as these employees are either already capable of performing the contract or unlikely to be capable of performing it even if they receive a disbursal. Disbursals to employees with FC or NC abilities would only decrease the profitability of the WISE. The disbursals made by WISEs to their employee-beneficiaries are thus more likely to be efficient than equivalent disbursals made by donative enterprises.

There are three principal ways in which WISEs gather information on their employees. First, they may simply invest a great deal in due diligence to study the capabilities of the workers prior to hiring them, even if such diligence is substantially more costly than conducting diligence in a market where all employees have FC abilities. The subsidy is used partly to fund the additional costs of diligence and research. Diligence includes reliance on referrals from training agencies, nonprofits or welfare departments,[37] and rigorous screening of referrals through interviews and tests (e.g., drug tests where appropriate).[38] Diligence, however, is not used extensively by all WISEs, as information on disadvantaged workers is likely to be limited in the absence of an employment track record. In any event, WISEs can always lay off employees if they turn out to have NC abilities. The Greyston bakery, for example, has adopted a policy of hiring any person on a 'no questions asked' basis (i.e., no ex ante diligence), but also of laying off employees that fail to meet stringent standards with respect to punctuality, attitude and productivity.[39]

Second, WISEs may transact with their employee-beneficiaries on the basis of imperfect information. At the time the contract is entered into, the WISE will have limited information on its newly hired employees, who may have FC, BC or NC abilities. The WISE then monitors their performance and gathers information on their abilities. This information is used to make decisions on the appropriate type and amount of disbursals. If the employee performs adequately (i.e., has FC abilities) then the WISE does not allocate a disbursal (e.g., professional training or a grace period for inadequate performance) to that employee. With respect to employees who turn out to be incapable of performing adequately (i.e., they have NC abilities), the WISE has to terminate their employment. If employees need assistance (i.e., have BC abilities), the WISE has an incentive to allocate them appropriate disbursals to help them reach the competitive level. Social enterprises have an incentive to minimize their costs, and thus no incentive to make wasteful disbursals, as, unlike donative enterprises, their solvency and profitability are dependent on their ability to generate profits. As many of the WISE's employees naturally turn out to lack

[37] Note that the training program is essentially a subsidy provided to the WISE, which is expended on diligence on behalf of the WISE.

[38] Bartik, *supra* note 27, at 219 (describing BMC Enterprises, a business operating grocery stores); interview with Jonathan Harrison of Rubicon National Social Innovations (February 4, 2010) (describing the hiring process at the Rubicon bakery, a for-profit bakery approximately 70% of whose employees are workers with a criminal record, behavioral problems, addiction, or very little employment record).

[39] Barker et al., *Open Hiring Policy*, *supra* note 18. By contrast, other WISEs take a more lenient approach in the first months of employment as long as they show improvement; see Bartik, *id.*, at 219.

the capabilities to perform their contract with the firm (i.e., have BC or NC abilities), the turnover rate tends to be very high and there is a constant need to hire and train new employees; hence the need for a subsidy.

The Greyston bakery provides a good example of hiring disadvantaged employees on the basis of imperfect information.[40] As mentioned above, the bakery has a policy of employing anyone who applies for a starting job. The employees are monitored mainly on the basis of their soft skills, i.e., attitude, punctuality and productivity. After one year's apprenticeship, during which they are evaluated on a biweekly basis, they may be hired as fulltime employees. In the course of their employment they receive substantial training, which includes ongoing professional development subjects and performance evaluations. The firm has incentives to develop training programs that are effective in enhancing its employees' abilities, as its profitability is dependent on their performance, and the effectiveness of such training programs is continuously tested on the job. Over time, the firm gathers information on employees' abilities and efforts. Those who continue to make progress and reach the competitive level may be promoted to a better position, or move to work for higher salaries at commercial firms. On the other hand, the firm terminates the employment of those who lack basic soft skills. The turnover rate at Greyston averages 20% annually and climbs as high as 36% in peak months. Thus the open hiring system entails substantial costs.[41]

Third, WISEs use standard incentive mechanisms embedded in the employment contract to reveal information on employee-beneficiaries' abilities and efforts. In order to obtain a job and potentially receive a disbursal, beneficiaries must reveal their abilities and, to the extent possible, their efforts in utilizing the disbursal they receive for its intended purpose. At the Greyston bakery, those who perform adequately may be hired as fulltime employees after a year's apprenticeship, and may later be promoted to better positions, including managerial ones.[42] In addition, the bakery provides positive reinforcement to its employees, including a monthly award of distinction. If employees were to represent themselves as having NC abilities they would not get a job. Those with BC capabilities have no incentive to understate their abilities because they might then lose their jobs. Those who have FC abilities may seek awards, a promotion, or a better salary. Furthermore, disbursals that take the form of training and technical assistance are unlikely to give them incentives to understate their abilities. This differs from disbursals of cash – for example, in the form of premium wages – where employees may have an incentive to represent themselves as having lesser abilities or to shirk.

It is important to emphasize that although every commercial firm uses incentive mechanisms to enhance employee productivity, the costs to a WISE of using such mechanisms are much higher than at equivalent commercial firms. In order to administer such incentive mechanisms, WISEs must continuously monitor their employees. The Greyston bakery conducts biweekly evaluations of its employees.[43] By contrast, in standard commercial firms, there is less need for an intensive incentive scheme coupled with frequent monitoring, as most hired employees have FC abilities, especially in the case of low-skilled workers. Such detailed and

[40] Barker et al., *id.*
[41] By contrast, the Rubicon bakery (see *supra* note 38) expends subsidies on recruiting and training costs, but its turnover is relatively stable.
[42] Barker et al., *Open Hiring Policy*, *supra* note 18.
[43] Barker et al., *id.*

frequent evaluations coupled with a high turnover rate entail substantial costs, which would not typically be attractive to commercial firms.[44]

2. Commitment Device and Organizational Form

Whereas the measurement role addresses information problems faced by firms with respect to beneficiaries' attributes, the design of social enterprise must also address information problems faced by subsidy-providers with respect to the firm. This problem is well-known in the case of donative enterprises. The non-distribution constraint serves as a commitment device by assuring the donors that managers entrusted with donative funds will not distribute such funds to themselves and can therefore be trusted to make disbursals to beneficiaries. Social enterprises are similar to donative enterprises, as they are recipients of subsidies that they are supposed to use to benefit third parties. Social enterprises must therefore adopt a commitment device to assure their subsidy-providers that they will use the subsidy for its purpose.

Many social enterprises, including the Greyston bakery, are for-profit firms. Social enterprises therefore employ other mechanisms as commitment devices. Each commitment device essentially ensures that the social enterprise is committed to transacting with the beneficiaries, and in some cases also provides them with certain disbursals. The Greyston bakery uses 'control mechanisms' as a commitment device. By control mechanism, I mean that the organization is owned by a nonprofit,[45] the Greyston Foundation. The foundation is in a position to make sure that the bakery does not compromise its mission by ceasing to employ workers from poor communities. In this way, the foundation ensures that the subsidies it provides to the bakery are used for their purpose. Similarly, other subsidy-providers, especially the bakery's customers, appear to rely on the foundation's control as well as the reputation of the bakery. To be sure, the social enterprise need not be wholly owned by the nonprofit; it is only necessary that the nonprofit has sufficient control.

An alternative commitment device is a contract with a nonprofit organization to use the subsidies for their intended purpose.[46] The Rubicon bakery, a WISE that was originally wholly owned by the Rubicon Foundation, was sold in 2009 to a group of private equity investors.[47] As part of the sale, the foundation licensed the use of its name to the bakery. The sale contract requires the bakery to continue to employ disadvantaged workers and pay them fair market wages, and Rubicon maintains rights of access to information in order to monitor the bakery's compliance. The foundation has the right to withhold the license of the Rubicon name or buy back the bakery if it fails to meet the conditions in the sale contract with respect to the social mission.[48] This mechanism is supposed to serve as a commitment not only to the nonprofit (i.e., the foundation), but also to the consumers as an additional class of subsidy-providers. Thus, this

[44] Note, though, that the Greyston bakery shifts a large part of the costs of information to its employees. The starting salary at the Greyston bakery is approximately $8 per hour, compared to approximately $12 per hour at a commercial bakery. This salary roughly reflects the average productivity of the employees, which is approximately 67% of the productivity of employees at commercial bakeries. In this respect, employees with FC abilities seem to partly subsidize the hiring of those with BC and NC abilities.

[45] As explained below, the organization may also be controlled by persons with a strong reputation for having a commitment to a social goal.

[46] See Allen Bromberger, *A New Type of Hybrid*, Stan. Soc. Innovation Rev. 49 (Spring 2011).

[47] Rubicon Program Inc. Press Release, Smart Business Deal Reaps Sweet Rewards for Rubicon Programs Inc. (Dec. 2, 2009), *available at* http://www.rubiconprograms.org/socialenterprise.html (last visited Feb. 5, 2012).

[48] Interview with Jonathan Harrison of Rubicon National Social Innovations (February 4, 2010).

contract as well as Rubicon's reputation is supposed to attract subsidies from consumers who may prefer buying from the Rubicon bakery over other bakeries.

WISEs may also use certification mechanisms as a commitment device. An example is programs that allocate subsidies to firms for employing disadvantaged workers. In this case, the certification is performed by a government agency. The program first defines the class of worker-beneficiaries, which may include disabled people, ex-offenders, welfare recipients or recipients of unemployment insurance.[49] Verification of a beneficiary's disadvantaged status is not costly because it is usually documented by government agencies. The program may also define the level of salary that such employees are entitled to receive by reference to the prevalent market wages.[50] In some European jurisdictions, there are also special laws that define social enterprises as firms that employ certain categories of disadvantaged workers. In that case, the certification covers the firm as a whole rather than each worker's status. Typically, the percentage of disadvantaged workers must be not less than 30% of the workforce employed by the firm.[51] It is noteworthy that, even if the certification applies to the firm as a whole, the amount of government subsidies is usually tied to the number of disadvantaged workers employed at a given time.[52] Thus there is little risk that subsidies will be exploited by the WISE to benefit the managers or investors.

Finally, it is important to emphasize that the non-distribution constraint itself may serve as a commitment device, and many WISEs form as nonprofits. Take, for example, Gulf Coast Enterprises ("GCE"), a business that provides custodial services, food services, and other administrative services. As of 2009, GCE was a $46 million business with 1,243 employees, 894 of them with developmental or physical disabilities and different types of behavioral disorders.[53] The main reason for forming as a nonprofit seems to be that the firm generally needs to source more subsidies in the form of donations or tax exemptions, and that it is less likely to attract equity capital. This is likely to be the case when the firm transacts with workers with lower abilities. The greater the proportion of workers with BC or NC abilities and the lower the abilities of those with BC abilities, the more likely it is that the firm will incorporate as a nonprofit. GCE, for example, employs workers with severe disabilities. On the other hand, at for-profit social enterprises, such as the Greyston bakery, most employees are required to display a competitive level of productivity, and the bakery does not receive donations on a regular basis.[54] Moreover, WISEs that employ workers with higher abilities and provide them with few disbursals (if any) are less likely to be eligible for tax benefits.[55] Such firms may still use the

[49] See Lipman, *supra* note 23.

[50] For example, see the wage subsidy scheme in Ireland at http://www.fas.ie/en/Allowances+and+Grants/Wage+Subsidy+Scheme.htm (last visited Feb.5, 2012)).

[51] For a discussion of the Italian Type-B social cooperative under Italian law (Law 381/1991), see Carlos Borzaga & Monica Loss, *Work Integration Social Enterprises in Italy*, EMES WP 02/02, *available at* http://www.emes.net/index.php?id=49 (last visited Feb. 5, 2012); Cafaggi & Iamiceli, *supra* note 12, at 7-15. For a discussion of Finish WISEs formed under the Finish Act on Social Enterprises (1351/2003), see Cafaggi & Iamiceli, *id.*, at 22-24; Defourny & Nyssens eds., *supra* note 16, at 17-19.

[52] See Borzaga & Loss, *id.*, at 9; Defourny & Nyssens eds., *id.*, at 18.

[53] Boschee, *supra* note 15, at 90-96.

[54] Furthermore, as pointed out *supra* note 44, a great deal of the ongoing costs of employing disadvantaged workers is shifted to the employees.

[55] In these circumstances, given the commercial nature of WISEs, they may be viewed as not operating exclusively for an exempt purpose under I.R.C. § 501(c)(3).

nonprofit form as a commitment device even without tax exemptions, but its restrictive nature, especially with respect to raising capital, makes it an unappealing form of organization. [56]

B. TOWARDS A GENERAL THEORY OF SOCIAL ENTERPRISE

The analysis can be extended to develop a general theory of social enterprise. In its essence, social enterprise is a subsidized commercial enterprise with a commitment to transacting with its patron-beneficiaries. Social enterprises must earn income to be sustainable, but they also channel a subsidy to their patron-beneficiaries. The subsidy may flow from different sources, including government, other nonprofits or another patron of the enterprise, such as investors who accept below-market returns or consumers who pay a premium for the products they buy. The two key limbs of social enterprises are the measurement function and the commitment device. The measurement function may be understood as creating a demand for social enterprises, i.e., the efficiency advantages of social enterprises in allocating subsidies. Commitment devices, on the other hand, facilitate the supply of social enterprises by enabling them to make a credible commitment to their subsidy-providers.

***(a) The Measurement Function*:** The measurement function can be summarized as follows. Information problems, i.e., adverse selection and moral hazard, make it unprofitable for commercial firms to transact with a class of disadvantaged groups – whether employees, customers or producers. As a result of such information problems, commercial firms avoid transacting with such disadvantaged patrons. For example, commercial banks do not lend to poor people, corporations do not buy input from small farmers, and large retailers do not sell their products to customers in developing countries. Likewise, there are information problems that make it difficult for donative enterprises to efficiently disburse cash payments, goods and technical assistance or training to those who lack the capabilities to transact with commercial firms. In particular, donative enterprises have difficulty in identifying beneficiaries that have BC abilities, in designing disbursals that will help them perform at the competitive level, and in monitoring how the disbursals are used.[57] When donative enterprises fail to identify those with BC abilities, they may allocate disbursals to beneficiaries who have FC or NC abilities; such disbursals are inefficient, as those with FC abilities do not need them, and assisting beneficiaries with NC abilities is likely to fail because by definition disbursals will not help them reach the competitive level.[58] Similarly, if donative enterprises fail to identify beneficiaries' needs they

[56] It is noteworthy that, as the Greyston bakery is wholly owned by a nonprofit, it is not clear why it does not form as a nonprofit. However, it seems that, since the bakery pays below-market wages to its workers (see *supra* note 44), it is arguably not operating exclusively for an exempt purpose. Second, the foundation may possibly be contemplating a sale of a stake in the bakery to private investors, similar to the sale of the Rubicon bakery.

[57] When the goals of donative enterprises are complex, especially in the case of charities and aid agencies dedicated to alleviating poverty in developing countries, accurate information on beneficiaries is usually not available, and conducting studies of the effects of disbursals can be extremely complicated and costly; see William Easterly, *Was Development Assistance a Mistake?*, American Economic Review, 328 (2007); Claudia Williamson, *Exploring the Failure of foreign Aid: The Role of Incentives and Information*, 23 The Review of Austrian Economics 17, 27-31 (2010); Eric D. Werker & Faisal Z. Ahmed, *What do Non-Government Organizations Do?,* Journal of Economic Perspectives (forthcoming). To be sure, monitoring the beneficiaries is not necessary where it is clear that they will indeed use the disbursal as required. To take a clear example, in the midst of a natural disaster, it is reasonably certain that beneficiaries will generally use disbursals (e.g., food aid) for the purpose for which they were provided.

[58] The rational strategy for a donative enterprise in these circumstances is to provide a subsidy to all beneficiaries in the same amount that would help those who have BC abilities attain FC abilities, i.e., it will assume that all

may provide them a disbursal which is inadequate to help them reach the competitive level. Finally, when it is costly for donative enterprises to monitor how their disbursals are used, these disbursals may be wasted or even used by the recipients for an improper purpose.[59]

Social enterprises are designed to address these information problems. Unlike commercial enterprises, social enterprises serve as a conduit for a subsidy. They thus have committed funds to invest in the costs of gathering information on their patron-beneficiaries. Unlike donative enterprises, they enter into contractual transactions with their beneficiaries, and they are dependent on the performance of their patron-beneficiaries. Social enterprises thus have the tools and the incentives to measure their beneficiaries' abilities, preferences and efforts, as well as the effectiveness of their own disbursals. The means by which social enterprises fulfill their measurement function may be divided into three types:

***(i) Due diligence*:** First, social enterprises can spend their subsidies on doing diligence to study the attributes of their beneficiaries ex ante entering into a contract with them. The subsidy is necessary given the limited information available with respect to the patron-beneficiaries' attributes. Social enterprises then use such information to decide whether to transact with such potential beneficiaries, whether to allocate them a disbursal, and what type of disbursal would help them reach the competitive level.

***(ii) Intensive monitoring*:** Second, social enterprises can transact with their patron-beneficiaries on the basis of imperfect information. In the course of transacting with the patron-beneficiary, the social enterprise monitors his performance, thus acquiring information on his abilities. This information is then used to make decisions on whether to continue the contractual relationship and the type of disbursals to be allocated to beneficiaries. With respect to patron-beneficiaries who turn out to be incapable of performing the contract (i.e., they have NC abilities), the social enterprise terminates their contracts.[60] If the patron-beneficiaries need assistance (i.e., have BC abilities), the social enterprise has an incentive to allocate them appropriate disbursals in order to help them reach the competitive level. On the other hand, the social enterprise has an incentive to minimize its costs, and thus no incentive to make wasteful disbursals, because, unlike donative enterprises, its solvency and profitability are dependent on its ability to generate revenues.[61] If a patron-beneficiary turns out to have FC abilities, then the social enterprise does not allocate a disbursal to that patron-beneficiary. This monitoring entails substantial costs for social enterprises, as many of the patron-beneficiaries naturally turn out to lack the capabilities to perform their transactions with the firm (i.e., they have BC or NC abilities); hence the need for a subsidy.

***(iii) Incentive mechanisms*:** Social enterprises may utilize the relationship with the patron-beneficiaries as the basis for developing incentive mechanisms to reveal information on patron-beneficiaries' abilities and efforts. In order to be eligible for a disbursal, beneficiaries with BC abilities must reveal their abilities to perform the contract and, to the extent possible, their efforts in utilizing the disbursal they receive for its intended purpose; if they were to

---

beneficiaries have BC abilities. The reason is that disbursals in any other amount and type will always be inefficient, whereas such disbursals will at least be efficient with respect to beneficiaries that have BC abilities.

[59] Note that I assume that the subsidy-providers' (i.e., the donors') intention is that their subsidies be used effectively.

[60] J.P. Morgan & The Rockefeller Foundation, *Impact Investments: An Emerging Asset Class* (November 29, 2010), *available at* http://www.rockefellerfoundation.org/news/publications/impact-investments-emerging-asset (last visited Feb. 5, 2012), at 45 (noting that a portion of the population with the lowest income levels will remain reliant on aid, i.e., disbursals from donative enterprises).

