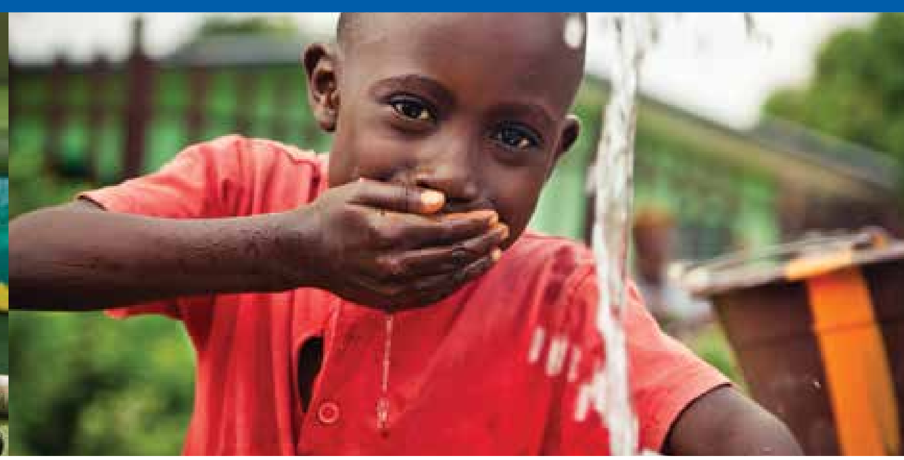
PRESENT AT THE CREATION



THE EMERGENCE OF SOCIAL BUSINESS, IMPACT INVESTING, AND THE FOURTH SECTOR IN MINNESOTA

DECEMBER 2013

JEFF OCHS BRAD BROWN

SOCENTIA
ADVISOR. PATHFINDER.

About Socentia

Socentia mobilizes capital for social impact. We provide consultation and coaching for social venture leaders, philanthropists, and investors committed to solving the leading social challenges of our time—economic opportunity, education, environmental sustainability, and healthcare for all.

Socentia assists social ventures seeking to grow their impact and scale as well as social venture investors who want to increase their social return on investment. Socentia works with clients on strategy and execution in these areas:

- Impact investing for foundations and philanthropists
- Growing nonprofit social enterprises and social businesses
- Raising growth capital
- Organizational capacity building

AUTHOR PROFILES

Jeff Ochs

Jeff is a successful Minnesota social entrepreneur. He first founded and directed Breakthrough Saint Paul (now Breakthrough Twin Cities), a nonprofit college access and teacher training program. Jeff then invented and commercialized Snake Oil, a hit party game that won the prestigious Mensa Select award and was licensed by Out of the Box Publishing. Most recently, he founded Customs Made, LLC, a social business that placed in the top three of the 2013 Minnesota Cup social entrepreneurial competition. In addition to completing his Master of Business Administration and Master of Public Policy at the University of Minnesota, Jeff is a Sands Social Venture Fellow and serves on the Social Enterprise Alliance Twin Cities board as well as Minnesota's Benefit Corporation statute drafting committee of the Minnesota State Bar Association.

Brad Brown

Brad worked as a business consultant for 25 years before committing to use his skills to the service of social missions. Since then he has served as a nonprofit executive and foundation program officer. Most recently he was the executive director of Social Venture Partners Minnesota. Previously Brad was Vice President for Kids Against Hunger, a food relief agency and was a program officer for the Southern Minnesota Initiative Foundation where he was responsible for a revolving loan portfolio and an entrepreneurship development program. Brad created the Social Entrepreneurs Cup, an awards program to seek out, support, and promote Minnesota's most innovative and effective social entrepreneurs and the organizations they lead. He has also served as a judge in social entrepreneurship and business competitions including the Acara Challenge, Eide Bailly ResourceFullness Award, University of St. Thomas Fowler Business Concept Challenge, and the Minnesota Business Magazine Corporate Community Impact Awards.

Brad has also served on several nonprofit boards including Rebuild Resources, PRISM, Social Enterprise Alliance Twin Cities, and the GiveMN.org strategy council as well as held elective offices as a city council member and school board member. He was included on the *Twin Cities Business Journal's* "200 Minnesotans You Should Know" in 2011.

He formed Socentia in 2013 to provide consultation for social venture leaders, innovators, philanthropists, and investors committed to solving the leading social challenges of our time. Brad's most recent initiative is launching IMNPACT Angels, Minnesota's first impact investing angel network in collaboration with Gopher Angels.

Brad has his Master in Public Administration from Hamline University and is currently enrolled in the Doctorate in Public Administration program there. Brad is particularly interested in the convergence of the business and nonprofit sectors, developing social capital markets to fund social entrepreneurs, and cross-sector social innovation.

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We are grateful for our team of reviewers, listed below, whose unique perspectives and feedback helped to strengthen our work. Please note that the final content of this white paper does not necessarily reflect the individual views of these reviewers.

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PRESENT AT THE CREATION

THE EMERGENCE OF SOCIAL BUSINESS, IMPACT INVESTING, AND THE FOURTH SECTOR IN MINNESOTA

Executive Summary

Minnesota is home to a new breed of entrepreneur committed to solving social problems using for-profit business models as an engine of social change. These social entrepreneurs are pioneering the concept of "social business" and demonstrating initial success even in the face of systemic challenges. Yet there is a limit to how far they can go, and to the number of entrepreneurs who can follow, without a more supportive ecosystem.

In this white paper, we explain what social businesses are and why they are important. We then identify three major systemic obstacles facing social businesses and outline solutions for each. Finally, we argue that these solutions, once enacted, will signal the creation of Minnesota's "Fourth Sector."

SECTION ONE:
WHAT ARE SOCIAL BUSINESSES AND WHY ARE THEY IMPORTANT?

Social businesses are distinct from traditional nonprofit and business corporation forms but integrate attributes of each. Like businesses (but unlike nonprofits), social businesses have owners and generate profit that may be distributed to owners. Like tax-exempt nonprofits (but unlike businesses), social businesses commit *legally,* via their corporate form or corporate bylaws, to pursue a social purpose, a commitment that must be transparent and reported against annually.[1]

Facilitating the emergence of social business is important for three reasons:

1. Businesses that focus solely on profit can do so at the expense of the environment and society, and nonprofits without sustainable revenue models and equity can struggle to survive and scale.

2. Government resources to support social impact are likely to diminish over time.

3. Social business can unleash the power of capitalism and the resources of the private sector for social good.

SECTION TWO:
THREE SYSTEMIC OBSTACLES FOR SOCIAL BUSINESS & PROPOSED SOLUTIONS

Obstacle 1: Lack of Theoretical Acceptance

One of the biggest barriers faced by social business entrepreneurs is widespread skepticism that an entity that commits to pursing both a profit and a social purpose is even theoretically viable. This skepticism is the result of an entrenched conceptual framework that places maximization of profit for owners and maximization of social benefit on opposite ends of the same purpose spectrum (see page 17). This view does not allow for the theoretical existence of social businesses, which seek to provide both social impact *and* financial return.

Solution: Revise Our Conceptual Framework to Make Room for Social Businesses

We can create a better conceptual framework (see page 18) by first recognizing that every entity, whether a business or nonprofit, has both a financial value proposition and social value proposition, even if both are not always articulated and regardless of whether each value proposition is positive or negative. This revised framework creates a theoretical space for organizations that exist for the dual purpose of making a significant financial return for owners and a significant social impact.

Obstacle 2: No Suitable Corporate Form

A second major impediment for social business entrepreneurs is the absence of a standard corporate form that is specifically suited to the dual pursuit of profit for owners and a social purpose within the same organization.

Currently, social business entrepreneurs must work within the constraints of the existing private and social sector corporate forms. The nonprofit corporation, while facilitative and protective of the pursuit of a social purpose, has no owners, prohibits private inurement of profits, and can place major restrictions on earned income. Conversely, the business corporation, while facilitative and protective of the pursuit of profit for owners, is not conducive to the pursuit of a social purpose, especially one that may reduce shareholder value in the long-term and especially as the entity grows and adds owners.

In addition to imposing legal constraints, current corporate forms also limit the ability of social businesses to differentiate themselves in the broader economy. While social businesses integrate unique elements of both business and nonprofit corporations into one entity, neither existing form fully signals to the public their true "double bottom line" nature. When a social business entrepreneur chooses one of the existing forms, the entity assumes the standard identity of that sector. As a result, the entrepreneur must repeatedly explain to investors, vendors, and customers, how and why they are different.

Solution: Create a New Corporate Form Specifically for Social Businesses

In light of the limitations of existing corporate forms, Minnesota's social businesses need a new type of entity that is specifically designed around their goals. While this idea has been under discussion at the state capital since 2005, this year, champions in the Minnesota legislature engaged the Minnesota State Bar Association to convene a committee of academics, lawyers, and other skilled professionals to draft a new corporate form for social businesses in preparation for the 2014 session. This group met regularly for six months and led a robust, transparent, and public drafting process. The resulting draft (see Appendix B), which calls for the creation of "Public Benefit Corporations," will be used as a starting point for the formal legislative process. It is the opinion of the authors that adoption of this statute, at least as it has been initially proposed, would be a major step forward for Minnesota's social business entrepreneurs.

Obstacle 3: Lack of Access to Capital

In addition to lacking theoretical acceptance and a suitable corporate form, social businesses also lack access to capital. The private and social sectors both have conventions for attracting investment. In the private sector, investors are motivated by profit and will consider investing in any entity with a positive financial value proposition. In the social sector, investors are driven by social return and will consider investing in any entity with a positive social value proposition. However, when a social business, which commits to attaining both a positive financial and social return, seeks investment, both types of investors lose interest. Unintentionally, we have built a system in which entities that commit to "doing well by doing good" have the greatest difficulty raising capital.

Social business entrepreneurs currently respond to this challenge by weighing the advantages and disadvantages of each sector and then choosing the sector that is most strategically important during the life of their particular entity. Generally, when it comes to raising capital, the private sector is disadvantageous during the idea, development, and early-launch stages but advantageous during late-launch, growth, and maturity. The social sector is just the opposite, generally providing capital well during the idea, development, and launch stages but less well thereafter.

Solution: Establish a New Development Pathway for Social Businesses

The private and social sector financial systems, which have offsetting strengths and weaknesses, are naturally complementary. Three collaborative investor roles can offer social businesses a continuum of investment from concept to liquidity event. A given institution or individual can play any single or all three roles over time with a social business. The three roles are (1) the philanthropic investor that is motivated to seek a social return, (2) the impact investor distinguished by the goal of gaining both social and financial return on investment, and (3) the for-profit investor whose investment decisions are driven by financial return.

Our contention is that if investors from each of these three groups collaborate as shown below, they can create a pipeline of social businesses that meet the social impact goals of philanthropists, the profit goals of for-profit investors, and the "double bottom line" goals of impact investors.

THE SOCIAL BUSINESS DEVELOPMENT PATHWAY

ROLE	PHILANTHROPIC INVESTOR	IMPACT INVESTOR	FOR-PROFIT INVESTOR
MOTIVATION	Social return	Social and financial return	Financial return
OUTCOME	Make a social business with a strong social value proposition investible	Strengthen the business' financial value proposition and lock in the social mission	Scale the business and prepare for liquidity event
MEANS	Grants, PRIs	PRI, MRI, angel investment, "soft" loans	Venture capital, bonds, stock, debt
$ RETURN	Negative to below market rate financial return	Below market to market rate returns	Market rate returns
INVESTORS	Foundations	Foundations, Angels, Donor Advised Funds	Stock market, funds

IDEA | DEVELOPMENT | LAUNCH | GROWTH | MATURITY

SECTION THREE:
MINNESOTA'S FOURTH SECTOR

By conceptualizing a new framework for social business, establishing supportive corporate forms, and creating a new development pathway for social businesses, Minnesota will be creating the foundation of an entirely new sector of the economy that we call the "Fourth Sector." The Fourth Sector will be populated by social businesses, which have owners to whom profit can be distributed, like a business, yet also commit legally to pursue a social purpose, like a nonprofit. As Minnesota's Fourth Sector grows and matures, it will also develop other elements that currently appear within the mature private, social, and government sectors. These include common language, supportive associations, standards and certifications, academic research, professional training, as well as sector-specific regulation and tax policy.

CONCLUSION AND CALL TO ACTION

Capitalism is a powerful economic system that, when at its best, can have incredibly positive social impacts. Through time, capitalism has lifted millions of people out of poverty into the middle-class. It is an engine of innovation and wealth, both of which can advance the common good. Even Karl Marx, who worked to replace capitalism with a new economic system, understood its productive power and held a grudging respect for it.[2]

However, there are many problems in our current form of capitalism. In the past twenty years, American capitalism has come to define success as growing shareholder value to the exclusion of all other interests.[3] The defining characteristics of this type of capitalism are a fixation on short-term profitability, fundamentalist free market ideology, manipulation of the political system, institutionalization of equity ownership, concentration of wealth, and the primacy of the shareholder over all other stakeholders.

A new form of capitalism can repair the damage done by the more exploitative form of capitalism while retaining its great power to create wealth, spread knowledge, and raise living standards. The creature of the new capitalism is social business.

In this white paper, we introduce social businesses and explain why they are important. We identify three major systemic obstacles facing social businesses and provide solutions for each. Finally, we argue that these solutions, once enacted, will form the foundation of Minnesota's Fourth Sector. We recognize that our recommendations are as bold as they are uncommon. Inspired by the importance, scope, and difficulty of the work ahead, we invite the reader to be "present at the creation" and to take part in cultivating social business, impact investing, and Minnesota's Fourth Sector.

Introduction

— A NEW BREED OF ENTREPRENEUR —

Thirteen years ago, frustrated by watching federal energy assistance dollars being spent year after year on non-renewable, carbon emitting fuels like natural gas, Jason Edens founded Rural Renewable Energy Alliance (RREAL). His goal was simple: make solar energy accessible to people of all income levels. Simple too was his strategy: RREAL started selling and installing solar furnaces in the homes of families in "fuel poverty" using a proprietary technology designed by RREAL. Once deployed, the systems provided a social benefit by saving the government at least $300 per year per home in subsidies and by avoiding carbon emissions that lead to global climate change.

Because of the clear social benefit and the long road to market validation, Edens chose to launch RREAL as a nonprofit corporation in Pine River, Minnesota. This allowed RREAL to receive philanthropic and government grants as well as critical pro bono support. "We probably would not have been able to stand on our own two feet as a for-profit corporation in the early going," says Edens.[4]

Now past the proof of concept phase and earning more than $1 million annually in revenue, RREAL is outgrowing its nonprofit structure. Its unrelated business income is creeping upward as a percentage of revenue, potentially jeopardizing its tax-exempt status, and it cannot raise equity capital to realize its strategic plan for national expansion. RREAL also struggles to secure bonding and insurance, typically only available to for-profits, and retain key talent without the ability to incent employees with ownership.

Entities like RREAL and entrepreneurs like Jason Edens are the face of "social business" in Minnesota. They are, as Joseph Schumpeter describes, "agents of creative destruction" playing a role in society that is at once "both disruptive and generative."[5] Their individual efforts have pioneered social business and taken it further than some expected against considerable odds. Yet there is a limit to how far they can go, and to the number of entrepreneurs that can follow them, without a sector and ecosystem that works for, rather than against, these special entities throughout their entire life cycles.

In this white paper, we explain what social businesses are and why they are important. We then identify three major systemic obstacles facing social businesses and outline solutions for each. Finally, we argue that these solutions, once enacted, will signal the creation of Minnesota's Fourth Sector.

SECTION ONE
THE EMERGENCE OF SOCIAL BUSINESSES

What are *social businesses?*

Organizations are a defining part of our human experience. From birth to death, we work, play, learn, and worship in them. Organizations themselves, from hospitals to schools to governments to businesses, all interact together as part of a massive, complex, and interdependent entity that we call the economy.

For all of the time we spend learning about and working in organizations, however, it is surprising how often we overlook their most important feature: that they are human constructs designed, managed, and perpetuated by people, and as such they can be redesigned and rebuilt as necessary. While it may not always feel like it, organizations exist to serve people, not vice versa.

Society has developed an economy based generally on three distinct types of organizations: government, business, and nonprofits, which make up the public, private, and social sectors respectively.[6] Traditionally, government exists to establish the rules of society and economic interaction, businesses exist to make a profit for their owners, and nonprofits exist to create a positive social impact.

During the last decade, a growing number of entrepreneurs, philanthropists, and investors have begun to challenge this structure of the economy in a new way.[7] They have rejected the notion that the deliberate creation of positive social impact by independent citizens belongs only in the social sector, believing instead that the pursuit of profit in the private sector can be facilitative of, not always detrimental to, the pursuit of social good.

The result is the emergence of a new type of organization, which can be described as "social business."[8] Social businesses are distinct from nonprofits and businesses but integrate attributes of each:

- Like businesses (but unlike nonprofits), social businesses have owners, and profit may be distributed to these owners.
- Like tax-exempt nonprofits (but unlike businesses), social businesses legally commit to pursue a social purpose, either by adopting a new social business corporate form (where they are available) or by voluntarily including this commitment in their corporate bylaws. This commitment to social purpose is transparent and reported against annually.

