TO BE OR NOT TO BE (A SECURITY): FUNDING FOR-PROFIT SOCIAL ENTERPRISES

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INTRODUCTION

Interest in for-profit social enterprise in the United States may be seen as, among other things, a reaction to perceptions about the focus of fiduciary duty law in for-profit entities, especially corporations. The labeling and parsing of fiduciary duties owed by constituents of the firm has been a major task of entity law over the years. The task is important because these fiduciary duties both reflect and foster trust among the constituents in a business enterprise. This undertaking has gotten the most attention in the area of for-profit corporate director fiduciary duties.

Some corporate law scholars claim that the fiduciary duties of for-profit corporate directors—the group, constituted as a board of directors, that manages or directs the management of the business of the corporation under state corporate law norms[1]—have evolved to the point that they no longer are truly owed to the firm, but (instead) are owed to shareholders and, in any event, serve the primary objective of enhancing shareholder value.[2] This general understanding of the fiduciary duties of

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1 Corporate directors manage a spectrum of financial interests and instruments that require regulation. DEL. CODE ANN. tit. 8, § 141(a) (2011); MODEL BUS. CORP. ACT § 8.01(b) (2011).

2 *See, e.g.*, Richard A. Booth, *Who Owns a Corporation and Who Cares?*, 77 CHI.-KENT L. REV. 147, 147 (2001) ("Most commentators would likely agree that a corporation is owned by its stockholders and that management has a duty to maximize stockholder wealth."); Tamara R. Piety, *Against Freedom of Commercial Expression*, 29 CARDOZO L. REV. 2583, 2623 (2008) ("Pursuant to conventional interpretations of black letter corporate law, the corporation's officers and directors have primarily one duty—to enhance shareholder value."). No doubt all would acknowledge that the fiduciary duties of corporate directors may, in certain factual contexts (notably, the adoption of takeover defenses in certain situations), require the board to give primary consideration to the accretion of shareholder wealth. *See, e.g.*, Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1425 (2008) ("Delaware has made clear that 'absent a limited set of circumstances' in which the corporation literally has no long-term future because its demise has become inevitable, 'a board of directors . . . is not under any *per se* duty to maximize shareholder value in the short term.'" (quoting Paramount Commc'ns,

corporate directors has been identified as the shareholder wealth maximization norm.[3] The shareholder wealth maximization norm may be seen as a manifestation or element of shareholder primacy theories of the firm[4] or as the aim of director primacy in corporate decision-making.[5]

The shareholder wealth maximization norm has been the subject of significant academic debate.[6] Scholars disagree about whether

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Inc. v. Time Inc., 571 A.2d 1140, 1150 (Del. 1989)); Brian JM Quinn, *Re-Evaluating the Emerging Standard of Review for Matching Rights in Control Transactions*, 36 DEL. J. CORP. L. 1011, 1030–31 (2011) ("In a sale of control boards 'have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders.'" (quoting Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 43 (Del. 1994)). This is, however, a narrow view on the operation of the norm.

3 *See generally, e.g.*, Grant M. Hayden & Matthew T. Bodie, *One Share, One Vote and the False Promise of Shareholder Homogeneity*, 30 CARDOZO L. REV. 445, 504 (2008) ("In the absence of actual expressions of preferences, the shareholder wealth maximization norm serves as a theoretical stand-in for shareholder preferences.").

4 *See* Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, 573 (2003) [hereinafter Bainbridge, *Director Primacy*] ("As a theory of the firm, shareholder primacy embraces two distinct principles: (1) the shareholder wealth maximization norm . . . ; and (2) the principle of ultimate shareholder control."); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 637 (2006) ("The shareholder primacy norm defines the objective of the corporation as maximization of shareholder wealth."); Hayden & Bodie, *supra* note 3, at 447 ("The notion that shareholder interests should be pursued as the ultimate ends of the corporation is known as shareholder primacy theory, or the shareholder wealth maximization norm."); Virginia Harper Ho, *"Enlightened Shareholder Value": Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 J. CORP. L. 59, 73 (2010) ("It should be noted that some ambiguity surrounds use of the term 'shareholder primacy,' which can refer to both the shareholder wealth maximization norm (the vertical axis) *and* to the view that the balance of power in corporate governance should be set in favor of greater shareholder control (the horizontal axis)."); David Millon, *Why Is Corporate Management Obsessed with Quarterly Earnings and What Should Be Done About It?*, 70 GEO. WASH. L. REV. 890, 901 (2002) ("Shareholder primacy is the idea that corporate management's primary duty is to maximize shareholder wealth."); Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 EMORY L.J. 809, 819 (2008) ("[M]anagers should manage the firm with a view to maximizing shareholder value. This shareholder primacy norm harnesses the zest for private wealth maximization to serve the broader goal of social wealth maximization.").

5 *See* Bainbridge, *Director Primacy*, *supra* note 4, at 551 ("In the director primacy theory, however, the board of directors has a contractual obligation to maximize the value of the shareholders' residual claim. In other words, the director primacy theory embraces the shareholder wealth maximization norm even as it rejects the theory of shareholder primacy."); Hayden & Bodie, *supra* note 3, at 503–04 (summarizing Bainbridge's argument in this regard).

6 *Compare, e.g.*, Stephen M. Bainbridge, Unocal *at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769, 785 (2006) ("[C]hief among the shareholders' contractual rights is one requiring the directors to use shareholder wealth maximization as their principal decision-making norm."), *with* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 249 (1999) ("[W]e take issue with both the prevailing principal-agent model of the public corporation and the shareholder

shareholder wealth maximization is, in fact, a legal or practical norm and, if it is either type of norm, the conditions under which it operates.[7] Postmodern corporate law scholars question the universal operation of all but the broadest interpretation of the shareholder wealth maximization norm (which would include nonfinancial elements of wealth in the shareholder wealth calculation), with one scholar noting that the shareholder wealth maximization norm "is the dominant position in American corporate law scholarship, although I do not personally share it."[8] In fact, the law in many contexts, as played out in different jurisdictions, is not altogether clear on the existence and application of the norm.[9] Some who believe that corporate law has evolved to support a unitary (or near unitary) corporate objective to maximize shareholder wealth perceive that development as negative.[10]

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wealth maximization goal that underlies it."). For further evidence of this debate, see LYNN STOUT, THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC 2–8 (2012) (describing and countering the shareholder wealth maximization norm); Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers.").

7 *See generally* J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 35 (2011) ("Academics debate whether the law guides directors to pursue shareholder wealth maximization (primarily or exclusively), or, more generally, advises directors to seek the health and welfare of the corporation as a whole.").

8 Brett H. McDonnell, *Professor Bainbridge and the Arrowian Moment: A Review of* The New Corporate Governance in Theory and Practice, 34 DEL. J. CORP. L. 139, 146 (2009).

9 One scholar makes the case that Delaware corporate law, the most well developed body of law on the subject, is ambiguous on the point.

> Ambivalence regarding the degree to which shareholder wealth maximization ought to be the aim of corporate decision-making manifests itself in the lack of a clear duty to maximize shareholder wealth in any but the most limited circumstances; a hostile takeover regime that—in addition to permitting interference with shareholder decision-making—actually permits boards some degree of latitude to consider the interests of other constituencies; and a somewhat murky statement of fiduciary duties owed simultaneously "to the corporation and its stockholders."

Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 21–22 (2011).

10 *See, e.g.*, STOUT, *supra* note 6, at vi ("Put bluntly, conventional shareholder value thinking is a mistake for most firms—and a big mistake, at that."); David Millon, *Communitarians, Contractarians, and the Crisis in Corporate Law*, 50 WASH. & LEE L. REV. 1373, 1378–79 (1993) ("'[C]ommunitarians' more readily look to legal rules to structure relations among the corporation's diverse constituent groups, believing that corporate law must confront the harmful effects on nonshareholder constituencies of managerial pursuit of shareholder wealth maximization."); *see also* Peter C. Kostant, *Team*

Concern about an excessive corporate focus on generating shareholder wealth in the traditional corporate form has led creative business and legal experts to develop and implement a growing number of ways to foster both shareholder wealth and public (social, environmental, etc.) benefit within a single business entity. The term "social enterprise" has come to describe a business with these dual central foci.

> Social enterprises integrate philanthropy into their business models at a more basic level than companies that make corporate contributions or practice [corporate social responsibility]. Social entrepreneurs pursue social and business goals together, viewing them as synergistic and mutually reinforcing, as equal partners in their business vision. This deep and particular commitment to philanthropic endeavor is the thrust of the social enterprise ideal.[11]

In effect, social enterprise businesses combine doing well (by generating profits and distributing them to investors) with doing good (by serving broader social and environmental objectives). Social enterprise also may be described as "social entrepreneurship," "creative capitalism," or the "fourth sector."[12]

Businesses that have this "deep and particular commitment to philanthropic endeavor" and want to enhance owner wealth face significant hurdles. Among these hurdles is the difficult matter of choosing the right legal structure for housing and conducting the business of the firm. Many observers believe that neither the legal rules and norms that operate in traditional for-profit forms of business association nor those that operate in not-for-profit forms of business association are well-suited to social enterprise.[13] Shareholder wealth maximization in the for-profit corporate form is not the only challenge for social enterprise businesses. The non-distribution constraint (which

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Production and the Progressive Corporate Law Agenda, 35 U.C. DAVIS L. REV. 667, 670 (2002) ("Too much of corporate law's rhetoric of shareholder wealth maximization undercuts incentives for corporations to consider legal and ethical issues.").

[11] Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2450 (2009); *see also* MARJORIE KELLY, OWNING OUR FUTURE: THE EMERGING OWNERSHIP REVOLUTION 8 (2012) ("[*S*]*ocial enterprises* . . . serve a primary social mission while they function as businesses . . . .").

[12] *See* Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 340 (2009); Murray & Hwang, *supra* note 7, at 6–7; Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 756 (2009–2010).

[13] *See* Keren G. Raz, *Toward an Improved Legal Form for Social Enterprise*, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 286 (2012) ("Many lawyers, policymakers, and social entrepreneurs argue that traditional legal forms, such as the limited liability company and the § 501(c)(3), hinder the impact of social enterprises by closing grant-funding opportunities and barring revenue generation.").

limits profit distributions) and, for tax-exempt not-for-profit firms, the prohibition on private inurement, for example, also are challenges in that they present barriers to the kind of profit-sharing ownership interest or revenue-sharing ownership rights that social enterprise typically seeks to establish.[14]

Although for-profit limited liability companies ("LLCs") and corporations may not be wholly welcoming legal entities for social enterprise, these forms of organization have provided a foundation for innovation.[15] For-profit firms engaging in social enterprise, including those organized as LLCs or corporations, may be certified as B Corporations—entities that have certain attributes consistent with social enterprise status.[16] In particular, in taking any action on behalf of the business, managers of entities that are certified as B Corporations are required to consider, e.g., "the long-term prospects and interests" of both the business and its owners "and the social, economic, legal, or other effects of any action" on employees (current and retired), suppliers, customers, and "the communities and society in which the firm or its subsidiaries operate."[17] In addition, some states have introduced new

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[14] *See* Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 607–08 (2011) ("[I]f formed as a tax-exempt nonprofit, a social enterprise will be prohibited from distributing net profits by the inurement, private benefit, and excess benefit transaction rules under federal tax law. Therefore, if a social entrepreneur wishes to distribute profits to investors, a nonprofit form is a nonstarter." (footnote omitted)); *id.* at 617 ("Due to the nondistribution constraint, equity capital will not be available to social enterprises formed as nonprofits . . . ."); Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2018–19 (2007) (describing a social enterprise venture that would not qualify for organization as a tax-exempt not-for-profit firm). Other detriments to using non-profit forms for social enterprise businesses also exist. *See* Brakman Reiser, *supra*, at 607–08, 617–18.

[15] *See generally* Murray & Hwang, *supra* note 7, at 8–22 (summarizing and analyzing the drawbacks of existing business entities and structures).

[16] *See, e.g.*, Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 637–43 (2010) (describing B-Corporation certification); Cassady V. ("Cass") Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (a/k/a "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 682–83 (2012) (same); Jaclyn Cherry, *Charitable Organizations and Commercial Activity: A New Era: Will the Social Entrepreneurship Movement Force Change?*, 5 J. BUS. ENTREPRENEURSHIP & L. 345, 354–55 (2012) (same); Jason C. Jones, *Environmental Disclosure: Toward an Investor Based Corporate Environmentalism Norm?*, 20 B.U. PUB. INT. L.J. 207, 222–24 (2011) (same); Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1368–70 (2011) (same); Taylor, *supra* note 12, at 759–61 (same). It is wise to highlight and reinforce here that a "B corporation," unlike a benefit corporation, is a traditional form of entity (e.g., a corporation or LLC) certified as a specific kind of social enterprise and not a separate statutory form of social enterprise entity in and of itself. *See* Murray & Hwang, *supra* note 7, at 20 n. 101.

[17] *Legal Roadmap for Corporations*, CERTIFIED B CORP., http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/1061-corporation-legal-roadmap (last visited

forms of for-profit business entity that, like B-Corporation certification, recognize in direct ways the dual central foci of social enterprise firms. These include low-profit limited liability companies ("L3Cs"), benefit corporations, and other specialized corporate forms of entity (like California's flexible purpose corporation or Washington's social purpose corporation).[18]

As a result of these innovations, distinctions among forms of business entity and among financial interests in business entities and projects have blurred. For-profit social enterprise business entities occupy a space somewhere between the traditional for-profit and not-for-profit legal structures for business enterprises, as ordained principally by state statutes. Similarly, the governance and financial interests in for-profit social enterprise ventures may occupy a somewhat uncertain middle ground between charitable donations and traditional equity and debt investment interests.