[61] By contrast, as discussed above, the sustainability of donative enterprises is dependent on their donors.

represent themselves as having NC abilities, they would not be able to transact with the social enterprise. Those with FC abilities may have an incentive to pretend they have BC abilities in order to qualify for a disbursal. However, various mechanisms, depending on the context, such as a promise of future transactions, better contractual terms to reward performance, joint liability of patron-beneficiaries or reputational rewards for high-quality performance, may mitigate their incentives to understate their abilities. Furthermore, these mechanisms are designed to provide incentives to patron-beneficiaries to exert the required level of effort in their dealings with the firm. As pointed out in the case of WISEs, while incentive mechanisms are generally used by all commercial firms, the costs of such mechanisms are higher in the case of social enterprises, which may have to continuously monitor and evaluate the performance of many patron-beneficiaries who fall short of FC abilities. Commercial firms would not generally undertake such costs without a subsidy.

***(b) Commitment Device and Organizational Form*:** The second limb of the theory concerns the choice of commitment device and organizational form. As stated above, social enterprises may be formed as for-profits or nonprofits. The choice of form is largely a function of capital structure and tax treatment, as long as the firm is committed to transacting with its beneficiaries.[62]

When an organization needs equity capital it will form as a for-profit, whereas when it relies on donative funds and/or income tax exemption it will form as a nonprofit. Social enterprises that transact with a greater proportion of beneficiaries with fewer abilities are likely to form as nonprofits, while those that transact principally with beneficiaries with FC abilities will form as for-profits. The former firms face a larger information problem than the latter. Thus, they are less likely to be profitable and more likely to need larger subsidies, especially donations and income tax exemptions. For nonprofit social enterprises, the non-distribution constraint serves as a commitment device in the same way as in the case of a donative enterprise. However, in the case of for-profit social enterprises, there is a need for an alternative commitment device to assure subsidy-providers that their subsidy will be used for its purpose.

With the growth of social enterprise, the use of alternative types of commitment devices, other than the non-distribution constraint, has increased. As discussed in the context of WISEs, there are three main types of commitment devices: ***(1) Control mechanisms*:**[63] the enterprise is controlled by a nonprofit or social entrepreneurs who have a reputation for being committed to social goals;[64] ***(2) Contractual mechanisms*:** a contract between the social enterprise and a

[62] While some commentators correctly point out that in the context of social enterprise the distinction between for-profits and nonprofits is gradually eroding, they fail to explain how for-profits can commit to pursue a social mission; see Joseph J. Cordes & C. Eugene Steuerle, *Nonprofits and Business: a New World of Innovation and Adaptation*, in NONPROFITS AND BUSINESS (J. Cordes & C. Steuerle eds., The Urban Institute Press 2008); Nicholls, ed., *supra* note 2; Jonathan Conning & Jonathan Morduch, *Microfinance and Social Investment*, Ann. Rev. Fin. Econ. 3.1 (2011), at 3.8.

[63] As pointed out, *supra* note 11, there is some uncertainty as to whether or not under Delaware corporate law, and possibly other jurisdictions, control mechanisms would be upheld by courts, the concern being that those in control of the firm would usurp their controlling position to benefit themselves or oppress the minority. On the other hand, certain European jurisdictions, where many social enterprises are incorporated, explicitly facilitate control mechanisms through a trust or a foundation (see Henry Hansmann & Steen Thomsen, *Virtual Ownership and Managerial Distance: The Governance of Industrial Foundations*, working paper (2012)), and at any rate, the structures analyzed below have not been subject to legal challenge. Thus, for the purposes of this article I will assume that control mechanisms are legal.

[64] Such entrepreneurs effectively pledge their reputation as a commitment not to expropriate the subsidies; in this respect, they may be perceived as being subject to the non-distribution constraint.

nonprofit organization or the government to use subsidies in a certain manner; and ***(3) Certification mechanisms*:** mechanisms by which firms or products become certified as a form of social enterprise by a third-party certifier, typically a nonprofit or a government agency, in accordance with certain criteria.

Although these commitment devices constitute alternatives to the non-distribution constraint, they in fact rely indirectly on organizations that are subject to the non-distribution constraint, i.e., nonprofits or government agencies. Depending on the type of commitment devices, such organizations control social enterprises, enter into a contract with them, or certify them. Accordingly, contrary 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,[65] it remains a key component of the commitment devices associated with social enterprise. The assumption is that organizations which are subject to a non-distribution constraint can be trusted to monitor for-profits to ensure that they use subsidies for their intended purpose.[66]

In principle, it would be ideal if these commitment devices could track how subsidies are actually used. However, gathering such information is likely to be very costly. Commitment devices are therefore designed primarily to verify that social enterprises have incentives to employ subsidies efficiently, as opposed to gathering specific information on the use of subsidies. As argued above, such incentives stem from their commitment to transacting with their patron-beneficiaries. Thus, by verifying that a social enterprise is in fact transacting with a class of patron-beneficiaries, the subsidy-providers receive assurance that it can be trusted to employ subsidies efficiently. Accordingly, commitment devices are designed to identify a class of patron-beneficiaries, such as borrowers or workers, and to verify the transactions of the organization with such beneficiaries. As it is relatively easy to verify transactions with patron-beneficiaries, implementing these commitment devices does not entail excessive costs.

To be sure, commitment devices may go beyond verifying the transaction with beneficiaries. Where the subsidy-providers expect a social enterprise to transact with beneficiaries with BC abilities, and hence that the subsidies will also fund disbursals to beneficiaries, the commitment device must also verify that such disbursals are indeed made. In the case of WISEs, it was shown above that the commitment often includes providing special training to the employees, and in some cases also paying them a fair market wage. Otherwise, there is a risk that social enterprises will transact exclusively with patron-beneficiaries with FC abilities, and that part of the subsidies will be appropriated by those who control the organization.[67]

III. APPLICATION OF THE THEORY TO OTHER FORMS OF SOCIAL ENTERPRISE

In the following sections, I apply the theory to other forms of social enterprise. The discussion illustrates the similarities across different types of social enterprises, as well as the

[65] See Malani & Posner, *supra* note 7; Pallotta, *supra* note 7, at 116-125; Clara Miller, *The Equity Capital Gap*, Stan. Soc. Innovation Rev. 41 (Summer 2008).

[66] Moreover, as stated above, many social enterprises choose to form as nonprofits, thereby further reinforcing the continued importance of the non-distribution constraint as a commitment device.

[67] Social enterprises may in principle commit only to transacting with those who have FC abilities. In that case, a subsidy is still needed to fund the information costs. At any rate, I discuss this risk, which is often referred to as "mission drift," in Part VII below.

differences, especially the various means by which social enterprises measure their beneficiaries' attributes and the different forms of commitment devices they tend to adopt.

A. SOCIAL INVESTMENT: MICROFINANCE INSTITUTIONS, SOCIAL INVESTMENT FIRMS AND COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS

There are three principal forms of social investment: MFIs, CDFIs and social investment firms. MFIs make loans and provide financial services to poor customers in developing countries who lack access to capital. MFIs specialize in making small short-term loans, which are typically unprofitable for commercial banks, but are essential to poor households and small businesses. MFIs have grown substantially in the last few decades and now provide financial services to millions of poor customers in countries such as Bangladesh, Bolivia and Mexico.[68] They may be formed either as nonprofits, such as BRAC and ASA in Bangladesh, or as for-profits, including publicly owned firms, such as Compartamos in Mexico. Nonprofit MFIs will usually be subsidized through income tax exemptions, grants and below-market rate loans. For-profit MFIs, on the other hand, are typically subsidized by their nonprofit owners. Compartamos, currently the most profitable bank in Mexico, and Basix, an Indian MFI, have benefited from various grants, guaranties and below-market loans from their owners, which include NGOs, the International Finance Corporation ("IFC"), social investment firms and social entrepreneurs.[69] MFIs also receive subsidies from government agencies, such as USAID and various development banks.

CDFIs provide various financial products to low-income customers in the U.S. that are generally not available from mainstream commercial banks.[70] There are several types of CDFIs, including regulated financial institutions that offer a wide range of financial products, such as loans, savings and insurance, and unregulated funds that focus mainly on making loans.[71] CDFIs were first created in the late 1960s. Their growth accelerated following the establishment of the CDFI Fund in 1994, a government corporation that provides subsidies to CDFIs mainly in the form of grants and below-market rate loans.[72] Investors in CDFIs are also eligible for various tax credits under the New Market Tax Credit Act.[73] To be eligible for assistance from the CDFI Fund, CDFIs must be certified as satisfying certain requirements to lend in low-income communities.[74] Like MFIs, CDFIs may form either as nonprofits or as for-profit corporations.

---

[68] BEATRIZ ARMENDÁRIZ & JONATHAN MORDUCH, THE ECONOMICS OF MICROFINANCE 12-15 (The MIT Press 2010) (2005); BRIGIT HELMS, ACCESS FOR ALL: BUILDING INCLUSIVE FINANCIAL SYSTEMS 2-5 (World Bank 2006).

[69] For Compartamos, see Richard Rosenberg, *CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits*, Focus Note No. 42 (CGAP, 2007), *available at* http://www.cgap.org/p/site/c/template.rc/1.9.2440 (last visited Feb. 5, 2012). For Basix, see Thomas Dichter, *Basix (India): The Challenges Permanently Pioneering*, Development Finance Forum Case Series (Jan. 20, 2009).

[70] CDFIs also operate in the UK, though on a smaller scale; see http://www.cdfa.org.uk/about-cdfis (last visited Feb. 5, 2012).

[71] See CDFI Coalition, *CDFI Types*, at http://www.cdfi.org/index.php?page=info-3 (last visited Feb. 5, 2012).

[72] Lehn Benjamin et al., *Community Development Financial Institutions: Current Issues and Future Prospects*, 26 J. Urb. Aff. 177, 177-179 (2004).

[73] Julia S. Rubin & Gregory M. Stankiewicz, *The New Markets Tax Credit Program: A Midcourse Assessment*, 1 Community Development Investment Review 1 (2005).

[74] See discussion in subsection III(A)(2).

Regulated financial institutions are usually formed as for-profits, whereas other non-regulated funds tend to be nonprofits.[75]

Social investment firms make investments in businesses and ventures in developing countries, which are often perceived as too risky by commercial investors, such as private equity firms, venture capital firms and institutional investors. They also make investments in other social enterprises, typically at below-market rates. They specialize in making relatively small investments, especially equity investments or loans with equity features.[76] Social investment firms may also be structured either as nonprofits or for-profits. The Acumen Fund is a nonprofit venture fund that invests in businesses in developing countries, such as ambulance services, bed nets, and low-cost eye care. The IGNIA fund also invests in businesses in developing countries, such as healthcare services and organic farming, but is structured as a limited partnership (i.e., a for-profit entity). Another prominent example is Triodos Bank, a for-profit social investment firm that invests in a range of social enterprises, including MFIs and FTSEs.[77] Like MFIs, for-profit social investment firms are usually owned by nonprofit owners, such as foundations and social entrepreneurs, which typically provide the seed capital to the firm and, in many cases, subsidies in the form of below-market returns. Moreover, the employees of such firms, especially the nonprofit ones, provide a subsidy in the form of lower wages than they would earn at commercial investment firms.

1. The Transaction with the Beneficiary and the Measurement Function

***(1) Information Problems in Commercial Transactions*:** Commercial banks have avoided transacting with poor borrowers. Similarly, investment firms tend to ignore small businesses in developing countries. Poor individuals and small businesses may lack access to capital, including in circumstances where they are capable of paying back the investment at commercial rates that reflect their abilities.[78] Commercial banks and investment firms face difficulties in evaluating the abilities of their investees.[79] In particular, it may be costly to distinguish between safe investees, i.e., those with FC abilities, and risky investees (i.e., those with BC or NC abilities). The presence of risky investees, and the firm's inability to observe their abilities, creates an adverse selection problem. Moreover, after providing capital to an investee, commercial firms face a moral hazard when they are unable to observe his efforts. In these circumstances, if the expected profits from his project after paying the firm are likely to be lower than his opportunity costs, the investee has incentives not to exert the required level of effort. In addition, where the firm has limited means of enforcing its contract with the investee, for example, as a result of weak enforcement mechanisms, as is often the case in developing countries, the investee has incentives not to pay the firm at all even if his project is profitable.

---

[75] CDFI Coalition, *supra* note 71.

[76] This funding is sometimes termed "patient capital" to reflect the fact that the social investment firm's expected returns are below-market and the exit strategy is slower than typical exit of commercial investors (eight to 15 years, compared to the 5-7 year average commitment of commercial private equity firms).

[77] Including Basix, mentioned above, and Cafédirect, discussed below.

[78] See Helms, *supra* note 68; C. K. PRAHALAD, THE FORTUNE AT THE BOTTOM OF THE PYRAMID: ERADICATING POVERTY THROUGH PROFITS (Pearson Education 2010) (2005); Benjamin et al., *supra* note 72.

[79] The analysis draws heavily from the literature on credit rationing; see Joseph Stiglitz & Andrew Weiss, *Credit rationing in Markets with Imperfect Information*, 71 American Economic Review, 393 (1981); Chapter 2 in Armendáriz & Morduch, *supra* note 68, at 29-66.

While adverse selection and moral hazard exist in any market, the solutions to these problems that have been devised in developed countries are often absent in developing countries, and therefore the problems are likely to persist. Commercial lenders rely on credit scores allocated by credit bureaus to evaluate investees. They also require collateral or other security to mitigate the risk of default. By contrast, in low-income communities, credit scores are usually not available, as borrowers lack a credit history, employment track record and, in some cases, even proof of identity. Moreover, poor borrowers usually lack collateral to pledge as security for a loan.[80] Similarly, in developed markets, investment firms, such as private equity firms, rely on audited financial information, the track record and reputation of their investees' management, and general market information. By contrast, in developing markets, the balance sheet of businesses may not be a reliable source of information, as financial standards either do not exist or are not enforced, and, more generally, data on the relevant market may be scarce. In addition, when a firm makes an investment in a new small business with no track record, it may have difficulties evaluating the potential of the investee as well as the skills of its management.

***(2) Information Problems in Donative Transactions*:** Donative enterprises can provide capital to individuals and businesses as a disbursal, i.e., essentially in the form of a grant. A form of disbursals is necessary to provide capital to individuals or businesses that cannot pay banks or investment firms commercial rates or who have no collateral (i.e., those with BC abilities). The grantee of the capital is required to commit to using the funds for certain purposes, such as investing in establishing a new business. It is somewhat obvious why a donative enterprise will usually be inappropriate to the task. First, there is a strong adverse selection problem, as donative enterprises have little means of evaluating the riskiness of investees, and those with risky projects have a strong incentive to apply for a grant. In addition, those with FC abilities have incentives to represent themselves as having lesser abilities to qualify for a grant. A donative enterprise is thus likely to make wasteful disbursals to those with NC or FC abilities. Second, after a grant is made, donative enterprises have limited means of monitoring its use. In principle, a donative enterprise can conduct diligence to select only safe projects as well as retain some contractual rights to monitor beneficiaries' projects. Such diligence and monitoring is likely to be extremely costly. Consider a contract with a poor borrower in a developing country to utilize a small amount of money in his weaving business; monitoring and enforcing such contracts, especially where enforcement mechanisms are weak, is practically impossible. Even in the case of small businesses in developed countries, it would be very hard for donative enterprises, presumably with no industry expertise, to prescribe and monitor how grant monies should be used by the beneficiary. In any event, as explained above, donative enterprises have limited incentives to carry out such costly diligence and monitoring.

***(3) The Measurement Function of MFIs, CDFIs and Social Investment Firms*:** Being subsidized, MFIs, CDFIs and social investment firms have the funds to spend on acquiring information on their investee-beneficiaries. Some also utilize the subsidy to make disbursals to investees that have BC abilities. The disbursals usually take the form of technical assistance (e.g., management and marketing advice), training and below-market returns, where the difference between the market return and the actual return represents a disbursal to the borrower.[81]

---

[80] See MARGARET J. MILLER ED., CREDIT REPORTING SYSTEMS AND THE INTERNATIONAL ECONOMY (MIT Press 2003).

[81] Note that standard commercial rates of return may be lower than the rates charged by MFIs, CDFIs and social investment firms. For example, the interest rates on loans by MFIs, which range between 25% and 100%, are much

As stated above, there are three principal ways in which social enterprises fulfill their measurement function: ***(i) Due diligence*:** First, a social enterprise may invest in due diligence to study the capabilities of patron-beneficiaries. CDFIs use alternative mechanisms to collect information on the creditworthiness of low-income borrowers, such as utility bills and rental payments.[82] CDFIs also rely on house visits and personal interaction with borrowers in specific communities. To reduce the costs of information, they also tend to specialize in specific industries, especially housing finance.[83] Social investment firms invest a great deal of effort and resources in due diligence, including vetting the character and qualifications of the management team and financial analysis of the fundamentals of their investees, especially where such investees are located in jurisdictions with weak accounting standards.[84] MFIs conduct a less onerous diligence process and rely more extensively on mechanisms employed after entering into a contract with the patron-beneficiary.[85] The reason seems to be that MFIs make very small loans to borrowers, so conducting detailed diligence with respect to every loan would be too costly.

***(ii) Intensive monitoring*:** Second, social enterprises transact with their investee-beneficiaries on the basis of imperfect information and use the latter's ongoing performance as information on their abilities and efforts. MFIs and CDFIs are committed to providing loans to low-income borrowers. In the initial stage, the MFI or CDFI has limited information as to whether borrowers have FC, BC or NC abilities. The assumption often is that borrowers have BC abilities, and they are therefore offered a loan at below-market terms, which reflects a disbursal to the borrowers, such as technical assistance. MFIs and CDFIs evaluate the performance of their borrowers, and over time they accumulate data on borrowers' business projects and repayment rates. MFIs use frequent repayment installments of very small amounts, in order to allow their credit officers an early opportunity to assess borrowers' performance.[86] Repayment of the loan on time is a clear indication that a borrower has at least BC abilities, and he may then be given additional loans. At some stage, it may become evident that borrowers no longer need a disbursal. At that stage they may indeed obtain loans at commercial rates; for example, the interest rates may be lowered and the loan size increased, not as a disbursal to the borrower, but to reflect the lower risk of lending to a borrower with higher abilities. On the other hand, if borrowers default they receive no further loans.[87]

---

higher than the rates charged by commercial banks. Nonetheless, such rates incorporate a disbursal because the market rates banks would charge to poor borrowers are higher than standard commercial rates to reflect the higher risk associated with lending to the poor.

[82] Katy Jacob, *Reaching Deeper: Using Alternative Data Sources to Increase the Efficacy of Credit Scoring* (The Center for Financial Services Innovation, March 2006), *available at* http://cfsinnovation.com/node/2510.

[83] See Ronald Grzywinski, *The New Old-Fashioned Banking*, Harv. Bus. Rev. 87 (May-June 1991); Michael Klausner, *Market Failure and Community Investment: A Market-Oriented Alternative to the Community Reinvestment Act*, 143 U. Pa. L. Rev. 1561 (1995), at 1578-1579.

[84] J.P. Morgan & The Rockefeller Foundation, *supra* note 60, at 70. For a useful illustration of the process, see the following case studies explaining the valuation process by the Acumen Fund of Ziqitza Healthcare Limited ("ZHL"): William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, Michigan Ross School of Business note 1-428-788 (May 2009); William Davidson Institute, *Acumen Fund: Valuing a Social Venture (B)*, Michigan Ross School of Business note 1-428-872 (Oct. 2009).

[85] To be sure, some MFIs do rely on diligence by sending loan officers to the villages and leaning about the applicants' characters from individuals in the relevant community; see Armendáriz & Morduch, *supra* note 68, at 159-160.

[86] Armendáriz & Morduch, *id.*, at 145-153.

[87] For example, Shore Bank, a known CDFI, experimented with loans to small businesses that suffered from high default rates before it started focusing on housing finance; see Grzywinski, *supra* note 83.

