

What the World Can Teach America

By Tatiana Sullivan†

Capitalism has made possible material progress never seen before. Despite its current malaise, capitalism continues to grow the world's economy through global trade and the spread of multinational corporations into the developing world.¹ While the dichotomies between wealthy and poor countries, industrialized and developing countries, and emerged and emerging countries narrow, it is clear that not everyone is reaping the benefits of this extraordinary growth as the income divide grows more unequal.²

Americans classify themselves as wealthy, industrialized, and emerged largely because of their sophisticated capitalist system. As a result, emerging market solutions are often overlooked due to the belief that because of America's complex economy, treating American ailments, such as the growing income gap, with solutions used in poor, developing, and emerging countries would be like trying to cure the flu with aspirin.

Recently, President Barack Obama stated "I'm calling on all Americans—Democrats and Republicans and independents—... to put good ideas ahead of old ideological battles, a sense of common purpose above the same narrow partisanship, and insist that the first question each of us asks isn't 'What's good for me?' but 'What's good for the country my children will inherit?'"³ In response to the President's call, this article seeks to formulate a plan for developing the appropriate regulatory and legal environment to enable the emergence of American social businesses as a long-term solution for sustainable economic growth.

Traditional Model

In a pure free-market society, Adam Smith's invisible hand works to allocate resources to the highest valued user. Under this model, individuals work to create wealth to buy the things they

cannot make. When each individual pursues their own happiness, the collective happiness of all is achieved. In America, capitalism has worked to develop one of the most productive work forces, spurred some of the greatest technological innovations, created some of the most sophisticated educational facilities, and developed one of the most mature financial systems in the world.⁴

While capitalism continues to operate in a manner that benefits some, it is clear that there are segments of the population being left out.⁵ This result is due, in part, to the inability of capitalism to account for human multidimensionality.⁶ By reducing individual motives to the pursuit of financial gain only, victory is measured only in terms of maximizing individual wealth.⁷

Ignoring other measures of victory has been indoctrinated into corporate legal mantra⁸ in cases like *Dodge v. Ford Motor Company*. In 1916, Henry Ford, who controlled the board of directors of the Ford Company, attempted to prevent layoffs within the company by ending the company's practice of paying special dividends so that profits could be reinvested in new plants.⁹ His aim, he stated, was "to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help

them build up their lives and their homes."¹⁰ Ford believed that this strategy could benefit the company long-term but only at the expense of current shareholder value. Minority shareholders brought suit claiming that a failure to pay special dividends was



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a breach of his duty to shareholders.¹¹ The Michigan Supreme Court found in favor of the minority shareholders, holding that “[a] business corporation is organized and carried on primarily for the profit of the stockholders,” as opposed to the community of its employees.¹² Therefore, “a manufacturing corporation cannot engage in humanitarian works as its principle business.”¹³

The court’s ruling in *Dodge* became the *raison d’être* for for-profit businesses for the next century.¹⁴ Consecrated as “the shareholder value movement,” which focused on short-term profits over long-term benefits, businesses looked to cost-cutting strategies to increase short-term profit margins and sustain corporate growth rates without regard to other social considerations.¹⁵ Further, corporate law has cemented the court’s ruling in *Dodge* by imposing a duty on directors and officers to pursue profit maximization over any other goal.¹⁶ Since well-managed companies are under pressure to pursue innovations in markets that can sustain corporate growth rates and enhance overall profit margins, they are not equipped to solve social problems.¹⁷

Emerging Solutions

Recently, this draconian profit-maximizing business model has been somewhat relaxed as companies realize that, in order to operate successfully, they need a strong, productive work force and sound infrastructure.¹⁸ The incorporation of social goals into the traditional model has manifested itself in two distinct approaches taken by corporations operating in emerging countries. The first approach can be generalized under the umbrella of “corporate social responsibility” projects. For example, when faced with inadequately-funded government programs, poor healthcare facilities, and poor educational facilities, companies initiate and fund projects such as building local infrastructure,

creating water treatment plants, extending water distribution systems to rural communities, erecting local housing, funding health care projects, and partnering with NGOs and community foundations to meet these needs.¹⁹

“Corporate social responsibility” projects, however, are based on good intentions and not indoctrinated into the ultimate goals of corporations.²⁰ Therefore, companies that take on these projects must juggle between satisfying shareholders or a parent firm and the risk of local community backlash if they retrench



their investments.²¹ Given that companies must battle between these two juxtaposed interests,²² relying on corporations to be socially responsible is not a sustainable long-term solution for delivering social benefits because when “the pursuit of profits and social responsibility conflict, profit maximization always wins out.”²³

“Disruptive innovation” is a second approach taken by businesses operating in emerging markets.²⁴ Disruptive innovation involves targeting the base of the economic pyramid largely ignored by mainstream market actors.²⁵ This is not simply a question of socially responsible projects aimed at lifting people out of poverty but a matter of finding the most exciting growth markets of the future by disrupting traditional approaches to business problems.²⁶ Established companies operating in upper levels of the economic pyramid often find disruptive innovation unreasonable because profits are not large enough to sustain corporate growth rates or increase overall profit margins.²⁷ Potential disrupters, therefore, can focus their businesses on the markets that the larger companies choose to ignore.²⁸

Disruptive innovation enables individuals to operate without relying on the assistance of affluent intermediaries.²⁹ It also creates jobs, generates revenues at the bottom of the economic pyramid, and makes affordable, high-quality products avail-

able.³⁰ Fostering disruptive innovation by itself, unfortunately, is not a viable long-term solution for sustainable economic growth because disruptive innovation focuses on expanding upward in the market, rather than delivering social benefits.³¹ As firms seek to compete with more established firms, they are forced to increase prices. Goods and services once affordable to the base of the economic pyramid become expensive.³²