To date, little has been said about the actual and desired nature of these interests—and the instruments that embody them—under federal and state securities laws. This issue has significance to the lawyer-as-*ex ante*-advisor, as well as the lawyer-as-*ex post*-enforcement-advocate. An understanding of the legal positioning of debt, equity, and other financial interests in social enterprise businesses (under, e.g., state entity law, federal and state tax laws, and federal and state securities laws) both enables legal advisors to better guide social enterprises and their funders in cost-effective choice-of-entity decision-making and fundraising and also facilitates the assessment of actual and possible legal claims by social enterprise and their funders. In addition, more specifically, an appreciation for the application of securities regulation to financial

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Feb. 24, 2013) (noting the need for charter amendment language to this effect to achieve B-Corporation certification); *see also LLC Legal Roadmap*, CERTIFIED B CORP., http://www.bcorporation.net/become-a-b-corp/how-to-become-a-b-corp/1065-llc-legal-roadmap (last visited Feb. 24, 2013) (noting the need for similar language in the relevant LLC governing documents).

[18] *See, e.g.*, Kelley, *supra* note 12, at 366–76 (describing new forms of legal entity available for social enterprises); J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1, 19–24 (2012) (same); Alicia E. Plerhoples, *Can an Old Dog Learn New Tricks? Applying Traditional Corporate Law Principles to New Social Enterprise Legislation*, 13 TRANSACTIONS: TENN. J. BUS. L. 221, 224–25 (2012) (same); *see also* John Tozzi, *Patagonia Road Tests New Sustainability Legal Status*, BLOOMBERG.COM (Jan. 4, 2012), http://www.bloomberg.com/news/2012-01-04/patagonia-road-tests-new-sustainability-legal-status.html (describing benefit corporations and flexible purpose corporations in the State of California); John Tozzi, *Washington State Tailors 'Social Purpose Corporation' to Sustainable Business*, BUSINESSWEEK.COM (Mar. 16, 2012), http://www.businessweek.com/articles/2012-03-16/washington-state-tailors-social-purpose-corporation-to-sustainable-business (describing social purpose corporations in the State of Washington).

instruments issued by new hybrid for-profit forms of social enterprise entity may be of use to policymakers in evaluating and establishing legal principles applicable in that context.

To that end, this Article explores the federal securities law status of financial interests in for-profit social enterprise entities.[19] When analyzed through the lens of the Securities Act of 1933, as amended (the "1933 Act"),[20] and the Securities Exchange Act of 1934, as amended (the "1934 Act"),[21] financial interests in social enterprise businesses raise both concerns and opportunities. Observations include reflections founded in theory, policy, and doctrine. Ultimately, the federal securities regulation status of interests in for-profit social enterprise ventures is important for choice-of-entity reasons (since the regulatory framework may impose different costs on interests in different structural business forms), for capital-structuring reasons within individual forms of entity, and for risk-management reasons at the entity level. In addition, an inquiry into the applicability of federal securities regulation to the funding of social enterprise also serves as a catalyst for further thought on the optimal applicability of federal securities regulation to interests in business entities and projects.

This brief exploration of social enterprise through the lens of federal securities law proceeds in four parts. Specifically, after a brief description of social enterprise in context in Part I, Part II of this Article analyzes whether different types of instruments representing financial interests in for-profit social enterprises are securities under the 1933 Act and the 1934 Act. The analysis shows that these instruments typically are securities under federal law—the lynchpin being whether instrument holders have the right to a financial return. Part II then identifies the implications of this insight. Part III questions whether the current treatment of for-profit social enterprise debt, stock, and investment contracts makes sense by identifying legal touchstones relating to the treatment of securities issued by for-profit and not-for-profit business associations. Principally, this Part asks whether and, if so, when an investment interest in a social enterprise that is a security is or should be designated as an exempt security or excused from compliance with registration or other substantive regulation under the 1933 Act or the 1934 Act. Part IV offers a brief summary conclusion

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[19] This Article focuses on federal securities regulation. However, parallel analyses under state securities regulation—as well as examinations of related issues under state entity laws and federal and state tax laws—also are important to the assembly of a full picture of financial interests in social enterprise firms. Analyses of these additional perspectives must, however, wait for another day.

[20] 15 U.S.C. §§ 77a–77aa (2006 & Supp. V 2011).

[21] 15 U.S.C. §§ 78a–78pp (2006 & Supp. V 2011).

emphasizing the importance of the interplay between for-profit social enterprise and securities regulation in ongoing conversations about the utility of hybrid forms of business association and the nature and extent of securities regulation.

I. FOR-PROFIT SOCIAL ENTERPRISE IN CONTEXT

Interest in social enterprise—and recently in new forms of for-profit social enterprise entity—is significant and seems likely to continue.[22] Over the past few years, the adoption and serious consideration of new, hybrid forms of business association by state legislatures has increased.[23] These new hybrid forms of entity, as they multiply in type and number, add complexity to the market for legal entities and to the markets associated with business finance.[24]

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[22] *See* Kelley, *supra* note 12, at 352 ("[T]he world of hybrid social enterprise has grown rapidly and has expanded from nonprofits engaging in market-oriented work to for-profits doing essentially charitable work."); Steven Munch, *Improving the Benefit Corporation: How Traditional Governance Mechanisms Can Enhance the Innovative New Business Form*, 7 NW. J.L. & SOC. POL'Y 170, 176 (2012) ("Interest in social enterprise and its related principles has increased in recent years in the wake of fresh corporate scandals and growing societal concerns."); Page & Katz, *supra* note 16, at 1361 ("The idea of social enterprise has been embraced by a growing number of influential leaders and institutions.").

[23] *See* Murray, *supra* note 18, at 1 ("In the past four years, nineteen states have passed at least one of five different types of social enterprise statutes and many additional states are considering similar legislation."); Anne Field, *A Corporate Status for the Crunchy Set*, CRAIN'S N.Y. BUS., Mar. 12–18, 2012, at 12 ("While there's no official count of social enterprises . . . , the number is growing . . . .").

[24] *See* Dennis R. Young & Jesse D. Lecy, *Defining the Universe of Social Enterprise: Competing Metaphors* 12–13 (Andrew Young Sch. of Policy Studies, Working Paper No. 12-25, 2012), *available at* http://ssrn.com/abstract=2166459 (employing a zoo metaphor to illuminate management, governance, and financial issues in social enterprise). The zoo metaphor adopted by Professors Young and Lecy expresses this complexity in a useful way, highlighting problems with research on social enterprise.

> The zoo metaphor is also helpful in guiding the study of how social enterprises are best managed, governed and financed. Clearly the answers to this question are different for different animals in the social enterprise zoo. For example, they don't all have the same diets. The zoo metaphor recognizes this and hence prescribes a customized approach to good practices. Governance and finance offer the clearest application of this realization. Governance and ownership structures differ markedly among business corporations, cooperatives and nonprofit organizations, for example. Similarly, revenue portfolios of these different kinds of entities are significantly different as well, relying to widely varying degrees on member contributions, philanthropy, and market revenues, and so on. By acknowledging the different animals in the social enterprise zoo, management, governance and financing strategies can be studied and developed with appropriate sensitivity to these distinctions.

Id. at 22.

This growth in interest and increased complexity has easily identifiable benefits and detriments attendant to corporate finance. New players in the markets for social enterprise finance (e.g., certification organizations, specialized intermediaries, new breeds of investor) are emerging, which may result in an expansion in the number of business markets or the size of those markets (including through, e.g., net job creation).[25] Other new market opportunities may result as the size and nature of the markets connected to for-profit social enterprise develop and become clearer.