It is important to emphasize that social businesses, while sharing traits in common with entities in both the private and social sectors, actually belong to neither. Instead, social businesses eventually will form the foundation of an entirely new "Fourth Sector" of the economy.[9]

Why are *social businesses* important?

Facilitating the emergence of social businesses is important for a number of reasons. First, the Great Recession has demonstrated the need for organizations that "do well" and "do good" concurrently. As the financial crisis so clearly revealed, when businesses have a sole, profit-maximizing purpose, they are motivated to make decisions that may harm society or the environment and even undermine their own success. Similarly, when nonprofits focus on social impact without sustainable earned revenue or the ability to raise equity capital, they can struggle with financial viability and growth.

Second, social businesses can help overcome systemic resource constraints experienced by the public and social sectors in the pursuit of social impact. In government, as entitlements increasingly crowd out discretionary spending, public resources to support social impact will only diminish.[10] In the social sector, total U.S. charitable giving from all sources is about $315 billion per year,[11] which, while substantial and growing, amounts to less than 1 percent of the $33.3 trillion in total U.S. investible assets.[12] By enabling the pursuit of profit and social impact within the same organization, social businesses can put more money to work for social good.

Third, society needs ways to scale effective social improvements, and historically, no system has been more powerful at scaling ideas than capitalism. The power that businesses have for raising capital, attracting talent, and delivering products and services at a mass scale can and should be harnessed by social entrepreneurs to take their social impact as far as possible, as fast as possible.

The importance of using for-profit business models for social good has been articulated by a number of authors in different contexts. For example, Paul Polak and Mal Warwick, the founders of International Development Enterprises, which designs and markets products for the world's poorest farmers to help them increase crop yields and escape poverty, argue that the power of business can tackle social problems in their book *The Business Solution to Poverty.* They assert that businesses can be used as a tool to attract capital and talent to social issues, to sustain and scale results quickly. They also advocate that business supply chains can be employed strategically to further social improvement.[13]

Minnesota's Emerging Social Businesses

Given Minnesota's long and rich history of innovation and entrepreneurship, it should come as no surprise that the state is already home to a growing number of social businesses. IMNPACT Angels, a new network of early-stage angel investors interested in double-bottom-line businesses, reports having received inquiries from 28 social businesses since its launch in August 2013. Figure 1 provides a number of examples of Minnesota entities that are already using for-profit business models deliberately to solve a variety of social problems.

BUSINESS	ENTREPRENEUR	SOCIAL IMPACT	DESCRIPTION
COGNIFIC	Solome Tibedu	Adolescent Mental Health	Makes life easier for both healthcare providers and patients through a system that offers education, therapy, and accountability. Cognific offers prescribed mental health activities to the patient in a fun gaming format, as well as a related analytics platform for the therapist. Incubated by University of St. Thomas. Minnesota Cup Division Winner.
CUSTOMS MADE	Jeff Ochs	Cultural Preservation & Cross-Cultural Awareness	Provides an online catalog of beautifully illustrated fables and parables from around the world, many of which are currently absent from the marketplace. Customers can select the most meaningful combination of stories for inclusion in their own personalized "Cornerstone Stories" storybooks. Minnesota Cup Finalist.
FINNEGANS	Jacquie Berglund	Hunger	Launched 12 years ago, Finnegans is now the fifth largest beer producer in Minnesota. It uses a hybrid corporate structure with the for-profit beer company donating all profits to an affiliated nonprofit that supports hunger alleviation.
GARDEN FRESH FARMS	Dave Roeser	Sustainable Agriculture	An urban factory that grows food products including lettuce, herbs, and fish, year round, in close proximity to consumers. Employs environmentally friendly aquaponic method to convert fish waste to fertilize plants hydroponically. Minnesota Cup Division Winner.
INSIGHTFORMATION	Bill Barberg	Collective Impact for Social Change	Serves governments, community coalitions, hospitals, and non-profit organizations seeking to maximize Collective Impact. The flagship product InsightVision, a cloud-based collaborative strategy management platform, enables leaders to execute strategies, goals, and initiatives with community stakeholders.
MYRAIN	Steele Lorenz	Small-Plot Farmer Poverty	Distributes drip irrigation systems and other farm tools to small-plot farmers in southern India. Farmers decrease water use and increase crop yields. Incubated by University of Minnesota Acara program.
NAIKU	Greg Wright	Education	Provides next generation classroom assessment to K-12 schools leveraging student access to iPods and smartphones in order to ascertain student and class understanding of material instantly. Teachers use Naiku to measure, monitor, and track student achievement, which better informs their instruction. Minnesota Cup Division Winner.
PRAXIS MARKETS	Glenn Ford	Urban Food Deserts Minority Community Economic Development	Builds and operates grocery stores for inner city neighborhoods to address "food deserts," where low-income residents lack access to healthy foods at affordable prices. Integrates hydroponic and aquaculture urban farms.
RETRACE HEALTH	Thompson Aderinkomi	Health Care Access	A system to make high quality primary care medical services personal, affordable, and convenient through in-home diagnosis and treatment.
ROWBOT	Kent Cavender-Bares	Environmental Sustainability	Robotic fertilizer application system that reduces fertilizer runoff and improves yields for U.S. farm fields. Minnesota Cup Finalist.
SUNBORN	Ray Menard	Small-Plot Farmer Poverty	A food processing company that allows small-holding, low-income farmers to sell their produce in mass markets
THEDATABANK	Chris Hanson Mark Paquette	Strengthening the Financial Sustainability of Nonprofits	Provides high performance, affordable software solutions to nonprofit organizations; and offers a workplace that respects diversity, encourages innovation, and creates sustainable employment. thedatabank's web-based software for relationship management and communications helps its nonprofit clients develop and sustain long-term relationships with their supporters.
TULOKO	Duane Johnson	Minority Community Economic Development	A mobile computing-based service to help African-Americans find black-owned businesses in their community and for the businesses to develop customer loyalty programs for Tuloko users. Minnesota Cup Division winner.

FIGURE 1.
EXAMPLES OF MINNESOTA-BASED BUSINESSES ALREADY PURSUING A DOUBLE BOTTOM LINE

Cheetah Development: *Building a market for small holding farmers*

Ray Menard made his first trip to Tanzania in 2008. What he found there deeply troubled him. He saw an agrarian society where half of the farmers make a subsistence living on their small plot farms, producing no cash income and, in some years, not growing enough food to feed their families. Most perplexing to Menard was the fact that almost half of the food that is grown is lost to spoilage after the harvest.

Driven by his desire to help and armed with his extensive knowledge of markets and supply chains from his long career in business, Menard began to analyze the problem and came to an inescapable conclusion – that the food value chain was broken. The problem begins with the low crop yields of Tanzanian small plot farmers working an average of less than 10 acres. Maize farmers there grow about 250 pounds per acre. By way of comparison, Minnesota corn farmers raise an average of 142 bushels per acre, or approximately 8,000 pounds per acre.

But low crop yields are only the beginning of the larger problem. The Tanzanian farmer has only his back or a low load capacity bicycle to transport his products to market. Lacking the means to get their products to market in a timely way or to preserve their perishable produce, farmers lose much of their inventory to rot, rats, and insects.

Once he had defined the problem, Menard set to work on a solution. He first created Cheetah Development, a Minnesota-based 501(c)(3) corporation, but with a twist. Menard knew the long-term answer was creating an efficient agricultural market for the Tanzanian farmers, not dependency on aid. This conclusion lead him to use the 501(c)(3) as an incubator to create a series of businesses that collectively would serve as an efficient value chain for the small holding farmers. Using a business called Pearl Foods, Menard helped farmers organize themselves into cooperatives to increase their group buying power and also introduced improved agronomy methods to raise crop yields. Next, Cheetah tackled the transportation problem by setting up a manufacturing business called Kabisa to make specially designed bicycles that can carry much heavier loads and speed transport to markets. To get at the food preservation problem, Cheetah launched Reservoir to manufacture and distribute a high throughput, low-cost solar food dryer so farmers can preserve produce for later sale. The final piece of the puzzle was Sunborn, a food processing business that uses the farmers' dried produce to make proprietary food products and additives for the mass market.

Cheetah Development now has four operating businesses that collectively increase farmer yields, give them higher volume transportation options, and create value-added products distributed in larger markets. Taken together, more farmers sell more of their crops for better prices with the attendant improvements in the farmer's standard of living.

Additionally, the Cheetah businesses are themselves catalysts for further economic development as the farmers prosper and company employees earn better wages causing a ripple effect of buying and saving.

Cheetah has been funded through both philanthropic donations and impact investment. In its early days when risk was highest, Cheetah was not attractive to financially motivated investors. Instead, it relied on philanthropists, who believed strongly in the social mission, for funding. Now past the riskiest phase of development, however, Cheetah is raising equity investment from impact investors willing to accept more financial risk in exchange for the potentially high social return. As the businesses become profitable, Cheetah will be able to gain credit relationships with local bankers and attract larger investors, adding even more momentum to agrarian economic development in Tanzania.

Praxis Markets: *An Oasis in Inner City Food Deserts*

After growing up in an inner city neighborhood of Chicago, Glenn Ford earned two degrees at Eastern Illinois University and a masters degree from Northwestern. Following a long career with Fortune 500 corporations and holding executive positions in the medical, scientific, food production, and the distribution industries, Ford came to believe that existing business practices and economic models had failed inner city communities. But he also believed that business, practiced in new ways, was the best means of supporting and strengthening those communities.

After examining a number of inner city neighborhoods, Ford identified the problematic abundance of "food deserts," areas in which residents lack access to healthy foods at affordable prices. In true entrepreneurial fashion, however, he saw not only a problem, but also an opportunity. He envisioned the presence of food oases within these urban food deserts and set about creating Praxis Markets, a chain of investible grocery stories that would commit to nourishing the people and the communities that need it most.

Praxis Markets are currently under development in Chicago, Kansas City, and Minneapolis. Ford's plan is for neighborhood residents to become each store's suppliers, employees, and customers. He estimates that each store and its corresponding aquaponics operation will together employ nearly 300 people from the community. To finance Praxis, Ford has worked with a combination of city economic development funders using a wide array of instruments including tax increment financing, New Market Tax Credits, strategic supplier investment, corporate foundation contributions, and equity investors.

Why Act Now?

While the topic of social business has generated a great deal of discussion, skeptics dismiss it either as a passing fad or an unworkable fantasy. The biggest risk to this movement is not that its supporters act too boldly or too soon but rather too timidly or too late. To make social businesses successful and permanent, advocates must solidify foundational theories, create new corporate forms, and provide them access to capital. The next section discusses each of these three needs in detail.

SUMMING IT UP:

- ✓ We have the power to redesign organizations to serve our economic and social needs.
- ✓ A social business is distinct from nonprofit and traditional business forms but integrates attributes of each. Like businesses, social businesses have owners, and profit that is earned may be distributed to these owners. Like tax-exempt nonprofits, social businesses commit, via their corporate form or corporate bylaws, to pursue a social purpose.
- ✓ Social business can unleash the power of capitalism for social good.
- ✓ Social businesses are already being formed and operating in Minnesota.

SECTION TWO
THREE SYSTEMIC OBSTACLES FOR SOCIAL BUSINESSES

Obstacle 1: Lack of Theoretical Acceptance

One of the biggest obstacles that aspiring social business entrepreneurs face is widespread skepticism that an entity that commits to pursuing both a profit and a positive social impact is even theoretically viable. This skepticism is the result of an entrenched conceptual framework.

ENTRENCHED FRAMEWORK: THE PURPOSE SPECTRUM

The existing framework hinders the theoretical acceptance of social business because within it social good and profit for owners are diametrically opposed or mutually exclusive, as is illustrated in Figure 2.[14] According to this framework, if an organization seeks to achieve more social benefit, it must *axiomatically* seek less profit. Similarly, if an organization seeks to increase its profits, it can do so only if it is willing to pursue less social benefit. This worldview pits profit against social impact in a zero-sum game. While this tradeoff may exist in some cases, it is not absolute.

This conceptual framework is problematic for a number of reasons. First, it rules out the possibility that a social business could align its activities such that it simultaneously maximizes social benefit and profit for owners at the same time. This in turn limits the thinking of entrepreneurs and forces them to choose between making money for owners and making a positive social impact.

THE PURPOSE SPECTRUM

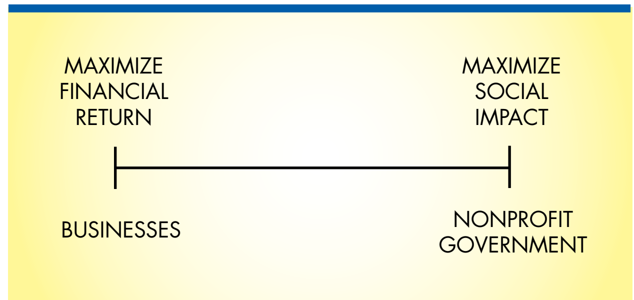

FIGURE 2.
THIS CURRENT CONCEPTUAL FRAMEWORK HINDERS ACCEPTANCE OF THE FOURTH SECTOR

Second, adherence to this framework precludes acceptance of pure double-bottom-line social businesses as theoretically viable. When confronted with the claim that a social business seeks to attain both high financial returns and social benefits, skeptics point to this framework and argue that pursuing both impact and profit really means doing neither well, and according to this framework, they are right. Fortunately, the skeptics can be proven wrong by proving this framework wrong as well.

Solution: Revise our conceptual framework to make room for social businesses

People will not support what they do not perceive as feasible, and they will not accept as feasible what does not fit their pre-existing mindset. For social businesses to thrive, a new conceptual framework of the economy must be nurtured and disseminated.

History is full of examples in which existing worldviews have delayed major advances from taking root. One familiar instance is the refusal to accept the earth as spherical because it clashed with the existing belief in a flat earth. Yet once this fact was proven and accepted, it unleashed a flood of innovation that we still benefit from centuries later.

THE NEW FRAMEWORK: FINANCIAL RETURN & SOCIAL IMPACT

The new framework recognizes that every entity, whether nonprofit or for-profit, has *both* a financial and a social value proposition, even if both are not always articulated and regardless of whether each value proposition is positive or negative. Instead of a single-axis spectrum, we propose considering financial return and social impact, *as viewed by investors,* on their own separate axes. This new framework is shown in Figure 3.

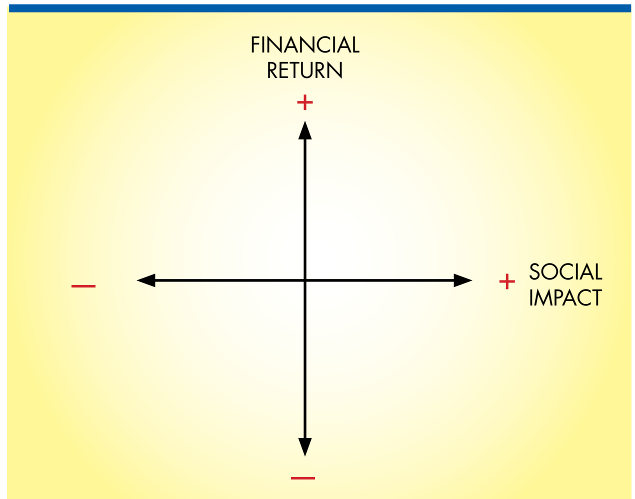

FIGURE 3.
THIS REVISED CONCEPTUAL FRAMEWORK MAKES ROOM FOR SOCIAL BUSINESSES

In this conceptual framework, an entity's financial value proposition is defined as the financial return a particular investor expects on an investment. The financial value proposition is likely to change depending on which type of capital the investor is providing (debt, equity, or donation) and depending on their own due diligence. While there is no theoretical limit to a positive financial return, a negative financial return is limited to loss of the entire principal.

An entity's social value proposition is the measure of its impact on society and/or the environment, and it may be negative or positive. This axis is more subjective and difficult to quantify than the financial return axis. Nonetheless, it is a vital evaluation tool in this circumstance. Entities are free to make any number of claims as to how they create social impact, but it is ultimately the investor who decides where on the axis they fall, especially relative to other entities. For a discussion about the most common ways entities claim to make a social impact, see the following inset.

How can an organization claim to have a social impact?

While the specific ways in which an entity, *regardless of its corporate form,* can claim to create a social impact are quite diverse, generally they fall into one of three categories: selling, sourcing, and sharing.[15]

1. SOCIAL BY SELLING

Some entities claim to provide positive social impact because of what they sell or to whom they are selling. In the first case, the product or service itself, when used by customers, results in a compelling social (not just private) value. In the second case, a company may sell a conventional private good but to an under-served population, potentially at a below market price.

ecoEnvelopes, LLC

Located in Eden Prairie, MN, ecoEnvelopes sells reusable envelopes that, when used in place of conventional envelopes, result in reduced mail costs for their customers as well as conserved resources, eliminated paper waste, and averted CO2 emissions.