Solution

One of the leading innovators at promoting long-term solutions for delivering social benefits through the free market has been the Grameen family of businesses pioneered by Muhammed Yunus. Instead of focusing on traditional approaches to business creation and profit maximization, businesses are tailored to deliver social benefits. In his most recent book, *Creating a World Without Poverty*, Yunus proposes the idea of the social business.³³

“Social Business” is defined as a “*non-loss, non-dividend business*.”³⁴ In a social business, profits are reinvested in the business instead of being distributed to shareholders.³⁵ The community benefits through lower prices, better service, and greater accessibility.³⁶ Similar to socially responsible businesses and disruptive innovation, social businesses must be profitable in order to pay back investors and support long-term social goals.³⁷ A social business is distinguished from traditional for-profit businesses by the fact that profitability is a secondary goal to its social objectives.³⁸ In essence, social businesses would compete in markets the way disruptive enterprises have done in the past, while operating like Ford Motor Company according to Henry Ford’s 1914 proposal.³⁹

Yunus proposes two models for social businesses. One form involves businesses that are almost entirely owned by the poor⁴⁰ (“community corporations”).⁴¹ Community corporations aim to provide social benefits indirectly through the returns provided to its poor shareholders.⁴² They do not necessarily have a social mission. One example of this business model is Grameen’s microfinance bank. Grameen’s microfinance bank delivers social benefits by encouraging borrowers to take an equity share of the bank.⁴³ Thus, when profits are made, they are retained by the borrowers themselves and not transferred to wealthy investors in other parts of the country and the world.



The second type of social business is those in which the primary objective is a social mission⁴⁴ (“social corporations”).⁴⁵ The focus is to deliver social benefits in a sustainable way. One example of this type of business model is one developed by Group Danone. Group Danone is a social business whose mission is to deliver low-cost nutritious yogurt to the poor. The business is focused not on obtaining the highest yield, but delivering food at a price that is both sustainable to

Group Danone and affordable by the poor.

Under both social business models, investors are limited to recouping their investment.⁴⁶ This limiting provision is necessary to protect social businesses from pressure exerted by investors in traditional for-profit companies to maximize profits at the expense of social objectives. Thus, unlike socially responsible businesses that must struggle between satisfying local communities and shareholders’ interests, social businesses will be able to focus on delivering social benefits.⁴⁷

The two social business models discussed here aim to cure the limitations socially responsible businesses and disruptive innovators have faced when trying to deliver social benefits in emerging markets. Instead of focusing on short-term profits, social businesses focus on delivering long-term benefits in a sustainable way. Social businesses have been successful in other parts of the world.⁴⁸ It is now time to bring that success to America.

American Social Business

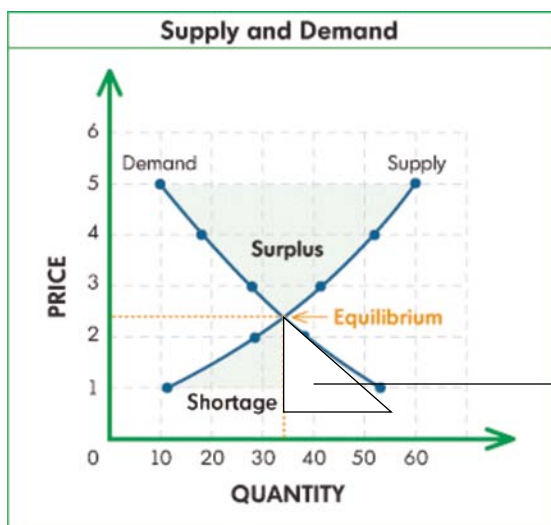
In applying emerging market solutions, it is important to keep in mind that while the definition of “the poor” can differ a great deal between countries,⁴⁹ their position in relation to the other classes within their societies is the same.⁵⁰ Hurricane Katrina and the current financial crises exposed how America’s

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poor, like the poor around the world, face problems with affordable housing, employment, medical care, educational facilities, college tuition, and access to private services.⁵¹ Both are left out of current markets that service only the middle and upper classes. As a result, the poor are put in the helpless position of relying on the changing habits of the economy, political parties in the government, and those with control over capital.⁵² Thus, while America's poor may own a television set and a telephone, the restrictions of the market operate in the same way around the world to keep them class-confined.

In America, approximately 37.3 million people are living in poverty, 12.5% of the population.⁵³ These communities are plagued with public safety deterioration, limited access to jobs, poor educational facilities, substandard housing, and inadequate private services.⁵⁴ These results can be deemed "market failures," but they can also be business opportunities.

To illustrate, in a typical supply and demand graph the demand curve represents the collective reservation price of buyers in the market. Based on industry costs, following a perfect competition model, price is set where supply meets demand. Those that have a reservation price above or equal to the market price purchase the goods because they value the good at its market price. Those with a reservation price below the market price are those that do not value the good at the market price. This only holds true under conditions of equal income. In markets for basic necessities, those with a reservation price below the market price are not those that do not value the good at its market price but those that cannot afford it. Instead of reallocating money to this segment of the population through government assistance programs, why not create an entire market out of it? In doing so, a new market would create ample opportunity for disruptive innovation through social businesses. Since these businesses will not be competing with industry leaders⁵⁵ they can successfully create a new and sustainable market out of this segment of the market.



Indeed, the crux of Grameen's success has depended on this idea of market segmentation that divides markets between the rich and poor.⁵⁶ The idea of market segmentation is not necessarily a new concept in this country. For example, our progressive tax system, qualifications for Medicaid and other welfare programs, and the divide in the credit market between primary and sub-prime all distinguish between income levels of the customers.