Social investment firms tend to make larger investments than MFIs and CDFIs, and therefore rely more on diligence ex ante an investment. But diligence is inevitably imperfect. Thus social investment firms, like standard commercial investment firms, exercise substantial monitoring over their investees. Again, the costs of monitoring small businesses with little or no track record is higher than with respect to seasoned businesses, and hence the need for a subsidy. The monitoring may consist of appointing directors to the board of the investee and requiring consent to certain business decisions, including not only major transactions, such as a sale or merger, but also managerial decisions regarding business strategy.[88] Social investment firms may divert their resources to other ventures or liquidate a business if it turns out to be unprofitable, in the same way that venture capital and private equity firms manage their portfolios. Thus, performance ex post entering into a contract reveals information on the investee's capabilities and efforts.

***(iii) Incentive mechanisms*:** MFIs, in particular, have developed specialized incentive mechanisms to reveal information on patron-beneficiaries. A notable example is group lending. The gist of group lending is that loans are made to a group of borrowers rather than to an individual.[89] Each borrower within the group is jointly liable for the debts of all other borrowers. Group lending gives rise to a process of assortative matching whereby safe (i.e., more capable) borrowers form groups with other safe borrowers, and risky (i.e., less capable) borrowers form groups with other risky borrowers. The risky borrowers effectively pay higher rates than the safe ones because their groups default more often, and each faces liability for the group members' defaults. In this way, group lending generates information on borrowers' abilities and mitigates adverse selection, even though MFIs have limited information on borrowers when loans are initially made. Group lending also reduces moral hazard, as group members monitor each other to make sure they repay their loans. It further creates social pressure on borrowers to repay their loans, as repayments are usually made in group meetings, and failure to pay entails a social stigma.[90] Although the group lending mechanism has proven to be effective in ensuring very high repayment rates at MFIs, the transaction costs of group lending, including conducting group meetings to collect payments and sending loan officers to rural communities, are high.[91] This again explains the need for a subsidy.

MFIs have gradually shifted away from group lending to increasing use of more standard incentive mechanisms and reliance on repeated interactions with their customers. Borrowers are promised an opportunity to borrow more capital on better terms if they repay their existing loans on time.[92] Thus loans may be made for larger amounts, longer terms, and at better interest rates.[93] This addresses the hazard that borrowers will not pay once project returns have been realized. Alternatively, MFIs threaten not to refinance their customers in the future if they do not repay; a

---

[88] For example, the term sheet for the issuance of shares to the Acumen Fund by ZHL includes, *inter alia*, the appointment of a director by the Acumen Fund, veto rights to the Acumen Fund with respect to any major transaction, such as issuance of shares or any amendments to articles of association, a specific target date for an IPO, including the right of the Acumen Fund to approve the investment banker for the IPO, and giving the Acumen Fund access to the premises and any corporate records; see William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, *supra* note 84, at 21-24.

[89] For a detailed explanation, see Chap. 4 in Armendáriz & Morduch, *supra* note 68.

[90] Armendáriz & Morduch, *id.*, at 157.

[91] Nitin Bhatt & Shui-Yan Tang, *The Problem Of Transaction Costs In Group-Based Microlending: An Institutional Perspective*, 26 World Development 623 (1998).

[92] Armendáriz & Morduch, *supra* note 68, at 143-144.

[93] By contrast, group lending is generally associated with poor customers, smaller loans and higher costs relative to loan size.

powerful threat in the case of borrowers with multiple projects.[94] Moreover, some MFIs continue to use group meetings and public repayments in order to utilize the threat of social stigma to induce higher repayment rates, even when borrowers are not jointly liable.[95]

2. Commitment Device and Organizational Form

MFIs and social investment firms principally use the nonprofit form or control mechanisms. ASA, BRAC and the Acumen Fund, for example, are nonprofits. The chief reason is that all these firms transact with beneficiaries with lesser abilities, and provide them with larger disbursals. ASA and BRAC provide principally very small loans to poor borrowers, mainly women, charge relatively low interest rates, and provide a range of services to their borrowers, including schooling, training and help with business and marketing plans.[96] The Acumen Fund targets investments, such as bed nets or ambulance services, which are unlikely to generate substantial returns as compared with other investments in emerging markets. All these firms rely partly on donations and tax exemptions as a source of funding.

By contrast, firms that seek to earn commercial returns and do not rely on donations (other than perhaps as seed capital) or tax exemptions are formed as for-profits. Most of these firms adopt control mechanisms. Compartamos is a rather extreme example of a for-profit social enterprise that focuses on serving those with FC abilities and provides them with few or no disbursals. Compartamos lends mainly to the moderately poor and the vulnerable non-poor.[97] It charges high interest rates and its profits have in fact been higher than the profits of other commercial banks in Mexico.[98] Compartamos is owned by a consortium of NGOs, the IFC, foundations and social entrepreneurs. Although it underwent an IPO in 2007, the core nonprofit shareholders continue to own 51% of the shares.[99] This mechanism provides reasonable assurance that the shareholders will not change the firm's mission if there are opportunity costs to lending to low-income persons. Similarly, the IGNIA Fund, which seeks to generate returns which are equivalent to those of private equity firms, is formed as a for-profit, but is partly owned by the IFC, foundations and social entrepreneurs.[100] Another way to implement a control mechanism is to place the voting rights in the hands of a nonprofit organization. The shares of Triodos Bank are held by a foundation which makes voting decisions on behalf of the holders of depository receipts, and is required to exercise its voting rights in a manner consistent with its

---

[94] Armendáriz & Morduch, *supra* note 68, at 140-143.
[95] Armendáriz & Morduch, *id.*, at 157-158.
[96] Armendáriz & Morduch, *id.*, at 22.
[97] Banco Compartmaos S.A., Offering Circular (April 19, 2007), *available at* http://www.compartamos.com/wps/portal/InvestorsRelationsBank/CorporateInformation/OfferingCircular (last visited Feb. 5, 2012), at 77.
[98] Many of the investors in Compartamos earned millions of dollars in its IPO in 2007, and Compartamos has been criticized for favoring the interests of its owners at the expense of its customer-borrowers (see Elisabeth Malkin, *Microfinance's Success Sets Off a Debate in Mexico*, N.Y. Times, Apr. 5, 2008); however, it is arguable that even these investors, some of whom include private equity financiers, had higher opportunity costs when they made their investment, and to this extent they may in fact be regarded as having provided a subsidy to the firm.
[99] More specifically, the core shareholders agreed that as long as the IFC remains a shareholder or creditor of Compartamos, the aggregate shareholding of the core shareholders must not fall below 51%. Moreover, they agreed to vote in the same manner for a period of two years following the IPO; see Compartamos Offering Circular, *supra* note 97, at 127-128.
[100] Interview with Alonso Bustamante Guerra of the IGNIA Fund, October 19, 2009; see also http://www.ignia.com.mx/bop/investors.php (last visited Feb. 5, 2012).

ethical goals and mission, its business interests, and the interests of the depository receipt holders.[101]

On the other hand, CDFIs use a commitment device that combines contractual mechanisms and certification. The CDFI Fund certifies financial institutions as CDFIs. The certification makes certain institutions eligible to receive grants, investments, tax benefits, or technical assistance from the CDFI Fund. Under the regulations, customers of CDFIs are required to be low-income persons, broadly defined by reference to various measures of wealth. For example, an applicant for CDFI certification must serve a Target Market, which is defined to include areas where the percentage of the population living in poverty is at least 20%, where the median family income is below 80% of the national average, or where the unemployment rate is 1.5 times the national average.[102] The regulations use contractual mechanisms, however, with respect to the terms that should be provided to customer-beneficiaries. The CDFI Fund must enter into an Assistance Agreement with each CDFI that is awarded assistance.[103] The Agreement incorporates the business plan submitted to the CDFI Fund, including performance goals to be accomplished by the CDFI, the scale of its activities, and the terms offered to low-income borrowers. In addition, CDFIs must annually submit information and documents to the CDFI Fund to enable it to review their progress.[104]

There are two main reasons for the difference in commitment devices between MFIs and social investment firms as compared to CDFIs. First, control mechanisms allow social enterprises much greater flexibility in deciding which beneficiaries merit assistance and what kind of disbursals should be extended to them. For example, whereas Compartamos focuses on borrowers with FC abilities, other for-profit MFIs, such as Basix, transact with customers who need greater assistance (i.e., those with BC abilities). Basix provides its borrowers with below-market rate loans and a wider range of services, including insurance and comprehensive technical assistance.[105] Similarly, whereas the IGNIA Fund seeks to generate competitive returns, Triodos bank earns moderate returns on equity.[106] The CDFI regime, on the other hand, is more specific in nature. The certification of CDFIs determines a specific standard with respect to the class of beneficiaries, whereas the contractual mechanism (i.e., the Assistance Agreement) imposes particular requirements relating to the terms afforded to the customer-beneficiaries. In developed countries where measures of poverty and income are widely available, and the banking system is well developed, there is better information on which customers should count as beneficiaries and what terms should be afforded to them. MFIs and social investment firms operate in developing countries, where there is a greater variety of investees in terms of abilities, and it is therefore harder to create specific standards. Second, the subsidy to MFIs and social investment firms is usually provided by their nonprofit owners, whereas most of the subsidies to CDFIs flow from the CDFI Fund. Control mechanisms serve as a commitment principally to the

[101] Triodos Bank Annual Report 2010, *available at* http://report.triodos.com/en/2010/servicepages/welcome.html (last visited Feb. 5, 2012), at 119-121. It is noteworthy, though, that the depository receipt holders appoint the members of the foundation.
[102] 12 CFR §1805.201 (2005).
[103] 12 CFR §1805.802 (2005).
[104] 12 CFR §1805.804 (2005).
[105] Dichter, *supra* note 69.
[106] Triodos Bank Annual Report 2010, *supra* note 101.

owners who provide a subsidy to the firm.[107] The nonprofit owners of Compartamos or Basix can ensure that their firm will not change its business and cease to serve low-income customers. Certification and contractual mechanisms provide assurance to external subsidy-providers, such as government agencies, that have no direct control over the firm.

B. FAIR TRADE SOCIAL ENTERPRISES

FTSEs buy their input from small producers in developing countries at fair prices and sell their products at a premium to customers in developed countries.[108] Sales of fair trade products have increased in the last 20 years, and annual sales of certified fair trade amount to several billion dollars.[109] Fair trade products include coffee, cocoa, tea, sugar, bananas, chocolate, and handicrafts. Most fair trade products are certified, especially hot drinks and fruits. The most popular certification is operated by the Fairtrade International ("FLO"), a nonprofit organization that licenses the Fairtrade mark to firms that sell products purchased from small producers. With fair trade becoming part of mainstream retail, large corporations, such as Starbucks and Nestle, sell fair trade products. There are also many firms that sell exclusively fair trade products, for example, Cafédirect, one of the largest hot drink companies in the UK, and Traidcraft plc, a trading company that imports and sells a wide range of products, such as handicrafts and food. FTSEs receive most of their subsidies from socially conscious consumers who pay a premium for fair trade products. For example, in 2002 fair trade arabica coffee received an average of nearly $0.72 per pound.[110] FTSEs also receive subsidies from their nonprofit owners or an affiliate thereof. For example, the Traidcraft Foundation established Traidcraft Exchange, a nonprofit that provides training and technical assistance to producers that sell their products to Traidcraft plc. Most FTSEs are formed as for-profits, as in the case of Cafédirect and Traidcraft plc, though some may form as nonprofits.[111]

1. The Transaction with the Beneficiary and the Measurement Function

***(1) Information Problems in Commercial Transactions*:** Large multinational corporations tend to avoid transactions with small producers in developing countries, for reasons again related to the well-known information problems of adverse selection and moral hazard. Commercial firms buy their supplies from well-established commercial producers or middlemen and avoid buying their input directly from small producers.[112] When a firm buys supplies of

[107] Note, however, that in some cases, for example, the Greyston bakery discussed above and Traidcraft discussed below, control mechanisms may serve as a commitment device to the customers, where the firm has a strong reputation for pursuing social goals.

[108] See generally, ALEX NICHOLLS & CHARLOTTE OPAL, FAIR TRADE: MARKET-DRIVEN ETHICAL CONSUMPTION (Sage 2005).

[109] See the website of the Fairtrade International at http://www.fairtrade.net/facts_and_figures.html (last visited Feb. 5, 2012).

[110] Daniele Giovannucci & Freek Jan Koekoek, *The State of Sustainable Coffee: A Study of Twelve Major Markets*, (IISD, UNCTD and ICO 2003) *available* at http://www.iisd.org/publications/pub.aspx?pno=579 (last visited Feb.5, 2012), at 40.

[111] See *infra* note 128.

[112] Small producers in developing countries sell their products to middlemen known as "coyotes" who are often in a position to exploit their monopsonist power. Thus, a common explanation for fair trade is that it is a solution to monopsonist pricing (see Nicholls & Opal, *supra* note 108, at 33-34; Mark Hayes, *On the Efficiency of Fair Trade*, 64 Review of Social Economy 447 (2006)). While it is true that small producers face monopsonist pricing, this view

input it is generally able to inspect the quality of that input. However, in a fragmented market of numerous suppliers, and with respect to products whose quality is not observable by cursory inspection, it may be too costly to evaluate each item of input.[113] Coffee beans and bananas are two notable examples.[114] If corporations were to buy such products directly from small producers there would be an adverse selection problem. They would have difficulty distinguishing between producers with FC and those with BC or NC abilities, especially as many small producers in developing countries do not meet the quality standards of export markets.[115] In principle, small producers may try to establish a reputation for high quality by using marketing and branding tools, but with few exceptions, they tend to be too segregated or too poor to establish a brand, even if they pool their resources by forming cooperatives. In addition, there is a moral hazard problem. Commercial firms usually rely on the orderly supply of input without having the ability to inspect its quality. They therefore rely on the producers to exert a sufficient level of effort.[116] If small producers face higher opportunity costs, for example, if the market prices of the product decrease, they may elect not to supply the relevant product or supply products of inferior quality, especially if enforcement of the transaction is costly. In the presence of information problems, firms adjust prices downward to reflect the lower quality. Lower prices in turn induce producers to shirk on quality or exit the market altogether,[117] a process which ultimately leads to rationing and collapse of the market.

***(2) Information Problems in Donative Transactions*:** In most cases, small producers in developing countries lack the abilities required to produce at the competitive level. There are multifold reasons for this.[118] Many small producers lack knowledge about the taste and quality requirements in export markets. They do not have sufficient capital to purchase high quality raw materials or efficient technology.[119] Small producers may also face difficulties in obtaining credit, which furthers restricts their ability to invest in quality. Moreover, they lack access to insurance markets; unable to insure against certain risks, such as drought or a decrease in commodity prices, small producers tend to be risk-averse and are thus less likely to shift their production when other profitable opportunities emerge. Accordingly, as noted above, the quality of their products is often likely not to meet the quality standards in export markets.

Donative enterprises may assist producers by providing them with technical assistance and training with respect to quality standards and production methodologies, or by providing

---

ignores a more fundamental question, which is why there is no competition in the first place. If multinational corporations traded directly with small producers, competition for the products of small producers would raise prices. The problem is that information problems preclude direct trading between corporations and small producers. This problem is similar to the problem of monopolist moneylenders with respect to lending to poor borrowers (see Armendáriz & Morduch, *supra* note 68, at 31-33). When commercial lenders refrain from lending to the poor because of information problems, monopolist moneylenders may step in and lend at exploitative rates.

[113] BENOIT DAVIRON & STEFANO PONTE, THE COFFEE PARADOX: GLOBAL MARKETS, COMMODITY TRADE AND THE ELUSIVE PROMISE OF DEVELOPMENT (Zed Books 2005), at 129-131.

[114] Coffee beans are sold by producers in cherry form, so their taste is hard to evaluate at the time of the sale. Bananas are susceptible to diseases and infections (see Nicholls & Opal, *supra* note 108, at 81, 87). Accordingly, both coffee and bananas are usually grown in large plantations owned by or affiliated with the importers.

[115] See Nicholls & Opal, *id.*, at 35-38.

[116] For example, a less labor-intensive harvesting may result in lower quality coffee.

[117] For example, by focusing on subsistence agriculture; Hayes, *supra* note 112, at 453.

[118] See Nicholls & Opal, *supra* note 108, at 34-39.

[119] Ashish Karamchandani, et al., *Emerging Markets, Emerging Models: Market-Based Solutions to the Challenges of Global Poverty* (Monitor Group, March 2009), *available at* http://www.monitor.com/tabid/69/ctl/ArticleDetail/mid/705/CID/20092503171300803/CTID/1/L/en-US/Default.aspx (last visited Feb. 5, 2012), at 5.

them with high quality input or new technologies. Such disbursals can only be used by producers to improve their performance rather than for personal consumption, and producers therefore have little incentive to misstate their abilities to qualify for such disbursals.[120] Such disbursals are nonetheless subject to information problems. Donative enterprises may be unable to properly evaluate the abilities of their beneficiaries and create a suitable training program.[121] To gather information on the efficacy of any such technical assistance, donative enterprises would need to test whether their beneficiaries in fact transact with commercial firms following the receipt of such assistance. That again may require monitoring and conducting expensive studies of how beneficiaries' abilities have changed ex post a disbursal. Not only are such studies expensive, but, as discussed above, they may not serve donative enterprises' fundraising efforts if they reveal information on the ineffectiveness of disbursals. Moreover, technical assistance in itself is not useful if commercial enterprises continue to ignore small producers, even if the latter reach the competitive level. In fact, as long as commercial enterprises don't actually transact with poor producers there is no way of knowing whether technical assistance is effective or not.

***(3) The Measurement Function of FTSEs*:** As FTSEs are committed to transacting directly with small producers in developing countries, they have incentives to utilize the subsidies they receive to acquire information on producers' abilities, as their sustainability is dependent on their producers' performance. Most small producers that transact with FTSEs have BC abilities, as most of them face capital constraints and lack the necessary industry knowledge. FTSEs also have incentives to use the subsidy for making disbursals to their producers with BC abilities in order to enable them to perform. Disbursals to such producers usually take the form of paying a floor price for products if market prices are lower than the floor price, a soft commitment to transacting with producers on a long-term basis if performance is adequate, paying a social premium to support community development projects in producers' communities, and technical assistance.[122]

Like the above kinds of social enterprise, FTSEs too measure their patron-beneficiaries' abilities and efforts in three main ways: ***(i) Due diligence*:** FTSEs invest in due diligence to study the capabilities of producers. They send expeditions to developing countries to visit farmers and other producers in order to evaluate the quality of their products. For example, the quality of the coffee may be sampled and graded, and the results are communicated to the producers, so that they can improve quality. This diligence need not be fully carried out by the FTSE itself, and a third party, typically a donative enterprise, may take responsibility for liaising with the farmers

[120] By contrast, disbursals that take the form of cash payments are subject to strong adverse selection and moral hazard problems, as producers have incentives to understate their abilities to qualify for a disbursal, and to use the cash for personal consumption rather than to invest in enhancing the quality of their products.

[121] Training programs have been found to suffer from lack of knowledge, difficulties in attributing impact to training efforts, low quality advice to farmers, little effort to learn from their experience and lack of suitable inputs; see Jock R. Anderson et al., *The Rise and Fall of Training and Visit Extension: An Asian Mini-drama with an African Epilogue*, World Bank Policy Research Working Paper 3928 (May 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=917499); IEG, *World Bank Assistance to Agriculture in Sub-Saharan Africa*, (2007), *available at* http://web.worldbank.org/WBSITE/EXTERNAL/EXTOED/EXTASSAGRISUBSAHAFR/0,,menuPK:4422655~pagePK:64829575~piPK:64829612~theSitePK:4422577,00.html (last visited Feb. 5, 2012), at 44, 54-56.