MyRain, LLC

Minneapolis based MyRain distributes drip irrigation systems and other farm tools to a significantly under-served market of small-plot farmers in southern India.

2. SOCIAL BY SOURCING

Some entities claim to be social because of how they produce their products or services. Common ways ventures source socially include using environmentally friendly processes and materials, employing vulnerable populations, contracting with minority owned suppliers, locating operations in target geographic areas, and using public co-production processes.

Ten Thousand Villages

Ten Thousand Villages sells unique handmade gifts, jewelry, home decor, art, and more. All products are created by a network of disadvantaged artisans in 38 countries using environmentally friendly processes and materials. Sales comprise 98 percent of the Minnesota affiliate's 2012 revenue.

Whole Trees

Whole Trees brings small diameter forest thinnings to the construction industry for use in custom buildings. Forest owners receive a much larger profit on these thinnings when selling them to Whole Trees rather than as pulp or firewood. This in turn encourages conservation and better care of mature forests.

3. SOCIAL BY SHARING

Finally, some entities claim to be social because they share some or all of their profit with other charitable organizations or causes. Non-profits automatically share 100 percent because they must reinvest any profits they have back into their social mission. Businesses may decide to share 1 percent, 5 percent, or more with organizations that then deliver the desired social impact. Some entities share their profit through a "Buy One Give One" model.[16]

Latitude, LLC

Located in Minneapolis, MN, Latitude is a full service creative marketing and production agency delivering the best in design, print, display, and fixtures. The company also invests 50 percent of its profits (over $1 million since 2009) directly to initiatives and programs that empower people living in extreme poverty.

Finnegans, Inc.

Minneapolis based Finnegans, Inc. sells its own brand of beer through bars and liquor stores. It then donates 100 percent of the profits to alleviate hunger. In 2012, Finnegans donated $100,000, which purchased over 140,000 pounds of locally grown produce for food shelves.

Entities also can claim a social value proposition that touches multiple dimensions at the same time. For example, Minnesota Computers For Schools (MNCFS) refurbishes used computers discarded from private companies (sourcing) and resells them to educational institutions at a below-market price (selling). Additionally, much of the refurbishing is done by inmates in a workforce development program at a state correctional facility in Stillwater, MN (sourcing). Because MNCFS is a nonprofit, all profits are reinvested into its social mission (sharing).

The Social Enterprise Census uses a similar classification and recently asked 325 social enterprises if they deem themselves social because of "what they do" (63 percent), "how they do it" (18 percent), or "why they do it" (14 percent).[17]

In reality, financial and social value propositions are both present in the way businesses and nonprofits pursue investment.

At first glance, the idea that every entity has *both* a financial and social value proposition may seem absurd. This is because we are used to traditional businesses only leveraging their financial value proposition as they seek investment. Likewise, in the social sector, we are accustomed to organizations leveraging only their social value proposition in order to attract donors. This is the whole reason why the current conceptual framework exists.

In reality, financial and social value propositions are both present in the way businesses and nonprofits pursue investment.[18] From an investing perspective, a growing number of investors apply screens to exclude from their portfolios companies that have negative Environmental, Social, or Governance (ESG) effects such as those that sell products like alcohol, tobacco, or firearms.[19] This means that even if businesses are not articulating a social value proposition, these investors are still independently identifying and considering it as they make their investment decisions.

Furthermore, businesses do articulate their social value propositions when it is advantgeous for them. For example, when pursuing public subsidies, businesses often highlight the ways in which they create positive social impact as a justification for taxpayer investment. In the Twin Cities, we heard how privately owned sports teams provide social benefit when the Twins and Vikings lobbied for public support of new stadiums.[20] Similarly, the Mall of America articulated its social impact as it sought public support of a new expansion.[21] Additionally, companies choose to advertise their social impact when they believe it will differentiate their products and attract customers.[22] As these examples demonstrate, businesses do have social value propositions, even if they are strategic about using them.

Just as a customer can refuse to buy a product even after hearing a company's value proposition, a socially-motivated investor does not have to invest in a given entity just because it claims to have a positive social impact. Similarly, because an entity claims it is benefitting society in one dimension of its business does not exclude the possibility that it is causing harm in another. Investors will have their opinions about which social impacts are most desirable and which metrics best demonstrate the achievement of the claimed social impact. While this certainly is an important discussion, it is outside the scope of this white paper.

Skeptics often object to the concept of social business citing that conventional companies have been behind some of the most important social improvements of our time. They point to rising standards of living, medical breakthroughs, and new communication tools and ask why we need social business if conventional for-profit businesses can also make such significant social contributions. Our framework concedes and celebrates that all entities, even for-profits, have a social impact, and that such an impact can be quite positive, even if those businesses have decided not to make a legal commitment to that impact or to leverage it by pursuing philanthropic investment.

In the same way that every business has a social value propositon, every nonprofit also has a financial value proposition for investors. When requesting a grant or donation, a nonprofit's financial value proposition to the investor is negative, because the donor "loses" the entire principal. Interestingly, however, depending on the donor's situation, he or she may save some money in taxes, which means the the financial return of a donation actually varies from individual to individual.

It may be tempting to argue that a nonprofit that employs an earned revenue model has a better financial value proposition for a donor than one that relies entirely on contributions. This is natural because in the private sector more revenue usually leads to more profit, which increases financial return for the investor. However, this is inaccurate in the social sector because in both cases a donor receives the same negative financial return on his or her donation. Unlike the for-profit sector, a nonprofit donation does not buy ownership or any claim to profit, so how effectively a nonprofit uses a donor's dollar to bring in earned income does not impact the donor's specific financial value proposition at all.

Also unique to the social sector, nonprofit managers often use the organization's financial model (i.e. contributed vs. earned income) to enhance the entity's *social value proposition*. Nonprofits that rely primarily on contributions often highlight the fact that the only way they can provide their services or products is through donations because the beneficiary cannot pay. In this way, the nonprofit is actually using what could be considered a financial disadvantage to strengthen its social value proposition and attract donations. On the other end of the spectrum, nonprofits with high earned revenue are likely to persuade donors that their social impact will go farther because of their earned revenue model. We are not advocating one over the other here; it is simply worth noting that for nonprofits, the financial model has nothing to do with the financial value proposition made to an individual donor and everything to do with the social value proposition, which is opposite to the way it works in the private sector.

THE NEW FRAMEWORK APPLIED

To demonstrate this new framework in action, we have placed a number of entities on our graph in Figure 4, based on fictional but plausible financial and social value propositions as *judged by one hypothetical investor* considering an equity/donation investment.

There is a large amount of subjectivity to the relative location of organizations along the social impact axis. Ultimately, investors decide, based on their values and on the metrics the organization chooses to measure its impact, where along the social impact axis to place each organization. While some may view the subjectivity of social value as a shortcoming, it is not unique to this framework; it is endemic in the social sector where organizations constantly compete for funding by demonstrating greater social impact, even though methods for evaluating that impact are difficult to identify and execute, and even though apples-to-apples comparisons between impacts of different types and across sectors are elusive.

This conceptual framework is superior to the existing purpose spectrum because it creates a theoretical space for organizations that exist for the *dual purpose* of making a significant financial return for owners and a significant positive social impact. Without this new framework, the whole idea of social business does not make conceptual sense.

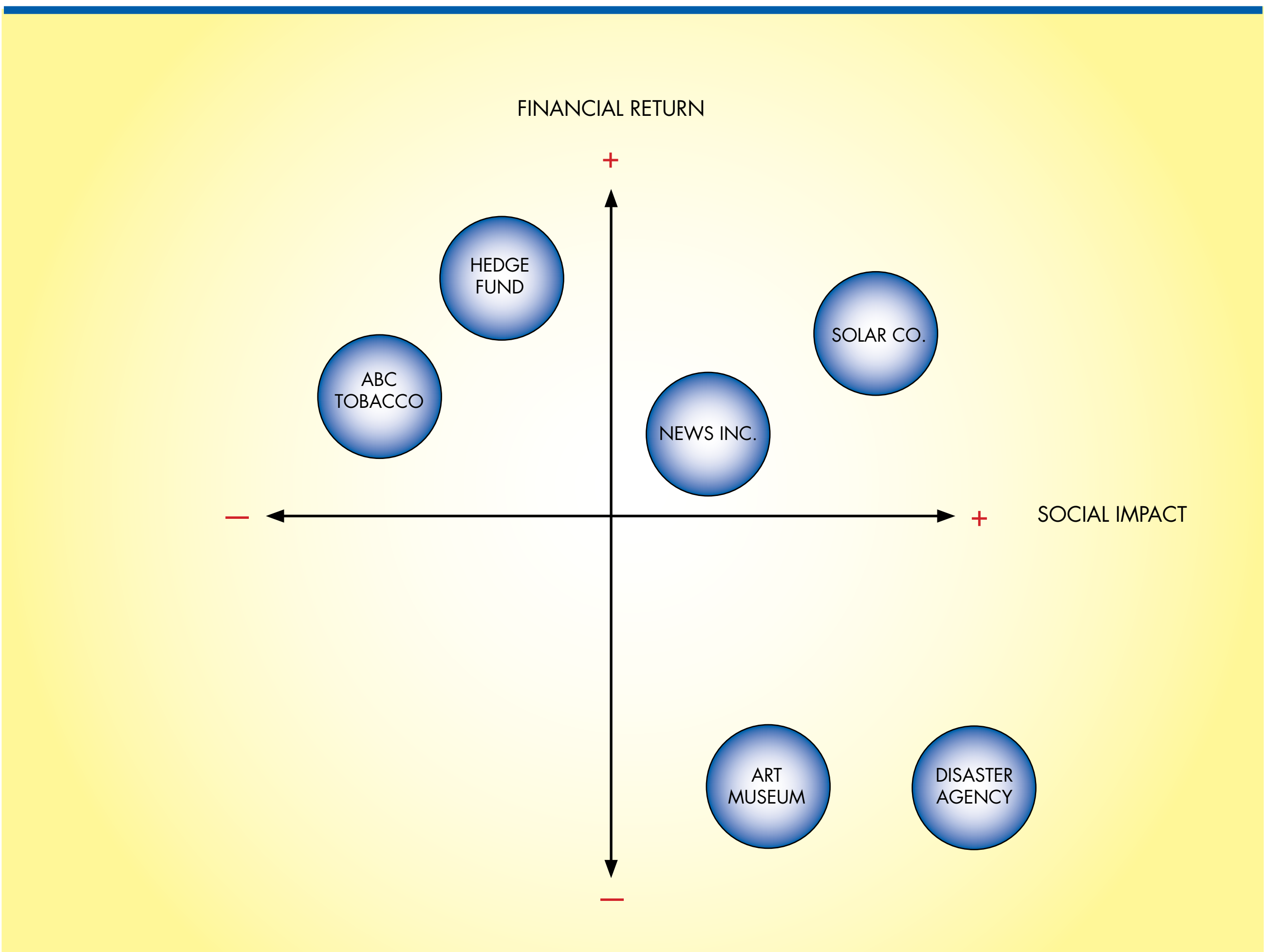

FIGURE 4.
FINANCIAL AND SOCIAL VALUE PROPOSITIONS OF VARIOUS ENTITIES AS VIEWED BY ONE HYPOTHETICAL INVESTOR USING THE NEW CONCEPTUAL FRAMEWORK

Before moving on, it is important to make two key points. First, our framework has cousins in the literature. The idea of representing financial return and social impact on separate axes is not new. Other scholars have articulated a similar concept,[23] and so have practitioners like Acumen (see Figure 5).[24] However, while the two-axis representation is similar, charts like Acumen's often include some type of frontier line, which helps to perpetuate the misconception that that social impact and financial return are opposites and that as one increases the other must decrease. We believe the presence of such a frontier line, while perhaps true in some cases, still conceptually slows the understanding and acceptance of social businesses.

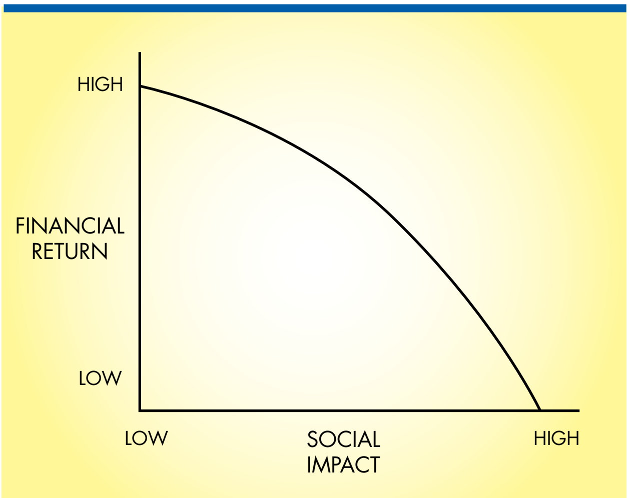

FIGURE 5.
THIS CHART BY ACUMEN IS HELPFUL BUT STILL CONCEPTUALLY LIMITING

Second, because all entities have both a financial value proposition and social value proposition, it is important to be clear that what distinguishes social businesses from nonprofit organizations and for-profit businesses is not the presence of both value propositions but rather the fact that a social business *officially commits to realizing and to leveraging for investment purposes* both a positive financial value proposition and a positive social value proposition.

In 1952, psychologist and researcher, Kurt Lewin, wrote, "There is nothing more practical than a good theory." Social business entrepreneurs could not agree more given that they continually confront skepticism born out of an outdated theoretical framework of the economy. For social businesses to take root, we must first affirm this accommodating theoretical groundwork.

SUMMING IT UP:

- ✓ The existing conceptual framework inhibits acceptance of social businesses by assuming profit and social impact are mutually exclusive as illustrated in the Purpose Spectrum.
- ✓ Every entity, for-profit or nonprofit, has both a financial and a social value proposition.
- ✓ An organization's social value proposition is the measure of its impact on society and/or the environment, and it can be positive or negative.
- ✓ There are many ways an organization can claim to create social impact, but generally they fall into three categories: selling, sourcing, and sharing.
- ✓ Investors ultimately decide the value of an entity's social impact.
- ✓ A social business is distinguished from nonprofit organizations and for-profit businesses because it officially commits to realizing and to leveraging for investment purposes both a positive financial value proposition and a positive social value proposition.

Obstacle 2: No Suitable Corporate Form

A second major impediment for social business entrepreneurs is the absence of a standard corporate form that is specifically suited to the official pursuit of *both* profit for owners *and* a positive social impact within the same organization. This means that, currently, social business entrepreneurs must work within the constraints of the existing private and social sector corporate forms. As we explain below, this approach has important limitations.

LIMITATIONS OF THE NONPROFIT FORM

From the perspective of a social business entrepreneur, the nonprofit form, while enabling the pursuit of positive social impact, has barriers to overcome.

The first barrier is that nonprofits do not have owners, and profits earned by a tax-exempt nonprofit must be retained by the organization or distributed to other charities.[25] This means that a nonprofit cannot sell equity to investors, which can limit access to capital, especially in the growth phase. Additionally, it means that neither the founding entrepreneur nor subsequent employees can maintain a personal financial stake in the entity itself. Given that shared employee ownership often serves as an important form of long-term, performance-based compensation, especially in the early stages of a new venture, nonprofits may struggle to attract and retain talent.[26]

A second barrier to running a social business as a tax-exempt nonprofit is the IRS restrictions on unrelated business income. Nonprofits can receive tax-exempt status in exchange for pursuing a recognized charitable purpose. When a tax-exempt nonprofit engages, on a regular basis, in a business activity that is not "substantially related" to its exempt purpose, the income from that activity is consequently subject to income tax.[27] Most importantly, if a "substantial" share of a tax-exempt nonprofit's revenue is classified as unrelated, its exempt status can be jeopardized.[28] While the IRS has not established an official numerical threshold for what counts as "substantial," case law has set a precedent at around 15-30 percent of income.[29] For social businesses that have substantial earned revenue from a variety of different products or services, like RREAL in the introductory case, the restrictions of unrelated business income can become a major limitation.

To summarize, when social business entrepreneurs incorporate their ventures as nonprofits, they are able to establish and protect the entity's social value proposition. However, as they subsequently try to earn revenue or distribute profits more like a business, they run into major barriers that were intentionally erected to keep the pursuit of profit for owners outside of the social sector.

LIMITATIONS OF BUSINESS FORMS

Multiple business forms are available (e.g. LLC, C-Corp) to social entrepreneurs and each has its own advantages and disadvantages.

Unlike the nonprofit form, a business corporation form presumes the presence of owners and a corporate purpose to pursue profit for these owners.[30] The question is can a business corporation pursue social impact as an objective equal to or greater than the pursuit of profitability. The answer is riddled with complexity and uncertainty, both of which work to stifle entrepreneurial activity.