In the context of social businesses, market segmentation is possible by limiting services to those that fit a certain criteria or through multiple pricing policies. Take for example the multiple pricing policy used by Grameen Health Trust at their eye care hospitals.⁵⁷ In order to keep markets separate and remain sustainable as a business, it charges regular market price to patients who have no difficulty paying the fee while providing services to the poor at a highly discounted rate.⁵⁸ The profit made on the market-rate charges subsidizes the services provided to the poor.⁵⁹ Alternatively, Grameen Bank achieves market segmentation by limiting access to its low cost loans to the poor through a customer criteria largely based on income.⁶⁰

Legal Remedies

Social entrepreneurship has served communities around the world and it is an attractive solution for dealing with the income gap in America.⁶¹ There are many factors which may enhance or inhibit the development of a social enterprise in a particular country. These barriers to the development of social enterprises include the legal, regulatory and taxation environments.⁶²

First, under the current legal regime, there is no legal entity defined as a "social business."⁶³ Thus, organizations are faced with the choice between a fully commercial organization and a registered charity,⁶⁴ both of which are ineffective legal vehicles for delivering social benefits in a sustainable way. Most entrepreneurs in the United States have decided on a non-profit model due to availability of philanthropy.⁶⁵

A social business charter should expand the duties of directors and officers to include social objectives such as acting in accordance with environmental safety, human rights, and public safety.

Second, a wide range of regulations designed to protect employees and consumers against unscrupulous business owners also constrain businesses because of the high cost of compliance and by

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making businesses inflexible. For example, the application of employment regulation, accounting rules, and financial regulations can be unclear and exert a heavy burden.⁶⁶ Compliance with federal regulations costs the American economy \$1.1 trillion per year.⁶⁷ Further, small businesses pay forty-five percent more per employee to comply with federal regulations than big businesses.⁶⁸

Finally, the greatest barrier to social entrepreneurship is adequate access to financial capital.⁶⁹ While innovative techniques are continuing to develop to deliver capital to this sector,⁷⁰ sources of risk capital remain elusive.⁷¹

Social Business Model Defined

As discussed above, two proposed social business models are “community corporations”⁷² and “social corporations.”⁷³ The defining features of each business model should be part of a social business charter and the simultaneous objectives of specific positive social impacts/returns and financial returns should be explicitly stated in the by-laws of the social business. Also, limitations on recovery of investments should be included in the by-laws of the social business so that investors’ expectations are clear.

Under current corporate law, directors and officers are required to promote the interests of the corporation before anything else.⁷⁴ A social business charter should expand the duties of directors and officers to include social objectives such as acting in accordance with environmental safety, human rights, and public safety. The focus on short-term profits should be explicitly replaced with the duty to serve first the employees, the customers and their products.⁷⁵

Additionally, to achieve market segmentation⁷⁶ and to prevent businesses from operating in traditional markets while claiming the benefits of a social business, a social business charter should require social businesses to deliver products and services to those below a certain level of income. While an obvious standard would be the national poverty threshold, a better solution would be to base the threshold level on the concept of the “living wage.”⁷⁷ This would significantly increase the total number of those that qualify as “poor” and expand the applicable market for social businesses.⁷⁸

Regulatory Fixes

In order to encourage the entrance of social businesses, there are several regulatory fixes that can be implemented. The first obvious approach is to offer tax incentives. Other social

enterprises, such as non-profits and charities, are currently exempted from federal income tax under section 501(c)(3) of the Internal Revenue Code.⁷⁹ This section offers tax exemption status to businesses that are “organized and operated exclusively” for “religious, charitable, scientific, testing for public safety, literary, or educational purposes.”⁸⁰ “Exclusively” has been interpreted to mean “predominantly.”⁸¹ While exempt organizations are authorized to engage in non-charitable activities without losing their tax exemption status, their primary purpose must be one of the exempt purposes. However, the presence of a single, substantial, non-exempt purpose will destroy the exemption regardless of the number and importance of truly exempt purposes.⁸² For example, if an organization directs any of its earnings or valuable economic benefits to a member or benefactor, it will not qualify for tax exemption under section 501.⁸³

Further, under the current law, section 511 imposes a tax on the unrelated business income of exempt organizations.⁸⁴ Thus, businesses that generate a profit from non-exempt purposes are taxed on that income, even if all of the profit remains with the business.⁸⁵ Therefore, both social business models will not fall under the exemption of section 501(c)(3) as it is currently written and interpreted.

Section 501 and section 511 will prevent community corporations from qualifying for tax exemption status. First, section 501 requires that “no earnings be directed to a member, benefactor, or owner.” Therefore, a community corporation will be unable to distribute dividends to pay back equity investors or redeliver profits to its customers without losing its tax exemption status. Thus, section 501(c)(3) will have to be amended to incorporate community corporations to encourage their establishment through favorable tax treatment.

Also, tax exemption is premised on the business purpose, not its overall result; and, since community corporations operate to deliver social benefits indirectly through its equity ownership, section 511 will probably disqualify community corporations from tax exemption.

Second, social corporations will probably not qualify as tax-exempt organizations under section 501. While their primary objective will probably qualify as “a charitable purpose,” because their secondary objective is to make profits they will not likely meet the “exclusive purpose” requirement. Therefore section 501(c)(3) will also have to be amended to incorporate social corporations in order to provide them with favorable tax treatment.

Additionally, section 501(c)(3) disqualifies businesses from raising equity or inuring any part of its profits to a particular member or benefactor, and therefore both social business models will be unable to pay back its investors without losing their tax exemption status. Limiting social businesses to debt financing would unreasonably restrict their access to financial capital. Moreover, allowing investors to recoup their investments through equity would give the social business flexibility in paying investors back from year to year in a way that debt financing could not.⁸⁶

In addition to extending tax exemption status for social businesses, the tax code should be amended to encourage investors to invest in social businesses. Currently, the code exempts charitable contributions to tax exempt organizations from personal income taxes.⁸⁷ The deduction is offered in the year the charitable contribution is made. However, section 170, as it is currently written, does not envision the recuperation of investments.⁸⁸

A proposed amendment to the tax code would be to treat an investment in a social business, whether equity or capital, as a “charitable contribution” under section 170. Then, as the investor recoups his investment throughout the years these payments would be treated as ordinary income in the year that they are paid.⁸⁹ This proposal will encourage investments in social businesses for two reasons. First, investors will benefit generally from deferring tax liability and reducing their tax burden in any given year. Second, long-term investment risk is mitigated because of the advantage of its present day deduction.⁹⁰

While some might be bothered by the loss in tax revenue that will result, one way to appease the skeptics is to remember that delivering social benefits and raising income levels among the poor will generate future tax revenues. Once the poor are elevated, they can begin to contribute to, rather than take away from, tax revenue. Also, social businesses will be replacing government funded programs to some extent.⁹¹ Therefore, while the government might lose tax revenue on the one hand, they reduce costs on the back end by reducing the dependency on government assistance. Also, social businesses would reduce the burdens current taxpayers normally bear.