For example, for-profit social enterprise ventures may have access to new and different sources of financial capital. These ventures may help to generate and sustain an investor market focused on blending financial return with altruistic return.[26] Social enterprise advocates believe that "[w]ith the right financial innovations, these enterprises can access a much deeper pool of capital than was previously available to them, allowing them to greatly extend their social reach."[27]

The potential may exist for a lower cost of capital for certain investors in social enterprise businesses, although that potential may be illusory. The L3C form of entity was designed in part to achieve this result through its envisioned investment tranches that blend philanthropic and traditional financial investment capital.[28] The L3C's potential in this regard has not yet been realized, however, in part because expected assurances from the U.S. Internal Revenue Service on the tax treatment of foundation investments have not been forthcoming.[29] Even outside the L3C area, the market for social enterprise capital is relatively undeveloped and suffering from growing pains.[30] Most agree that the cost of social enterprise capital remains

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[25] *See generally* Murray, *supra* note 18, at 46–52 (describing various potential capital raising and other financial benefits related to social enterprise).

[26] *See* Brakman Reiser, *supra* note 14, at 619 ("The benefit corporation form . . . may attract potential investors or lenders who are interested in combining their financial contributions with a purchase of social good.").

[27] Antony Bugg-Levine et al., *A New Approach to Funding Social Enterprises*, HARV. BUS. REV., Jan.–Feb. 2012, at 118, 120; *see also id.* at 122 ("It isn't hard to imagine that at some point social enterprises will have an even broader universe of funding options than conventional businesses do.").

[28] *See* Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 884–85, 894–96 (2010) (describing and analyzing the finance rationale underlying the L3C).

[29] *See* Murray, *supra* note 18, at 47.

[30] *See* Timothy Ogden, *The True Cost of Social Capital*, STAN. SOC. INNOVATION REV. (Mar. 7, 2012), http://www.ssireview.org/blog/entry/the_true_cost_of_social_capital (describing and illustrating various problems with the social capital market).

quite high when compared with the cost of traditional financial investment capital.[31]

There may be a number of different costs that offset any finance-related benefits as social enterprise markets grow. For example, it may be hard for many social enterprise businesses to find funding. Social enterprise (like other commerce) often is conducted through small businesses (despite the notoriety of larger, better-established social enterprise firms like Patagonia, Inc.[32]). Absent the engagement of an interested fund investor or market intermediary to help them find more potential funders, small businesses typically have a hard time identifying funders and attracting and securing funding after friends and family are tapped out. The federal securities laws have been unfriendly to small business finance in this context because of, among other things, restrictions on general solicitation and advertising in connection with the offer and sale of securities and the potential application of both federal and state securities laws to offers and sales of securities.[33] Although the Jumpstart Our Business Startups Act ("JOBS Act")[34] and, more specifically, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act of 2012 ("CROWDFUND Act") included as Title III of the JOBS Act,[35] have the potential to make the federal securities laws more friendly to small firm capital-raising, this potential may or may not be realized in the wake of forthcoming Securities and Exchange Commission ("SEC") regulations and ensuing market reactions.

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31 *See id.* ("[S]ocial capital is usually significantly more expensive than commercial capital."); Bugg-Levine et al., *supra* note 27, at 120 ("The social value of providing poor people with affordable health care, basic foodstuffs, or safe cleaning products is enormous, but the cost of private funding often outweighs the monetary return.").

32 Patagonia, Inc., as a better-established firm engaged in social enterprise, converted to a California benefit corporation. *See B Corps: Firms with Benefits*, ECONOMIST, Jan. 7, 2012, at 57; Marc Lifsher, *Businesses Seek State's New 'Benefit Corporation' Status*, L.A. TIMES (Jan. 4, 2012), http://articles.latimes.com/2012/jan/04/business/la-fi-benefit-corporations-20120104.

33 *See, e.g.*, C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1, 5–7 (2012); Rutheford B Campbell, Jr., *Federalism Gone Amuck: The Case for Reallocating Governmental Authority over the Capital Formation Activities of Businesses*, 50 WASHBURN L.J. 573, 573 (2011); Rutheford B Campbell, Jr., *The Insidious Remnants of State Rules Respecting Capital Formation*, 78 WASH. U. L. Q. 407, 407 (2000); Stuart R. Cohn & Gregory C. Yadley, *Capital Offense: The SEC's Continuing Failure to Address Small Business Financing Concerns*, 4 N.Y.U. J.L. & BUS. 1, 36 (2007); *see also* Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879, 918 (2011).

34 Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (to be codified in scattered sections of 15 U.S.C.).

35 *Id.* §§ 301–305.

The capital markets for investment in social enterprise businesses may be smaller than advocates anticipate. Certain sources of funding for not-for-profit (especially charitable) organizations are not readily available to for-profit social enterprise organizations.[36] Also, not all traditional sources of investment capital are interested in financing or able to invest in for-profit social enterprise.[37] Although investment firms and funds have emerged (and likely will continue to emerge) to focus on for-profit social enterprise investments,[38] it is unclear how many firms and funds will concentrate on the emergent fourth sector. With an increased number of entrants in these markets, increased competition for available funds may discourage market entrants and limit prospects for those who choose to participate.

Uncertainty also may increase transaction costs in the market for investment interests in social enterprise entities.[39] Although investors are no doubt becoming more familiar with for-profit social enterprise as the number of ventures engaged in creative capitalism increase, the business and regulatory landscapes for the fourth sector are unsettled, and questions about the operation, regulation, and sustainable profitability of these firms remain.

> For-profit public benefit ventures raise several questions. Are they charities? Are they a new phenomenon? Are they more efficient and effective than traditional charities? Are social enterprises permanent entities or merely reflections of transitory stock market success or rising earnings? Should they receive tax benefits? If so, under what circumstances? Do social enterprise organizations live up to their hype?[40]

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[36] *See* Brakman Reiser, *supra* note 14, at 618–19 ("A social enterprise organized as a for-profit will also have limited access to donated funds."); Kelley, *supra* note 12, at 354 ("Social entrepreneurs' . . . capitalization problems are not entirely solved by choosing to launch as for-profit ventures. As an initial matter, for-profit social entrepreneurs generally cut themselves off from the sources that traditionally have funded socially beneficial activities—private foundations and governments.").

[37] *See* Kelley, *supra* note 12, at 354 ("[T]he practices and the expectations of the normal sources of for-profit capital—venture capitalist and institutional investors such as pension funds—do not line up neatly with the needs of hybrid social enterprises.").

[38] *See* James J. Fishman, *Wrong Way Corrigan and Recent Developments in the Nonprofit Landscape: A Need for New Legal Approaches*, 76 FORDHAM L. REV. 567, 599 (2007) ("[B]usinesses and entrepreneurs, such as private equity funds, have also formed large pools of capital for social purposes outside of charitable tax-exempt structures.").

[39] *See* Murray, *supra* note 18, at 42–44; *see also* Michael P. Van Alstine, *The Costs of Legal Change*, 49 UCLA L. REV. 789, 822–36 (2002) (describing uncertainty costs as one of the costs associated with legal change).