One source of uncertainty is conflicting case law regarding the nature of corporations and their obligations. Two main, opposing legal models exist, the property and entity models. The property model asserts that a business corporation has a sole purpose of maximizing wealth for its owners.[31] This is in contrast to the entity model, which contends that the corporation simultaneously serves the interests of multiple constituencies.[32] Since the 1980s, the American Bar Association argues, "it has become clear to most commentators that the property model is ascendant."[33] The property model is especially predominant in Delaware,[34] which, as home to more than one million corporations and 50 percent of all U.S. public companies,[35] has a major influence on corporate law nationwide.[36]

The impact of the property model is most clearly revealed in change-of-control contexts, during which the interests of stakeholder groups and shareholders regularly diverge. In normal day-to-day, operational contexts, however, there is more room for directors and officers of business corporations to consider non-shareholder interests.[37] Even so, as the Delaware Court of Chancery explained

The question is can a business corporation pursue social impact as an objective equal to or greater than the pursuit of profitability.

in 2010, "promoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders." In other words, under the property model, directors and officers of business corporations can promote the interests of non-shareholders but only when they can rationalize it as also maximizing long-term shareholder value.[38]

In response to the primacy of the property model, 30 states have enacted constituency statutes similar to Minnesota's, which declares, "A director *may* … consider the interests of the corporation's employees, customers, suppliers, and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation and its shareholders including the possibility that these interests may be best served by the continued independence of the corporation."[39] The operative word in this statute is "may" because it *allows* rather than *requires* a director to consider these non-shareholder interests. Additionally, because the original intent of Minnesota's constituency statute was to create a defense against hostile corporate take-overs, whether or not it also allows consideration of non-shareholder interests in operational contexts is less certain.[40]

Social business entrepreneurs can technically attempt to address some of the shortcomings of the default business corporation form by changing their articles of incorporation and through additional, customized legal actions. There are problems with this approach. First, little case law in this area makes it hard to know if such actions actually will provide sufficient legal protection in a court of law. Second, the constituency statute itself is fairly short, leaving many critical questions unaddressed. Specifically, what are the consequences if a director fails to pursue the corporation's social purpose? And who has standing to bring a legal action in such a situation? Without clear statutory direction, it is uncertain how judges will rule on these questions in specific cases.

From the perspective of the entrepreneur, the third and most obvious problem with lawyering around the limitations of the default business corporation form is that it can be prohibitively expensive. Every start-up deals with a shortage of cash, and the last place most entrepreneurs want to spend their money is on legal fees, especially when the resulting document offers uncertain protection.

Another fact worth considering is that it is the stockholders of a corporation who are, in most cases, responsible for enforcing (or not) the de jure expectation of profit maximization. If the directors of a business corporation decide to prioritize the needs of a non-shareholder group in a way that clearly does not add shareholder value in the long-term, and if the owners of the business do not object, then legally there is no problem. This means that in closely-held business corporations, a small group of owners can more feasibly commit to pursue a social purpose that comes at the expense of long-term profit. As the business grows and takes on new owners, however, or even as owners change opinions, adherence to such a social purpose becomes increasingly difficult.

To summarize, for a social business entrepreneur in Minnesota, the business corporation form clearly *permits* the pursuit of social impact when such actions also arguably support the long-term financial interests of shareholders. Additionally, in a change-of-control setting, a Minnesota business corporation can be confident that it *may* consider non-shareholder interests that come at the expense of shareholder value. However, a business corporation has much less confidence that it may *allow* (to mention nothing of *requiring*) the pursuit of non-shareholder interests at the expense of shareholder value on a regular, operational basis. Finally, these concerns become increasingly pronounced as a business corporation grows and adds owners.

The following case on Engine for Social Innovation provides an example of a pioneering Minnesota social business that has struggled to find a corporate form that adequately communicates and facilitates its double-bottom-line purpose.

Engine for Social Innovation

After holding leadership positions in both for-profit and nonprofit organizations, Jim Delaney set out on his own and founded Engine for Social Innovation, a pioneering Minnesota social business, in 2010. Engine's Dynamic Leaders program engages teams of professionals to work on 12-week consulting projects for Twin Cities nonprofit organizations. As Engine's nonprofit clients receive quality consultation services from talented professionals for a below-market rate, the participants also develop leadership skills.

Jim first incorporated Engine for Social Innovation in Vermont as an L3C, an early experimental corporate form associated with social businesses that is not available in Minnesota, in order to differentiate Engine as being about both social impact and profit. "Our business model fits right in between for-profits and non-profits," Delaney says. "Existing forms do not accurately describe or facilitate what it is we are trying to do."

Since then, Delaney has moved Engine from the Vermont L3C form and into a traditional Minnesota LLC form. One major reason he cites is the additional administrative hurdles of filing paperwork in Vermont while still being treated like a traditional LLC in Minnesota for tax purposes.

Delaney believes that Minnesota is poised to be a regional and national leader in social enterprises, but even once a suitable Minnesota corporate form exists, it will be up to these types of companies to prove that double–bottom-line businesses are worthy investments. "It is a new concept, so it is going to take some time for social enterprises and investors to come together on this type of investment. But that is right around the corner," he says.

SUMMING IT UP:

✓ A social entrepreneur must work within the constraints of the existing private and social sector corporate forms, which have significant limitations.

✓ Limitations of the Nonprofit Form

- A nonprofit form does not have owners, and profits earned by the organization must be retained by the organization or distributed to other charitable organizations.
- Tax-exempt nonprofits face numerous IRS restrictions on "unrelated business income."

✓ Limitations of the Business Corporation Form

- Legal uncertainty and complexity regarding the pursuit of a social purpose within a business corporation form stifles the creation of social businesses.
- In Minnesota, the business corporation form clearly permits the pursuit of social impact when such actions also support the long-term financial interests of stakeholders.
- In Minnesota, in a change-of-control context, a business corporation can be confident that it may consider interests of non-shareholders.
- A business corporation, even one that has taken customized legal actions, has much less confidence that it may allow or require the pursuit of non-shareholder interests at the expense of shareholder value on a regular, operational basis.
- Concerns over the pursuit of a social purpose that comes at the expense of shareholder value intensify as a business corporation grows and adds owners.

Solution: Create a new corporate form specifically for social businesses

In light of the limitations of existing corporate forms identified above, Minnesota's social businesses need a new corporate form that is specifically designed around their goals and needs. Such a form would most importantly provide the necessary legal protection for social businesses to pursue profit as well as a social purpose within the same organization.

Additionally, creating a new corporate form would clearly identify social businesses as distinct from nonprofit and business corporations for external stakeholders. Currently social businesses must join either the private or social sector even though neither fully captures their intentions or fits their methods. This means that it can take a considerable effort to communicate the true "double bottom line" nature of the venture to consumers, investors, and vendors, who automatically project all of the host sector's conventions onto the social business. Having a unique corporate form for social businesses would facilitate understanding between all of these external constituencies and ultimately encourage more economic activity.

Finally, the act of creating a new corporate form in itself would provide social business entrepreneurs with additional credibility. As discussed earlier, social businesses struggle to convince stakeholders of all types that the pursuit of profit and a social purpose within the same organization is even theoretically viable. The creation of a new corporate form designed specifically to enable this activity, would lend considerable weight to their argument and legitimacy to their actions.

MINNESOTA'S PROPOSED PUBLIC BENEFIT CORPORATION STATUTE

The effort to create a new corporate form for social businesses in Minnesota has been underway for nearly a decade. The Minnesota Legislature has considered some variation of such legislation in each session since 2005 [41] yet, in each case, the legislation has failed to move out of committee. During the 2012 session, a bi-partisan bill was heard in several committees in both the House and Senate but not on the floor of either chamber. The sponsors of the bill then "asked a volunteer committee of academics, lawyers, and other skilled professionals to examine and improve the language of the proposed legislation" in preparation for the 2014 session.[42]

From February through September 2013, this "B Corps Drafting Committee" met regularly to draft a proposed statute. The committee started by reviewing and comparing legislation from other states as well as model legislation advanced by interest groups. Members also identified, shared, and analyzed articles and works of scholarship on benefit corporations. They then considered all of this information "in light of [Minnesota's] existing business law statutes."[43] Also as part of this process, a series of round tables was convened with social enterprise practitioners, philanthropic and private investors, and other field developers to solicit input. In August and September, the committee circulated an "exposure draft" to key constituencies for comment and held open comment sessions with legislators and the broader public. At the time of publication, the committee has submitted its final proposal draft (see Appendix B) to the sponsoring legislators, who will then usher it through the legislative process.

The final proposal draft for the "Public Benefit Corporation" statute calls for the creation of a new chapter 304A that "provides an overlay to chapter 302A [Minnesota's business corporation statute] that authorizes the formation of two distinct forms of for-profit corporations that require a corporate purpose broader than shareholder value maximization (emphasis added) that do not prohibit pecuniary gain for shareholders.[44] Collectively these corporations are referred to as "Public Benefit Corporations" and separately as either "General Benefit Corporations" and "Specific Benefit Corporations," which differ primarily on the nature and extent of their social commitments, as well as how they report against those commitments. Furthermore, the "enforcement of the duties created by the proposed chapter 304A is not accomplished through governmental oversight, but rather by provisions requiring public disclosure, accountability, and designation."[45] In other words, the State of Minnesota will not directly police and judge a Public Benefit Corporation's social impact; rather investors, customers, and the general public will have access to information they need to evaluate each company's performance on their own.

It is our opinion that adoption of this statute, at least as it has been initially proposed, would be a major step forward for social business entrepreneurs in Minnesota. With 19 states, including Delaware, having already passed similar benefit corporation legislation, the time is right for Minnesota to do the same.

SUMMING IT UP:

- ✓ Minnesota's social businesses need a new corporate form specifically designed around their goals.
- ✓ Minnesota's legislature has been discussing some type of social business corporate form for nearly a decade. A Public Benefit Corporation statute draft has been proposed by a special committee comprised of academics, lawyers, and skilled professionals acting at the request of a number of Minnesota state legislators.
- ✓ Passing the Public Benefit Corporation bill would be a major step forward for social businesses in Minnesota.

Obstacle 3: Lack of Access to Capital

In addition to lacking theoretical acceptance and a suitable corporate form, social businesses also lack access to capital. This section explores the current obstacles social businesses face in raising capital as well as the responsive actions commonly taken by aspiring entrepreneurs.

SOCIAL BUSINESSES: NEITHER, EITHER, OR BOTH?

The private and social sectors both have conventions for attracting investment. In the private sector, investors are motivated by the promise of a positive financial return (profit) to themselves as shareholders. In the social sector, philanthropic investors (e.g. foundations and individuals) are motivated to invest by the positive social impact that will result. Figures 6 and 7 below highlight areas of the new conceptual framework in which private and social investors could meet their respective goals.

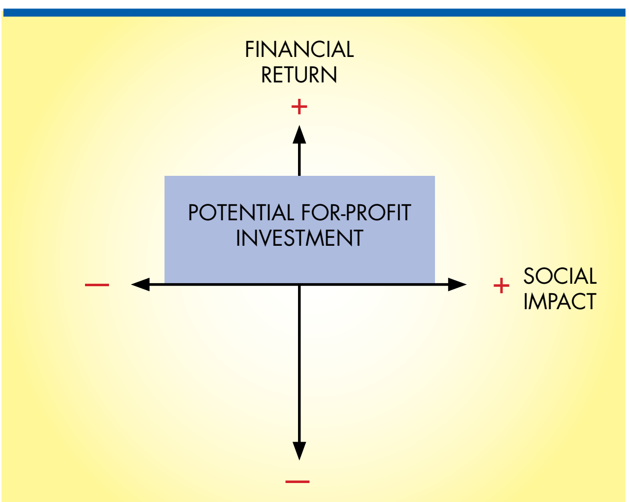

FIGURE 6.
FOR-PROFIT INVESTORS SEEK FINANCIAL RETURN

In Figure 6, the entire area above 0 percent financial return is in play for the for-profit investor. Theoretically, if an entity claims it will make its investors money (i.e. leverages its positive financial value proposition), it is potentially investible. This is the case even if the social impact of the business is negative, as long as it remains within legal boundaries.

In Figure 7, the entire area that represents positive social impact is in play for the philanthropic investor. If an organization claims it will make a positive social impact (i.e. leverages its positive social value proposition), it should be of interest to philanthropists.

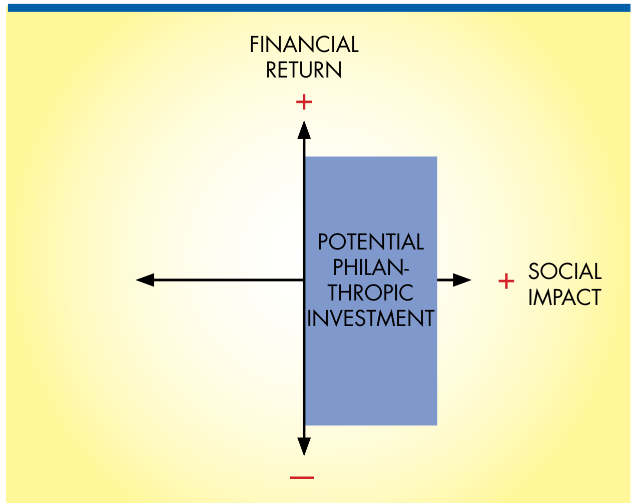

FIGURE 7.
PHILANTHROPIC INVESTORS SEEK SOCIAL RETURNS

While the previous diagrams are accurate when an entity leverages just one of its value propositions as it seeks investors, as soon as it declares that it commits to pursue a positive financial return for owners *as well as* a positive social impact, both types of investors can grow confused and lose interest, as shown in Figure 8. The social business, which hopes to make the potential pool of capital as large as possible, actually makes it as small as possible.

Reflecting on this situation, we have unfortunately built a financial system in which entities that commit to "doing good" and "doing well" at the same time have the most difficult time raising capital. At best this is ironic. At worst it is counterproductive. Regardless, this is the fundamental problem that must be addressed for social businesses to thrive.

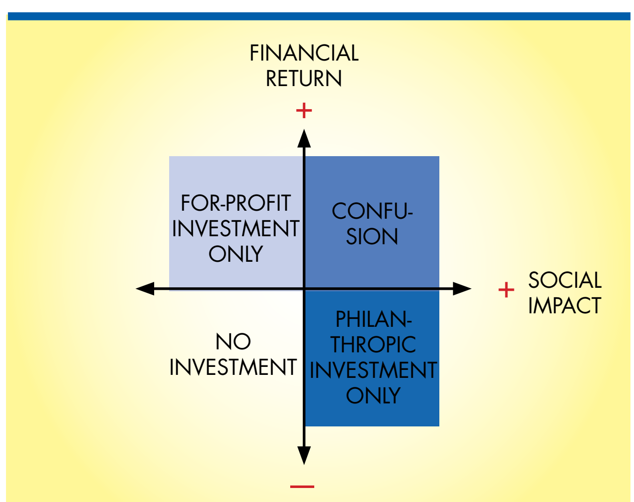

FIGURE 8.
SOCIAL BUSINESSES STRUGGLE TO SECURE INVESTMENT FROM EITHER SECTOR

Philanthropic Investors

1. Ineligibility for Tax Advantages

While the income tax deduction for charitable donations is not the only (or even most important) reason for giving, it does provide an incentivize for individuals and foundations to make philanthropic investments. Investments in a social business are usually not eligible because the entity is not a tax-exempt nonprofit. While tools like Program Related Investments can circumvent this problem for foundations, they are not widely used and are generally unavailable to individuals.

2. Resource Scarcity and Opportunity Cost

The social sector exists in a state of resource scarcity; there are always more worthy causes that need funding than there is money to fund them. As a result, philanthropists may assert that charitable dollars should go toward causes that cannot pay for themselves in other ways. Since a social business can theoretically raise for-profit capital, philanthropists may see the opportunity costs of investing in a social business as high.

3. Lack of Familiarity and Experience

The foundation community is primarily set up to support nonprofits through grants. While program officers are experts at evaluating social value propositions, they may have less experience in evaluating financial value propositions and structuring investments beyond grants. Additionally, within a foundation, program staff and investment staff often have very different goals and limited interaction.

4. The Role of Profit

Within the social sector, there are different and conflicting views of the value of profit in the private sector. On one hand, there is respect for how profitability enables sustainability, scale, and even corporate generosity. On the other hand, many recognize that, in some cases, the pursuit of profit actually contributes to the creation of the same social and environmental problems the social sector exists to address. When a social business claims to have a profit motive in addition to a social impact motive, suspicion may result.

For-Profit Investors

1. Distraction from Profit

For-profit investors typically make an investment only to maximize their financial return, and they do not want any other competing interests to distract from that priority. The introduction of a social mission, even if it does not hurt profits, increases the complexity of running the business.

2. Lack of Precedent = Increased Risk

For-profit investors are generally risk averse. The more risk is involved in a deal, the less likely they will be to invest, or the higher the price of their investment will be. As the presence of a concurrent social mission is still a novel concept, it is perceived as increased risk.