Tax incentives are just one way the government can help social businesses get off the ground. Another is to offer exemptions in the securities laws. Securities are regulated under the Securities Act of 1933 and 1934. Section 5 of the Securities Act of 1933 provides that all securities must be registered with the

Securities and Exchange Commission (SEC). Registration with the SEC costs over \$2 million per year and is, therefore, a huge financial barrier for corporations. Similar to the tax code, the Securities Act of 1933 provides exemptions for securities “issued by a person *organized and operated exclusively* for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and *not for pecuniary profit*, and *no part of the net earnings which inures to the benefit of any person*, private stockholder, or individual.”⁹²

Social businesses would not likely fall under this exemption for several reasons. First, both social business models aim to recover profits and, therefore, would not likely meet the requirement that the business be “organized and operated exclusively” for charitable purposes. Second, because both models aim to produce a profit as a secondary goal, they will be expressly inconsistent with the requirement that exempt organizations⁹³ be organized “not for profit.” Third, both social models will be inconsistent with the provision requiring that “no part of the net earnings . . . inures to the benefit of any person . . .”⁹⁴

While section 5 of the 1933 Act requires that all securities must be registered according to the provisions of the Act, there are several exemptions within the statute. First, section



3(a)(11) of the Act exempts “any [security] which is part of an issue offered and sold only to persons resident within a single State or Territory, where such security is business within such State or Territory . . .”⁹⁵ This exemption was offered “to represent local financing by local industries, carried out through local investment.”⁹⁶ community corporations will likely find this provision attractive considering that customers will generally be local in nature.⁹⁷

Second, section 4(2) of the Act exempts “transaction[s] by an issuer not involving any public offering.”⁹⁸ A sale of securities is not a “public offering” if it is made only to “sophisticated investors.”⁹⁹ Social corporations might find this exemption attractive since most of their funding will probably come from “sophisticated investors.”¹⁰⁰

For established businesses that wish to transform into a social business, Groupe Danone provides a good model. In order to expand their role in delivering social benefits while placating current shareholders, Group Danone created a special mutual fund with a specific social mission.¹⁰¹ The mutual fund provides that 90% of assets will be reinvested in money-market instruments yielding a predictable market rate of return.¹⁰² The

remaining 10% will be invested in social businesses which will pay no return.¹⁰³ Taken together, these two pools will provide investors with a near-market yield on their money, while, at the same time, supporting businesses that are bringing specific benefits to people in need.¹⁰⁴

Mutual funds are investment companies that must register with the SEC and are subject to rigorous regulatory oversight.¹⁰⁵ Since the SEC is in charge of overseeing mutual fund compliance with these regulations, it could further aid the development of social businesses by relaxing some of these regulations for social mutual funds.

Conclusion

“Every generation needs a new revolution,’ Thomas Jefferson wrote at the end of his illustrious life. The revolution for the current generation is the entrepreneurial one.”¹⁰⁶

This paper has discussed just a few examples of how the new president could create a legal environment that fosters sustainable long-term growth through social entrepreneurship.

The emergence of the “American social business” offers a targeted approach to solving the problem of concentrated poverty in this country. First, by using a bottom-up approach and a “back to the basics” model, social businesses can be flexible in the areas they operate, taking into account regional differences that are often overlooked by large multistate and multinational corporations.¹⁰⁷ Second, building capital from the ground up brings communities together and generates capital locally. Profits and growth remain within the community instead of being allocated to investment moguls in New York or faraway corporate headquarters, only to be taxed and redelivered back to the community as government assistance after passing the costly bureaucracy myriad. Third, a social business model follows the basic market approach that has worked for centuries. Skeptics of big government should be satisfied because fostering social entrepreneurship will relieve the public from relying on government assistance programs. This is because social businesses are self-sustaining. Hence, they are not dependant on on-going government assistance, donations, and grants. Lastly, fostering social businesses is a flexible approach to sustainable long-term economic growth because profit maximizing businesses can opt to meet the legal requirements of a social business to derive their favorable tax treatment and social businesses can easily convert into a profit maximizing business once it makes sense.

Given the real success in creating economic growth in emerging markets, these solutions should not be overlooked in the coming months of regulatory reform. **BLB**

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1 MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY: SOCIAL BUSINESS AND THE FUTURE OF CAPITALISM 3 (Public Affairs 2008); see also Pamela Hartigan, Managing Director, Schwab Foundation for Social Entrepreneurship, Living on the Edge – and Thriving (2007), http://www.sustainability.com/downloads_public/skoll_reports/Living_on_the_Edge.pdf (calling for a new global landscape).

2 Compare the Gini Coefficient data for the United States, Japan, Spain, Germany and Czech Republic all noting growth in income inequality. Organisation for Economic Co-Operation and Development, OECD. Stat Extracts, Current Query: Income Distribution – Inequality – Country Tables, <http://stats.oecd.org/WBOS/Index.aspx?QueryId=11112&QueryType=View> (last visited May 1, 2009).

3 President-Elect Barack Obama, Speech on the Economy at George Mason University (Jan. 8, 2009). While the new president has taken office with ambitious goals to solve our nation’s most urgent social problems, he operates in a climate with limited tolerance for new government spending and government-only solutions. There is, however, a historic opportunity to transform old market habits by creating a new market for social entrepreneurship.