[40] Fishman, *supra* note 38, at 599–600 (footnote omitted).

These types of uncertainty are only likely to be resolved over an extended period of time. In the interim, the availability and cost of capital may be adversely affected.

The net bottom line? "[I]f you talk to people who have attempted to raise commercial and social capital at different points in their career, they will routinely tell you that raising social capital takes two to four times as much time and effort as raising commercial capital."[41] Regulatory and other transaction costs have been and may continue to be uncertain, and some contend that "the real cost of social capital, when you take into account the amount of effort and time the average entrepreneur has to put in to find and meet the demands of social investors, is much higher than it would be with commercial investors."[42]

Together with state-based entity law and federal and state tax law, federal and state securities regulation plays an important and under-appreciated role in the ongoing viability of for-profit social enterprise. Specifically, securities regulation establishes critical rules of the game for social enterprise financed through the issuance of securities and, in doing so, imposes various types of costs on for-profit social enterprise. Accordingly, it is important to the future of for-profit social enterprise to resolve uncertainties in securities regulation, especially (but not exclusively) at the key and leading federal level.[43]

II. FUNDING INTERESTS IN SOCIAL ENTERPRISE AS "SECURITIES" UNDER FEDERAL SECURITIES LAW

Among the regulatory uncertainties associated with for-profit social enterprise firms is the status of various forms of financial instrument as securities under federal law. The categorization of different instruments as securities is meaningful because it triggers the application of federal

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41 Ogden, *supra* note 30.

42 *Id.*

43 Although this Article focuses on a federal securities law analysis, it is important to note that state securities law may be applicable even when federal securities law is inapplicable. For example, the definition of a "security" under state regulatory frameworks is often more all-inclusive than the federal definition. In other words, financial instruments that are not securities under federal law may, in fact, be securities under applicable state law. Moreover, state law exemptions from securities registration requirements are different from federal law exemptions. Accordingly, an examination of federal securities law principles is necessary but insufficient in analyzing resolving specific transactional issues. *See, e.g.*, Keith Paul Bishop, *Are There Silver Hills in Other States?*, CAL. CORP. & SEC. L. (Feb. 27, 2013), http://calcorporatelaw.com/2013/02/are-there-silver-hills-in-other-states/; Keith Paul Bishop, *Is Crowdfunding Subject to the UCC?*, CAL. CORP. & SEC. L. (Mar. 14, 2013), http://calcorporatelaw.com/2013/03/is-crowdfunding-subject-to-the-ucc/?utm_source=feedburner&utm_medium=email&utm_campaign=Feed%3A+CaliforniaCorporateLaw+%28California+Corporate+Law%29.

securities laws (including the 1933 Act and the 1934 Act), as a distinct body of regulation, to the instrument, the issuer, investors, and various market intermediaries (among others).

> If the interests being issued are not securities, the federal statutes do not apply at all. There would, for instance, be no possibility of a cause of action under the federal securities laws for fraud or misrepresentation, although it is always possible that state securities laws or the common law might apply to the transaction. On the other hand, if the interests are classified as securities, at the very least the anti-fraud provisions of the federal securities laws will apply, even if the securities are technically "exempt." Beyond that, it is also possible that the registration and other requirements will be imposed, depending on . . . the often-demanding requirements of the applicable statutory exemptions.[44]

Although the current status of most financial instruments as securities is relatively well settled, there is opportunity (and there may be appetite) for innovation in the regulation of investment interests in for-profit social enterprise ventures. This Part locates various forms of investment in for-profit social enterprise in the current federal securities regulation landscape and assesses the current categorization of these investment interests as securities for federal law purposes.

A. The Current Federal Securities Law Status of Financial Instruments Issued by For-Profit Social Enterprise Ventures

As a general matter, instruments that comprise financial interests in business associations with a profit-sharing or revenue-sharing component are securities under the 1933 Act and the 1934 Act.[45] Both the 1933 Act and the 1934 Act define a "security" by reference to a listed group of instruments, "unless the context otherwise requires."[46] The listed instruments are substantially the same under each statutory definition.[47] The issuer's identity as a particular form of business association having a particular tax status is not relevant in determining the federal securities law status of interests in the issuer's business. The definition of a security is meant to be expansive. "Congress . . . did not attempt precisely to cabin the scope of the Securities Acts. Rather, it enacted a definition of 'security' sufficiently broad to encompass virtually

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[44] Carol R. Goforth, *Application of the Federal Securities Laws to Equity Interests in Traditional and Value-Added Agricultural Cooperatives*, 6 DRAKE J. AGRIC. L. 31, 46 (2001) (footnote omitted).

[45] *See infra* notes 52, 60 & 73 and accompanying text (identifying an element of profit as a characteristic of debt, stock, and investment contracts that is associated with security status).

[46] 15 U.S.C. § 77b(a)(1) (2006); 15 U.S.C. § 78c(a)(10) (2006).

[47] *See* United Hous. Found., Inc. v. Forman, 421 U.S. 837, 847 & n.12 (1975).

any instrument that might be sold as an investment."[48] However, not every investment interest in a business is a security.

Specifically, both the 1933 Act and the 1934 Act define a security (absent a context that requires a different conclusion) as "any note, stock, . . . bond, debenture, . . . [or] investment contract."[49] These words delineate the three principal types of financial instruments likely to be issued by for-profit social enterprise entities: debt, equity, and investment contracts that may be in the nature of unequity—a short-term profit-sharing or revenue-sharing interest without governance rights.[50] The status of each of these three instruments as a security under federal law has been explored in decisional law.

1. Debt

As debt instruments, notes, bonds, and debentures are presumed to be securities, but that presumption may be rebutted by a showing either that the instrument at issue is or has a strong resemblance to an instrument on a list of judicially created exceptions or that the instrument should be added to that list of judicial exceptions.[51] To gauge that resemblance or make that addition to the judicial list, the Supreme Court assesses (and directs the assessment of) four factors.

> First, we examine the transaction to assess the motivations that would prompt a reasonable seller and buyer to enter into it. If the seller's purpose is to raise money for the general use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a "security." If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a "security." Second, we examine the "plan of distribution" of the instrument to determine whether it is an instrument in which there is "common trading for speculation or investment." Third, we examine the reasonable expectations of the investing public: The Court will consider instruments to be "securities" on the basis of such public expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not "securities" as used in that transaction. Finally, we examine whether some factor such as the

48 Reves v. Ernst & Young, 494 U.S. 56, 61 (1990) (footnote omitted).

49 § 77b(a)(1); § 78c(a)(10).

50 *See* Joan MacLeod Heminway, *What Is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 335, 360–61 (2012) (defining the concept of "unequity").

51 *See Reves*, 494 U.S. at 63–64.

> existence of another regulatory scheme significantly reduces the risk of the instrument, thereby rendering application of the Securities Acts unnecessary.[52]

The overall test is known as the "family resemblance" test.[53] The test, including the four factors, applies broadly across all issuers.