3. Lack of Flexibility

Business leaders and investors understand the need to respond to the market. Many major businesses we know today pivoted away from their original idea once they learned what the market really needed. Tying a company to an overly specific social mission could create another barrier to adaptation. For more discussion of this topic, see Appendix A.

4. High Transaction Costs

Because investing in social businesses is unfamiliar to investors, most deals are treated as "one off" transactions that require the time and expense of attorneys, CPAs, and other financial advisors. The result is a high cost of transactions, which is counted against any potential return on investment.

5. Slow or No Exit

Equity investors only realize their full financial return upon a liquidity event, which usually is an acquisition of the investee by another company or a public stock offering (IPO). Social businesses that are pioneering new markets can have long development periods that stretch the investment return timeline. Additionally, social business founders are often highly committed to maintaining their social mission, a desire that may not be shared by an acquiring company, which further complicates exit strategies.

HOW SOCIAL BUSINESS ENTREPRENEURS CURRENTLY RESPOND

Given that neither philanthropic nor for-profit investors are generally prepared to invest in a social business, an entrepreneur is pressured to choose one value proposition to emphasize over the other. This compels him or her to weigh the advantages and disadvantages of each sector and choose the sector that is most strategically important during the life of the entity, which includes five stages: 1) idea, 2) development, 3) launch, 4) growth, and 5) maturity. Table 1 lists major milestones at each stage:

TABLE 1.
THE FIVE STAGES OF THE SOCIAL BUSINESS LIFE CYCLE & MAJOR MILESTONES OF EACH STAGE

IDEA	DEVELOPMENT	LAUNCH	GROWTH	MATURITY
Research customer needs and social issue	Test core assumptions	Commercialize the Minimum Viable Product	Product improvement and line extensions	Improving margins & economies of scale
Define initial value propositions	Develop and market test prototypes	Acquire initial customers	Repeat and new customers attained	Sustaining impact
Research competition	Build strategic relationships	Prove feasibility	Revenue and impact growth	Growth slowing
Design the business model and plan	Adjust business plan as necessary	Monitor and adjust	Breakeven and profitability achieved	Invent new products
Connect with experts	Protect Intellectual Property	Achieve first social outcome evidence	Increased headcount	Consider new markets or social needs matching core competencies

At each stage of its life cycle, a social business faces different challenges and requires different resources. Generally the amount of financial capital required is lower during the first stage and increases gradually through development and launch. It then jumps dramatically during the growth phase before tapering slightly during maturity.

From the perspective of a social business entrepreneur, the private sector is disadvantageous in the first two and a half stages but advantageous thereafter. Since the standards of for-profit angel investors and venture capitalists are so high, it is very difficult to attract their funding until the company has initially launched and started to prove the concept in the marketplace. Even if an entrepreneur can find outside money earlier, it will be expensive and require a lot of equity or a high interest rate to compensate for the risk. Once a majority of the risk has been removed, however, the private sector excels at providing late-launch and growth capital to scale a successful business.

If the entrepreneur has the ability to fund the social business through the first stages with savings, family, and friends; or if the long-term financial value proposition is so compelling (even without proof of concept) that for-profit investors will invest in the earliest stages, then the private sector may be the best option. Without these attributes, the social business entrepreneur may prefer the social sector.

Figure 9 graphically captures the development pathway of businesses vis-à-vis outside, private sector investment. As mentioned above, during the first stages of business development, most entrepreneurs will struggle to find outside capital and will likely rely on self-financing or friends and family. Once the concept is proven in the market with sales growing, outside, for-profit capital will be abundant.

FIGURE 9.
GENERAL AVAILABILITY AND SUFFICIENCY OF CAPITAL FROM PRIVATE SECTOR

The social sector is just the opposite (see Figure 10), generally providing advantages in the first two and a half stages of an organization's development but disadvantages thereafter. Because philanthropic investors are motivated by creating social impact and not financial gain, they are more willing to take risks on unproven ideas to see if the social impact can be realized. While early-stage investments are not easy to come by, individuals and foundations are incentivized through taxes to donate charitably. Additionally the amount of money needed by many social entrepreneurs to advance from idea to launch is well within the range of philanthropists to satisfy. Once nonprofit organizations have launched successfully, however, they struggle to get the financial support necessary to scale their impact without the ability to raise equity capital.[46]

FIGURE 10.
GENERAL AVAILABILITY AND SUFFICIENCY OF CAPITAL FROM SOCIAL SECTOR

One strategy that social entrepreneurs currently can employ to capture the advantages of both the private and social sectors is to establish multiple organizations and to connect them contractually. One of the most popular approaches is to establish a nonprofit organization for the first three stages of development and then to "drop down" a for-profit subsidiary that is owned by the nonprofit to help grow the business. This practice, while feasible, has major drawbacks because it increases governance complexity and comes at a financial cost; customized legal documents can be expensive and running two organizations rather than one requires additional ongoing resources. Furthermore, attracting outside, for-profit investment into a subsidiary for-profit still presents a major challenge, especially if the nonprofit insists on retaining majority control of the subsidiary, as is almost always the case.

THE EMERGENCE OF IMPACT INVESTING

Recently, a new class of investors, commonly called "impact investors," has also started to emerge. Impact investors seek both a social and financial return [47] and are an ideal source of capital for social businesses.

Relative to the multi-trillion dollar size of the mainstream capital markets, impact investing , while growing, is still small.[48] Over time, however, impact investors will eventually create funding mechanisms all along the development pathway that mirror those of the private sector. For example, impact investors aspire to develop their own angel networks, venture capital firms, lenders, brokers, funds, and perhaps even stock exchanges that exist in parallel to those in the private sector. The main difference is that impact funding mechanisms will deliberately seek both a social and financial return, while their private sector counterparts will seek only a financial return.

Because impact investors share, to a large extent, the *financial* goals of for-profit investors, they will also be hesitant to invest in a social business before there is some initial success in the market place. As a result, as is shown in Figure 11 below, impact investment will similarly be most abundant in later stages of a social business's life cycle.

FIGURE 11.
EVENTUAL AVAILABILITY AND SUFFICIENCY OF CAPITAL FROM IMPACT INVESTORS

To summarize, as Figures 9 and 10 reveal, the existing private and social sector capital systems have complementary advantages throughout a social businesses life cycle, as is shown in Figure 12.

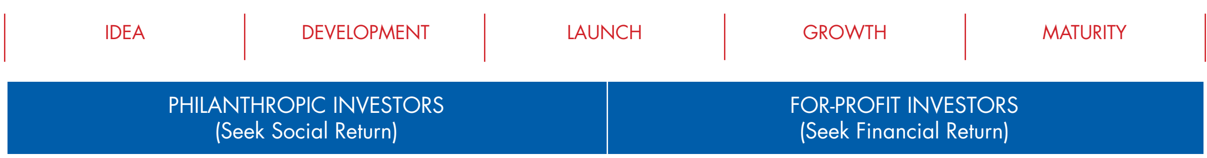

FIGURE 12.
PRIVATE AND SOCIAL SECTOR CAPITAL SYSTEMS HAVE OFFSETTING ADVANTAGES FOR A SOCIAL BUSINESS

Furthermore, as impact investors continue to emerge and organize, they will create funding mechanisms that run parallel to those in the private sector, as is shown in Figure 13.

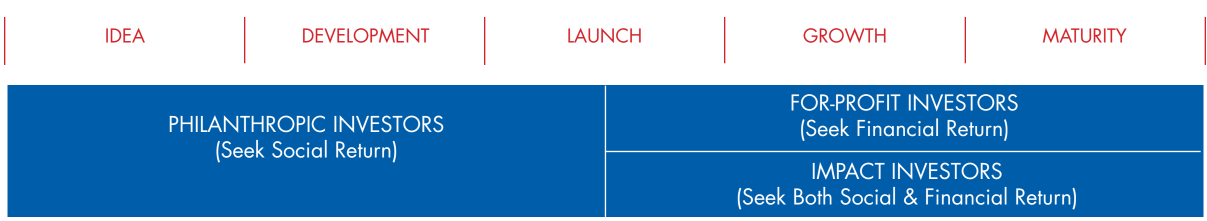

FIGURE 13.
A NEW CLASS OF IMPACT INVESTORS IS EMERGING TO SUPPORT SOCIAL BUSINESSES IN LATER STAGES

SUMMING IT UP:

- ✓ For-profit investors consider investments when there is a positive financial value proposition. Philanthropic investors consider investments where there is a positive social value proposition.
- ✓ Currently, when a social business commits to both a positive social value proposition and a positive financial value proposition, both philanthropic and for-profit investors are less inclined to invest.
- ✓ There are valid reasons for this reaction from investors in both sectors.
- ✓ Entrepreneurs who would like to start social businesses are currently forced to choose one sector.
- ✓ The social sector excels at providing capital during the idea, development, and early-launch stages of an entity's development. The private sector excels at providing capital during the late-launch, growth, and maturity stages of an entity's development. As such, they are naturally complementary.
- ✓ A new class of investors, commonly called "impact investors," is emerging. Impact investors seek both social and financial returns on the same investment

Solution: Establish a new development pathway for social businesses

As discussed in the preceding section, the private and social sector capital systems, which have offsetting advantages and disadvantages, are naturally complementary. Three collaborative investor roles can offer social businesses a continuum of investment from concept to liquidity event. A given institution or individual can play any single or all three roles over time with a social business. The three roles are (1) the philanthropic investor that is motivated to seek a social return, (2) the impact investor distinguished by the goal of gaining both social and financial return on investment, and (3) the for-profit investor whose investment decisions are driven by financial return.

If investors from each of these three roles invest at the right time for the business' development, as shown in Figure 14 ("The Social Business Development Pathway"), they can create a pipeline of social businesses that meet the social impact goals of philanthropists, the "double bottom line" goals of impact investors, and the profit goals of for-profit investors. Variations of this approach have been called "philanthrocapitalism,"[49] "phased investing," or "baton-passing."[50] Whatever name is used, this method is key to providing social businesses with the right amount of capital, at the right time, and in the right form.

THE SOCIAL BUSINESS DEVELOPMENT PATHWAY

ROLE	PHILANTHROPIC INVESTOR	IMPACT INVESTOR	FOR-PROFIT INVESTOR
MOTIVATION	Social return	Social and financial return	Financial return
OUTCOME	Make a social business with a strong social value proposition investible	Strengthen the business' financial value proposition and lock in the social mission	Scale the business and prepare for liquidity event
MEANS	Grants, PRIs	PRI, MRI, angel investment, "soft" loans	Venture capital, bonds, stock, debt
$ RETURN	Negative to below market rate financial return	Below market to market rate returns	Market rate returns
INVESTORS	Foundations	Foundations, Angels, Donor Advised Funds	Stock market, funds

IDEA	DEVELOPMENT	LAUNCH	GROWTH	MATURITY

FIGURE 14.

Figure 14 shows the developmental pathway of a social business, from idea to maturity, mapped to the three investor roles. Each investor role has distinct purposes, means of investing, expectations of financial return, and investment vehicles. In this section, we discuss in detail how social businesses can engage philanthropic, impact, and for-profit investors throughout their development.

PHILANTHROPIC INVESTMENT: ENGAGE SOCIAL SECTOR FUNDERS TO MAKE SOCIAL BUSINESSES INVESTIBLE

During the first stages of the Social Business Development Pathway, a social business engages philanthropic investors motivated by the company's social value proposition but also because its long-term financial value proposition will facilitate sustainability and scaling. The first goal of early philanthropic funders is to support the social business through development and launch, ultimately positioning it for impact and for-profit investment in later stages.[51]

A second objective of philanthropic investors in the Idea and Development stages is to create a "social impact term sheet" with the entrepreneur to establish exactly how the social impact will be made, evaluated, and embedded into the social businesses before any outside impact or for-profit capital is invested. This is an important task that must balance social and financial considerations. For a detailed discussion on this topic, see Appendix A. In return for accepting the higher level of risk, the philanthropic investor will be assured that the social mission will remain intact and "locked" unless altered through an agreed upon process (see Appendix A).

The most significant sources of philanthropic capital are foundations, individuals, crowdfunding, and contests, and by far the most common investment structure used by these sources are grants or donations, which are not repaid and enjoy tax advantages for the donor. These types of investors and similar tools should be engaged strategically when possible to support early-stage social businesses and to build a pipeline of social businesses suitable for impact and for-profit investment.[52] The following section describes three potential sources of philanthropic investment for a social business during the idea, development, and launch stages.

1. Private Foundations and Program Related Investments

A private foundation is one of two types of organizations designated by IRS section 501(c)3 as charitable. Unlike public charities, the second type, private foundations typically have one major source of funding, such as a family or corporation, and usually make grants to other organizations that make a positive social impact.[53] In exchange for distributing at least 5 percent of their assets charitably each year, private foundations receive tax advantages and pay only a 2 percent federal excise tax on net investment returns.[54]

Currently, private foundations in the United States give nearly all of their charitable contributions to public charities through grants. However, private foundations also have a special tool at their disposal called a Program Related Investment (PRI), which allows them to give their charitable dollars to any type of entity, even for-profit businesses, if it supports the same charitable mission.[55] For this reason, PRIs have the potential to be a major source of seed capital for social businesses.

PRIs have the following characteristics: [56]

- PRIs must further the tax-exempt mission of the private foundation
- PRIs can be made to any type of organization (e.g. nonprofit or LLC)
- PRIs count as a qualifying distribution toward the 5 percent payout requirement
- PRIs can be structured as recoverable grants, senior or subordinated loans, loan guarantees, lines of credit, equity, bonds, or other tools
- PRIs must not be made for the purpose of producing income or appreciating property, so most are structured to receive a below-market financial return
- PRIs are recoverable, and repaid funds are reused for other charitable causes.
- Any positive financial return from a PRI is usually treated as investment income
- If a PRI is not repaid, it can be counted as a grant
- PRIs do not violate jeopardizing investment rules
- Outstanding PRIs are excluded from total assets when calculating annual payout

Foundations have been using Program Related Investments since their creation under the Tax Reform Act of 1969. The Ford Foundation was one of the early pioneers of PRIs, allocating $10 million to them shortly after the law passed.[57] While PRIs remain largely underutilized, the Lilly School of Philanthropy reports that over the last two decades, PRI investments have grown significantly from $139 million in 1990 to $701 million in 2009.[58] In Minnesota, PRIs have been used by, among others, the Northwest Area Foundation, Otto Bremer Foundation, McKnight Foundation, The Saint Paul Foundation, The Minneapolis Foundation, Pohlad Foundation, and Bush Foundation.[59] Overall, PRIs are currently most commonly structured as large loans and made to nonprofit organizations.[60]

Because social businesses legally commit to creating a positive social impact in the same way that nonprofits do, a private foundation with an aligned social mission could use a PRI to provide a modest amount of early-stage risk capital to a social business. This concept has been advocated by well-respected philanthropic leaders like The Bill & Melinda Gates Foundation, The Monitor Group, Omidyar Network, Acumen Fund, and others.

One of the barriers to more foundations using PRIs is the transaction costs associated with "one off" PRI deals that require staff time and legal expenses. For this reason, we advocate for the creation of a simple agreement that: is easily valued and understood by all parties across industries and contexts; could become a template and shared; and clearly fits within IRS guidelines, so there is low risk of fines. Such an agreement could easily become a standard of practice and significantly reduce PRI transaction costs for Minnesota's foundations to a point where they are no more expensive to administer than a grant.

One example of such a deal structure would be a recoverable grant with a payback timeline that is generous, flexible, and tied to the venture's success. The recoverable grant would be unsecured, but the foundation would also require the entrepreneurs to make their own equity investment. Finally, the recoverable grant would be forgivable if the venture fails. The idea is that if an early-stage PRI is unsuccessful, it would yield the same negative100 percent financial return received by foundations on nearly all of their current charitable distributions. However, if a PRI is successful, the foundation would receive at least the principal back, perhaps with some interest, and be able to reinvest that money in other social businesses or nonprofits.

Ultimately, we envision a dynamic, decentralized system in which private foundations of all types know about this basic form of a PRI and have plenty of templates to use and precedents to reference if they want to execute one with a social business. With a simple and standard recoverable grant arrangement such as the one introduced above, supported by basic training and support from an organization like the Minnesota Council on Foundations, private foundations could relatively easily integrate social business PRI recoverable grant proposals into their existing program staff responsibilities and current grant review procedures. And just as nonprofits currently research foundations with which they have mission alignment and apply for grants, social businesses could identify aligned foundations and apply for a PRI crafted as a recoverable grant.

While technical solutions like templates and training will certainly help create a system in which PRIs are used to invest in early-stage social businesses, these activities alone will not be sufficient. Most importantly, advocates of social business need to convince area foundations that this type of system makes strategic sense.