4 *Id.*

5 ROBERT HEILBRONER & LESTER THUROW, ECONOMICS EXPLAINED: EVERYTHING YOU NEED TO KNOW ABOUT HOW THE ECONOMY WORKS AND WHERE IT IS GOING 189-91 (6th ed., Touchstone 1998) (1982) (“That the distribution has shown a remarkable change is beyond question: in 1976 the top 1 percent of families in the nation owned 22 percent of all family wealth. In 1992 the top 1 percent owned 42 percent.”).

6 YUNUS, *supra* note 1, at 18 (explaining how the capitalist system simplifies humans into a one-dimensional model who pursue financial gain without regard to the religious, political, and social aspects; further, this one-dimensional human is sustained by other one-dimensional individuals who support him by investing their money to achieve their own financial gain).

7 *Id.*

8 Although *Dodge v. Ford* is commonly cited as a source of legal authority for the idea that corporate law requires boards of directors to maximize shareholder wealth, the Court’s statements on this subject were dicta. *Lynn A. Stout, Why We Should Stop Teaching Dodge v. Ford* 5 (Univ. of Cal. Los Angeles Sch. of Law, Law & Econ. Research Paper Series, Research Paper No. 07-11, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1013744#.

9 *Dodge v. Ford Motor Co.*, 170 N.W. 668, 671 (Mich. 1919).

10 *Id.*

11 *Id.* at 670-71.

12 *Id.* at 684. Beginning in the 1980s, in America, and other countries around the world, companies began decreasing workforces in order to cut costs. To illustrate, workers in the 1960s had an average of four different employers by the time they reached the age of sixty-five. Today, workers have had, on average, eight employers by the time they are thirty. *An Idea Whose Time Has Come: Entrepreneurialism Has Become Cool*, ECONOMIST, Mar. 17, 2009. Since the social contract between big business and their employees broke, entrepreneurship has been gaining increasing fanfare.

13 *Dodge*, 170 N.W. at 684. Although it is within the board of director’s discretion to engage in incidental charitable donations. *Id.*

14 Stout, *supra* note 8, at 2.

15 Francesco Guerrera, *Welch Condemns Share Price Focus*, FIN. TIMES, Mar. 12, 2009.

¹⁶ Robert Hinkley, *How Corporate Law Inhibits Social Responsibility: A Corporate Attorney Proposes a 'Code for Corporate Citizenship' in State Law*, BUS. ETHICS: CORP. SOC. RESP. REP., Jan./Feb. 2002, available at <http://www.commondreams.org/views/02/0119-04.htm>. Under section 8.30(a) of the Model Business Corporation Act, directors are required to perform their duties in good faith and in a manner reasonably believed to be in the best interests of the corporation. MODEL BUS. CORP. ACT § 8.30(a) (2002). Similarly, section 8.42(a) dictates that officers act in a manner they reasonably believe to be in the best interests of the corporation. MODEL BUS. CORP. ACT § 8.42(a)(3) (2002). Absent from this definition are other interests such as acting in accordance with environmental safety, human rights, public safety, etc. Recently, Jack Welch, former General Electric CEO and pioneer of short-term profit strategies under the shareholder value movement has rejected this business model stating, “[s]hareholder value is a result, not a strategy . . . [y]our main constituencies are your employees, your customers and your products.” Guerra, *supra* note 15.

¹⁷ YUNUS, *supra* note 1, at 5; see also SATISH SHANKAR ET AL., MIT SLOAN MANAGEMENT REVIEW, HOW TO WIN IN EMERGING MARKETS 19-20 (2008), <http://sloanreview.mit.edu/the-magazine/files/pdfs/49309SxW.pdf> (discussing the limitations on large corporations operating in emerging markets).

¹⁸ Mike Valente & Andrew Crane, *Private, but Public: Companies in Emerging Markets Often Have to Take on Services Usually Provided by the Government. It Isn't Always Easy*, WALL ST. J., Mar. 23, 2009, at R6.

¹⁹ *Id.* For example, Magadi Soda Co, a mining company operating in Kenya, found that most government funded programs were focused on Nairobi, but the company facilities were outside of the city. So, the company extended a seventy-five mile road from the central city of Nairobi to its facilities, constructed a railway along the road, built water treatment plants and extended water distribution to the communities surrounding its facilities. The road and railway now serve Kenyans that have little connection to the company. *Id.*

²⁰ YUNUS, *supra* note 1, at 16.

²¹ STUART L. HART & CLAYTON M. CHRISTENSEN, MIT SLOAN MANAGEMENT REVIEW, THE GREAT LEAP: DRIVING INNOVATION FROM THE BASE OF THE PYRAMID 51 (2002), <http://sloanreview.mit.edu/the-magazine/files/pdfs/4415SxW.pdf>.

²² Valente, *supra* note 18.

²³ YUNUS, *supra* note 1, at 17.

²⁴ HART, *supra* note 21, at 52.

²⁵ *Id.* at 52, 54.

²⁶ *Id.* at 52. In the past, entrepreneurship has entered into markets by offering new products to satisfy new demands. In particular, William Nordhaus, an economist at Yale, “points out that about 70% of the goods and services consumed in 1991 bore little relationship to those consumed 100 years earlier.” *The Entrepreneurial Society*, ECONOMIST, Mar. 12, 2009.

²⁷ HART, *supra* note 21, at 52. It can often be expensive for big lending institutions to process small loans without charging very high interest rates. Microfinance institutions, however, can usually lower interest rates somewhat by focusing on this market. Leo Abruzzese, *Small is Beautiful*, ECONOMIST, Nov. 19, 2009.