Although one might suspect that application of the factors would not differ substantially as applied in the context of for-profit social enterprise entities, several factors give cause for pause. Because a debt investor in a for-profit social enterprise may not be primarily interested in profit—instead, being equally interested in profit and the issuer's social or environmental objectives (or even less interested in profit than in social or environmental objectives)—the first factor may weigh against security status. Although the Court identifies commercial or consumer purposes as a contrast to a profit objective in articulating the family resemblance test, its focus on interest "primarily in the profit [of] the note" may be at issue in the social enterprise context.[54] Similar questions might be raised in specific issuances with respect to a speculation or investment motive for common trading of debt instruments issued by a for-profit social enterprise entity and with respect to the reasonable expectations of the investing public as to debt instruments issued by a for-profit social enterprise.[55] In most circumstances, however, despite these concerns, a court is likely to determine that a debt instrument other than a bank loan (including, e.g., a mortgage loan note or a note for installment purchase indebtedness) is a security under the 1933 Act and the 1934 Act.

A for-profit social enterprise issuer also may contend that "another regulatory scheme significantly reduces the risk of the instrument" such

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[52] *Id.* at 66–67 (citations omitted).

[53] *Id.* at 63–64.

[54] *Id.* at 66.

[55] These and related questions have been raised with respect to debt issued by cooperatives, starting with the debt at issue in the seminal debt-as-a-security case, *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

> The Supreme Court . . . has held that promissory notes issued by a cooperative may be securities in certain circumstances. The offering of notes by a cooperative to nonmembers at market or above-market interest rates clearly is a security based on *Reves*. If a cooperative solicits loans only from current members at interest rates that are at or below market, however, a strong argument can be made that these notes are not securities. A member making such a loan to his or her cooperative clearly is not motivated to do so by profit, is not making the loan for investment purposes, and has no reasonable expectation that a profit will be derived as a result of the activities of others.

Kathryn J. Sedo, *The Application of Securities Laws to Cooperatives: A Call for Equal Treatment for Nonagricultural Cooperatives*, 46 DRAKE L. REV. 259, 283 (1997) (footnotes omitted).

that the protection of the federal securities laws is "unnecessary."[56] The entity law statute under which the for-profit social enterprise firm is organized or another system of regulation applicable to the social enterprise entity may serve this function if, for example, it requires disclosure to the debt-holders of information substantially similar to that required in an applicable 1933 Act registration statement or 1934 Act report and allows for private enforcement for fraud, misstatements, or misleading omissions or if it offers another form of protection against risk.[57] Common forms of contractual protection include insurance or collateralization.[58] Absent these types of risk reduction, however, a court is more likely to find a debt instrument to be a security. Basic federal and state law protections for debt-holders, taken alone, are insufficient to contravene security status under this factor.[59]

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[56] *Reves*, 494 U.S. at 67.

[57] A benefit corporation does have disclosure obligations under state law—specifically, it is required to file an annual report with the state that includes disclosures relating to its general public benefit.

> A benefit corporation is required to deliver an annual benefit report to the shareholders and to post it on its website so it is available to the public. Some states require filing the report with a department of the state. The report must include a narrative description of the ways in which the benefit corporation pursued a general public benefit and the extent to which it was created; the ways the benefit corporation pursued any specific benefit (if stated in the company's articles) and the extent to which it was created; and any circumstances that may have hindered creation of either such benefit. In recently passed legislation in California and New York, the narrative description must also include the process and rationale for selecting the third-party standard.

William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 WM. MITCHELL L. REV. 817, 842–43 (2012) (footnotes omitted); *see also* Brakman Reiser, *supra* note 14, at 603–04. However, these disclosure mandates are not tantamount to, or an adequate investor-protection substitute for, the disclosure obligations under the federal securities laws.

[58] *See Reves*, 494 U.S. at 69.

[59] *See, e.g.*, Delgado v. Ctr. on Children, Inc., No. 10-2753, 2012 WL 2878622, at *5 (E.D. La. July 13, 2012) ("Although state law relief for breach of the promissory notes or relief through federal bankruptcy law may be available to Plaintiffs, this relief falls short of the comprehensive regulatory schemes that have exempted notes from classification as securities in other cases."); Nat'l Bank of Yugoslavia v. Drexel Burnham Lambert, Inc., 768 F. Supp. 1010, 1016 (S.D.N.Y. 1991) ("As for the federal bankruptcy and common law, such protections are available in any transaction, including ones that are clearly securities transactions, and they existed at the time Congress perceived the need for the additional protections of the 1933 and 1934 Acts."). The analysis of debt instruments issued by a not-for-profit entity is, again, useful here.

> One could argue that a member's involvement in the cooperative through voting rights, election of the board of directors, and attendance at annual meetings where financial information is provided are factors that reduce the risk of the loan. While there is no public market for the notes nor other

2. Stock

Decisional law also determines when stock (as another item in the list of instruments that are, unless the context otherwise requires, securities) is not a security. In the leading case on this issue, the Supreme Court of the United States found that stock, as a security, has the following attributes:

- "the right to receive 'dividends contingent upon an apportionment of profits'";[60]
- negotiability;[61]
- the capacity to "be pledged or hypothecated";[62]
- "voting rights in proportion to the number of shares owned";[63] and
- the ability to "appreciate in value."[64]

The Court later reaffirmed and restated these attributes of stock as a security.[65] Other courts have applied the attributes to various different types of corporate stock, including stock in closely held corporations.[66] In these opinions, the courts focused on the foundational principle that "Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto."[67]

These economic realities dictate that stock is a security if it represents a profit-sharing interest in a for-profit business (because it is an investment for profit). This core economic reality has, for example, been the key touchstone in cases involving the analysis of agricultural and certain other cooperative memberships as securities.[68] To avoid the

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> regulatory scheme, this factor should not be determinative. Stock or equity credits sold to nonmembers should be treated as any other security would be—coverage of the Acts would apply unless some other exemption applies. There are no policy reasons that would compel other treatment.

Sedo, *supra* note 55, at 283 (footnote omitted).

60 United Hous. Found., Inc. v. Forman, 421 U.S. 837, 851 (1975).

61 *Id.*

62 *Id.*

63 *Id.*

64 *Id.*

65 *See* Landreth Timber Co. v. Landreth, 471 U.S. 681, 686 (1985).

66 *See* Sulkow v. Crosstown Apparel, Inc., 807 F.2d 33, 36 (2d Cir. 1986); Fong v. Oh, 172 P.3d 499, 508 (Haw. 2007).

67 *Forman*, 421 U.S. at 849.

68 *See* Goforth, *supra* note 44, at 74 ("[M]embership interests in such co-ops are not usually treated as securities—they lack the essential attributes of an 'investment' seeking 'profits,' and instead are more in the nature of a purchase for use."). The *Forman* case—the seminal case involving the analysis of stock as a security—involved stock in a cooperative public housing project. *See Forman*, 421 U.S. at 840 ("The issue in these cases is whether

characterization of stock as a profit-sharing interest (and, potentially, as a security), a for-profit social enterprise corporation could manipulate some of the acknowledged core attributes of stock. For example, a for-profit social enterprise firm organized as a benefit corporation could designate a class or series of nonvoting stock that is not entitled to dividends and carries transfer restrictions and limits on pledging and hypothecation. Even in this event, however, the stock may not avoid security status if it can appreciate in value, is tradable in some way, and has a claim on assets in liquidation.[69]

The Supreme Court identifies the context of a stock transaction as a key factor in determining the status of stock as a security, and it notes that a sale of stock as equity in a corporation is a classic context favoring security status.[70] In general, "[w]hen an instrument is both called stock and bears the usual characteristics of stock, . . . a purchaser may justifiably assume that the federal securities laws apply."[71] As one commentator observed a number of years ago, "'[S]tock' cases no longer are making their way into print. Presumably, defendants have given up the ghost in light of the clear-cut plaintiff success rate in this area."[72] In all likelihood, stock representing an equity interest in a for-profit social enterprise is a security.