The good news is that foundations themselves, not just social businesses, stand to benefit strategically from adoption of PRIs. Research by a number of well-respected institutions such as the Lilly School of Philanthropy,[61] Foundation Center,[62] and Trillium Asset Management Corporation [63] have demonstrated these advantages and advocated for the expanded use of PRIs. Overwhelmingly, the biggest benefit of a well-executed PRI strategy identified is that it can expand both the foundation's social impact as well as its corpus.[64]

Other benefits include:

- **Leveraging Initial Investment**

U.S. foundation assets totaled nearly $650 billion in 2011,[65] while total investable assets under management in 2012 was $33.3 trillion.[66] If philanthropists can help birth and raise a social business, which then turns to the private sector for growth capital, they will free a huge pool of funds that was otherwise unavailable. [67]

- **Financially Sustainable Social Impact**

A common concern among foundations is how to support social ventures that do not become dependent on them in order to exist.[68] As they mature, social businesses are actually financially sustainable from their own business activities.

- **Using Profit Motives for Good**

Profit motives are powerful catalysts, and the diffusion of ideas moves quickly when profit is involved. It follows, then, that if the philanthropic sector can incorporate social impact into a profit-making model, that impact can be scaled more quickly. [69]

- **Recycling Charitable Dollars**

Unlike a grant, PRIs are intended to be repaid and potentially earn a small return. This money may in turn be recycled and put to additional charitable use. Over time a PRI strategy can allow a foundation to increase its charitable giving and grow its financial assets.[70]

While PRIs may legally be made to any type of corporate form, it is common for private foundations to write into their own bylaws a requirement that all charitable contributions must be given to nonprofit 501(c)(3) organizations. This creates an obstacle for short-term use of PRIs by social businesses, at least among some private foundations. The good news, however, is that bylaws can be changed. It is incumbent upon the advocates of social businesses to prove the effectiveness of PRIs in this context and to motivate private foundations to amend their bylaws and offer them in addition to their traditional grants.

2. Individual Donors and Intermediaries

Individuals are another major source of philanthropic capital.[71] In addition to their philanthropic motivations, individuals are financially incentivized by a tax deduction. Whenever a donor gives money to a 501(c)(3) tax-exempt nonprofit organization, that organization provides a receipt, which the donor then uses as proof of the donation for tax filing. Under current law, however, a donation to a social business would not be tax deductible, even if that social business commits to providing the same or better social benefit as a tax-exempt nonprofit. For individual donors, this eliminates the most significant financial incentive to support a social business.

Intermediaries would be an effective means of engaging individual donors with social businesses. By bringing buyers and sellers together, aggregating capital, and developing efficient mechanisms that lower transaction costs, intermediary organizations are one of the hallmarks of a well-developed capital market. Social businesses would benefit from supportive intermediaries of their own. Two intermediary forms, that would facilitate social business investment, incubators and institutions drawing on the capital from Donor Advised Funds, are discussed below.

- **Social Business Incubators**

A social business incubator that is incorporated as a tax-exempt nonprofit would be able to raise tax-deductible donations from individuals interested in supporting this nascent sector and then use those funds to provide developmental programming and seed capital to the social businesses. The incubator could even take equity stakes in the social businesses it supports with the potential for a return on its investment. That return could then be used for operating capital and to fund new ventures. Whether through loans or equity, investments in a social business would be mission aligned for the incubator, and any income generated would arguably be mission related, not jeopardizing the incubator's tax-exempt status with unrelated business income.

In addition to providing seed capital, incubators help new social businesses by giving them office space, technical support, business mentoring, and seed capital. Since they help new ventures across multiple dimensions, incubators have been shown to greatly increase the success rate of start-ups.[72]

A further advantage of incubators is that they could accept grants or PRIs from foundations as an intermediary, allowing those foundations to indirectly support social businesses.

The concept of a nonprofit incubator supporting social businesses has already been proven effective at the national level. The Acumen Fund, which describes itself as "a nonprofit that raises charitable donations to invest in companies, leaders, and ideas that are changing the way the world tackles poverty."[73] Additionally, Acumen provides "a wide range of management support services nurturing the company to scale."[74] To date, the organization reports investing $83 million in 73 breakthrough companies, creating 58,000 jobs and impacting 100 million lives.[75]

Currently, Minnesota has no full-scale incubator expressly serving social businesses. The closest example is Acara, a program operated under the Institute on the Environment at the University of Minnesota. Acara works with "emerging student entrepreneurs to envision and launch social and environmental ventures by teaching courses, mentoring teams, and providing ongoing incubation."[76] The program organizes cross-functional teams of students from business, engineering, and other disciplines to develop business models that address social problems like providing potable water for the slums of India. One of the teams went on to launch a social business called MyRain, which manufactures and sells a low-cost drip irrigation system to small holding Indian farmers.

- **Donor Advised Funds**

Donor Advised Funds (DAF) have become one of the most popular vehicles for individual and family philanthropy holding billions in assets with both community foundations and financial service companies operating these funds.[77] This pool of capital can be a rich source for funding intermediaries serving social businesses. To date, most DAF contributions have gone to intermediaries in the community development and microfinance sectors. One of the more innovative intermediaries using DAF for investment is RSF Social Finance (RSF), a nonprofit financial services company. RSF makes equity investments in social businesses operating in the environmental improvement, sustainable agriculture, and education.

3. Crowdfunding

Crowdfunding is the newest method employed by social businesses to raise capital during the idea and development stages. It offers a new way for artists, inventors, activists, and entrepreneurs to raise contributed money for start-ups and projects. Crowdfunding capital is seldom the single, or even major, source of capital, but it can be the money that closes the gap between the social business' total capitalization needs and what it can raise from founders and their friends and family. The advantage of crowdfunding for the entrepreneur is that it does not require giving up equity or taking on debt. There has been a proliferation of crowdfunding sites including Kickstarter, Indiegogo, and RocketHub among others.

4. Competitions

Competitions are another way for philanthropic investors to support social business development in the idea and launch stages. Entrepreneurs gain important benefits from participation in such competitions. The most obvious benefit is the prize money that is often the "first money" invested in the emerging business. Beyond that, entrepreneurs gain the invaluable experience of preparing clear, compelling presentations of their concepts and making a "pitch" to judges. The exposure to a wider audience and media coverage often leads to new investors, supporters, and customers.

In Minnesota, Social Venture Partners Minnesota hosts the Social Entrepreneurs Cup, a division of the Minnesota Cup, with $25,000 in prize money provided by the Mosaic Foundation. Both RREAL, profiled in the introduction of this paper, and Tuloko, which is developing an app that helps consumers and businesses identify minority-owned businesses to patronize, were winners of that competition and used the prize money to take their respective businesses to the next level of development.

Building a healthy pipeline of social businesses will require investment in more than the occasional homerun. The social sector must provide modest amounts of risk capital to a large number of social businesses in order to develop enough investible social businesses that are ready for impact and for-profit capital. Otherwise, as has already been observed, we will continue to see impact investors "lined up around the proverbial water pump waiting for the flood of deals, while no one is actually priming the pump."[78]

It should be noted that philanthropic investors ought to encourage and even require that the founding team of entrepreneurs also invest their own capital and "sweat equity" into the social business. Doing so ensures that the founders have "skin in the game" and are fully committed to the endeavor.

IMPACT INVESTMENT: STRENGTHEN BOTH THE SOCIAL AND FINANCIAL VALUE PROPOSITIONS

Once a social business has been nurtured through the idea, development, and initial launch stages by philanthropic investors, it is ready for impact investment. At this point the extent of the company's social commitments will be known, which, in addition to clarifying the social value proposition for an impact investor, will also clarify the financial value proposition. As discussed in Appendix A, how a social business commits to making a social impact—whether through selling, sourcing, or sharing—also impacts its ability to grow and make money for investors. A social business that has launched successfully will have attained some concrete resolution to the potentially ambiguous interplay of mission and money, a critical prerequisite to securing impact investment.

Impact investors are like traditional for-profit investors in that they seek a financial return. However, unlike for-profit investors, impact investors also desire social return and see the company's social value proposition as an asset not a liability. They are drawn to, rather than deterred from, the social business based on the presence of the social value proposition. Therefore, while for-profit investors are inclined to price capital for social businesses at a premium, impact investors may actually discount their capital in order to facilitate achievement of the company's social mission. As a result, impact investors will become the major source of late-launch and growth capital for social businesses.

Developing an active impact capital system will be vital to supporting social businesses through the late-launch and early-growth stages:

1. Impact Angel Investors

Within the private sector, the earliest investors in a business, after the entrepreneur and her friends and family, are often angel investors. Angel investors are accredited investors that invest their own capital into early-stage businesses. Many angels were themselves entrepreneurs who gained their wealth from the sale of their businesses. Therefore, angel investors offer skills, experience, and relationships in addition to capital.

Angels are most commonly organized as either a network or a fund. In the network configuration, the angels share deal flow and due diligence duties, and make individual investment decisions. Investors in an angel fund will pre-fund a pool of investment capital and the contributing angels jointly select investees. Many angel investors work alone or with a small number of trusted co-investors on a deal-by-deal basis.

A new class of angel investor, the impact angel investor, is emerging with a focus on social businesses. Impact angels seek both a financial and social return, but they may be willing to accept a below market financial return in exchange for a social return. They may also be willing to hold an investment for the longer period required by many social businesses that are pioneering markets. Recently, Minnesota welcomed its first impact angel network, IMNPACT Angels, an affinity group of the Gopher Angels network, to the state.[79]

2. Foundations and Mission Related Investment (MRI)

After supporting a social business during the first three phases, foundations may also consider later stage investments as impact investors. Increasingly, foundations are looking to invest their corpus in ways that achieve social impact but do not sacrifice financial return,[80] and one of the biggest barriers to using an MRI strategy is a lack of investible deal flow. In exchange for early-stage investment, a foundation or a syndicate of foundations could be offered a right of first refusal to provide growth capital at a competitive market rate. This would provide more incentives to foundations to support companies through the initial three stages.

It is important to note that even pioneering foundations interested in investing in a social business have also wanted to see other impact or for-profit investors involved as a sign that the financial value proposition is accurate and compelling. The reason is simple: private investors often have more experience in assessing financial value propositions of growth companies, so for-profit investment it acts as a seal of approval.[81]

3. Impact Venture Funds

As the number of investible social businesses increases, we anticipate the emergence of social business funds, which invest in a variety of growing social businesses to spread their risk. Some pension funds are already beginning to go beyond negative screening of their investments (not investing in companies with negative social value propositions) and toward the more proactively social practice of impact investing.[82] These vast pools of for-profit capital could significantly expand the system's capacity to capitalize social businesses.

4. Community Development Financial Institutions

"Community Development Financial Institution" (CDFI) is an umbrella term for intermediaries that provide financial services for underserved populations and communities and may take the form of a bank, credit union, loan fund (small business or microenterprise), or venture fund. In Minnesota's Twin Cities metro area there are several CDFIs doing effective work including the Nonprofits Assistance Fund, Sunrise Banks, and the Neighborhood Development Corporation. The CDFI entity could be readily adapted for the needs of social businesses whose social missions match that of the CDFI requirement to serve low-income communities.

5. Family Offices

Family offices provide professional investment management, tax, trusts, and philanthropy services, and in some cases, private equity placement. The family office's overriding goal is to protect the family assets and transfer wealth across generations. As younger generations of the family come to the fore, many want to bring their investments in closer alignment with their values and social concerns. This shift has created new demands on family offices to engage in impact investing.

6. Social Business Accelerators

Accelerators are similar to incubators, but they meet different needs. The best analogy is that incubators support the birth and infancy (idea, development, and launch) of a social business while the accelerator guides it through its adolescence into adulthood (early growth). Incubators often do not have a fixed time period that the venture can remain in the incubator; in fact, an entity may stay for a period of years. In contrast, businesses participate in accelerators for a shorter time period of typically three to six months.

Chicago is home to Impact Engine, a potential model for a Minnesota accelerator. Impact Engine is a social business accelerator that recruits cohorts of 6 to 8 start-ups and takes them through a 16-week program that helps them to hone their business models, receive coaching from experienced entrepreneurs, and take part in training on technical and management topics. Each business also receives $25,000 in seed capital in exchange for 7 percent equity in the company.

7. Equity Crowdfunding

In the spring of 2012 Congress passed the JOBS Act that contained a new provision that, if successful, could greatly alter how social businesses raise capital. That provision removed the ban against businesses raising capital by making direct appeals to investors through advertising. The U.S. Securities and Exchange Commission (SEC) has recently announced rules that companies can make direct appeals to investors for equity investment through online platforms restricted for verified accredited investors sometimes called "walled gardens."

An even greater departure from past regulations will open the way for non-accredited investors to take equity positions in early stage businesses. Title III of the JOBS Act would allow non-accredited investors to use crowdfunding mechanisms to invest in early stage businesses. The SEC is currently taking public comment as it formulates rules to implement this portion of the law. Depending on the conditions set for non-accredited investors to participate in this new capital market it is estimated that it would open a $2 trillion capital market for investment, some of which could become available for social businesses.

While impact investors will likely not invest in the social business until the business has launched and shown some initial market success, this does not mean that they should not be intimately involved in the building of the business in the earlier phases. To ensure a successful first round raise, impact investors should be at the table early.[83] Otherwise, the philanthropic sector risks building a financial value proposition that is not attractive and does not scale.

FOR-PROFIT INVESTMENT: SCALE THE BUSINESS AND PREPARE FOR LIQUIDITY EVENT

Once a social business has entered the growth phase successfully, it will be able to approach conventional private investors motivated solely by financial return.

The institutions of for-profit investment are well known and have evolved over centuries into their current forms. They include venture capitalists, which mainly focus on growth stage companies, as well as the vast capital marketplace of Wall Street, which aggregates and deploys trillions of dollars into tens of thousands of businesses using a myriad of funds, banks, and brokerage houses. Community banks and credit unions also play a part in this financial ecosystem. All of the members of this well-established, private sector capital system are motivated by the pursuit of profit.

While for-profit investors will consider investing in a social business if its financial value proposition is adequately compelling, it is important to recognize that the presence of a social mission is likely to cause some initial concern. For this reason, the further down the development pathway a social business moves and the more established its social commitments and business model becomes, for-profit investors will perceive less risk in an investment in a social business. Since for-profit investors have access to larger amounts of capital than impact investors, then there will likely come a time at which a social business will transition from impact capital to traditional private sector capital. This will likely happen in the late-growth and maturity phase.

SUMMING IT UP:

- ✓ If existing philanthropic and for-profit investors, as well as the newly emerging class of "impact investors" collaborate effectively, we can develop a robust pipeline of social businesses.
- ✓ Philanthropic investors are best positioned to invest in a social business during the idea, development, and early-launch stages when capital requirements are lowest but risks are highest. In exchange, the social business "locks in" its social commitments.
- ✓ Foundations can utilize Program Related Investments and individuals can utilize intermediaries in order to qualify their investments or donations as charitable for tax purposes.
- ✓ During the first three stages, philanthropic investors must help the social business clarify the ways in which it will make a social impact and prepare it for private sector investment in the final stages. More discussion on this point can be found in Appendix A.
- ✓ Differences in motivation and the amount of available capital will result in impact investors being most involved in a social business during the late-launch and early-growth stages, while for-profit investors will likely wait until the late-growth and maturity stages before investing.
- ✓ Impact and for-profit investors need to be actively involved in building the social business in the earlier stages to ensure that it becomes investible and can scale.
- ✓ The social business development pathway that we propose provides a method for ensuring that social businesses get the right amount of capital, at the right time, in the right form.

SECTION THREE
MINNESOTA'S FOURTH SECTOR

By adopting a new conceptual framework, establishing a new corporate form, and creating a new development pathway for social businesses, Minnesota will be creating the foundation of an entirely new sector of the economy, which we call the "Fourth Sector."

Evolution Of Fourth Sector Terminology

Because the term, "Fourth Sector," has been introduced and used by others in slightly different ways, it is necessary to discuss the evolution of the term and to defend our appropriation and unique use of it here.

In 2009, Fourth Sector Networks (FSN), an early advocate of the sector supported by The Aspen Institute and Kellogg Foundation, popularized the term "Fourth Sector" proposing that it is "comprised of organizations that pursue social purposes while engaging in business activities."[84] FSN also offered the diagram shown in Figure 15 below to illustrate how FSN views the relationship between the Fourth Sector and the existing public, private, and social sectors.[85]

According to FSN, what unites the Fourth Sector, unlike the other sectors, is not any particular legal corporate form but rather the simultaneous pursuit of social purpose and engagement in business activities. This means that members of the Fourth Sector could be legally incorporated as nonprofits, for-profits, cooperatives, government entities, or even new hybrid organizations.

While its definition of the Fourth Sector is organization-agnostic, FSN predicts that Fourth Sector entities will naturally evolve toward an archetypical form called a "For-Benefit" organization. In addition to pursuing a social purpose and engaging in business activities, for-benefit organizations will practice stakeholder governance, inclusive ownership, fair compensation, environmental and social responsibility, and transparency. However, FSN adds a caveat that "every organization follows its own journey toward [for-benefit] maturity and faces its own unique opportunities and constraints along the way."[86] In other words, FSN asserts that while Fourth Sector organizations will evolve toward this archetypical form, the sector itself will not, even in the future, be exclusively defined by it.