²⁸ HART, *supra* note 21, at 52. When discussing entrepreneurship a commonly used phrase is “creative destruction.” Creative destruction, however, is a misnomer in the sense that disruptive innovation or creative destruction does not seek to destroy existing markets, but rather it seeks to create new ones. As such, entrepreneurial capitalism is not as disruptive as other systems because it provides more opportunities for individuals to exercise their unique talents. *The Entrepreneurial Society*, *supra* note 26. Take, for example, Grameen bank, which was a bank created to serve the poor that were deemed not “credit worthy” by existing financial institutions. See generally Grameen Bank, Introduction, http://www.grameen-info.org/index.php?option=com_content&task=view&id=16&Itemid=164 (last visited May 1, 2009).

²⁹ HART, *supra* note 21, at 52.

³⁰ *Id.* For example, in the 1950s, Honda created a business model where they sold motorcycles at low prices. When Honda entered the United States in the 1960s, this business model allowed people that could previously not afford a motorcycle to buy one. Thus, Honda had a competitive advantage over U.S. motorcycle manufacturers because it could afford to sell its products at prices that other companies found unattractive. *Id.*

³¹ Cf. *Poor People, Rich Returns*, ECONOMIST, May 15, 2008 (discussing CompartamosBanco’s, a Mexican micro lender, recent transition to a for-profit public corporation).

³² See *id.* (explaining how as the bank moved to expand its clientele, they were forced to raise interest rates to over 100% a year on the rationale that high rates allow the bank to reach the untapped demand of borrowers just out of the mainstream market). While new competition tends to drive prices down, disruptive innovators expanding upwards face increases in fixed costs, which force them to raise their once-affordable prices.

³³ See generally YUNUS, *supra* note 1 (discussing the idea of social business).

³⁴ *Id.* at 24.

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ Foundations, endowments, and non-profits must rely on public and private philanthropy since they are unable to accept investor equity capital. Recovering costs is not an objective and so debt financing is limited. Corporate social responsibility involves committing a specific percentage of corporate profits to social initiatives that are generally separate and unrelated to the company’s primary business. In contrast to all of these other business forms, social businesses are not limited from accessing financial capital. Further, while social businesses can have periods of operating losses as they start-up or when pursuing periods of forward investing, in the end social businesses should be self-sustaining by fully recovering costs. *Id.* at 31.

³⁹ Michele Jolin, *A New Office of Social Entrepreneurship*, in CHANGE FOR AMERICA: A PROGRESSIVE BLUEPRINT FOR THE 44TH PRESIDENT 42, 45 (Mark Green & Michele Jolin eds., Basic Books 2009) (“Business entrepreneurs are increasingly using for-profit investments to produce greater social good, especially in the areas of micro-enterprise, health care, and the environment.”).

⁴⁰ YUNUS, *supra* note 1, at 28-30.

⁴¹ “Community corporation” is a term invented for the purpose of this paper.

⁴² YUNUS, *supra* note 1, at 29.

⁴³ *Id.* at 30 (stating that 94% percent of Grameen Bank is owned by its customers).

⁴⁴ *Id.* at 28.

⁴⁵ “Social corporations” is a term invented for the purposes of this paper.

⁴⁶ *Id.* at 30.

⁴⁷ Current disruptive innovators and socially responsible businesses use a hybrid model between a non-profit and a for-profit business. Profit maximization is still the primary goal for each. Yunus rejects hybrid models describing these businesses as regular businesses that happen to focus on a specific segment of the market. YUNUS, *supra* note 1, at 31-32. Risk of exploitation is greater when the business is disguised as “socially responsible,” as critics have charged in the CompartamosBanco example. *Poor People, Rich Returns*, *supra* note 31. This is because the hybrid model is harder to define. *Id.* Therefore, any regulation to create social businesses should be limited to the two narrow definitions discussed here.

⁴⁸ Abruzzese, *supra* note 27 (discussing the fact that microlenders have a ninety-five to ninety-eight percent repayment record when lending to people formally excluded from capital markets; even American credit card holders do not have a repayment record that high).

⁴⁹ As used here, “poor” refers to people generally suffering from hunger, homelessness, no work or low-paid work, poor health, neighborhoods plagued by safety issues, unsuccessful schools, substandard housing, and inadequate private services and not necessarily tied to any particular income level.

⁵⁰ Octavio Blanco, *The Changing Face of Poverty: Millions of Americans Live in Poverty, More Families are Suffering and Hunger is Seen Growing*, CNNMONEY.COM, Dec. 30, 2004, http://money.cnn.com/2004/12/22/news/economy/poverty_overview/index.htm (“Poverty and hunger are problems that many Americans relegate to the Third World. But the steady growth of poverty has left millions of American families afraid they won’t have enough money to put food on the table.”).

⁵¹ *Id.*; see also *Poverty in America: Consequences for Individuals and the Economy: Hearing Before the H. Comm. on Ways and Means* 110th Cong. 1-3 (2007), available at <http://www.gao.gov/new.items/d07343t.pdf> [hereinafter *Poverty in America*]; *The Entrepreneurial Society*, *supra* note 26.

⁵² Most anti-poverty measures initiated by governments, international consultants, and many NGOs focus on elaborate training programs based on the flawed assumption that poor people are poor because they lack skills. A more correct premise is poor people are poor because they cannot retain the genuine results of their labor because they have no control over capital. Instead, the poor work for the benefit of those with control over capital – moneylenders, landlords, factory owners, or agents. Since the poor do not inherit any capital and the traditional market system does not provide them with capital, the poor remain class-confined. YUNUS, *supra* note 1, at 114.

⁵³ CARMEN DE NAVAS-WALT, BERNADETTE D. PROCTOR & JESSICA C. SMITH, U.S. CENSUS BUREAU, U.S. DEPARTMENT OF COMMERCE, “INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN UNITED STATES: 2007,” 12 (2008), <http://www.census.gov>. *But see* Jessie Willis, *How We Measure Poverty: A History and Brief Overview*, OREGON CENTER FOR PUBLIC POLICY, Feb. 2000, <http://www.ocpp.org/poverty/how.htm> (criticizing the census information because the poverty threshold is based on an outdated formula; and, proposing a more accurate measure based on the “living wage,” which would reflect the reality that there are many more people living in poverty).