3. Investment Contracts

Similarly, investment contracts issued by for-profit social enterprises are likely to be securities, although the matter may not be

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shares of stock entitling a purchaser to lease an apartment in Co-op City, a state subsidized and supervised nonprofit housing cooperative, are 'securities' within the purview of the Securities Act of 1933 and the Securities Exchange Act of 1934.").

69 Again, the cases relating to analyses of equity interests in cooperatives as securities may be instructive here.

> While the laws and court decisions have provided a safe harbor for certain forms of cooperatives, such as agricultural cooperatives, and for certain forms of cooperative securities, such as membership and patronage dividend stock or equity, other problem areas remain. Some problem areas that remain are transferable stock, stock that pays dividends, stock not issued to evidence membership or patronage rebates, and notes issued by a cooperative.

Sedo, *supra* note 55, at 282.

70 *Landreth*, 471 U.S. at 687 ("[T]he context of the transaction . . .—the sale of stock in a corporation—is typical of the kind of context to which the Acts normally apply. It is thus . . . likely here . . . that an investor would believe he was covered by the federal securities laws.").

71 Lewis D. Lowenfels & Alan R. Bromberg, *What Is a Security Under the Federal Securities Laws?*, 56 ALB. L. REV. 473, 520 (1993) (referencing the Supreme Court's decision in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985)).

72 Theresa A. Gabaldon, *A Sense of a Security: An Empirical Study*, 25 J. CORP. L. 307, 345 (2000) (footnote omitted).

free from doubt. An investment contract, as that term is used in the definitions of a "security" in the 1933 Act and the 1934 Act, is

> a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[73]

Membership interests in LLCs, including L3Cs, typically are securities under this definition.[74] However, the analysis will be different for each investment tranch in an L3C, and those differences may lead to different outcomes.[75]

In certain contexts, a funder of social enterprise may be seen to have both an altruistic and investment interest in the business and may not have been led to expect profits to the exclusion of social or environmental good.[76] In fact, in the crowdfunding era that preceded the JOBS Act, social enterprises were among the businesses that chose to venture into crowdfunding, raising a potential argument that these crowdfunded interests were not securities.[77] However, the investment contract definition typically has been broadly interpreted to encompass profit-sharing and revenue-sharing interests in social enterprise entities.[78]

4. Bottom Line

When a for-profit social enterprise firm issues debt, stock, or other financial instruments that include profit-sharing or revenue-sharing interests, it should be cognizant of the probable application of the federal securities laws, since these instruments are securities unless the context otherwise requires. There is an abundance of decisional law construing these instruments in context. This body of law is rich and continues to get richer. "[N]otwithstanding many settled interpretations and accepted conventions, there also are standing invitations for creativity and

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[73] SEC v. W. J. Howey Co., 328 U.S. 293, 298–99 (1946).

[74] *See* Kelinberger, *supra* note 28, at 902.

[75] See *id.* ("For an L3C, the securities law determination will be especially complicated because nominally, at least, the foundations will not be investing with any expectation of profit and yet will need some fundamental control over the enterprise. Depending on how fundamental that control is, its existence could increase the likelihood that the other investors are purchasing a security from the L3C when they become members (co-owners) of the L3C. In any event, the securities determination will differ for each tranch of investors." (footnote omitted)).

[76] *See Howey*, 328 U.S. at 300 (noting that the purchasers were "attracted *solely* by the prospects of a return on their investment" (emphasis added)).

[77] *See* Heminway & Hoffman, *supra* note 33, at 897.

[78] *See id.* at 897–902.

transformation."[79] Accordingly, while a court is likely to determine that non-bank debt, stock, and investment contracts that afford holders the right to financial return are securities under the 1933 Act and 1934 Act, there may be some room for argument to the contrary in specific cases.

B. Implications of the Status of Financial Instruments Issued by For-Profit Social Enterprise Ventures as Securities

The presumptive categorization of non-bank debt, stock, and investment contracts issued by for-profit social enterprises as securities when those instruments include profit-sharing or revenue-sharing interests has implications for the capital-raising process for social enterprise entities and the cost of capital for social enterprise. As a general matter, for-profit social enterprise entities selling securities should be able to tap funds from the same group of investors that finance other for-profit business ventures.[80] However, a social enterprise entity enjoys unique benefits and detriments in attracting traditional forms of investment capital from conventional sources of investment capital; "the dual mission embedded in the form may or may not prove advantageous."[81] Traditional for-profit venture investors may not be interested in funding the dual bottom line that exists in social enterprise.[82] Conversely, "socially motivated" entrepreneurial investors may be attracted to social enterprise.[83] Securities issued by social enterprise entities may not operate in investment markets the same way that securities issued by more traditional for-profit ventures operate.

Regardless, the classification of profit-sharing or revenue-sharing instruments issued by social enterprises as securities under federal law means that the vast scheme of federal securities regulation, with its attendant costs, will add expense to the capital-formation process for social enterprise firms.[84] Under the 1933 Act, offers and sales of securities must be registered absent an exemption,[85] and public company

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[79] Gabaldon, *supra* note 72, at 347.

[80] *See* Brakman Reiser, *supra* note 14, at 619 (noting that "benefit corporations can pursue the funding sources available to traditional for-profits"); Bugg-Levine et al., *supra* note 27, at 121 (describing financing alternatives for social enterprise ventures that are "analogous to the way conventional companies are financed").

[81] Brakman Reiser, *supra* note 14, at 619.

[82] *See id.* at 618 ("[F]or diligent investors or lenders who closely examine the business plan of a social entrepreneur, the mix of social and profit purposes may raise eyebrows . . . .").

[83] *See id.* at 619.

[84] *See generally* Heminway & Hoffman, *supra* note 33, at 907–11 (describing these costs in the context of crowdfunded securities).

[85] *See* 15 U.S.C. §§ 77d, 77e (2006 & Supp. V 2011) (requiring registration of offers and sales of securities unless an exemption is available).

status under the 1934 Act obligates issuers to periodic and transactional reporting.[86] The costs associated with producing these filings are significant and may be slightly higher for social enterprise issuers than for other issuers until there is a critical mass of disclosure for publicly held social enterprise issuers that satisfies regulators and is litigation-tested for accuracy and adequacy. In the interim, these issuers and their counsel will be drafting and refining disclosures about the social enterprise aspects of the entities from scratch, creating new precedent disclosures for social enterprise in the public-company realm, and defending these nascent disclosures in legal actions stemming from offers, sales, and other transactions in (and activities relating to) their securities.