[122] See Nicholls & Opal, *supra* note 108, and the Fairtrade Standard (May 1, 2011), *available at* http://www.fairtrade.net/generic_trade_standards.0.html (last visited Feb. 5, 2012). The social premium must be invested in the producers' business and community.

and assisting with sampling and training.[123] In addition, where fair trade products are certified, some of the diligence on producers is facilitated through the certifier. The FLO, for example, assists in creating networks between farmers and importers. Additionally, to obtain certification, producers are required to meet certain environmental standards, including the nonuse of certain hazardous pesticides. They are also required to pay fees to the FLO as well as form a democratically-run cooperative with which the FTSE transacts.[124] While these requirements are not directly linked to measuring the quality of crops, as they entail relatively high costs to producers, they indirectly provide a signal of the value that producers attach to transacting with the importers, and of their belief that their crop meets the required quality.

***(ii) Intensive monitoring*:** FTSEs transact with small producers on the basis of imperfect information and gather information on their abilities and efforts in the course of the relationship. FTSEs almost invariably sell high quality products, mainly to address concerns about the quality of products produced by small producers.[125] Therefore, they depend on the quality of the input they use. If the quality of the input is low, naturally the quality of the end product will be low too, and to that extent it is inevitable that firms will learn about producers' abilities. Although the relationship between the importers and producers is generally expected to be long-term, and FTSEs are expected to provide technical assistance to producers,[126] there is no commitment to transacting with producers who turn out to be unable to perform (i.e., producers with NC abilities). In the course of transacting with producers, FTSEs learn which producers are more capable than others, as the quality of the input supplied to the firm affects the quality of the end product that is sold to consumers. If a producer provides products of the required quality in timely fashion, the firm will continue to transact with that producer.

***(iii) Incentive mechanisms*:** The transactions with small producers are designed to give them incentives to reveal their abilities. First, fair trade standards require small producers to be members of cooperatives, an arrangement under which producer-members own shares in an umbrella business with equity ownership proportional to the quantity of product they sell through the cooperative.[127] The function of the cooperative, other than to enable producers to pool resources (e.g., share transportation costs), is to address information problems. The formation of cooperatives leads to assortative matching among producers, similar to group lending in the case of MFIs. Producers with high or at least sufficient capabilities (i.e., BC abilities) will partner with producers with similar capabilities in order to ensure their cooperative will produce products of sufficient quality, so that FTSEs continue to transact with them. Once the cooperative starts transacting, producers have incentives to monitor each other to ensure that each of them supplies products that satisfy buyers' quality requirements and does so in timely

[123] For examples of cooperation of Starbucks with various donative enterprises, see James E. Austin & Cate Reavis, *Starbucks and Conservation International*, Harvard Business School Case 9-303-055 (2002), at 12; Paul Argenti, *Collaborating with Activists: How Starbucks Works with NGOs*, 47 California Management Review 91 (2004), at 108-110. Note that collaboration between a for-profit and a donative enterprise constitutes a social enterprise and is distinguishable from a donative enterprise which provides training or technical assistance without a contract with a firm (i.e., an FTSE) that commits to transacting with the producers and buying the products; see the discussion of Technoserve in section V(C) below.

[124] Nicholls & Opal, *supra* note 108, at 129-137.

[125] Nicholls & Opal, *id.*, at 24.

[126] Section 4 of the Fairtrade Standard, *supra* note 122.

[127] Nicholls & Opal, *supra* note 108, at 24; Section 4.2 of the Fairtrade Standard for Small Producer Organizations (May 1, 2011), *available at* http://www.fairtrade.net/generic_producer_standards.0.html (last visited Feb. 5, 2012).

fashion. Thus, the requirement to form cooperatives mitigates both adverse selection and moral hazard.

Second, fair trade standards contain requirements which enhance producers' incentives to invest in the quality of their products by insuring producers against risks outside their control. FTSEs operate on the principle that the relationship between the firms and the producers is long-term. Importers are expected to continue to transact with producers that supply products of the desired quality, even if the opportunity costs of transacting with other producers are lower. Although this requirement is not legally binding, importers that cut-off small producers in such circumstances may face reputational costs. Moreover, under the Fairtrade standards, importers must pay either the market price or floor price of a commodity, whichever is higher, and must pre-finance up to 60% of orders. The reason for this is not only to transfer wealth to the producers; rather, the primary reason is that producers, who face risks outside their control and lack access to credit and insurance products, may have to cut costs at the expense of quality and sell their products at low prices. Such income-smoothing mechanisms and price insurance to producers assure producers that they will not face short-term capital constraints or severe loss as a result of circumstances outside their control, such as a sharp decline in commodity prices or a drought. Being given a price that reflects their efforts and the promise, albeit informal, of future transactions if they perform well, producers have stronger incentives to meet the quality requirements set by FTSEs.

2. Commitment Device and Organizational Form

Most FTSEs are for-profits, the reason being that, although most small producers have BC abilities, the extent to which they fall short of FC abilities is relatively limited. For example, many farmers have reasonable capabilities to produce crops, and with some training they can reach FC abilities. Moreover, a substantial part of the subsidies an FTSE receives, and in a large number of cases all the subsidies, flow from ethically-driven consumers. Thus, the need for donations is relatively limited.[128]

Certification is the most common commitment device used by FTSEs. As noted above, the best known certification is operated by FLO. Firms that sell products that comply with the FLO standards may be licensed to attach the Fairtrade mark to such products to signal to consumers that they are deserving of a premium over other products (i.e., a subsidy).[129] The FLO's certification possesses the two main elements of commitment devices. First, it certifies the class of patron-beneficiaries as "small producers", loosely defined as producers that produce labor-intensive products, but employ a limited number of permanent workers.[130] Second, the FLO ensures through audits and inspections that the importer provides producers with the disbursals specified in the Fairtrade standards, including the fair trade minimum price, a social

[128] There are exceptions to this. Indego Africa is a nonprofit that sells jewelry, accessories and home décor produced by women's cooperatives in Africa. These cooperatives are especially poor and need substantial training. Only 24 percent of Indego's revenues come from sales, and the remainder comes from donations. See Kathleen McGinn & Rachel Gordon, *The Indego Africa Project*, Harvard Business School Case Study 9-911-011 (2010).

[129] Certification for products rather than firms enables firms to have both a social enterprise and a profit-maximizing enterprise operated by the same organization (e.g., Starbucks selling fair trade products). This is possible in the case of FTSEs because fair trade products can be segregated and traced to small producers.

[130] Section 2.1 of the Fairtrade Standard for Small Producer Organizations, *supra* note 127.

premium, and, when requested, pre-financing of up to 60% of the orders.[131] Importers must report to the FLO on orders supplied by certified producers and the price paid on such orders.

The widespread use of certification among FTSEs is again due partly to the fact that most of the subsidies to FTSEs come from the consumers. It is noteworthy that the certification is per each unit of product. Certification signals to consumers which products are deserving of a subsidy. In addition, this allows any for-profit firm, such as Starbucks, to sell fair trade products, but later abandon this line of business. Second, unlike banking and investment where industry structure and business practice vary from one firm to another, coffee and other products are traded on global commodity exchanges. As a result, it is feasible to create uniform standards that define small producers, identify commodity prices, and prescribe other standards relating to financing and premiums.

To be sure, some FTSEs may wish to diverge from the FLO standards either by subjecting themselves to more demanding standards (e.g., transacting with poorer farmers) or creating a long-term commitment to not transacting with small farmers. To this end, certain FTSEs rely on control mechanisms and reputation. Both Traidcraft and Cafédirect use a guardian share mechanism as a commitment device. The guardian share of Traidcraft is held by a nonprofit, the Traidcraft Foundation,[132] and the guardian share of Cafédirect is held by a subsidiary of Oxfam International and Cafédirect Producers Ltd., a cooperative of producers that transact with the firm.[133] The guardian share has the right to block any proposal, including a takeover that would compromise the firm's social mission.[134] Moreover, in the case of Cafédirect no shareholder may hold more than 15% of the shares.[135] I emphasize that the commitment in this case is primarily to the nonprofit owners themselves who partly provide the subsidy. Both Traidcraft and Cafédirect are publicly traded on a matched bargain exchange, and therefore the firms' subsidy-providers, such as the Traidcraft Foundation, want to ensure that none of the other shareholders will be able to pressure management to compromise the firm's social mission. By contrast, firms that use product certification, such as Starbucks, may abandon their fair trade business without expropriating any subsidies, as the subsidies are per product. It is noteworthy that while Cafédirect products remain subject to the Fairtrade mark, Traidcraft avoids the use of the Fairtrade mark altogether, relying exclusively on control mechanisms and reputation to market their fair trade products. Traidcraft thus appears to be able to use control mechanisms coupled with reputation to attract subsidies from consumers.

---

[131] Section 4.2 and 4.3 of the Fairtrade Standard, *supra* note 122. An alternative fair trade certification mechanism named UTZ CERTIFIED does not include such pricing or financing requirements, and to that extent it seems to apply to FTSEs that transact only with small producers who have FC abilities.

[132] Traidcraft plc Financial Statements 2010-2011, *available at* http://www.traidcraft.co.uk/about_traidcraft/financial_accounts (last visited Feb. 5, 2012), at 12.

[133] Cafédirect Annual Report 2009-2010, *available at* http://www.cafedirect.co.uk/discover-our-difference/our-beliefs-2/shareholders (last visited Feb. 5, 2012).

[134] Traidcraft plc Financial Statements 2010-2011, *supra* note 132, at 12; Cafédirect Annual Report 2008-2009, *available at* http://www.cafedirect.co.uk/discover-our-difference/our-beliefs-2/shareholders (last visited Feb. 5, 2012). The social mission of Cafédirect, termed the "gold standard," goes beyond adherence to the FLO standards to include investing one third of the profits in growers' communities.

[135] Cafédirect Annual Report 2008-2009, *id.*

C. LOW-COST SELLERS

There are many types of social enterprise that sell low-cost products or services to poor customers in developing markets.[136] I will focus on several examples. VisionSpring is a low-cost manufacturer and seller of affordable reading glasses, which help address the problem of Presbyopia, or blurry up-close vision.[137] A to Z Textile Mills of Tanzania is a producer of long-lasting insecticide-treated bed nets, which are sold at discounted prices to vulnerable groups.[138] The Aravid Eye Care provides low-cost eye-care services, including screening 2.7 million people and performing 285,000 surgeries annually. Ziqitza Healthcare Limited ("ZHL") is a private ambulance service provider, operating ambulances in areas lacking high-quality emergency services. LifeSpring Hospitals is a network of hospitals in India, specializing in maternal and child healthcare, that serves mainly lower-income women who have limited access to healthcare.

Low-cost sellers may be incorporated as either for-profits or nonprofits. Whereas VisionSpring and The Aravind Eye Care are nonprofit organizations, A to Z, ZHL and LifeSpring Hospitals are for-profit firms. Nonprofit low-cost sellers are subsidized primarily by donations, grants and tax exemptions, whereas for-profits are usually subsidized by their investors, though they may qualify for grants or other government subsidies. Some firms, like A to Z, may also benefit from government voucher schemes that subsidize prices for vulnerable groups.[139] Moreover, many low-cost sellers are subsidized by a wealthier segment of their consumers. The wealthier patients of The Aravind Eye Care, which is financially self-supporting, essentially subsidize the free services to other patients. Similarly, ZHL and LifeSpring Hotels implement a tiered pricing system, whereby they charge their poorer customers a lower price than they charge their more affluent customers.[140]

1. The Transaction with the Beneficiary and The Measurement Function

(1) Information Problems in Commercial Transactions: Commercial retailers and service-providers have long avoided transacting with poor customers in developing countries, leaving many poor customers underserved.[141] While multinationals are increasingly penetrating emerging markets, many rural markets continue to be ignored. Although poor customers in developing markets may not be able to afford products and services produced in developed markets, many of them have substantial purchasing power.[142] Commercial firms may in principle step in and produce affordable products designed specifically for these customers at a profit. Suppose that a commercial firm, say an eye-care company, sells a product to customers who

---

[136] See generally, Karamchandani, et al., *supra* note 119; Prahalad, *supra* note 78.

[137] See William Davidson Institute, *Scojo Foundation: A Vision for Growth at the Base of the Pyramid*, Michigan Ross School of Business note 1-428-610 (Apr. 2008); Nico Clemminck & Sachin Kadakia, *What Works: Scojo India Foundation* (Columbia Business School, June 2007).

[138] See Winifred Karugu & Triza Mwendwa, *A to Z Textile Mills: A Public Private Partnership Providing Long-Lasting Anti-Malaria Bed Nets to the Poor*, (UNDP, Sep. 2007), *available at* http://cases.growinginclusivemarkets.org/documents/120 (last visited Feb. 5, 2012).

[139] Gita Johar & Joanna Harries, *Dial 1298 for Ambulance Marketing EMS in Mumbai*, Columbia Business School CaseWorks ID#100507 (June 28 2010), at 11-13.

[140] See Johar & Harries, *id.*; Gita Johar, *LifeSpring Hospitals*, Columbia Business School CaseWorks ID#100503 (April 26 2010).

[141] Prahalad, *supra* note 78.

[142] DARYL COLLINS, ET AL., PORTFOLIOS OF THE POOR: HOW THE WORLD'S POOR LIVE ON $2 A DAY (Princeton University Press 2009).

have HC ("highly competitive") abilities in terms of their ability to pay, where HC>FC. That firm is capable of producing lower-cost products that will be affordable to customers who have FC abilities. This line of business may be as profitable as the products for those with HC abilities, because the costs of the input would be cheaper. In a mature developed market, it is likely that a commercial firm will emerge to provide such products. The growth of low-cost retailers and food chains, such as Wall Mart and McDonalds, is a pertinent example.

The problem seems to be the costs of gathering information on consumers' abilities and preferences. First, in rural markets they may be difficult to observe. Household income of the poor tends to be not only low, but also irregular and unpredictable.[143] The preferences of poor consumers may yield unpredictable tastes, for example, a willingness to spend a high proportion of their income on 'aspirational goods', such as TVs, mobile phones and primary education, but little on products they "need", such as low-energy stoves.[144] Moreover, distribution channels based on face-to-face interaction and sales in traditional markets, lack of effective means of communication in many areas, and language and cultural differences further exacerbate this information problem because they make it costly for firms to observe consumers' spending patterns and tailor their products to consumers' abilities and preferences.[145] Second, consumers in rural markets tend to differ sharply from one another in their purchasing power. The more heterogeneous consumers' abilities, and the more segregated their communities, the more costly it is to obtain information on their abilities and thereby identify potential markets. Rural communities typically include a large proportion of very low-income consumers, but also consumers with substantial purchasing power.[146] Identifying those consumers who have sufficient abilities to buy existing or hypothetical products that commercial firms can produce and sell at a competitive price may be prohibitively costly.

Take, for example, a firm that sells reading glasses and is considering whether it should sell glasses to consumers in a rural market. Assume the relevant market consists of 1,000 consumers. Only 200 consumers are capable of paying $3 per unit. Developing glasses that are affordable to these consumers and producing 200 units would cost the firm $500 ($2.5 per unit). The firm's investors expect a return of approximately 20% on their investment, so that the firm must sell the glasses at about $600 ($3 per unit). Even though there are 200 consumers who could pay $3 per unit of glasses, however, the presence of 800 who cannot do so can make it difficult for commercial firms to evaluate the demand for glasses in this market. Such a firm could conduct experiments or surveys, but technological barriers, lack of communication systems, and the heterogeneity of abilities across different markets, which are often too small to justify an expensive study, make such studies very costly. Therefore firms may be inclined to assume that all consumers in such a market cannot afford to buy reading glasses.

(2) Information Problems in Donative Transactions: Many poor customers in developing countries are genuinely too poor to afford products that could generate profits for commercial firms (i.e., there are not enough consumers with FC abilities). In these circumstances, donative enterprises may step in and provide such goods or services to their beneficiaries. However, donative enterprises also face information problems relating to their

[143] Collins, et al., *id.*, at 16-17; Karamchandani et al., *supra* note 119, at 36-39; Karamchandani et al., *Is the Bottom of the Pyramid Really For You?*, Harv. Bus. Rev. (March 2011), at 3.
[144] Karamchandani et al., *Is the Bottom of the Pyramid Really For You?*, *id.*, at 4.
[145] See Karamchandani et al., *supra* note 119; Karamchandani et al., *id.*, at 4-5; Prahalad, *supra* note 78.
[146] SANAL KUMAR VELAYUDHAN, RURAL MARKETING: TARGETING THE NON-URBAN CONSUMER (Response 2005) (2007), at 74-76.

beneficiaries' attributes. Such information problems may result in an inefficient allocation of donative funds. First, donative enterprises may fail to identify beneficiaries who actually value the relevant product or service they provide and will in fact use it. The costs of studying the preferences or needs of beneficiaries are likely to be very high, given the lack of communication technologies and the difficulty of reaching rural areas. To a certain extent, there is also an adverse selection problem, as some may prefer to represent that they need a given product even if they do not need it and later go on to sell it in the market.[147] Second, donative enterprises also face difficulties in evaluating their abilities. The consumers' ability to pay may be difficult to measure for similar reasons to those discussed above with respect to commercial enterprises, including the lack of communication mechanisms, difficulties in observing spending patterns, and lack of records of people's income. Moreover, there is an adverse selection problem, as beneficiaries have an incentive to represent their abilities as lower than they actually are in order to qualify for a disbursal of a good, service or cash.

Consider again the example of reading glasses mentioned above. Assume that 200 consumers can pay $3 (FC abilities), 600 can pay $2 (BC abilities), and 200 cannot pay anything (NC abilities), and that all consumers need the product. Assuming the donative enterprise is designed to assist those with BC abilities, the most efficient strategy would be to give a voucher to those with BC abilities in the amount of $1 per each customer. However, if a donative enterprise cannot distinguish among consumers, it has to provide disbursals to all of them, including those with FC and NC abilities. This strategy would result in an efficient allocation of $600 and an inefficient allocation of $400.[148] Note that both those with FC abilities and those with NC abilities would prefer to receive the voucher and thus misrepresent their abilities. Those with FC abilities would get a $1 discount. Those with NC abilities would not use the voucher themselves, but could sell it to those with FC abilities for any price between 0 and $1.

(3) The Measurement Function of Low-Cost Sellers*:* Low-cost sellers are committed to transacting with poor consumers. They thus have incentives to gather information on their beneficiaries and make disbursals only to those consumers who cannot afford to pay a competitive price for the relevant product. Unlike the other forms of social enterprise described above, low-cost sellers enter into short-term transactions with their patron-beneficiaries, whereby the latter pay for goods or services provided to them. Low-cost retailers may utilize their transaction with their consumer-beneficiaries in two main ways.

First, low-cost retailers simply invest more capital – essentially out of the subsidy funds – than a commercial enterprise would in diligence and researching the relevant market in order to learn about their consumers' abilities and preferences, especially, their spending patterns, distribution channels, and sociological factors. Low-cost sellers conduct thorough research and studies of beneficiaries' preferences and abilities before they start selling products. In addition, they invest in marketing and in educating the population on the benefits of certain products, such as bed-nets and eye care products. Following such diligence, low-cost sellers design business models tailored to the needs and preferences of low-income households. Examples of such business models include the tiered pricing system, mentioned above. Low-cost sellers develop

[147] For example, there is evidence that beneficiaries who received bed nets used to fight the spread of malaria either did not use them and resold them or used them inadequately; see World Health Organization, Insecticide-Treated Mosquito Nets: A WHO Position Statement (2007), *available at* http://www.who.int/malaria/publications/atoz/itnspospaperfinal/en/index.html (last visited Feb. 5, 2012).