⁵⁴ *See generally Poverty in America*, *supra* note 51 (discussing the effects poverty has on health, safety, and education).

⁵⁵ HART, *supra* note 21, at 52.

⁵⁶ YUNUS, *supra* note 1, at 181; *see also* Abruzzese, *supra* note 27 (discussing the debate over whether markets should remain separate; while some believe that commercialization will ruin microfinance, others note that “a decent return will attract more capital, broaden its reach and make the whole enterprise more sustainable”).

⁵⁷ YUNUS, *supra* note 1, at 99.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ President-Elect Barack Obama, Speech on the Economy at George Mason University (Jan. 8, 2009) (“We start 2009 in the midst of a crisis unlike any we have seen in our lifetime Nearly two million jobs have now been lost, Just in the past year, another 2.8 million Americans who want and need full-time work have had to settle for part-time jobs. Manufacturing has hit a twenty-eight year low. Many businesses cannot borrow or make payroll. Many families cannot pay their bills or their mortgage. Many workers are watching their life savings disappear.”). Just as governments in the past have created a tidal wave of innovation and entrepreneurship by creating the legal vehicles that produced some of the world’s greatest companies government can do the same for social businesses. *An Idea Whose Time Has Come*, *supra* note 12 (“The world’s governments are now competing to see who can create the most pro-business environment.”).

⁶² LINKLATERS, FOSTERING SOCIAL ENTREPRENEURSHIP: LEGAL, REGULATORY AND TAX BARRIERS: A COMPREHENSIVE STUDY 4 (2006), <http://www.linklaters.com/community/Schwabsummary.pdf>.

⁶³ A separate legal form for social enterprises, trading commercially for profit, does not yet exist in any jurisdiction. This stems from the fact that regulators may be unsure as to how to treat social businesses since they are not exclusively profit driven and are sometimes not sufficiently charitable in their purpose. *Id.* at 4, 7.

⁶⁴ *Id.* at 4-7 (summarizing how other jurisdictions, such as Brazil, Germany, India, Poland, and the United Kingdom, have changed their regulatory landscape).

⁶⁵ Hartigan, *supra* note 1.

⁶⁶ LINKLATERS, *supra* note 62, at 4, 7 (there is no separate treatment for ‘social businesses’ under the current legal framework, the application of employment regulation, accounting rules, and financial regulations are sometimes unclear and can create a heavy burden).

⁶⁷ *See* Office of Advocacy, U.S. Small Business Administration, Two New Regulations Added to 2009 r3 Top 10 Rules for Review and Reform (Feb. 27, 2009), <http://www.sba.gov/advo/press/09-07.html>.

⁶⁸ *Id.*

⁶⁹ LINKLATERS, *supra* note 62, at 8. Because there is no legal framework in place for accessing and attracting investment, microfinance institutions must rely on financing from private donors. Jonathan Kestenbaum, *Breaking Down the Barriers to Social Enterprise: NESTA Boss, Jonathan Kestenbaum, Believes that Social Enterprise is the Business Model that will Characterize the 21st Century*, TIMESONLINE, Jan. 23, 2009, http://business.timesonline.co.uk/tol/business/related_reports/social_entrepreneurs/article5575697.ece (“[T]he greatest barrier to social entrepreneurship is adequate access to finance and an awareness of available sources of funding.”).

⁷⁰ *See* Blanco, *supra* note 50.

⁷¹ LINKLATERS, *supra* note 63, at 8.

⁷² *See supra* text accompanying note 44.

⁷³ *See supra* text accompanying note 50.

⁷⁴ *See supra* text accompanying note 16.

⁷⁵ *Id.*

⁷⁶ *See supra* text accompanying note 62.

⁷⁷ Willis, *supra* note 53.

⁷⁸ *Id.*

⁷⁹ I.R.C. § 501(c)(3) (2006); *see also* Hartigan, *supra* note 1 (discussing the fact that many entrepreneurs in the US have decided on a non-profit model due to the influx of philanthropy, though this model may limit the non-profit from expanding and innovating).

⁸⁰ I.R.C. § 501(c)(3) (2006). “Organized and operated exclusively” is given a liberal construction and includes organizations incorporated under general corporate laws in addition to laws relating to charitable, educational, or non-business corporations. *See* Universal Oil Products v. Cambell, 181 F.2d 451, 457 (7th Cir. 1950); Kanawha-Roane Lands, Inc. v. US, 136 F. Supp 631, 636 (S.D.W.V. 1955); Liberty Nat. Bank & Trust Co. v. US, 122 F. Supp 759, 762 (D.C.Ky. 1954); Samuel Friedland Foundation v. US, 144 F. Supp. 74, 84 (D.C.N.J. 1956) (explaining that “‘organized’ means ‘created to perform’ or ‘established to promote’ charitable purposes rather than meaning merely ‘incorporated’ with powers limited solely to charitable activities”); Dulles v. Johnson 155 F. Supp 275, 278 (D.C.N.Y. 1957) (discussing the fact that a company’s articles of incorporation are not the only evidence to be considered when examining the company’s purpose). Courts will look to the purpose of the organization as evidenced by its corporate charter and factual circumstances surrounding its adoption and operations. Samuel Friedland Foundation v. US, 1956 F. Supp. at 85).

⁸¹ Oklahoma State Fair & Exposition v. Jones, 44 F. Supp. 630, 632 (W.D.Ok. 1942) (“[E]xclusively” in the matter of the operation for scientific and educational purposes should be entitled to a construction of its broadest capable meaning to the end that the greatest possible accomplishment might be obtained in a laudable undertaking.”). *But see* Samuel Friedland Foundation v. US, 144 F. Supp. at 84-90 (explaining that the fact that a corporation has net income does not prove that it is not organized and operated exclusively for exempt purposes, but proving that the corporation is organized for profit will be dispositive).