While we are grateful for FSN's pioneering work in advocating for the "Fourth Sector," we have some concerns with this definition. Although we agree that FSN's "social purpose and business activities" definition and its corresponding graphic accurately describe the *current,* organically emerging "Fourth Sector," we do not think that this definition can ultimately form the foundation of an entirely new, enduring, independent sector of the economy. The main issue is that FSN's definition is not mutually exclusive; a sector built on it would mean that some entities simultaneously belong to the Fourth Sector as well as an existing sector. This would cause confusion and make it even more difficult to establish the supportive Fourth Sector ecosystem that both FSN and we advocate.

Instead, we argue that ultimately *the Fourth Sector must be defined by a new entity type* that we call a "social business," which is distinct from nonprofit and business forms but integrates attributes of each. To review, like entities in the private sector (but unlike the social sector), social businesses have owners, and profit that is earned may be distributed to these owners. And like tax-exempt nonprofits in the social sector (but unlike the private sector), social businesses commit *legally,* via their corporate form or corporate bylaws, to pursue a social purpose in addition to profit, a promise that must be transparent and reported against annually. As stated above, while FSN does assert Fourth Sector organizations will gravitate toward the "for-benefit" archetype, which is similar to our definition of "social business," it does not embed that archetype *into the definition of the sector,* as we believe is necessary as a prerequisite to action.

In our view, once the Fourth Sector as defined by social business becomes a reality, it will be distinct from the other sectors of the economy as illustrated in Figure 16. At that time, nonprofits that employ earned revenue models but cannot distribute any profit to owners would still census in the social sector. Similarly, socially responsible for-profit companies that make no legal commitment to a social purpose when incorporating would remain in the private sector. Civic enterprises that are run in government agencies would still belong to the public sector. Only social businesses that *legally* exist to make both profit for owners and a positive social impact would be included under the Fourth Sector umbrella. Nonprofits, for-profits, or government enterprises that intend to join the eventually formalized Fourth Sector would need to change to a social business corporate form unique to the "Fourth Sector."

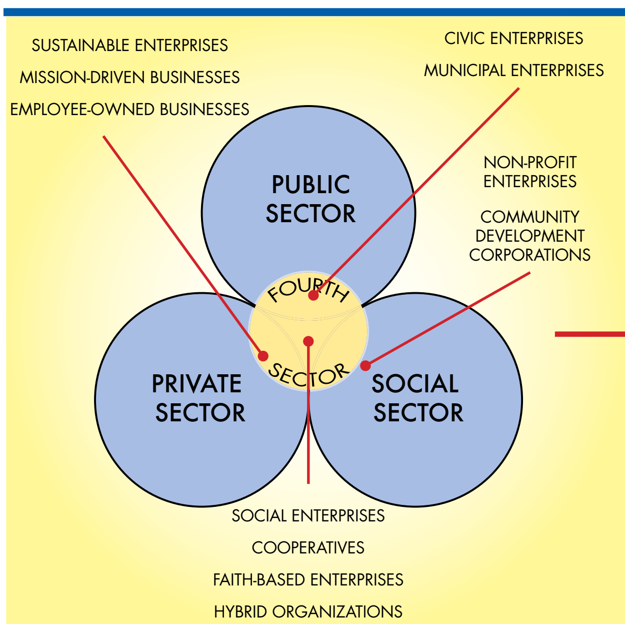

FIGURE 15.
CURRENT CONFIGURATION OF THE FOURTH SECTOR

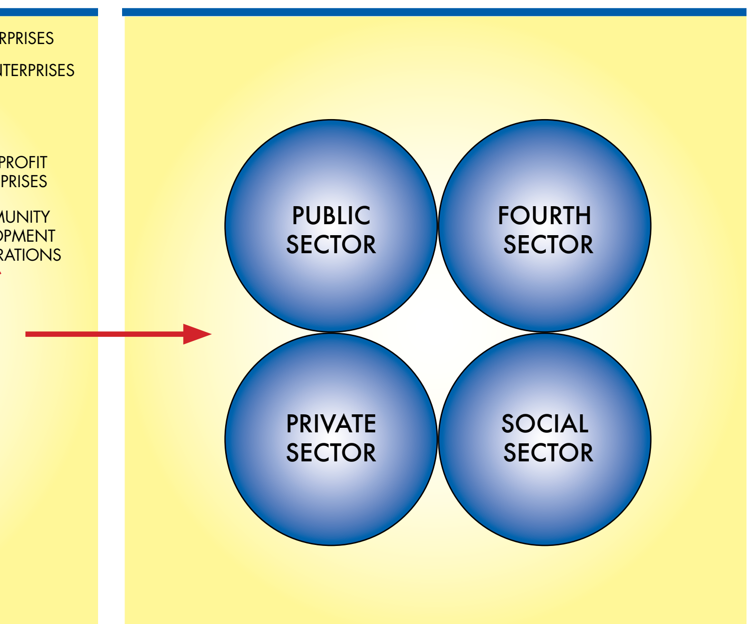

FIGURE 16.
MATURE CONFIGURATION OF THE FOURTH SECTOR

We argue that this definitional clarity is critical in order to mobilize stakeholders to actually establish the Fourth Sector and to construct the same supportive ecosystem elements present in existing sectors. These elements include common language, distinctive legal structures, active financial markets, supportive trade associations, appropriate regulations, clarifying certifications, academic research, and dedicated professional training. [87]

BUILDING THE FOURTH SECTOR ECOSYSTEM

In the natural world, an ecosystem is a community of biotic (living) and abiotic (non-living) things in a particular unit of space as well as all of their interrelationships. The biotic elements of a natural ecosystem include organisms of all types, from bacteria to birds. The abiotic components include soil, nutrients, oxygen, and sunlight, among others.[88] A key feature of natural ecosystems is that every organism is dependent on the entire system in order to exist. The organisms found are limited to those that the ecosystem can support. If a particular organism needs a special nutrient that is not present in the ecosystem, it cannot survive there.

In the same way, organizations cannot exist without a hospitable ecosystem to support them. Like plants need water, soil, and sunlight in a natural ecosystem, organizations need an adequate supply of money, a legal system, and other elements to survive and thrive. The nature of organizations currently present in an economic ecosystem is therefore constrained by the nature of the ecosystem itself.

If biologists hope to introduce a new species into a natural ecosystem, they must ensure that the ecosystem has the necessary ingredients to be hospitable. Similarly, if we seek to introduce a new type of organization into our economic ecosystem, we must ensure that certain elements are present. Entrepreneurs may desire to start social businesses, but without other actors like philanthropic, impact, and private investors, as well as colleges and government creating a supportive ecosystem, these entities will not take root and thrive.

We are confident that the three recommendations we advocate for in this white paper – the dissemination of a new conceptual framework, the creation of a new corporate form, and the establishment of a new development pathway for social businesses—are the three most fundamental elements necessary to create a thriving Fourth Sector ecosystem. Other elements of this ecosystem would include:

1. Common Language

One of the most important elements in any ecosystem is common language. It is impossible to imagine our robust private financial system operating without relatively strong consensus about the meaning of terms like "corporation," "owners," and "the bottom line." Even common business models like "freemium" (providing a basic version of a product for free and charging for upgrades) and "razor & blade" (giving away a base unit at a cheap price and making money on replacement parts) have shared significance. To create a Fourth Sector we need to develop a common vocabulary that all players in the ecosystem share.

Creating new terminology and shared definitions over an entire global industry is a messy process that occurs somewhat organically. However, a smaller network (i.e. the Twin Cities or Minnesota) that wants to create a local ecosystem is able to reach consensus definitions more deliberately. Major stakeholders simply take the lead and establish the standards.

2. Supportive Associations

Another feature present in each sector are associations that connect their members and collectively advocate for them. It is hard to imagine Minnesota's social sector without the Minnesota Council of Nonprofits or Minnesota Council on Foundations. Similarly, the state's private sector has the Minnesota Chamber of Commerce. The Fourth Sector should develop similar associations that unify and represent the interests of social businesses.

3. Standards and Certifications

Each existing sector has developed standards and certifications that help investors and stakeholders vet and compare entities. The social sector uses third party evaluators like Charities Review Council or Charity Navigator. The private sector has companies like Morningstar and Moody's. What entities will rate social businesses on both their social and financial returns, so that investors and consumers can compare? Some progress has been made in this area by GIIRS on the social impact front and ImpactAssets on the financial evaluation of social businesses, but we are far from the standardized metrics and practices of the mature private sector.

4. Academic Research

Over time, universities have established centers of research around government, nonprofit management, and business. This research draws from but also helps to improve the work of practitioners. While some higher education institutions in Minnesota have begun paying attention to topics like social enterprise or social entrepreneurship, the evolution of the Fourth Sector poses a plethora of research questions for academics to pursue. Academic research can create a body of theory to underpin the work of practitioners.

5. Professional Training

Higher education institutions participate in the training of new leaders for government, nonprofits, and business. Given the special challenges inherent in running social businesses, Minnesota's colleges and universities will need to offer dedicated training as the sector grows.

6. Regulation and Tax Policy

The private and social sectors have their own government regulations and tax policy that have been created over the years to provide certain protections and incentives. The Fourth Sector will also need policy and regulation that facilitate the growth of the sector and protect the interests of investors and consumers.

7. Intermediaries

The use of financial intermediaries offers foundations several advantages as a means of mission investing including aggregating capital while diluting risk, gaining access to investment analysis and due diligence skills often not available in foundation staff, and casting a wider net for better deal flow.

SUMMING IT UP:

✓ By adopting a new conceptual framework, establishing a new corporate form, and creating a new development pathway for social businesses, Minnesota will be creating the foundation of an entirely new "Fourth Sector" of the economy.

✓ Once the Fourth Sector as defined by social business becomes a reality, it will be fully distinct from but still interconnected with the other sectors of the economy.

✓ Natural ecosystems consist of living organisms and non-living things, as well as all of their inter-relationships. Organisms are dependent on their ecosystem for survival. Organizations also need a supportive ecosystem in order to exist and thrive.

✓ Even a small group of philanthropic and for-profit investors working together can create a viable Fourth Sector ecosystem within which social businesses can succeed.

Conclusion and Call to Action

"Capitalism has created more massive and more colossal productive forces than have all preceding generations together." [89]

The above quote is not from a Captain of Industry, Robber Baron, Wall Street Master of the Universe, or some other disciple of the capitalist creed. Quite the contrary, it is from the man who dedicated his life to replacing capitalism with a new economic system: Karl Marx. Even the father of socialism understood the enormous power of the market and held a grudging respect for it.

The underlying assumption of this white paper is that capitalism is, again quoting Schumpeter, both "destructive and generative."[90] Much of the work done by government agencies and nonprofits is to correct or ameliorate the destructive aspect of capitalism. But capitalism has also lifted millions of people out of poverty into the middle-class. It is an engine of innovation that creates wealth that can be applied for the common good. Here in our own community, the pools of risk capital for social change contained in our foundations came from the wealth created by the Bush, Cargill, Carlson, Dayton, Hill, McKnight and other families. In addition to their philanthropy, the businesses they created continue to employee tens of thousands of people and deliver valuable products and services to the world.

However, there are many problems with our current form of capitalism. American capitalism in the past twenty years has evolved into a breed of capitalism that defines success as growing shareholder value to the exclusion of all other interests.[91] The defining characteristics of this type of capitalism are a fixation on short-term profitability; fundamentalist free market ideology; manipulation of the political system; institutionalization of equity ownership; concentration of wealth; and the primacy of the shareholder.

A new form of capitalism can repair the damage done by this more exploitative form while retaining the great power of the capitalist system to create wealth, spread knowledge, and raise living standards. The embodiment of the new capitalism is social business.

In this white paper, we have introduced social businesses and explained why they are important. We have identified three major systemic obstacles facing social businesses and provided solutions for each. Finally, we have argued that these solutions, once enacted, will form the foundation of Minnesota's Fourth Sector. We recognize that our recommendations are as bold as they are uncommon. Inspired by the importance, scope, and difficulty of the work ahead, we invite the reader to be "present at the creation" and to take part in cultivating social business, impact investing, and Minnesota's Fourth Sector.

BELOW IS A LIST OF SPECIFIC ACTIONS YOU CAN TAKE TO START ENACTING THESE SOLUTIONS:

1. To revise our conceptual framework to make room for social businesses:

a. Recognize when the existing conceptual framework, which places the goals of maximization of profit and maximization of social impact on opposite ends of the same purpose spectrum, is being used and reframe the conversation.

b. Practice identifying the financial and social value propositions, whether positive or negative, of every entity you encounter.

c. When an entity claims to make a social impact, try to categorize it under the selling, sourcing, or sharing dimensions. Remember some entities make social impact claims in multiple dimensions.

2. To create a new corporate form specifically for social businesses:

a. Read the final proposal draft of the proposed "Public Benefit Corporation" statute (Appendix B).

b. Learn more about the proposed "Public Benefit Corporation" statute and spread the word.

c. Follow and support the upcoming legislative process in 2014.

3. To establish a new development pathway for social businesses:

a. Foundations can examine their charitable giving strategy and explore ways to support early-stage social businesses with programmatic dollars. Seek opportunities to pilot PRIs and share results and tools with the wider ecosystem. Also consider impact investing in later-stage social businesses.

b. Impact investors, continue to develop local impact angel networks and help encourage and coordinate deal flow with philanthropic investors.

c. Encourage collaboration between foundations, impact investors, and entrepreneurs to establish a social business intermediary.

Aligning the Social and Financial Value Propositions

Regardless of the source or structure of early-stage philanthropic capital, the entrepreneur and investor must work together to define the social business's social value proposition and clarify how it will and will not impact the venture's long-term financial value proposition. Finding a way to provide both meaningful social and financial returns is critical.

1. Social by Selling

Pursuing a "social by selling" strategy can be advantageous for a social business because it allows for natural alignment between social impact and profit. As the business achieves its financial goals in selling the product to the designated market, it is simultaneously achieving its social goals. This means that as the business scales, so does the impact. No tradeoff between profit and social impact need exist.

The challenge in a "social by selling" arrangement is that the product and target market get "locked in" as the conduit for achieving impact. If an early philanthropic investor is too narrow in the product or market definitions, the social business may be unable to alter the product or target customer segments in response to the market.

2. Social by Sourcing

When social businesses pursue a "social by sourcing" strategy, social impact does not automatically scale with the business. For example, while certain environmentally friendly processes may be possible at low volumes, it may not be feasible at higher production volumes. Similarly, while a social business may be able to rely on inputs from minority owned suppliers during launch, it may outgrow supplier capacity once it grows to a national or international scale. Community Products, Inc. ran into this exact problem as it expanded past the capacity of its native Brazilian cooperative supply partners.[92]

One common "social by sourcing" strategy involves employing vulnerable populations, and a number of issues may arise with this strategy as the business scales. First, as the business grows and needs more labor, the supply of eligible labor could be depleted, causing the social business to employ other vulnerable populations or mainstream labor. Second, as economies of scale are reached, the social business may not need as much labor per unit of sales, meaning that social impact does not keep pace with financial returns.

In the first phases of building a social business, entrepreneurs will need to decide how to address "social by sourcing" tradeoffs like these. A business following this strategy could face the choice of having its growth constrained by the limitations of its source, or allow its "social by sourcing" value proposition to be diluted by using sources outside the social mission. The way an entrepreneur answers these questions will have a major impact on both the social and financial value propositions of the company.

Because sourcing relates to the way a product or service is prepared and delivered, it impacts the "cost" element of the profit equation. Given that some of the methods for sourcing socially add costs, the tradeoff between profit and social impact is often felt.[93] However, this is not always the case. Because pollution from existing techniques may also add costs into the equation (e.g. through cleanup expenses), abating pollution could theoretically increase profits and social impact at the same time. Similarly, public co-production processes, which deliberately invite a wide array of groups or individuals to participate in the creation of a good or service, may require extra costs to manage, but they may also result in better marketing and a more profitable brand.

3. Social by Sharing

At first glance, pursuing a "social by sharing" strategy that involves giving away a percentage of profit does seem to scale naturally with the business. However, it is important to recognize that sharing profit only indirectly makes an impact, and it is possible that the marginal social return on each dollar shared could decrease depending on the receiving organization's production economies. When using a "social by sharing" strategy, the social business should ask the receiving nonprofits to pass along their impact metrics to ensure that efficiencies are also being achieved.

Compared to the other two strategies for achieving social impact, sharing most directly pits profit and social impact against each other in a zero-sum situation. Every dollar of profit shared with a nonprofit is one that is neither given to owners nor reinvested in the business. However, at the same time, if sharing is done strategically with nonprofits that help market the product and create a stronger more authentic brand, then it could ultimately be beneficial to profits.

A "social by sharing" strategy has a number of challenges. First, to create more social impact, a social business is motivated to earn more profit, which could actually incentivize the company to sell more profitable products or to cut costs from production, regardless of the social impact of those decisions. Second, because start-ups often are starved for cash, the social impact of a "social by sharing" business may counter-intuitively be furthered in the long-term if the business avoids sharing profit in the short-term as it grows. Third, a "social by sharing" commitment need not only be articulated in percentage of profit earned. Rather a social business could commit to returning a particular amount per share to investors and then sharing any remaining profit. The founder and early investors should openly address these challenges.