[148] If a donative enterprise disbursed vouchers in the amount of $3 per voucher or simply produced the product and disbursed it to all beneficiaries, the disbursals would result in an efficient allocation of $1,200 and an inefficient allocation of $1,800.

different methods to discriminate among consumers. ZHL charges a standard fee to patients who request to be taken to full-service hospitals and a discounted rate to those taken to government hospitals.[149] Another example is innovative cost-cutting methods. LifeSpring Hospitals' service is designed to cut costs by standardizing services, focusing on specific areas, such as maternal heath, and cutting on unnecessary aspects of the service (e.g., air conditioning or canteens).[150] The Aravind Eye Care service is reducing the demand on doctors' time by training paraskilled paramedics to undertake certain clinical and administrative tasks, so that doctors' time is spent on critical tasks, especially surgeries.[151]

Second, once they start offering products and services to their consumer-beneficiaries, low-cost sellers continue to test the quality of their products and consumers' preferences. Even with extensive diligence, low-cost sellers initially offer their products on the basis of imperfect information. When customer-beneficiaries pay to purchase a product, it is an indication that they actually value the product and are capable of paying for it; and if they do not pay, it is an indication that they either do not value the product or cannot afford it.[152] Referring again to reading glasses, we are concerned with those who can only afford to pay $2 per unit. A low-cost seller may simply charge all consumers $3 per unit. After the initial sale, it will become apparent how many consumers value the product and have the ability to pay $3. At this stage, the firm can decide to experiment by designing a more affordable product that would cost $1.8 per unit to produce, as opposed to $2.5 per unit, and sell it at $2 per unit – the return of 11.1% (not including the costs of information) is lower than the commercial return of 20% and reflects an efficient disbursal of $216 to these consumers.[153] Those with FC abilities are still likely to continue to purchase the product that costs $3, whereas those with BC abilities will purchase the product that costs $2.[154] In this way, low-cost sellers facilitate transactions with capable consumers and an efficient allocation of disbursals.[155] The firm can continuously adjust the prices until it gains a better understanding of consumers' abilities and preferences.

2. Commitment Device and Organizational Form

Low-cost sellers, like MFIs and social investment firms, rely mainly on the nonprofit form and control mechanisms. I mentioned The Aravind Eye Care and VisionSpring as examples of nonprofit low-cost sellers. ZHL is owned by the Acumen Fund and social entrepreneurs that together have control over the firm's mission. ZHL's mission is expressly stated in its charter as

---

[149] Johar & Harries, *supra* note 139. Similarly, LifeSpring Hospitals charges a higher rate to those who use private wards and discounted price to those who use a general ward; Johar, *supra* note 140, at 10.

[150] Karamchandani et al., *supra* note 119, at 47-52; Prahalad, *supra* note 78.

[151] Karamchandani et al., *id.*, at 62-63.

[152] Regarding the example of bed nets mentioned *supra* note 147, by selling low-cost bed nets to consumers, A to Z ensures that consumer-beneficiaries actually value the bed nets and will use them.

[153] Note that the fact that the $216 amount of efficient disbursal is less than $1,200 does not indicate that the disbursals are less effective; rather, the organization would simply have more capital to disburse more efficiently; in this respect, the potential for increasing the scale of the operations would be higher; see Part VI below.

[154] VisionSpring, for example, offers fours lines of glasses at varying costs. Note that in practice, it may turn out (as it did in the case of VisionSpring) that most consumers actually prefer to buy the more expensive glasses; see William Davidson Institute, *supra* note 137.

[155] Note that some social enterprises, such as The Aravind Eye Care, also operate as a donative enterprise by providing free services to their poorest beneficiaries. Note, however, that in this case the donative enterprise benefits from the informational efficiencies of the social enterprise, as the transaction with paying customers allows the firm to design services that are also valuable to its non-paying customers.

being to save human lives by becoming the leading network of ambulance services in India.[156] LifeSpring Hospitals is jointly owned by the Acumen Fund and an Indian government enterprise, each holding a 50 percent stake. A to Z is not actually owned by nonprofits; rather it seems to rely on contractual mechanisms in the form of a partnership among international organizations, NGOs, and commercial firms, under which A to Z is committed to selling bed nets through the partnership at discounted prices to vulnerable groups.[157]

In general, nonprofit low-cost sellers appear to transact on a larger scale with consumers with lower abilities or weaker preferences for the relevant product or service. A majority of the patients of The Aravind Eye Care are extremely poor and do not pay at all for the services they receive. VisionSpring remains reliant on grants and donations, in large part because of its inability to charge prices that would cover its high operating costs, which are due to the capital- and labor-intensive process of producing and selling glasses. Although LifeSpring and ZHL transact with poor consumers, they provide essential services, i.e., ambulance services and maternity care, which most people, including the poorest, are willing to pay for. Therefore, their prospects of profitability appear more realistic. A to Z sells many bed nets at market prices, and its sales to vulnerable groups rely on external subsidies other than donations; thus it is able to operate a profitable business.

IV. SOCIAL ENTERPRISE AND PUBLIC GOODS

The above discussion assumed that social enterprises are designed for the benefit of a specified class of patrons, such as consumers or employees. In practice, however, most commentators have discussed social enterprises as generating public goods. MFIs and FTSEs, for example, are often mentioned as alleviating poverty and promoting development, including healthcare and education. Moreover, there are other types of firms, which I call "external beneficiary social enterprises" ("EBSEs"), which are associated with the concept of social enterprise, but do not commit to transacting with their beneficiaries. I treat EBSEs as a form of social enterprise because, like the social enterprises discussed above, they seem to constitute a solution to certain types of information problems and serve, under certain circumstances, as efficient vehicles for channeling subsidies to beneficiaries. Nonetheless, I argue that there is substantial uncertainty concerning the quantity and quality of public goods produced by EBSEs, in large part because they cannot commit to transacting with their beneficiaries. I therefore treat EBSEs as a residual category of social enterprise. In this section, I first discuss the role of EBSEs, and then turn to discussing why social enterprises that transact with their beneficiaries may also be viewed as a form of EBSEs, though their ability to produce public goods is also subject to uncertainty.

A. EXTERNAL BENEFICIARY SOCIAL ENTERPRISES

EBSEs may be defined as subsidized commercial enterprises with a commitment to producing a public good. EBSEs cannot transact with their beneficiaries who consume the public good. By definition, public goods are non-rival and non-excludable, so that in principle anyone can consume them. The most conspicuous example of EBSEs is firms that produce environmentally friendly products, i.e., products whose production or consumption does not

[156] See William Davidson Institute, *Acumen Fund: Valuing a Social Venture*, *supra* note 84, at 2.
[157] Karugu & Mwendwa, *supra* note 138.

harm the environment or harms the environment less than equivalent products. An example of such a firm is Patagonia, which produces high-quality outdoor clothing. The firm is committed to pursuing a range of environmental policies, in particular the use of materials that are less harmful to the environment, for example organic cotton, and production processes that are more environmentally friendly, including reduction of its carbon emissions and the use of recycled materials.[158]

The subsidy in the case of Patagonia, for example, seemingly comes from its consumers and owners. Consumers pay a premium for the environmental quality of the products, or at least prefer to buy Patagonia products over products of other firms of the same price and quality.[159] The owners seem willing to accept lower rates of return than they would if they used materials and processes that were less environmentally friendly.[160] Subsidies may also be obtained from governments. For example, governments may provide subsidies to firms to encourage them to develop energy-efficient production technologies.[161] Social enterprises may use such subsidies to generate a public good. In fact, even some forms of regulation are in essence a system of subsidies. For example, a cap and trade regime which allocates credit to firms that refrain from certain conduct, such as carbon emission, is essentially a system whereby the firms that do not refrain from the relevant conduct subsidize those that do. The firms that emit carbon above a certain level have to make a payment, essentially a subsidy, to those that reduce their carbon emissions below that level.

Although EBSEs do not transact with their beneficiaries, they nonetheless perform a measurement function. However, in this case the firm measures its own attributes rather than those of its beneficiaries. I first discuss the measurement role of EBSEs, and then the commitment devices adopted by EBSEs.

1. Public Goods and the Measurement Function

EBSEs arise as a response to information problems in the regulation of commercial enterprises. Government regulates commercial enterprises primarily through command-control mechanisms, which require firms to either internalize the negative externalities of their activities or produce public goods that are undersupplied in the market. One example is environmental regulation that restricts air pollution or imposes a mandatory cap on carbon emissions. The assumption underlying such regulation is that the aggregate benefits to the public are larger than the costs to the firms' patrons, such as reduced profits for owners or higher prices for customers. For regulation to be efficient, it must be based on information on both the benefit to the public and the costs to patrons of regulated firms. In this respect, regulation gives rise to similar issues

[158] See Reinhardt et al., *Patagonia*, Harvard Business School Case 9-703-035 (2004) (henceforth "*Patagonia 1*"); Reinhardt et al, *Patagonia*, Harvard Business School Case 9-711-020 (2010) (henceforth "*Patagonia 2*"). Patagonia is also involved in other social activities which do not, as I explain below in section V(D), conform to the definition of social enterprise, including donating 1% of its profits to environmental organizations, and requiring its employees to spend a certain amount of time working on environmental projects.

[159] See Reinhardt et al., *Patagonia 1*, *id.*, at 10 (Patagonia's products sell for 15% to 50% or more above other similar brands, although this premium may be due to the higher quality of its products); Reinhardt et al., *Patagonia 2*, *id.*, at 4,27 (following the shift to using organic cotton, Patagonia's margins decreased, despite having to raise the price of its cotton products; thus both owners and consumers provided a subsidy).

[160] Reinhardt et al., *Patagonia 1*, *id.*, at 16 (some environmental policies increased costs, though some saved money); Reinhardt et al., *Patagonia 2*, *id.*, at 4 (the costs of production increased following the shift to using organic cotton), 8-9 (describing the additional expected costs from Patagonia's repair and recycle initiative).

[161] See, for example, the Innovative Technology Loan Guarantee Program, 42 U.S.C. § 16511 (2006).

as does a subsidy, with some differences. Regulation is essentially a form of subsidy whereby firms that comply with the regulation at little or no cost are essentially subsidized by those firms that cannot comply with it or can comply with it only at higher cost. Assume that Firms A and B, the only two firms in a given market, make a profit of $100 each in a given period. Regulation would impose $200 costs on Firm A and $50 on Firm B in the same period. If regulation were to be adopted, Firm A would go out of business. Firm B might start serving some of Firm A's former customers, and so continue to make a profit of $100 ($150 in sales minus the $50 costs of producing public goods). The costs to Firm B of producing the public good are effectively subsidized by Firm A, because if Firm A were to continue to operate, Firm B's profits would decrease by $50 (i.e., the costs to Firm B of producing the public good). In the case of a standard subsidy, the costs to the subsidy-providers are usually apparent, but its value to the beneficiary is uncertain. That is why information problems associated with subsidies relate primarily to attributes of the beneficiaries. With respect to regulation, both the costs imposed by the regulation and its benefits to the ultimate beneficiaries may give rise to uncertainties. Information problems thus relate not only to beneficiaries, but also to attributes of the firms themselves.

***(a) Information Problems in Regulating Businesses*:** In order to create efficient regulation, regulators must possess information with respect to the benefits of regulation to beneficiaries (i.e., the public) and its costs to firms (i.e., the costs to patrons of the firm). Government may, however, face information problems, with respect to either the benefits or costs of regulation.

First, government may have limited information on the external effects of the activities of commercial firms, in particular, effects on the environment. The lack of information may be due to scientific uncertainty. Despite a growing consensus worldwide on the benefits of protecting the environment, such benefits are not easily observable and often are related to long-term effects which are difficult to quantify. In these circumstances, government may have limited information on the benefits of environmentally friendly policies. In the above example of Firms A and B, there would be uncertainty as to how much public good is produced by regulating firms. If the public good were to be worth less than $100 to external beneficiaries, the regulation would be inefficient.

Second, requiring firms to internalize their negative externalities or produce public goods may hamper the production capabilities of many firms and therefore harm their patrons, especially their owners, employees and customers. Different firms may have different business models. Some firms may be able to produce public goods with relatively little impact on their patrons, whereas other firms' productivity would suffer substantially. To create optimal regulation, it may be better to identify those firms that are more efficient than others in producing public goods. In the above example, if the benefit of the public good were to be $70, social welfare would be reduced from $200 (the aggregate profits of Firms A and B ex ante regulation) to $170 (the profits of Firm B ex post regulation and the value of the public good). The more efficient policy would be to have only Firm B produce public goods, in which case social welfare would increase from $200 to $220.[162] This policy, however, assumes that governments have information on firms' production capabilities and the potential effect of regulation on productivity.

The problem is that governments may lack information on the attributes of individual businesses that would allow them to determine which firms can produce public goods more

[162] The $100 profit of Firm A, $50 profit of Firm B, and $70 worth of public goods.

efficiently than others. If such businesses all belong to a specific industry, such as coal, and the benefits to society from, say, restricting the use of hazardous materials are obvious, government is well positioned to know which firms to regulate. On the other hand, where commercial firms belong to a wide range of industries with varying degrees of impact on the environment, governments are unlikely to be able to determine which are better positioned to incur the costs of regulation. Moreover, where producing a good depends on creating a new technology, for example, renewable energy, governments have limited information on which firms would be most efficient in developing it. Whether a firm can develop a new technology or not depends on many factors, including its research capabilities and the availability of capital. Governments are ill-equipped to evaluate these factors across a wide spectrum of firms.

***(b) The Measurement Function of EBSEs*:** As explained above, it is not generally possible for an EBSE to transact with its beneficiaries. The lack of a transaction with its beneficiaries limits the measurement function of EBSEs. The question is in what respects EBSEs have informational advantages over governments in measuring the benefits and costs of producing public goods.

With respect to the benefits of regulation, EBSEs are unlikely to have a significant informational advantage, if any, over governments. The managers of EBSEs may be more motivated than governments to invest resources in acquiring information on the external effects of their activities in order to satisfy their subsidy-providers.[163] This advantage, however, is likely to be modest at best. EBSEs have limited means of gathering information on their beneficiaries' consumption of public goods; in fact, the beneficiaries themselves may be unaware of their own consumption. Even if an EBSE has conclusive evidence of the benefits of a public good, it has both commercial and altruistic reasons to disclose such information, which would prompt government to step in and regulate all firms. Such regulation would be commercially advantageous to the EBSE because it may put it in a better competitive position as compared to other firms that would face higher costs of producing public goods.

On the other hand, a social enterprise seems to have a clear informational advantage over command-control regulation with respect to measuring the costs it will incur by providing public goods. An EBSE is likely to have better information than government on its production process, and is best positioned to measure the costs of internalizing externalities or producing public goods. As commercial enterprises, EBSEs have incentives to constantly test their business model to ensure they can continue to conduct their commercial activities profitably. The subsidy provided to the EBSE would be used to fund the costs of creating a business model that generates public goods, but otherwise, EBSEs have incentives to cut their costs like any other commercial firm. In some cases, such business models may fail. For example, there have been several unsuccessful attempts to make shoes from recyclable materials.[164] On the other hand, Patagonia has successfully developed processes for making clothes from environmentally friendly materials, such as organic cotton, where such production is more costly than producing conventional cotton, and despite experiencing quality problems in the initial stages.[165]

---

[163] For example, Patagonia conducts assessments of the environmental impact of its activities, and such assessment revealed that its natural fibers harm the environment (see Reinhardt, et al., *Patagonia 1*, *supra* note 158, at 15).

[164] See, for example, Paul W. Hardy, *DEJA SHOE (A): Creating The Environmental Footwear Company*, University of Michigan CEPM Case Study (1996); Paul W. Hardy, *DEJA SHOE (B): Product Launch*, University of Michigan CEPM Case Study (1996).

[165] Reinhardt, et al., *Patagonia 1*, *supra* note 158, at 26 (detailing Patagonia's evaluations of the costs of using organic cotton fabric as compared with the costs of conventional cotton), 27 (quality problems included poor colorfastness, shrinkage, and pilling).

The problem with this model is that it is often unclear how to measure the benefits of policies in the absence of any external study or review of such policies. While organic cotton has advantages in pesticide use, toxic chemical use, and energy and water use, such benefits may be difficult to quantify. In this respect, EBSEs are in a similar position to that of donative enterprises vis-à-vis their external beneficiaries. When there is a stronger consensus, and presumably better information, that a certain conduct or technology benefits the environment governments may introduce subsidy programs to encourage firms to undertake such conduct or develop such technology.[166] However, under such programs, the firms themselves, which have better information on their production capabilities, make the choice as to whether to accept the subsidy and, in turn, adopt an environmentally friendly policy or develop the relevant technology.[167]

In summary, EBSEs perform a measurement function mainly with respect to the costs imposed on commercial firms by regulation. However, there may be substantial uncertainty regarding the benefits they generate. Unlike other social enterprises, EBSEs have limited means of eliciting accurate information on the desired quantity or quality of the public good they generate. They also have limited incentives to acquire information on their beneficiaries, because their profitability or solvency is not dependent on their beneficiaries' abilities or efforts. Thus, when there is no clear information on the benefits of certain public goods or of reducing negative externalities, the effectiveness of EBSEs is inherently limited.

2. Commitment Device and Organizational Form

The commitment devices employed by EBSEs are similar to those used by other social enterprises. In the case of EBSEs, commitment devices seek to verify that the firm adopts a process which is supposed to generate public goods.

First, there are many different environmental certification mechanisms. Most of them apply to specific products, and are designed for consumers who wish to pay premiums for these products. Rainforest Alliance certifies that products are produced in accordance with a specific set of criteria balancing ecological, economic and social considerations. Carbondfund.org calculates carbon emissions generated in the production of certain products and licenses the use of the Carbon Free mark. Organic products whose production is regarded as benefiting the environment may be certified as such by the U.S. Department of Agriculture (USDA).[168] For each of these certification mechanisms, the relevant agency conducts periodic inspections and relevant records must be kept to ensure that certified products are not mixed with other products. Some certifications are embedded in regulation, such as the cap and trade mechanisms discussed

[166] As noted above, such subsidy programs may include a cap and trade system, under which the firms themselves make the decision as to whether it would be efficient for them to refrain from certain conduct, such as emitting carbon.

[167] In practice, subsidy systems are inherently deficient because they will usually also provide subsidies to firms for whom it would be profitable to produce the public good. For some firms, reducing carbon emissions would reduce their costs. Such firms would be expected at least in principle to have incentives to engage in such efficiency measures without a subsidy, and therefore a subsidy granted to such firms would be a waste. The problem is that governments are incapable of distinguishing between firms that can produce public goods at a profit and those that cannot.

[168] I note that organic food is often mentioned as a form of social enterprise because it is healthier than non-organic food. This characterization is clearly misguided. To the extent that customers buy products because they believe it would be conducive to their health, organic products are no different from other products in the market.

above. They are generally addressed to government agencies for the purpose of calculating the allocation of credits or offsets, depending on the type of regime, and are usually enforced by a government agency. Whether or not each such a mechanism is effective in generating public goods is debatable, given the difficulty in measuring the benefits to the environment.[169] Nonetheless, such mechanisms seem reasonably effective in ensuring that a certain specified process is followed.