⁸² Roundtable Club v. Fontenot, 143 F.2d 196, 196 (C.A.5 1944).

⁸³ Birmingham Business College, Inc. v. Comm’r., 276 F.2d 476, 480-81 (C.A.5 1960) (holding that the fact that the net earnings were used to benefit the shareholders prevented the application of the exemption).

⁸⁴ I.R.C. § 511 (2006).

⁸⁵ *See* I.R.C. §§ 501(b), 509, 511 (2006). Under the previous law, an exempt organization engaged in a for-profit trade or business, not arising out of its exempt purpose, was not taxed on the profit if it was required to use its earnings for exempt purposes. The theory was that the law is not concerned with the source of the money but with its destination. Samuel Friedland Foundation v. US, 144 F. Supp. at 85 (citing Trinidad v. Sagrada Orden de Predicadores, 263 U.S. 578, 580 (1924)). The rule was amended in 1954 to the current form.

⁸⁶ Debt requires annual payments of a fixed amount. However, if a social business can return investments through equity, those payments can be a percentage of profits. Therefore, payments are flexible, and there is no additional pressure to make profits at the expense of social objectives.

⁸⁷ I.R.C. § 170 (2006).

⁸⁸ I.R.C. § 170(c) (2006) (defining a “charitable contribution” as a gift).

⁸⁹ Cf. *Burnet v. Logan*, 283 U.S. 404 (1931) (involving a case about the treatment of future payments). In this case, the taxpayer was paid a series of payments as a percentage of profits made in the future in addition to a fixed sum upon the sale of its ownership in a mine. Because the court was uncertain how to value these future payments, the taxpayer was allowed to defer payments until payments were received). *Id.* Although, in the case of social businesses, the ultimate recovery is fixed in quantity, investors in social businesses should be allowed to defer tax liability until then.

⁹⁰ Traditionally, the decision to invest is tied to the potential of the investment to produce a profit. With a social business, the decision to invest is tied to the ability of the social business to deliver social benefits in a way that would allow investors to recoup their investment. In order to alleviate the fear that a social business will be unable to generate a profit, allowing investors to initially treat their investment as a charitable contribution would deliver some immediate benefit to outweigh this risk.

⁹¹ Many people assume that if free markets can't solve social problems, governments can by stepping in to provide the necessary regulatory regime. While an excellent government regulatory regime can affect the way business is done, it cannot address the areas that business neglects. In addition, while governments can mobilize vast resources, "they are inefficient, slow, prone to corruption, bureaucratic, and self-perpetuating." Lastly, while governments are often good at creating regulatory systems, it takes time to shut down the regimes when they are no longer needed because politics often stand in the way of governmental efficiency. YUNUS, *supra* note 1, at 8.

⁹² 15 U.S.C. § 77c(a)(4) (2006) (emphasis added).

⁹³ Here the term "exempt organizations" refers only to those that are exempt from registration with the SEC.

⁹⁴ The SEC is given broad rulemaking power to exempt organizations from registration requirements. 15 U.S.C. § 78mm (2006). Their power to exempt securities, however is limited. 15 U.S.C. § 78l (2006). Therefore, a statutory change will be required so that this limitation does not operate to hinder social businesses from raising equity capital.

⁹⁵ 15 U.S.C.A. § 77c(a)(11) (2006).

⁹⁶ 17 C.F.R. § 230.147 (2008).

⁹⁷ *Id.* Indeed, forcing a social business primarily owned by the poor to comply with this exemption when issuing securities might be a way of curtailing any abuse by forcing social businesses to stay local.

⁹⁸ 15 U.S.C. § 77d(2) (2006).

⁹⁹ 17 C.F.R. § 230.506 (2008).

¹⁰⁰ A "sophisticated investor" is considered a purchaser who "has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment. . . ." 17 C.F.R. § 230.506 (2008).

¹⁰¹ A "social mutual fund" is a mutual fund with a special mission in which shareholders of establishing companies have the option of joining. Group Danone created one in France which is listed as a mainstream money market fund on the French financial market. Investors are informed of the social mission and that the return will be two to three percent (known as the social dividend) with very limited downside risk or upside potential. In turn, ninety-seven to ninety-eight percent of profits will be reinvested. The fund is entirely open to the public and marketed by one of the retail banks. People can buy and sell their shares freely every day. YUNUS, *supra* note 1, at 171. In its SEC filings, Danone decided "in order to pursue its mission 'to bring health through nutrition to the largest amount of people in the world' and in the context of realization of its double economic and social project the company wished to initiate a social approval on a global level centered around the creation of a development fund with social purpose for companies called danone. communities . . . [to finance] profitable companies whose primary vocation is the maximization of social objectives and not that of their profit." Danone, Annual Report (Form 6-K), at 25 (Apr. 3, 2007).

¹⁰² YUNUS, *supra* note 1, at 171.

¹⁰³ *Id.*

¹⁰⁴ *Id.*; see also Jolin, *supra* note 39, at 45 (discussing a type of social mutual fund developed by Pierre Omidyar, founder of eBay, which uses a private equity fund "to expand the use of microloans and encourage the development of a commercial equity market to serve global microfinance institutions.").

¹⁰⁵ Mutual Funds' operations are controlled by the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisors Act. The Internal Revenue Code sets additional requirements regarding a funds' portfolio diversification and its distribution of earnings. Finally, the National Association of Securities Dealers, Inc. oversees most mutual fund advertisements and other sales materials.

¹⁰⁶ *The Entrepreneurial Society*, *supra* note 26.

¹⁰⁷ Abruzzese, *supra* note 27 (describing the irony of how Wall Street's titans are finding it hard to repay their debts in the current financial crisis, if they are in business at all, while many of the world's poor are proving to be better credit risks than the Lehman Brothers).