As explained above, selling, sourcing, and sharing strategies for social impact each have their unique advantages and disadvantages.[94] For this reason, a social business may prefer to use more than one of the strategies or choose to prioritize strategies differently throughout the company's development.

Mission Locks

An early philanthropic investor in a social business is investing in the company's social value proposition and should have assurances that the social impact remains a priority for the company. Tools that can be employed as "Mission Locks" for this purpose include language in the articles of incorporation, PRI contracts, and board seats for philanthropic investors, or fees paid to early philanthropic funders if the company drops its social commitment without approval.

While mission locks are justified, it is critical that the philanthropic investor also recognizes the importance of balancing social and financial needs as well as commitment and flexibility. Care should be taken not to be overly prescriptive, such that directors or managers have no room for discretion as conditions change. Furthermore, the investor should articulate a set process for changing how the social business may achieve its social impact in response to the marketplace.

Proposed Minnesota Public Benefit Corporation Statute

A bill for an act

relating to corporations; providing for the organization and operation of public benefit corporations; proposing coding for new law as Minnesota Statutes, chapter 304A.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MINNESOTA:

Section 1. [304A.001] CITATION.

This chapter may be cited as the "Minnesota Public Benefit Corporation Act."

APPLICATION

Sec. 2. [304A.011] APPLICATION AND EFFECT OF CHAPTER.

Subdivision 1. General rule. This chapter applies to all public benefit corporations.

Subd. 2. Laws applicable. Chapter 302A applies to all public benefit corporations and all statutes and rules of law that apply to a corporation formed under chapter 302A also apply to a public benefit corporation. If chapter 302A conflicts with sections 304A.001 to 304A.301, sections 304A.001 to 304A.301 govern. The chapter does not affect a statute or rule of law that applies to a corporation formed under chapter 302A that is not a public benefit corporation.

Subd. 3. Articles; bylaws. A provision of the articles, shareholder control agreement, or bylaws of a public benefit corporation may not limit, be inconsistent with, or supersede a provision of this chapter.

Sec. 3. [304A.021] DEFINITIONS.

Subdivision 1. Terms. For the purposes of this chapter, unless the language or context clearly indicates that a different meaning is intended, the words, terms, and phrases defined in this section have the meanings given them.

Subd. 2. General benefit corporation. "General benefit corporation" means a public benefit corporation that elects in its articles to pursue general public benefit and that may state in its articles a specific public benefit purpose it elects to pursue.

Subd. 3. General public benefit. "General public benefit" means a net material positive impact from the business and operations of a general benefit corporation on society, the environment, and the well-being of present and future generations.

Subd. 4. Independent. "Independent" means having no material relationship with a public benefit corporation or a parent, a subsidiary, or other affiliate of a public benefit corporation.

Subd. 5. Minimum status vote. "Minimum status vote" means that the shareholders shall take action by the affirmative vote of the holders of at least two-thirds of all of the issued and outstanding shares.

Subd. 6. Organization. "Organization" means a domestic or foreign business or nonprofit corporation, limited liability company, whether domestic or foreign, partnership, limited partnership, joint venture, association, trust, estate, enterprise, or other legal or commercial entity.

Subd. 7. Public benefit corporation. "Public benefit corporation" means a corporation formed under chapter 302A:

(1) that has elected to become subject to this chapter; and

(2) whose status as a public benefit corporation has not been terminated or revoked.

Subd. 8. Specific benefit corporation. “Specific benefit corporation” means a public benefit corporation that states in its articles a specific public benefit purpose it elects to pursue, but does not include a general benefit corporation that states in its articles a specific public benefit purpose it elects to pursue.

Subd. 9. Specific public benefit. “Specific public benefit” means one or more positive impacts, or reduction of a negative impact, on specified categories of natural persons, entities, communities, or interests, other than shareholders in their capacity as shareholders, as enumerated in the articles of a public benefit corporation.

Subd. 10. Third-party standard. “Third-party standard” means:

(1) a publicly available standard or guideline for defining, reporting, and assessing the performance of a business enterprise as a social or benefit corporation;

(2) promulgated by a natural person or an organization; and

(3) that is independent of the public benefit corporation.

INCORPORATION

Sec. 4. [304A.101] PUBLIC BENEFIT CORPORATION PURPOSES.

Subdivision 1. General benefit corporation purpose. A general benefit corporation has a purpose of pursuing general public benefit. A general benefit corporation may also state in its articles one or more specific public benefit purposes the general benefit corporation elects to pursue. Purposes under these subdivisions are in addition to the purposes under section 302A.101.

Subd. 2. Specific benefit corporation purpose. A specific benefit corporation shall have a purpose of pursuing one or more specific public benefit purposes stated in its articles. Purposes under this subdivision are in addition to the purposes under section 302A.101. The election to pursue a specific public benefit purpose under this subdivision does not require a specific benefit corporation to pursue general public benefit under subdivision 1.

Subd. 3. Effect of purposes. The pursuit of general public benefit or a specific public benefit purpose under subdivision 1, or a specific public benefit purpose under subdivision 2, is in the best interests of a public benefit corporation.

Subd. 4. Amendment of a specific public benefit purpose. In accordance with the procedures stated in chapter 302A and with approval by the minimum status vote, a general benefit corporation or a specific benefit corporation may amend its articles to add, amend, or delete a specific public benefit purpose unless the amendment would cause a termination of public benefit corporation status under section 304A.104.

Sec. 5. [304A.102] INCORPORATION OF A PUBLIC BENEFIT CORPORATION.

Subdivision 1. Incorporation. A public benefit corporation must be incorporated in accordance with chapter 302A, and its articles must also state that the public benefit corporation is a:

(1) general benefit corporation;

(2) general benefit corporation that also elects to pursue a specific public benefit purpose as stated in its articles; or

(3) a specific benefit corporation that elects to pursue a specific public benefit purpose as stated in its articles.

Subd. 2. Name requirements. A public benefit corporation name must comply with the requirements of section 302A.115 other than subdivision 1, paragraph (b), and with respect to:

(1) a general benefit corporation, contain the words “general benefit corporation,” or the abbreviation “GBC;” and

(2) a specific benefit corporation, contain the words “specific benefit corporation,” or the abbreviation “SBC.”

Sec. 6. [304A.103] ELECTION OF PUBLIC BENEFIT CORPORATION STATUS.

Subdivision 1. By amendment. In accordance with the procedures stated in chapter 302A and with approval by the minimum status vote, an existing corporation formed under chapter 302A may elect to become a public benefit corporation under this chapter by amending its articles to meet the requirements of section 304A.102.

Subd. 2. By merger, exchange, conversion, or transfer. (a) This subdivision applies if:

(1) an organization, other than a nonprofit corporation, that is not a public benefit corporation is a party to a merger, exchange, or conversion, or a transfer in accordance with section 302A.601; and

(2) the surviving organization in the merger, the acquiring organization in an exchange, the converted organization in the conversion, or the transferee is to be a public benefit corporation.

(b) If this subdivision applies, the transfer or the plan of merger, exchange, or conversion, must be adopted in accordance with the procedures stated in chapter 302A and with approval by the minimum status vote.

Subd. 3. Rights of dissenting shareholders. A shareholder of a corporation or the member of a limited liability company may dissent from, and obtain payment for the fair value of the shareholder’s shares or the member’s membership interests pursuant to sections 302A.471 and 302A.473, or section 322B.383 or 322B.386, in the event of an election of public benefit corporation status pursuant to this section.

Sec. 7. [304A.104] TERMINATION OF PUBLIC BENEFIT CORPORATION STATUS.

Subdivision 1. By amendment. In accordance with the procedures stated in chapter 302A and with approval by the minimum status vote, a public benefit corporation may terminate its status as a public benefit corporation and cease to be subject to this chapter by amending its articles to delete the requirements of section 304A.102, subdivision 1, and change its name to remove the information required by section 304A.102, subdivision 2.

Subd. 2. Merger, exchange, conversion, or transfer. If a merger, exchange, conversion, or transfer would have the effect of terminating the status of a public benefit corporation under this chapter, the transfer or the plan of merger, exchange, or conversion must be approved by the minimum status vote.

Subd. 3. Rights of dissenting shareholders. A shareholder of a public benefit corporation may dissent from, and obtain payment for the fair value of the shareholder’s shares pursuant to sections 302A.471 and 302A.473 in the event of a termination of public benefit corporation status pursuant to this section.

Subd. 4. Effects of termination. A public benefit corporation that terminates its status, or has its status revoked more than once pursuant to section 304A.301, subdivision 5, may not elect to become a public benefit corporation under this chapter until three years have passed since the effective date of termination or revocation.

ACCOUNTABILITY

Sec. 8. [304A.201] STANDARD OF CONDUCT FOR DIRECTORS.

Subdivision 1. Considerations for a general benefit corporation. In discharging the duties of the position of director of a general benefit corporation, a director:

(1) shall consider the effects of any proposed, contemplated, or actual conduct on:

(i) the general benefit corporation's ability to produce general public benefit;

(ii) if the articles also state a specific public benefit purpose, the general benefit corporation's ability to produce that specific public benefit; and

(iii) the interests of the constituencies stated in section 302A.251, subdivision 5, including the pecuniary interests of its shareholders; and

(2) may not give regular, presumptive, or permanent priority to:

(i) the pecuniary interests of the shareholders; or

(ii) any other interest or consideration unless the articles identify the interest or consideration as having priority.

Subd. 2. Considerations for a specific benefit corporation. In discharging the duties of the position of director of a specific benefit corporation, a director:

(1) shall consider the effects of any proposed, contemplated, or actual conduct on:

(i) the pecuniary interest of its shareholders; and

(ii) the specific benefit corporation's ability to pursue its specific public benefit purpose;

(2) may consider the interests of the constituencies stated in section 302A.251, subdivision 5; and

(3) may not give regular, presumptive, or permanent priority to:

(i) the pecuniary interests of the shareholders; or

(ii) any other interest or consideration unless the articles identify the interest or consideration as having priority.

Subd. 3. Liability. A director who performs the duties of a director stated in subdivisions 1 and 2 is not liable by reason of being or having been a director of a public benefit corporation.

Subd. 4. Other applicable law. The conduct and liability of a director of a public benefit corporation is subject to section 302A.251, subdivisions 1, 2, 3, and 4.

Subd. 5. Duty of loyalty. The articles of a public benefit corporation may include a provision that any disinterested failure to satisfy subdivision 1 or 2 of this section shall not, for purposes of this section or section 302A.251, subdivision 4, constitute a breach of the duty of loyalty.

Sec. 9. [304A.202] RIGHT OF ACTION.

Subdivision 1. Standing and grounds for claims. (a) No person other than a shareholder may assert a claim under this chapter or chapter 302A against a public benefit corporation, its directors, or its officers on account of the public benefit corporation's director's or officer's failure to pursue or create general public benefit or a specific public benefit.

(b) A public benefit corporation is not liable for monetary damages under this chapter for any failure of the public benefit corporation to pursue or create general public benefit or a specific public benefit.

Subd. 2. Grounds for relief. In addition to the grounds for relief stated in section

302A.751, subdivision 1, paragraph (b), a court may grant relief under this chapter when:

(1) directors or those in control of a public benefit corporation have breached the duties stated in section 304A.201 to a substantial extent and in a sustained manner; or

(2) the public benefit corporation has for an unreasonably long period of time failed to pursue:

(i) in the case of a general benefit corporation:

(A) general public benefit; or

(B) any specific public benefit purpose stated in its articles; and

(ii) in the case of a specific benefit corporation, any specific public benefit purpose stated in its articles.

Subd. 3. Particular relief available. (a) In an action under this chapter, in addition to granting any other equitable relief the court deems just and reasonable in the circumstances, the court may:

(1) order the public benefit corporation to terminate its status as a public benefit corporation pursuant to section 304A.104, subdivision 1;

(2) remove one or more directors from the public benefit corporation's board of directors and determine whether the vacancy will be filled:

(i) as provided in section 302A.225; or

(ii) by court appointment, with the appointee to serve only until a qualified successor is elected by the shareholders at the next regular or special meeting of the shareholders;

(3) appoint a receiver of the public benefit corporation to:

(i) wind up and liquidate the activities and business of the public benefit corporation; or

(ii) carry on the business and activities of the public benefit corporation in a manner consistent with this chapter.

(b) Paragraph (a) does not imply any limitations on the relief available in a proceeding brought under section 302A.751 without reference to this chapter.

TRANSPARENCY

Sec. 10. [304A.301] ANNUAL BENEFIT REPORT.

Subdivision 1. Report required. No later than 90 days after the conclusion of each calendar year, a public benefit corporation must deliver to the secretary of state for filing an annual benefit report covering the 12-month period ending on December 31 of that year and pay a fee of $35 to the secretary of state. The annual benefit report must state the name of the public benefit corporation, be signed by the public benefit corporation's chief executive officer not more than 30 days before the report is delivered to the secretary of state for filing, and must be current when signed.

Subd. 2. Annual benefit report for a specific benefit corporation. For a specific benefit corporation, the annual benefit report must contain:

(1) with regard to the period covered by the report, a narrative description of:

(i) the ways in which the corporation pursued and created the specific public benefit purpose stated in its articles;

(ii) the extent to which that specific public benefit purpose was pursued and created; and

(iii) any circumstances that hindered efforts to pursue or create the specific public benefit; and

(2) a certification that its board of directors has reviewed and approved the report.

Subd. 3. Annual benefit report for a general benefit corporation. The annual benefit report of a general benefit corporation must:

(1) certify that its board of directors has:

(i) chosen the third-party standard designated pursuant to clause (2), item (i);

(ii) determined that the organization that promulgated the third-party standard is independent; and

(iii) approved the report;

(2) with regard to the period covered by the report:

(i) identify a third-party standard determined by the board; and

(ii) with reference to that third-party standard, describe:

(A) how the corporation has pursued general public benefit;

(B) the extent to which and the ways in which the corporation has created general public benefit; and

(C) any circumstances that hindered efforts to create general public benefit;

(3) if the report is the first delivered for filing by the general benefit corporation, explain how and why the board chose the third-party standard identified under clause (2), item (i);

(4) if the third-party standard identified under clause (2), item (i), is the same third-party standard identified in the immediately prior report:

(i) state whether the third-party standard is being applied in a manner consistent with the third-party standard's application in the prior reports; and

(ii) if the third-party standard is not being so applied in a consistent manner, explain why;

(5) if the third-party standard identified under clause (2), item (i), is not the same as the third-party standard identified in the immediately prior report, explain how and why the board chose a different third-party standard; and

(6) if the general benefit corporation has also stated a specific public benefit purpose in its articles, the information required in subdivision 2, clause (1).

Subd. 4. Audit not required. A public benefit corporation is not required to have its annual benefit report audited, certified, or otherwise evaluated by a third party.

Subd. 5. Failure to file an annual benefit report. If a public benefit corporation fails to file an annual benefit report in accordance with this section within 90 days of the date on which an annual benefit report is due, the secretary of state shall revoke the corporation's status as a public benefit corporation under this chapter and must notify the public benefit corporation of the revocation using the information provided by the corporation pursuant to section 5.002 or 5.34 or provided in the articles.

Subd. 6. Effects of revocation; reinstatement. (a) A public benefit corporation that has lost its public benefit corporation status for failure to timely file an annual report is not entitled to the benefits afforded to a public benefit corporation under this chapter as of the date of revocation.

(b) Within 30 days of issuance of revocation of public benefit corporation status by the secretary of state, filing a renewal complying with this section and a $500 fee with the secretary of state will reinstate the corporation as a public benefit corporation under this chapter as of the date of revocation.

Subd. 7. Intentional failure to file an annual benefit report. A shareholder of the public benefit corporation may obtain payment for the fair value of the shareholder's shares pursuant to section 302A.473 as a result of revocation of public benefit corporation status pursuant to this section caused by the intentional failure to file an annual benefit report.

End Notes

1 The term "social business" has been used before and in somewhat different ways by other authors, most notably by Muhammad Yunus, in his 2007 book "Creating a World Without Poverty: Social Business and the Future of Capitalism" and his 2010 work "Building Social Business: The New Kind of Capitalism that Serves Humanities Most Pressing Needs." While many important aspects of our definitions are the same, such as the presence of an official social purpose and private ownership structure, we deviate significantly from Yunus's concept by permitting the distribution of profits to social business owners. Our view is that prohibiting profit distribution to owners significantly impairs access to impact and for-profit capital, which is one of the major advantages to the hybrid social business form. We also believe Yunus's prohibition on profit distribution and his reasons for such a strict policy are symptoms of the entrenched conceptual framework that incorrectly places the profit and social impact motives on opposite ends of the same purpose spectrum as discussed on page 17.

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8 See Endnote #1

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