Second, certain subsidy programs use contractual mechanisms as a commitment device. One example is the Innovative Technology Loan Guarantee Program, pursuant to which the U.S. Department of Energy (DOE) may issue loan guarantees for projects that employ new technologies to reduce air pollution or greenhouse gas emissions.[170] The DOE has discretion to choose projects, which tend to focus on energy efficiency, renewable energy, and advanced transmission and distribution projects. The Loan Guarantee Agreement, i.e., the contract between the firm and the DOE, defines the firm's responsibility for developing the relevant project. The terms of the contract are left to the discretion of the parties, except that the guarantee must not cover more than 80% of the loan,[171] DOE must have access to the project to monitor its performance, and the borrowers must keep records concerning the project for audit purposes.[172]

Third, EBSEs may use control mechanisms by forming a close corporation. Patagonia, which is owned by a social entrepreneur, is a good example. The firm's owner has a reputation for his commitment to the environment, and the firm has established trust with its customers over a long period of time that its products are environmentally friendly. But using control mechanisms and reputation does not seem to be a realistic strategy for most EBSEs. If numerous firms sought to establish a reputation for being environmentally friendly, it would become largely impossible for subsidy-providers of such firms to evaluate their environmental contribution, especially given the difficulty of verifying the benefit to the environment. Patagonia is fairly successful because of its unique reputation and close ownership structure. By contrast, large public corporations that try to establish a reputation for pursuing environmentally friendly policies lack effective commitment mechanisms, and in many cases fail to live up to the reputation they seek to develop.[173]

Moreover, only rarely do for-profit EBSEs owned by environmental nonprofits control the organization's mission. The main problem again appears to be the difficulty in verifying the benefits to the environment. When the benefits from pursuing environmentally friendly policies are uncertain and such policies are costly, there may be substantial pressure by the firm's investors to use the cheapest form of production. On the other hand, the nonprofit owners may be more willing to bear the costs if there is some probability of benefiting the environment.[174] Thus,

---

[169] For criticism of cap and trade systems, see, Tamra Gilberston & Oscar Reyes, *Carbon Trading: How It Works and Why It Fails*, Critical Currents No. 7 (Dag Hammarskjold Foundation, 2009), *available at* http://www.carbontradewatch.org/publications/carbon-trading-how-it-works-and-why-it-fails.html (last visited Feb. 5, 2012).

[170] Innovative Technology Loan Guarantee Program, 42 U.S.C. § 16511 (2006).

[171] 42 U.S.C. § 16512(c) (2006).

[172] 42 U.S.C. § 16512(i) (2006).

[173] Most strikingly, British Petroleum, an oil company that had been involved in a series of environmental initiatives, had a troubling record of violating safety regulations culminating in the recent oil spill in the Gulf of Mexico in 2010 (see Miriam A. Cherry & Judd NC. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing after the BP Oil Disaster*, 85 Tul. L. Rev. 983).

[174] To be sure, such tensions also exist in a firm such as Patagonia, but there close ownership ensures that they do not involve any conflict between for-profit and nonprofit investors.

the costs of decision-making in such firms are likely to be very high.[175] Accordingly, control mechanisms may be associated with an inefficient decision-making process.

Finally, I note that EBSEs are unlikely to be formed as nonprofits. By definition, EBSEs are for-profits that governments have difficulty regulating because of information problems. These firms are unlikely to qualify as being formed for an exempt purpose under the tax code, as they have a predominantly commercial purpose. Moreover, especially in the case of environmental firms, the need for equity capital to develop new technologies, whether for organic production or renewable energy, is likely to be a paramount consideration in choosing to avoid the non-distribution constraint.

B. OTHER SOCIAL ENTERPRISES AS PROVIDERS OF PUBLIC GOODS

The above discussion suggests that social enterprises that transact with their beneficiaries are designed for the benefit of a specified class of patrons, such as consumers or employees, while EBSEs produce public goods. In practice, however, all social enterprises are viewed as generating public goods. Social enterprises are supposed to benefit external beneficiaries who are affiliated with the patron-beneficiaries. MFIs and CDFIs are widely regarded as tools for alleviating poverty and promoting development, the assumption being that access to capital generates public goods. A family that receives a loan from an MFI may be able to send its children to school and obtain better healthcare services. Similar effects potentially occur with respect to external beneficiaries affiliated with small farmers that sell their products to FTSEs or disadvantaged employees that work at a WISE. Likewise, the availability of healthcare services, medicines or other products, such as reading glasses and bed nets, enhances productivity and reduces the costs of illness.

Hence, most social enterprises are often regarded as having external beneficiaries themselves; these are usually affiliates of the patron-beneficiaries, such as their families and communities. In that respect, all social enterprises may be regarded as a solution to information problems in regulation. Consider the Community Reinvestment Act, which requires commercial banks to make loans to borrowers in low-income communities.[176] The assumption underlying the Act is that lending to borrowers in low-income communities generates public goods, such as higher home prices and community development. An alternative to the Community Reinvestment Act would be for CDFIs to provide loans and other financial services to borrowers in low-income communities. The Community Reinvestment Act has been criticized by some commentators who argue that commercial banks may not be effective in providing financial services to the poor, and the costs imposed on them are too high.[177] The Act itself seeks to minimize the costs to commercial banks by limiting the requirement to lend to poor communities only to areas in which banks already have branches.[178] But this reduction in costs arguably comes at the expense of effectiveness; banks are required to provide credit in an arbitrary area rather than specialize in efficient lending to capable borrowers in poor communities. As

[175] By contrast, the transaction with beneficiaries is relatively easy to verify by the nonprofit owners and gives such owners sufficient assurance that the subsidies are being used effectively.

[176] See Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. Rev. 513 (2005); Jonathan R. Macey & Geoffrey P. Miller, *The Community Reinvestment Act: An Economic Analysis*, 79 Va. L. Rev. 291 (1993); Klausner, *supra* note 83.

[177] Macey & Miller, *id.*; Klausner, *id.*; Cf. Barr, *id.*

[178] 12 U.S.C. § 2903 (the actual text of the act requires banks to meet the needs of their "entire communities" including low-income groups).

discussed above, the main advantage of social enterprises, including CDFIs, is that they have incentives to develop a business model that measures patron-beneficiaries' abilities and efforts and allocates disbursals to those with BC abilities.[179] Commercial banks are less likely to invest in developing an elaborate business model geared towards acquiring information on low-income persons because, whereas CDFIs' profitability is dependent on the performance of low-income customers, that of the larger banks is less likely to be affected by it.[180] It therefore seems that CDFIs generally enjoy an informational advantage over regulation by government, because government is not well positioned to identify those banks that can most efficiently serve the poor.

To be sure, there are good arguments in favor of the Community Reinvestment Act, as the informational advantage of CDFIs may not be overwhelming. Commercial banks have some efficiency advantages over CDFIs, which are likely to be applicable in serving low-income communities. Banks enjoy greater economies of scope and scale than CDFIs because they have superior back-office facilities, high capital reserves and profound expertise in banking services. In addition, since banks are required to serve the poor, they have some incentive to gather information on the poor, as they will naturally make more profits by lending to borrowers with better abilities. These incentives may not be as strong as those of CDFIs, so commercial banks may not specialize in lending to the poor, but they are still present.[181] Thus, many commercial banks are reasonably well positioned to serve low-income persons without incurring excessive costs, and therefore the informational problems faced by governments in identifying the most cost-efficient lenders to the poor are not severe.

This analysis further explains why in most countries firms are rarely required by regulation to employ disadvantaged employees, buy products from disadvantaged suppliers, sell to low-income customers, or invest in small businesses.[182] In principle, if firms were required to transact with disadvantaged patrons they could potentially be effective in overcoming information problems and allocating disbursals efficiently, like commercial banks under the Community Reinvestment Act. However, with respect to other types of firms, there is likely to be a much greater differentiation in their abilities to transact with disadvantaged patrons at reasonable cost. Some businesses may be better positioned than others to employ disadvantaged employees. Similarly, investment firms specialize in a variety of forms of investment, which often require different skills and processes from those that are suitable for investing in small businesses. Government is clearly incapable of identifying those firms that could transact with disadvantaged patrons at low cost. By contrast, social enterprises are positioned to transact with disadvantaged patrons at low cost because they are designed in the first place to specialize in such transactions. As explained above, social enterprises have developed various diligence,

[179] Klausner, *supra* note 83, at 1578-1579 (describing the expertise acquired by Shore Bank in making loans to housing projects in Chicago).

[180] Klausner, *id.*, at 1574-1576; The costs of specialization may be higher than the losses commercial banks will incur from lending to poor borrowers without identifying those with FC and BC abilities and allocating efficient disbursals; especially as the proportion of bank lending under the Community Reinvestment Act is usually very small, as compared to the proportion of lending by CDFIs to low-income borrowers.

[181] In practice, banks may meet their CRA requirements partly by investing in CDFIs rather than lending directly to low-income borrowers. In this way, banks rely on the expertise of CDFIs when making such loans; see Barr, *supra* note 176, at 606-607, 644-645.

[182] In some countries, such as Germany and France, employers with more than a certain amount of employees (e.g., 20) are legally required to employ a quota (e.g., five percent) of persons with disabilities. However, most if not all of these quota systems have failed to achieve their targets; Arthur O'Reilly, *The Right To Decent Work of Persons with Disabilities*, (International Labour Office, 2006), at 90-96.

monitoring and incentive mechanisms to measure their patron-beneficiaries' attributes. Accordingly, social enterprises' expertise in transacting with disadvantaged patrons lowers the costs of transacting with such patrons as compared to commercial firms. Thus, to the extent that social enterprises produce public goods, they may be viewed as arising, like EBSEs, as a response to an information problem in regulation.

I emphasize that, as in the case of EBSEs, the evidence on the effectiveness of social enterprises as providers of public goods is largely equivocal. MFIs are a case in point. Although they are often perceived to be central tools in the fight against global poverty, empirical studies that measure their effect on poverty levels have often been inconclusive. There is no clear evidence that MFIs uniformly alleviate poverty and improve the standard of living in a given community in areas such as healthcare and education.[183] On the other hand, there is strong evidence that access to credit has improved the lives of the borrowers themselves.[184] It seems to be the case, then, that the patron-beneficiaries of MFIs have substantially benefited from the ability to transact with them, while the benefits to the community at large are inconclusive. The distinction between patron-beneficiaries and external beneficiaries may be the reason for these results. The positive externalities which arguably flow to external beneficiaries of MFIs are somewhat uncertain and may be dependent on numerous factors. For example, the availability of credit may improve a family's financial condition, but without educational opportunities or the availability of healthcare services, it will do little to improve education or health. There is similar empirical data with respect to fair trade and its effect on communities of small farmers.[185] The ability to transact with FTSEs has increased the income of farmers and their households, but, though there is some evidence of modest positive effects on education and health, it is inconclusive and falls short of showing clear results.[186] There seem to be no detailed empirical studies of the overall impact of social investment firms, CDFIs, WISEs, or low-cost sellers.

---

[183] See for example: David Roodman & Jonathan Morduch, *The Impact of Microcredit on the Poor in Bangladesh: Revisiting the Evidence*, Working Paper #164 (Center for Global Development, 2009), *available at* http://www.cgdev.org/content/publications/detail/1422302; Abhijit Banerjee et al., *The Miracle of Microfinance? Evidence From a Randomized Evaluation*, (Financial Access Initiative, 2009), *available at* http://financialaccess.org/research_areas/121 (last visited Feb. 5, 2012); Dean Karlan & Jonathan Zinman, *Expanding Microenterprise Credit Access: Using Randomized Supply Decision to Estimate the Impacts in Manila*, (Financial Access Initiative, 2010), *available at* http://financialaccess.org/research_areas/121 (last visited Feb. 5, 2012).

[184] Banerjee et al., *id.* (finding that microcredit supports household borrowing and investments and the creation and expansion of small businesses, but has no impact on health, education and women's decision-making); Karlan & Zinman, *id.* (finding that the introduction of microlending to new populations leads to an increase in business profits for male borrowers, but no overall effects on income or poverty); Collins et al., *supra* note 142 (claiming that microfinance may be most effective at smoothing out borrowers' cash flows, so that poor borrowers are less vulnerable to fluctuations in their income).

[185] For a review of impact studies, see Chapter 9 in Nicholls & Opal, *supra* note 108, at 201-228; Anne Le Mare, *The Impact of Fair Trade on Social and Economic Development: A Review of the Literature*, 2/6 Geography Compass 1922 (2008). For notable impact studies finding that fair trade leads to an increase in farmers' income and reduces vulnerability, see Christopher Bacon, *Confronting the Coffee Crisis: Can Fair Trade, Organic and Specialty Coffees Reduce Small-scale Famer Vulnerability in Northern Nicaragua?* 33 World Development 497 (2005); Loraine Ronchi, *The Impact of Fair Trade On Producers And Their Organisations: A Case Study With Coocafé in Costa Rica*, Prus Working Paper No. 11 (2002), *available at* www.sussex.ac.uk/Units/PRU/wps/wp11.pdf (last visited Feb. 5, 2012); Leonardo Becchetti & Marco Costantino, *The Effects of Fair Trade on Affiliated Producers: An Impact Analysis on Kenyan Farmers*, 36 World Development 823 (2008); Eric J. Arnould, et al., *Does Fair Trade Deliver on Its Core Value Proposition? Effects on Income, Educational Attainment, and Health in Three Countries*, 28 J. of Public Policy & Marketing 186 (2009).

[186] See Rochi, *id.*, Bechetti & Constantino, *id.*, Arnould, et al., *id.*, and Nicholls & Opal, *id.*, at 208-209.

However, it is reasonable to assume that they provide benefits to their patron-beneficiaries: the employees, investees and consumers enjoy the opportunity to be employed, obtain capital and consume a wider range of goods. In fact, most social enterprises simply evaluate their impact by measuring the extent to which they transact with patron-beneficiaries, e.g., the total output sold to low-income consumers or the number of loans made.[187] On the other hand, while employment, capital and a wider range of products and services may yield positive externalities and public good to external beneficiaries, there is no convincing evidence that such effects are consistent or large.

Accordingly, it appears to be relatively easier to measure the effects of social enterprises when they engage in market transactions with their patron-beneficiaries. When they do not engage in transactions with beneficiaries, it is usually very complicated to measure the effects of their activities on them.[188] Vis-à-vis their external beneficiaries, social enterprises that transact with their patron-beneficiaries are in a similar position to EBSEs and donative enterprises. Unless they are measurable at reasonable costs, the benefits to external beneficiaries are uncertain.

V. OTHER FORMS OF HYBRID ENTERPRISE

The term social enterprise is usually used in conjunction with a wider set of hybrid organizations that combine for-profit and nonprofit motives than those discussed above. In fact, most accounts seem to equate social enterprise with all other types of hybrid enterprise. It is true that some forms of hybrid enterprise, especially commercial nonprofits and cooperatives, may under certain limited conditions qualify as social enterprises as defined herewith. However, most forms of hybrid enterprise, especially CSR and corporate charity, do not perform the distinctive role of social enterprise and tend to be less efficient in utilizing subsidies. Identifying the "true" social enterprises that perform the measurement function is thus critical for designing policies that facilitate the formation of social enterprises. Policy proposals that do not carefully distinguish between organizations that perform the measurement role and organizations that do not, especially if they advocate subsidizing the latter, are likely to be inefficient.[189] In the following subsections I discuss different forms of hybrid enterprise.

---

[187] MFIs and CDFIs primarily measure the amounts of loans they make to low-income borrowers and their repayment rates, though CDFIs have attempted with limited success to measure also the number of jobs created by the businesses in which they invest (see Robinson Hollister, *Measuring the Impact of Community Development Financial Institutions' Activities*, *in* JULIA S. RUBIN ED., FINANCING LOW-INCOME COMMUNITIES (Russell Sage Foundation 2007); WISEs evaluate the number of disadvantaged employees employed, their wellbeing and their performance (see Barker, Open-hiring Policy, *supra* note 18, at 7-8); social investment firms measure primarily the number of patron-beneficiaries served by the investee, e.g., the amount of bed nets sold (see Acumen Fund, *The Best Available Charitable Option* (Jan. 2007), *available at* http://www.acumenfund.org/knowledge-center.html?document=56 (last visited Feb.5, 2012); low-cost sellers measure the number of consumers they serve (for example, The Aravind Eye Care measures the number of surgeries it performs, and VisionSpring measures the number of affordable reading glasses it sells).

[188] To be sure, certain methodological difficulties exist also when measuring impact with respect to patron-beneficiaries, and most studies are subject to some weaknesses, such as difficulties in assessing counterfactuals (i.e., the hypothetical situation if patron-beneficiaries had not transacted with the social enterprise) and selection biases (i.e., social enterprises choose to transact with patron-beneficiaries with higher abilities).

[189] One recent example is Posner & Malani's proposal to extend tax benefits to for-profits for their charitable or socially responsible activities (Posner & Malani, *supra* note 7).

A. COMMERCIAL NONPROFITS

Commercial nonprofits have been defined as nonprofits that receive the bulk of their income from selling goods or services.[190] They include hospitals, daycare centers, nursing homes and universities. The structural attributes of commercial nonprofits appear to be similar to those of social enterprises, as they constitute a subsidized commercial enterprise, where the subsidy takes the form of income tax exemption and potentially some donations, and they channel such subsidy for the benefit of a class of patrons, typically their customers. For the most part, though, commercial nonprofits have emerged to address a different information problem, that is, customers' inability to evaluate the quantity and quality of complex services provided by the firm, or more generally the ability of managers to expropriate the firm's profits at the expense of quality of service.[191] For example, parents may have difficulty evaluating the quality of education and care provided to their children at a daycare center at the time of contracting. Without the non-distribution constraint, the managers might distribute profits instead of investing in the quality of the service. Thus commercial nonprofits do not seem to perform a measurement role.

One possible exception to this is universities. Universities seem to engage in a thorough measurement of the abilities of their customer-beneficiaries, i.e., the students, with respect to both their talent and their ability to pay. First, they have incentives to admit the most talented students, as such students will not only enhance the university's reputation, but are also likely to earn higher income and make larger donations to their alma mater. Second, they also have incentives to disburse financial aid efficiently, such that aid does not exceed the amount students need to attend school. Unlike social enterprises, though, elite universities invariably form as nonprofits. This is partly because universities rely in great part on donative funding, and also engage in allocating large disbursals, such as funding research projects with uncertain outcomes. It is also due to the risk of expropriation referred to above. Both professors and students expect universities to commit to maintaining their reputation and academic quality many decades after they no longer work or study, as applicable, at those institutions. Strong pressure by investors to generate profits which may make social enterprises, such as WISEs or MFIs, more efficient in allocating subsidies, may in fact be inconsistent with a long-term commitment to promoting academic excellence. In these circumstances, the design of a simple commitment device to facilitate the formation of universities as for-profits is largely impossible.[192]

B. COOPERATIVES

Cooperatives have often been referred to as social enterprises without a clear account of their economic function. Like social enterprises, cooperatives may be designed to resolve information problems in commercial transactions.[193] As explained above, as a result of such

---

[190] Hansmann, *supra* note 5, at 840-841.

[191] For an analysis, see Hansmann, *id.*; Glaeser & Shleifer, *supra* note 5. Note that other types of commercial nonprofits, such as museums or the performing arts, are formed as nonprofits mainly to source donations from their more affluent customers. Hospitals, except those dedicated to serving the poor, form as nonprofits largely for historical reasons; see Hansmann, *id.*, at 866-868.

[192] In other words, universities do much more than committing to transacting with the most talented students and allocating them certain disbursals.

[193] Ajit Banerjee, et al., *Thy Neighbor's Keeper: The Design of a Credit Cooperative with a Theory and a Test*, The Q. J. of Econ. 491 (1994). Cooperatives may also be understood as a solution to a natural monopoly or monopsony;

information problems, commercial firms may fail to transact with individuals even when they are capable of performing transactions with the firm. Cooperatives are formed by such individuals to provide services to themselves (in the case of consumer-owned cooperatives) or buy input from themselves (in the case of producer-owned cooperatives) as members of the cooperative. Cooperatives are generally controlled by the members. A well-known example is credit cooperatives which provide loans to their members. The cooperative pools the resources of all the members in order to provide loans to those in need. The main advantage cooperatives have over commercial firms is that they have better information on their patrons, who are also the cooperative's members, the reason being that members usually belong to the same community. Each member has information on the attributes of other members and is capable of monitoring their performance. Credit cooperatives, for example, have better information than commercial lenders on the creditworthiness of their members. Since they are controlled by their members and members have a financial stake in their operations, members have incentives to monitor each other to ensure they repay their loans.

The informational efficiency of cooperatives is limited. In large cooperatives with many members, members have little control over management, which no longer has discrete information on members' attributes. As more members join the cooperative, the costs of identifying high-ability members and monitoring their performance increase. A large credit cooperative does not have information on its member-borrowers. A farmers' cooperative with numerous members will have difficulty monitoring the quality of the crop supplied by each member-producer. [194] When a cooperative loses its informational efficiencies, it requires subsidies in order to fund the costs of information; such subsidies are essentially the same as those which are channeled through social enterprises. At this stage, the organization essentially functions as a social enterprise rather than a cooperative, given that membership has a relatively small economic function and the costs of information are supported by subsidies.

Credit unions, for example, evolved from relatively small, member-controlled organizations designed to address information problems into large institutions that do not rely on close proximity among members and peer monitoring to gather information on their member-customers.[195] In fact, credit unions may be certified as CDFIs if they satisfy the certification requirements, especially those relating to serving low-income communities. In other cases, small cooperatives are replaced by social enterprises which are not necessarily incorporated as cooperatives. Microfinance developed gradually from various forms of small credit cooperatives.[196] Similarly, the fair trade movement evolved partly from self-help groups and farmers' cooperatives, which pooled the resources of farmers in order to jointly sell their produce to Northern importers.[197]

---

see HENRY B. HANSNMANN, THE OWNERSHIP OF ENTERPRISE (Harvard Press 1996), at 12-16; Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. Pa. L. Rev. 497 (1981), at 508, 595-596. In practice, as pointed out *supra* note 112, when there are information problems in commercial transactions and commercial firms avoid transacting with disadvantaged patrons, middlemen (e.g., moneylenders or a coyotes) will be in a position to exploit monopoly or monopsony powers vis-à-vis the disadvantaged patrons (e.g., borrowers or producers).

[194] In fact, free-riding is a known problem in agricultural cooperatives, especially those with an open membership, as each member has limited incentive to provide low quality products to the cooperative.

[195] See Donal McKillop & John O.S. Wilson, *Credit Unions: A Theoretical and Empirical Overview*, 20 Fin. Markets, Inst. & Instruments 79 (2011). Similarly, loan and saving associations in the nineteenth century evolved from small cooperatives that financed house purchases for their members into large subsidized institutions; see Hansmann, *supra* note 193, at 252-254.

[196] See Armendáriz & Morduch, *supra* note 68, at 69-82.

[197] See Nicholls & Opal, supra note 108, at 19-22, 33-40.

To be sure, although many cooperatives in fact function as social enterprises, the cooperative legal form itself is not necessarily redundant. Social enterprises may use the cooperative form as a commitment device. Most statutes require a cooperative to transact mainly with its patron-members. Although patron-beneficiaries are not involved in decision-making, they have voting power over fundamental decisions, and thus the organization cannot convert to a for-profit without their consent. More generally, allocating ownership rights or voting control to patron-beneficiaries may have the same effect, as long as they have control over the fundamental mission.[198] For example, the borrowers of the Grameen Bank hold approximately 75% of the voting rights in the bank.[199] Although they exercise little power over routine decision-making, their consent is required for fundamental changes to the firm's commitment to serving the poor.

C. INNOVATIVE FORMS OF DONATIVE ENTERPRISE

The rise of social enterprise has been frequently confused with the complementary evolution of innovative forms of donative enterprise, which seek to address different, albeit similar, goals, but have a distinctly different structure and role. In particular, these enterprises are ultimately dependent on donative funding and are engaged in disbursals to external beneficiaries. To be sure, each of these donative enterprises may be effective; the key point, however, is that this depends on the availability of information or external review of the effect of disbursals.

(1) Innovative Ways to Increase the Assets of Donative Enterprises: Donative enterprises have substantial assets. Instead of disbursing all these assets at once to eligible beneficiaries, they may use them to make investments that increase the size of these assets, and only then make disbursals to beneficiaries. One notable example that existed for many years in the U.S. is the museum shop that sells books and artwork to museum visitors. The shop may be part of the same nonprofit entity as the museum, or it may be a for-profit entity owned by the nonprofit museum. Another, more recent example is Housing Works, an organization dedicated to combating AIDS and homelessness in New York City.[200] It is composed of several businesses, including a coffee shop, a secondhand bookstore, and a secondhand clothing store, all supported by donations and owned by a donative enterprise. The profits made by the shops are used to make disbursals to beneficiaries, especially housing assistance. Housing Works is often associated with social enterprise, in large part because its programs are supported by earned income. It is, however, a form of donative enterprise, because it continues to rely on donations (e.g., books, clothes and cash) and, more importantly, is largely involved in making disbursals to external beneficiaries.[201]

(2) Innovative Ways of Making Disbursals: Some donative enterprises which promote entrepreneurship are often referred to as social enterprises. One conspicuous example is Technoserve, which provides technical assistance and business advice to small businesses in

---

[198] In fact, as pointed out above in the context of fair trade (see section III.B), a trust may hold the control rights on behalf of the patron-beneficiaries.

[199] Section 7.1(b) of The Grameen Bank Ordinance, 1983 (ORDINANCE NO. XLVI OF 1983), *available at* http://bdlaws.minlaw.gov.bd/print_sections_all.php?id=651 (last visited Feb. 5, 2012).

[200] See the website of Housing Works at http://www.housingworks.org/ (last visited Feb. 5, 2012).

[201] Another example is the Hershey Company, a chocolate company, which is controlled by a charitable trust that supports schooling for poor children; see Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trust, and Corporate Control: Evidence from Hershey's Kiff-Off*, 108 Colum. L. Rev. 749 (2008).

developing countries in the fields of agriculture, alternative energy and tourism.[202] Technoserve is funded mainly by donations and provides disbursals to small businesses. The difference between it and more traditional donative enterprises is that instead of providing grants, Technoserve focuses on building business capacity. It differs from social enterprises, though, in that Technoserve is not dependent on the performance of its beneficiaries for its continued existence and does not engage in market transactions with them itself. Technoserve is thus a donative enterprise.[203] It should be emphasized, though, that a partnership between Technoserve and a for-profit business may qualify as a social enterprise. In many cases, Technoserve enters into an agreement with a business that it will provide training, technical assistance, quality control and other disbursals to farmers or workers, while the business commits to employing them. The business essentially becomes a conduit for a subsidy provided by Technoserve, and hence a social enterprise (i.e., an FTSE or a WISE).[204]

D. CORPORATE CHARITY

Corporate charity is essentially a form of subsidized commercial enterprise. The subsidy that flows to the corporation comes either from the shareholders, who agree to concede some financial returns to allow the managers to donate some funds to charity, or from the customers, i.e., the customers prefer to transact with firms that donate some of their profits to charities. However, the function of a corporate charity is not to mitigate information problems by measuring beneficiaries' attributes. In specific instances corporate managers may have superior information as to how to allocate disbursals, but there is nothing to suggest that corporations have any distinct advantage in this regard. In that respect, they face the same information problems as donative enterprises when they make disbursals to external beneficiaries. In addition, although commercial enterprises may adopt a commitment device with respect to making charitable donations, firms rarely do so.

This analysis is equally valid with respect to some recent innovations. Google.org, which is dedicated to addressing climate change, poverty and emerging disease,[205] is a division of Google, Inc., which has promised to dedicate 1% of its equity and profits to philanthropy. Google.org extends grants to nonprofits, but also makes some investments in for-profits, such as small to medium-sized enterprises or firms that do research on renewable energy. This type of investment seems similar to investments made by social investment firms. The difference, however, is that Google.org is not dependent on the returns it obtains from its investments for its profitability. It is funded essentially by donations from Google, Inc., and, with respect to some of its investments, the expected returns are actually negative. Moreover, other than by pledging its reputation, Google.org is not subject to a commitment device with respect to its charitable mission. Thus Google.org appears to be a form of corporate charity.

Other examples do seem to involve some form of commitment device, but they remain a form of corporate charity. RedF is an example of a contractual mechanism. RedF is an LLC that

---

[202] See the website of Technoserve at http://www.technoserve.org/ (last visited Feb. 5, 2012).

[203] Note that Technoserve may be more suitable than social enterprises for promoting very risky projects and developing new industries that have a high probability of failure because, unlike social enterprises, it does not need to earn revenues to be sustainable.

[204] See Aneel Karnani, *Reducing Poverty through Employment*, 6(2) Innovations 73 (Spring 2011), at 82-86 (describing a partnership between Technoserve and entrepreneurs to establish cashew nut plants in Mozambique).

[205] See Dana B. Reiser, *For-Profit Philanthropy*, 77 Fordham L. Rev. 2437 (2009).

licenses the Red trademark to commercial firms, including, Apple, Starbucks and Gap.[206] These firms attach the Red label to certain products. When customers buy Red products the firm is committed under its contract with RedF to making a certain donation, for example, 10% of the price of the product, to the Global Fund, a donative enterprise dedicated to fighting AIDS.[207] Thus the firm adjusts the amount of its donations in accordance with the volume of purchases of Red products by customers. While this may be a novel mechanism for firms to market their charitable activities, receive feedback from their customers concerning their desired volume, and perhaps also reduce the transaction costs of raising donations, it is essentially a for-profit that makes donations to a charity.

An example of a control mechanism used as a commitment to charity is Better World Books, a firm that sells used books and is committed to supporting literacy groups.[208] Many of the books sold by the firm are donated to the firm to support its social mission. Literacy nonprofits have options in Better World Books that are vested on two metrics, performance measures of their social mission and how many donated books they bring in. The vested options ensure that upon sale of the firm, the nonprofits will receive a proportion of the sale amount. Performance, which is related to students' progress, is relatively easy to measure, and the disbursals to the literacy nonprofits appear to be effective. Again, the basic structure of Better World Books, albeit highly innovative, is identical to corporate charity, i.e., a for-profit making disbursals to a nonprofit.

E. CORPORATE SOCIAL RESPONSIBILITY

CSR is often used as a blanket term for any policy undertaken by firms that has a social or environmental mission, including corporate charity and social enterprise. The reason again is that most forms of CSR involve a similar structure, i.e., a commercial enterprise and potentially a subsidy designed to promote a social or environmental goal. CSR should, however, be viewed as having a different role than social enterprise. Whereas social enterprise is primarily designed to address market failures, CSR, like corporate charity, addresses unfair outcomes or distributional problems. This perceived unfairness leads commercial firms to distribute resources to certain beneficiaries, either patron-beneficiaries or external beneficiaries.

Many large firms have faced pressure in recent years to increase the wages of their employees and improve working conditions, especially for those who work in factories in developing countries, where working conditions and low wages may be perceived as unfair compared to equivalent standards in developed countries. [209] This pressure exists, even though in economic terms the wage paid by such firms is efficient and higher than wages paid by other local firms. Nike, Levi's and other large multinational corporations have started paying premium wages to their employees and avoid transacting with sweatshops, even if they comply with local law. Other similar initiatives include volunteer work of employees in the community, the provision of technical assistance to small businesses by large commercial firms, and pro bono work for clients that cannot afford to pay for services.

---

[206] Sarah Dadush, *Profiting In (Red): The Need For Enhanced Transparency in Cause-Related Marketing*, 42 N.Y.U. J. Int'l L. & Pol. 1269 (2010).

[207] The exact amount of the donations is not actually transparent; see Dadush, *id*.

[208] Kevin Jones, *Mission Insurance: How to Structure a Social Enterprise So Its Social and Environmental Goals Survive Into the Future*, 5(2) Community Dev. Investment Rev. 1 (2009).

[209] See Geoffrey Heal, *Corporate Social Responsibility: An Economic and Financial Framework*, 30 The Geneva Papers 387 (2005), at 389, 392-393.

In essence, such CSR policies are structurally and functionally identical to corporate charity. A commercial firm makes a disbursal to a beneficiary. As in the case of corporate charity, most for-profits lack a commitment device which obliges the firm to adopt CSR policies. The apparent difference from corporate charity is that CSR can be viewed as referring to a wider range of disbursals, including also different forms of services or terms other than cash disbursals. Moreover, unlike donations, which are invariably given to external beneficiaries, the disbursal may be transferred to a patron of the firm, such as employees (e.g., higher wages or better working conditions). The problems with CSR resemble those with corporate charity and donative enterprises. While CSR policies may be highly effective,[210] it may be difficult to evaluate their social value in particular cases. In fact, evaluating CSR policies is arguably more problematic because for-profits have incentives to exaggerate the magnitude and effectiveness of their CSR policies in order to enhance their reputation among consumers, a practice known as greenwashing.[211]

F. OTHER FORMS OF SUBSIDY TO PATRON-BENEFICIARIES

There are other forms of subsidized commercial enterprise that channel a subsidy to patron-beneficiaries. In recent years there have been several proposals for using subsidies or new organizational forms to support certain businesses that have difficulties competing under new circumstances, such as competition from abroad or technological advancement. Examples include initiatives to save the timber industry in North Carolina, which faces competition from firms in developing countries,[212] or to help local newspapers facing competition from the internet.[213] The economic function of these initiatives is primarily to create soft lending for employees of certain businesses. However, maintaining these businesses in the long run, despite little demand for their services, is inefficient. Moreover, there are many instances where subsidies, such as free land or tax credits, are granted by states or local government in order to induce large corporations to open branches in their localities. Such subsidies are designed to create jobs in the locality and make products available to local consumers. One comprehensive study suggests that the availability of subsidies is one of the key factors in any Wal-Mart decision to open a branch.[214] Such subsidies are not intended to address market failures. They may in fact be distorting because they attract businesses to localities where the costs of production are actually higher.

VI. OTHER ACCOUNTS OF SOCIAL ENTERPRISE

Other rationales for social enterprise have been proposed by various commentators. I explain briefly why they inadequately explain the role of social enterprise.

---

[210] For example, Microsoft may be well positioned to provide information technology training and equipment to community colleges; see Porter & Kramer, *supra* note 10, at 89.

[211] See Janet E. Kerr, *The Creative Capitalism Spectrum: Evaluating Corporate Social Responsibility Through A Legal Lens*, 81 Temp. L. Rev. 831 (2008); Aneel Karnani, *supra* note 10; Henry G. Manne, *Milton Friedman Was Right*, Wall. St. J., Nov. 24, 2006.

[212] Kelley, *supra* note 12, at 345-347.

[213] Richard Schmalbeck, *Financing the American Newspaper In the Twentieth Century*, 35 Vt. L. Rev. 251 (2010).

[214] Philip Mattera & Anna Purinton, *Shopping for Subsidies: How Wal-Mart Uses Taxpayer Money to Finance Its Never-Ending Growth* (Good Jobs First, 2004), *available at* http://www.goodjobsfirst.org/corporate-subsidy-watch (last visited Feb. 5, 2012).

***(1) Mixed Mission or Blended Value*:** As stated above, most definitions of social enterprise focus on the social mission of commercial enterprises as its key element.[215] As argued above, this definition tells us little about how social enterprise differs from numerous other forms of subsidized commercial enterprises, especially CSR initiatives and corporate charity. In fact, even non-subsidized profit-maximizing firms are designed to indirectly produce public goods, so they would potentially be regarded as having a mixed mission or blended value. Moreover, this account fails completely to explain how for-profit firms can commit to a social mission without running the risk that their funds will be expropriated. This problem is not merely definitional, but has policy implications. New legal hybrid forms, such as the L3C, have relied primarily on this account of social enterprise by defining social enterprises largely as firms that have a mixed mission.[216] These forms have generally failed to attract subsidies from tax authorities,[217] which tend to view them with suspicion, and they are seldom used by entrepreneurs, who question their utility. The reason for this is that these legal forms are based on an inadequate account of social enterprise that fails to explain its advantages and does not prescribe adequate commitment devices to ensure the efficient use of subsidies.[218]

***(2) Donative Funding versus Sustainability*:** It is often said that donative enterprises are ineffective in pursuing their mission because of capital constraints due to limited funding from donors.[219] As donative funding and grants may dry up, the ability to sell products and services makes social enterprises more sustainable.[220] However, there is no systematic evidence that earned income is more sustainable than donative income.[221] Donative enterprises, such as large foundations and aid agencies, have very substantial funds. The problem is that the utilization of these funds, particularly for the goal of eliminating poverty in developing nations, has been for the most part ineffective; there is little reason to believe that simply increasing the amounts of disbursals would generate different results. Moreover, it is reasonable to assume that donative enterprises have less difficulty raising funds when they can measure the effectiveness of their

---

[215] For examples, see references *supra* note 2.

[216] See *supra* note 13.

[217] See William J. Callison & Alan 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). The L3C was in fact created for the purpose of attracting program-related investments ("PRIs") from foundations (see Callison & Vestal, *id.*). PRIs are essentially below-market rate investments that may qualify as distributions for the purpose of satisfying foundations' minimum distribution requirements (See Jane M. Searing, *Capital with a Conscience*, J. of Accountancy (July 2008), *available at* http://www.journalofaccountancy.com/Issues/2008/Jul/CapitalWithaConscience (last visited Feb. 52012). Although foundations may make PRIs in for-profits, the procedure for approving such investments as PRIs entails a costly and lengthy review by the IRS of the activities of the investee. As a result, most foundations avoid making PRIs in for-profits. Designation of investees as L3Cs was supposed to streamline this procedure by signaling the investees' commitment to a social purpose. However, as the L3C form does not actually incorporate any effective commitment device, the IRS has largely ignored the L3C, and continues to follow its own procedures. For-Benefit Corporations, by contrast, do possess a commitment device in the form of certification as B-Corporations and a qualified majority requirement for conversions to for-profit corporations (see *supra* note 13). However, many of the criteria for certification are opaque and of questionable value, especially those relating to corporate governance, CSR and charitable contributions. I discuss these legal issues in greater detail in future work on the law of social enterprise.

[218] *Id*.

[219] For example, see Jerr Boschee & Jim McCurg, *Toward a Better Understanding of Social Entrepreneurship* (Minnesota, MN: Institute of Social Entrepreneurs, 2003).

[220] Yunus, *supra* note 7; J.P. Morgan & The Rockefeller Foundation, *supra* note 60, at 13.

[221] Beth Battle Anderson & Gregory J. Dees, *Rhetoric, Reality, and Research: Building a Solid Foundation for the Practice of Social Entrepreneurship*, in Nicholls ed., *supra* note, at 144, 148-150.

programs. In order to make efficient disbursals to beneficiaries, enterprises need to gather information on them, and for that to happen, they should have the incentives to do so. By contrast, social enterprises have stronger incentives to ensure that the quantity and quality of disbursals they allocate to their patron-beneficiaries is efficient.

***(3) Scale and Capital*:** Some commentators consider the most important aspect of social enterprise to be its ability to reach scale. This view associates social enterprises primarily with the gradual shift of organizations that pursue social missions from the nonprofit to the for-profit form. On this view, an organization's ability to distribute profits and generate commercial returns to investors is critical to obtaining the capital necessary to scale its operations. Without scaling, firms cannot reach a large number of beneficiaries and have a substantial social impact. For example, an MFI with a small number of borrowers arguably has only a modest social impact, whereas one with numerous branches and borrowers has a larger social impact.[222]

While this view has some merit, it somewhat obscures the main advantage of social enterprises in scaling social impact. In some cases, attracting equity capital may be essential for scaling. But when social enterprises transact with beneficiaries with lower abilities, equity capital is less likely to be available, and subsidies in the form of donations and income tax exemption remain essential for scaling. Many social enterprises with a very wide reach continue to form as nonprofits. Nonprofit MFIs, such as ASA and BRAC, serve millions of borrowers in developing countries and have as wide a reach as for-profit MFIs. The scale of The Aravind Eye Care and VisionSpring, two nonprofits, is comparable to, or even larger than, for-profit social enterprises running similar businesses, such as ZHL and LifeSpring Hospitals.

The advantage that social enterprises – both for-profit and nonprofit – have in terms of scaling social impact is primarily over donative enterprises. Social enterprises are better in scaling than donative enterprises because, as explained above, they allocate their disbursals more efficiently. For example, whereas a donative enterprise distributes a good (e.g., reading glasses or bed nets) worth $5 to say 200 beneficiaries, a social enterprise may be able to sell this good at say $2.5 to 400 beneficiaries, assuming beneficiaries can pay $2.5 themselves. In this way, a social enterprise reaches more beneficiaries and may be said to have a greater impact.

***(4) Stakeholders and Participation Theories*:** Some commentators have advanced a view of social enterprise as a form of for-profit designed to maximize the interests of its stakeholders as a whole as opposed to merely its shareholders, or one in which stakeholders have a greater say in the decision-making process.[223] In some social enterprises there are in fact board members that represent the class of beneficiaries,[224] or a class of beneficiaries owns some shares in the firm.[225] However, many, if not most, social enterprises do not share this attribute; only rarely in fact do beneficiaries of social enterprises take an active part in decision-making. The reason why social enterprises appear to be attentive to their stakeholders' interests is that they are in the first place committed to utilizing a subsidy for the benefit of a specific class of patron-beneficiaries, and

---

[222] Michael Chu, *Commercial Returns at the Base of the Pyramid*, Innovations 115 (Winter & Spring 2007).

[223] For example see Jacques Defourny, *Introduction: From Third Sector to Social Enterprise*, *in* Borzaga & Defourny, eds. *supra* note 2, at 1 (defining social enterprise as meeting certain criteria, including: participatory nature, which involves the persons affected by the activity, and decision-making power not based on capital ownership).

[224] For example, under 12 CFR §1805.201(b)(3)(iii)(B)(5), "A CDFI must maintain accountability to residents of its Investment Area(s) or Targeted Population(s) through representation on its governing board or otherwise." In another example, the producers of Cafédirect have the right to appoint two directors to its board.

[225] For example, the borrowers of Grameen Bank hold approximately 94% of its shares as well as 75% of the voting rights.

they have incentives to do so; to that extent, social enterprises are indeed more attentive to the interests of their stakeholders.

The argument that social enterprises are pro-stakeholders ignores the problems that stakeholder models give rise to, in particular the costs of decision-making, which tend to be high when managers have discretion to pursue the interests of multiple stakeholders, given the potential conflicts of interest among different classes of patrons or stakeholders and the likelihood that managers will use their discretion to benefit themselves.[226] In fact, decision-making in most for-profit social enterprises seems substantially more efficient than in the traditional stakeholder model of corporations, which is based on managerial discretion; the reason being that social enterprises must adopt a commitment device, which not only resolves the potential contract failure in utilizing subsidies, but also addresses the problem of decision-making.

The commitment device essentially defines how the enterprise utilizes its subsidies. Certification and contractual mechanisms define the class of beneficiaries and the terms of their transactions with the enterprise. Control mechanisms may actually be susceptible to tension between the for-profit investors and the nonprofit controllers. However, as discussed above, control mechanisms are usually effective in ensuring that social enterprises commit to transacting with patron-beneficiaries as well as providing them with disbursals. Accordingly, what's left to managers of for-profit social enterprises is the task of pursuing profits, other than as required by the commitment device. The latter essentially defines how to balance the profit and nonprofit missions against each other, and the margin of discretion left to managers in this respect is relatively limited. The costs of decision-making in social enterprises thus tend to be relatively low as compared to stakeholder models of the corporation.

VII. DISADVANTAGES OF SOCIAL ENTERPRISE

***(a) Risk-bearing*:** Social enterprises must generate profits to be sustainable. Therefore, their ability to take on very risky projects with uncertain expected returns is limited. As discussed above, social enterprises are generally not designed to transact with patron-beneficiaries with NC abilities, who are incapable of performing at a level that will allow the enterprise to rely on their performance. Donative enterprises remain the appropriate form of organization for dealing with those beneficiaries whose abilities to transact with social enterprises are too low. Social enterprises, including EBSEs, are also not well positioned to carry out risky tasks that could generate public goods, but might jeopardize their sustainability, for example, research and development projects with extremely unpredictable or uncertain results. Donative enterprises, such as Technoserve discussed above, are positioned to address such tasks.

***(b) Mission-drift*:** A common criticism of for-profit social enterprises is that they have incentives to seek profits at the expense of their social mission. This criticism may broadly be divided into two claims. First, social enterprises have an incentive to transact only with patron-beneficiaries with FC abilities and avoid those who have BC abilities. However, this is only a problem where the subsidies provided to the social enterprise are intended also to be used as disbursals to patron-beneficiaries with BC abilities. Such subsidies may be distributed to the owners as profits or simply wasted. In this situation, presumably, the commitment device used by the social enterprise is either badly designed or inadequately enforced. In practice, though,

[226] Hansmann & Kraakman, *supra* note 3, at 444.

there are not many known cases of such problems.[227] Organizations that focus on patron-beneficiaries with FC abilities are usually committed to serving only such patrons. For example, Compartamos, which is often criticized for neglecting the destitute, is admittedly committed only to serving the vulnerable non-poor and the moderately poor.[228] Moreover, there presumably is scope both for organizations that serve only patrons with FC abilities and for those that also serve patron-beneficiaries with BC abilities. Thus, nonprofit MFIs tend to focus more on small loans to poorer borrowers and women, while for-profit MFIs tend to make larger loans to less-poor borrowers.[229]

Second, the profit motive may induce for-profit social enterprises to abuse their patron-beneficiaries by offering them unfavorable terms. This concern applies primarily to social enterprises that are not committed to providing disbursals to their patron-beneficiaries. The most conspicuous example is the recent criticism of predatory lending practices employed by MFIs in some regions, which include exorbitant rates, aggressive sales techniques, incorrect or misleading advertising, reckless lending without reference to borrowers' ability to repay, excessive penalties, and aggressive or illegal collection methods.[230] Compartamos, for example, has been criticized for its loan rates, which may exceed 100 percent.[231] The problem, however, seems to lie less in the design of social enterprises and more in the lack of effective regulatory frameworks in many developing countries to protect consumers and employees. In the context of MFIs, there have been proposals to reform consumer protection laws to address the risk of predatory lending.[232]

***(c) Difficulties in attracting capital*:** Social enterprises are generally better at attracting capital than traditional nonprofits. For-profit social enterprises can attract equity capital, and some, like Compartamos, are publicly listed on a stock exchange. Moreover, there is a growing trend among institutional investors to invest in socially responsible businesses, and the social investment sector is gradually growing.[233] On the other hand, many social enterprises still face capital constraints, which are more likely to exist when there is a lack of external subsidies and subsidies are sourced from investors. Social enterprises that rely on control mechanisms vesting control in the hands of a small group of nonprofits and social investors have difficulty tapping capital markets. Some social enterprises, such as Traidcraft, Triodos Bank and Cafédirect, do

---

[227] One situation when this may be possible is where the definition of patron-beneficiary is inadequate. Arguably, under the Fairtrade standards, small producers may not always be disadvantaged, for example, where small producers' cooperatives have sufficient capital and resources. In that case, the disbursals to such farmers in the form of social premiums and a floor price may not be efficient.

[228] Compartamos Offering Circular, *supra* note 97, at 77. Concerns that social enterprises transact with patron-beneficiaries with higher abilities have been raised also in the context of FTSEs (e.g., Mark Sidwell, *Unfair Trade* (Adam Smith Institute 2008), *available at* http://www.adamsmith.org/blog/international/unfair-trade (last visited Feb. 5, 2012)) and WISEs (Carlos Borzaga & Monica Loss, *Profiles and Trajectories of Participants in European Work Integration Social Enterprises, in* Nyssens ed., *supra* note 16, at 169).

[229] Conning & Morduch, *supra* note 62, at 3.7-3.8.

[230] See Conning & Morduch, *id.*, at 3.5-3.6; Eric Bellman & Arlen Chang, *India's Major Crisis in Microlending*, Wall. St. J., Oct. 28, 2010; Keith Epstein & Geri Smith, *The Ugly Side of Microlending,* Bus. Wk., Dec. 13, 2007.

[231] Note, though, that these rates arguably reflect borrowers' attributes and the transaction costs of the loans. In addition, the high rates are also partly due to the lack of competition in the Mexican banking industry. See Chu, *supra* note 222.

[232] See Brigit Helms & David Porteous, *Protecting Microfinance Borrowers*, Focus Note No. 27 (CGAP, 2005), *available at* http://www.cgap.org/p/site/c/template.rc/1.9.2571 (last visited Feb. 5, 2012).

[233] See Jonathan Burton, *Investing with Principles: Socially Responsible ETFs Are Multiplying, With A Variety Of Approaches*, Wall. St. J., Apr. 4, 2011; Monitor Institute, *Investing for Social & Environmental Impact* (2009), *available at* http://www.monitorinstitute.com/impactinvesting.

issue public shares, though such issuances are usually of relatively small amounts of shares with limited voting rights, and the shares are often traded on matched bargain systems that lack the liquidity afforded by large stock exchanges.[234]

Social enterprises are better able to attract capital primarily in two situations. The first is where the subsidies are not paid by investors, but rather by consumers, donors or government. Fair trade and organic products are two prominent examples. Usually subsidized by the consumers, fair trade and organic products have become profitable businesses for large corporations. Second, even where the subsidies are provided by investors, when they are relatively small social enterprises may still generate substantial returns. The subsidies are likely to be small when the costs of acquiring information are not substantially higher than in efficient developed markets, and when the disbursals to beneficiaries are small. As mentioned above, Compartamos primarily serves the moderate and marginally poor, but not the destitute. Moreover, over time the firm has acquired substantial expertise in lending to low-income borrowers. Thus, the costs of information are not substantially higher than in developed markets.

***(d) Excess subsidies*:** Despite the advantages offered by social enterprises in terms of efficient allocation of subsidies, there is considerable scope for inefficiencies. The subsidies provided to the enterprise may be larger than necessary to fund the costs of information and the disbursals to beneficiaries. If the commitment device is somewhat flawed, these "excess subsidies" may simply be distributed to the owners. Alternatively, where the commitment device is strong, the excess subsidies may simply flow to the beneficiaries, also an inefficient outcome, as they presumably will be used in a way inconsistent with the intention of the subsidy-providers. The greater problem, however, is that if the excess is substantial, the profitability of the enterprise may no longer be dependent on the performance of its patron-beneficiaries, but on the provision of subsidies. The enterprise is then left with no incentives to acquire information on its patron-beneficiaries or monitor their performance. The effect of excess subsidies is to transform an enterprise from a social enterprise into a donative enterprise. For example, a CDFI or MFI that receives large grants from the government may be inclined to make loans to many borrowers, even if they are incapable of paying back these loans (i.e., they have NC abilities), or simply to neglect to monitor borrowers' efforts.[235] An example of such excess subsidies is India's Integrated Development Program (IRDP), a heavily subsidized government program to fund loans from state banks to excluded groups in India. Under the IRDP, credit was allocated according to arbitrary lending targets to certain excluded groups. The IRDP repayment rates were as low as 30% and many debts were forgiven, mainly because banks had little incentive to allocate credit to the most productive borrowers.[236]

VIII. INCENTIVES VERSUS INFORMATION AND ORGANIZATIONAL DESIGN

Social enterprise, as well as other forms of hybrid enterprise, is often mentioned as an alternative to the traditional form of capitalism, which is based on the norms of profit-

[234] Jamie Hartzell, *Creating an Ethical Stock Exchange*, Oxford Said Business School, Skoll Centre for Social Entrepreneurship Research Paper (Aug. 2007), *available at* http://www.sbs.ox.ac.uk/centres/skoll/research/Pages/ethicalstockexchange.aspx (last visited Feb. 5, 2012).

[235] Likewise, an FTSE or WISE that is heavily subsidized may be left with no incentives to invest in the quality of its products, identify producers or employees with higher abilities, or make effective disbursals to enhance its producers' or employees' abilities.

[236] Armendáriz & Morduch, *supra* note 68, at 10-11.

maximization and shareholder primacy. The theory offered herewith effectively dispels these claims because the role it ascribes to social enterprise is not intrinsically inconsistent with profit-maximization and shareholder primacy. Social enterprises can be profit-maximizing if the subsidies they receive flow from government or consumers rather than owners. Even if the owners do provide the subsidies, social enterprises still act under a shareholder primacy norm as long as the owners agree to provide such subsidies. Accordingly, the theoretical underpinning of social enterprise is not, as some have argued, its apparent divergence from profit-maximization or shareholder primacy.

Social enterprise should be understood in a broader framework of capitalism. Firms may be viewed as a nexus of contracts between an enterprise and its patrons. Contract prices generally provide information on the value of the contracts to both the enterprise and its patrons. Where the parties are unable to evaluate the quality or quantity of the other party's performance, there is a contract failure due to an information problem. When there is an information problem the law may rely on two main alternatives: (1) transparency mechanisms and (2) incentive mechanisms. Transparency mechanisms are designed to make one party reveal information to the other party. Incentive mechanisms are designed to either align the incentives of one party with those of the other or curtail one party's ability to act in a way which is inconsistent with his obligations under the terms of the contract.

Traditional for-profits and nonprofits are shaped primarily by parties' ability to enter into contractual relationship on the basis of full and accurate information. Profit-maximization and shareholder primacy are norms that reflect the implicit contract between owners of corporations and the corporation, pursuant to which it is the latter's duty to pursue the interests of its owners. These contracts are not susceptible to a contract failure because transparency mechanisms, such as accounting standards and disclosure requirements, provide shareholders with information on the firm's performance. Nonprofit organizations are formed primarily when transparency mechanisms are not available to address contract failure. It is largely impossible for donors to gather information on how a donative organization uses their donations, and it would be prohibitively costly for external agencies to gather information on how donative funds are disbursed to beneficiaries. The non-distribution constraint is an incentive mechanism because it proscribes conduct (i.e., distribution of profits) which may be inconsistent with the firm's contractual obligation to make disbursals to beneficiaries.

In the same manner, the design of social enterprises is dictated by the feasibility of contracting on the basis of full information. Social enterprises, like donative enterprises, are a conduit for subsidies. Evaluating and monitoring how subsidies are used to benefit third-party beneficiaries is extremely costly, and therefore transparency mechanisms are not available. Social enterprises therefore need to be structured as incentive mechanisms. But, whereas donative enterprises are largely designed to distribute subsidies, social enterprises are designed to use subsidies in more complex situations, for example, to improve employment rates or facilitate access to credit. In these circumstances, the non-distribution constraint, which largely protects subsidy-providers against expropriation of the subsidies, is insufficient on its own because it does not provide any assurance that subsidies will actually be used efficiently. Moreover, in some cases, the non-distribution constraint may unduly limit the firm's ability to obtain capital.

The commitment of social enterprises to transacting with the beneficiaries is the key element in assuring subsidy-providers that their subsidy will be used efficiently. This commitment is essentially an incentive mechanism, first because it proscribes certain conduct,

such as avoiding transactions with disadvantaged individuals, and more importantly because it aligns the interests of the firm with those of the subsidy-providers.[237] Given their dependence on the performance of their beneficiaries, social enterprises have an interest in ensuring that the subsidies are not wasted, and that beneficiaries are provided with the adequate amount and type of disbursal that will help them perform their transaction with the firm. In this way, the interests of social enterprises are aligned with the interests of subsidy-providers who presumably do not want their subsidies to be transferred to beneficiaries who have sufficient abilities to transact with commercial firms.

In summary, the goal of a capitalist system as a whole is to allocate capital to its most valuable use. Such allocation is dependent on information regarding the value of that capital to its recipient and the costs to its provider. Contract is usually the most efficient form of allocating capital because the contract price provides easily verifiable information on that value. In the case of subsidies, there is generally a contract failure because it is extremely costly for the subsidy-providers to evaluate how the subsidies are utilized to benefit third parties. This problem is particularly acute where subsidies are supposed to be employed to resolve complex problems, such as poverty and unemployment. The measurement role of social enterprise provides a solution to information problems in allocating subsidies for such complex purposes. In this way, social enterprises are designed to complement traditional organizational forms that lack the incentives to utilize subsidies efficiently.

IX. CONCLUSION

Most theories of social enterprise tend to view such enterprises as organizations that mix profit and social mission, and the many forms of enterprise that combine profitmaking and subsidized funding as indistinguishable. They thus fail to explain the apparent effectiveness of many social enterprises, such as MFIs and FTSEs, as compared to other forms of hybrid enterprise whose effectiveness is much harder to measure. I have suggested here that the term "social enterprise" should be limited to a specific set of enterprises that serves a specific measurement function. That function is a response to a well-defined set of economic problems which arise in the context of different types of transactions, especially subsidies. By identifying the distinctive role of social enterprise, the theory advanced here will, I hope, inform a legal policy that helps social enterprises fulfill their function.

The theory I offer may provide guidance on various related policy issues, especially the design of a new legal form. As discussed above, existing legal hybrid forms, such as the L3C or the For-Benefit Corporation, have largely failed to serve as an effective commitment device with respect to channeling subsidies to specified beneficiaries. In future work, I shall consider a new legal form which is based on the notion of commitment to transacting with specified classes of patron-beneficiaries. Such a legal form may be effective in streamlining subsidized investments from foundations[238] as well as attracting subsidies from consumers. In addition, the theory I have advanced in this article provides a normative framework for determining the efficient amount of subsidies that should be allocated to social enterprises. Such subsidies should not exceed the

[237] To be sure, certification and contractual mechanisms make some use of transparency mechanisms, especially when verifying the status of beneficiaries as such (e.g., welfare recipients or small producers). Control mechanisms are more akin to the non-distribution constraint, as they essentially rely on the incentives of the nonprofit to control the mission.

[238] See *supra* note 217.

costs of information associated with transacting with patron-beneficiaries and the costs of disbursals to such beneficiaries. Further work is necessary for considering the different types of subsidies (e.g., tax credits, grants, or other forms) and developing an efficient process for allocating such subsidies to social enterprises.