The classification of financial instruments issued by for-profit social enterprise ventures as securities discourages the generation of social capital through these forms of entity. The "security" label is not a perfect fit for some of these instruments, enhancing investor uncertainty (in the form of confusion, concern, etc.). Moreover, for-profit social enterprise issuers must bear the transaction costs associated with registering offers and sales of these instruments or finding an applicable exemption and may also be required to assume the costs of complying with stringent periodic and transactional reporting requirements. If for-profit social enterprise is to be a meaningful proposition, these disincentives should be acknowledged and addressed.

III. Does It Make Sense to Categorize and Regulate Financial Instruments Issued by For-Profit Social Enterprise Entities as Securities?

It seems appropriate to question the status of for-profit social enterprise debt, stock, and investment contracts as securities. For-profit social enterprise firms and their securities can be located somewhere between other for-profit issuers and their funding interests and not-for-profit issuers and their funding interests. Accordingly, at least two comparative perspectives on this issue seem relevant: a comparative perspective based on other for-profit issuers and financial interests, and a comparative perspective based on not-for-profit issuers and financial interests.

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[86] *See, e.g.*, 15 U.S.C. §§ 78m(a), (e), 78n(a), (e) (2006 & Supp. V 2011) (requiring the filing of quarterly and annual reports and proxy, going private, and tender offer statements).

A. For-Profit Social Enterprise Issuers as Compared to Other For-Profit Issuers

On the one hand, for-profit social enterprise businesses are for-profit businesses with risk profiles similar in nature to other forms of business association. Each exists to create profits and provide goods or services to a target population. Funders provide financial capital and, in return, may be promised some form of financial return. They provide funding to the firm based on, among other things, the business it conducts and how it conducts that business.

But the business of a for-profit social enterprise venture or the way it conducts that business (or both), is distinctive in that it integrally engages social or environmental objectives. Funders, therefore, assume a specific risk that management of the social enterprise may act (indeed, perhaps may be compelled to act) in a manner that advances the firm's articulated social or environmental purpose and adversely affects the firm's profitability.[87] Should this distinction make a difference under federal securities law? In other words, is the nature of a debt, stock, or investment contract instrument issued by a for-profit social enterprise venture sufficiently different from a debt, stock, or investment contract instrument issued by another for-profit venture that it should not constitute a security?

An assessment of the foundational policy considerations underlying the security definitions in the 1933 Act and the 1934 Act leads to the inescapable conclusion that financial instruments issued by for-profit social enterprises should be treated the same as those issued by other for-profit entities for purposes of that definition. The concept of a security under the two federal statutes is, and should be, a broad one.[88] To protect investors, help maintain the integrity of the federal securities markets, and encourage capital formation,[89] the statute requires

> full and fair disclosure relative to the issuance of "the many types of instruments that in our commercial world fall within the ordinary concept of a security." It embodies a flexible rather than a static

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[87] Said differently, social enterprises do not behave in accordance with the shareholder wealth maximization norm. *See supra* notes 3–10 and accompanying text.

[88] *See* Gabaldon, *supra* note 72, at 311 ("Without a doubt, perusal of the statutory language defining a security conveys a firm sense that Congress intended broad coverage of the '33 and '34 Acts."). Professor Gabaldon goes on to add that "[t]his sense is confirmed by an explicit expression of congressional policy: legislative history announces that the term 'security' is defined 'in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'" *Id.* (quoting H.R. REP. NO. 73-85, at 11 (1933)).

[89] These three objectives are well-acknowledged policy underpinnings of the federal securities laws. *See* Heminway, *supra* note 50, at 337 & n.5.

> principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.[90]

This breadth, however, only extends to investment instruments. "Congress was concerned with regulating the investment market, not with creating a general federal cause of action for fraud."[91] Unless the aggregation of interests represented by a financial instrument issued by a for-profit social enterprise firm represents something other than an investment (e.g., a donation, a gambling interest, a consumption interest, an insurance or commodities contract, or a commercial banking arrangement), the instrument is, and should be, classified as a security.

B. For-Profit Social Enterprise Issuers as Compared to Not-For-Profit Issuers

For-profit social enterprise entities and the financial instruments they issue also share characteristics with not-for-profit entities and their financial instruments. Instruments that afford profit-sharing or revenue-sharing rights to holders are securities under the tests set forth *supra* in Part II.A, regardless of whether they are issued by for-profit or not-for-profit entities.[92] Because of the non-distribution constraint and, in the case of tax-exempt not-for-profit entities, private inurement restrictions, not-for-profit entities typically issue debt when seeking financial capital.[93] As a security, the offer and sale of this debt would be subject to the registration requirements of the 1933 Act.[94]

However, not-for-profit issuers are favored under the 1933 Act and the 1934 Act.[95] This is part of a larger legal avoidance of placing undue regulatory burdens on not-for-profit organizations.

> Federal and state governmental agencies generally attempt to avoid regulation of nonprofit organizations by granting them privileges and exemptions not available to others. The securities laws

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[90] SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946) (citation omitted) (quoting H.R. REP. NO. 73-85, at 11).

[91] Reves v. Ernst & Young, 494 U.S. 56, 65 (1990).

[92] Timothy L. Horner & Hugh H. Makens, *Securities Regulation of Fundraising Activities of Religious and Other Nonprofit Organizations*, 27 STETSON L. REV. 473, 473 (1997) ("Nonprofit organizations that engage in fundraising activities involving the offer and sale of securities must comply with the federal securities laws.").

[93] *Id.* ("Nonprofit organizations engage in a wide variety of fundraising activities that involve the issuance of securities. Such organizations may issue notes, bonds, and other debt instruments to raise funds for general operations or for the construction or purchase of churches, schools, hospitals, retirement homes, or other facilities.").

[94] 15 U.S.C. §§ 77d, 77e (2006 & Supp. V 2011).

[95] *See* Horner & Makens, *supra* note 92, at 527 ("Nonprofit organizations have always received favorable treatment under the federal and state securities laws and have been entitled to a variety of exemptions not available to other organizations.").

> follow this pattern by exempting nonprofit organizations from many securities regulatory requirements.[96]

For example, under the federal securities laws, certain securities issued by not-for-profit entities are exempt from the registration requirements of the 1933 Act and the 1934 Act, and certain not-for-profit organizations, together with those who solicit funds for them, are excluded from various definitions of market intermediaries (e.g., brokers and dealers).[97] The registration exemption under each act is only available for securities of an issuer "organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of" specified persons.[98] The definitional exclusions from coverage as brokers, dealers, and other similar statuses under the 1934 Act apply generally to a not-for-profit organization and each trustee, director, officer, employee, or volunteer engaged in buying, selling, or trading securities

> for its own account in its capacity as trustee or administrator of, or otherwise on behalf of or for the account of: (a) a charitable organization; (b) a charitable income fund; (c) a trust or other donative instrument for which the assets are permitted in a charitable income fund; or (d) the settlors (or potential settlors) or beneficiaries of any such charitable trusts or donative instrument. This exclusion is broad enough to cover most securities sales activities of nonprofit organizations.[99]

Notably, the definitional exclusions only apply to solicitors of funds for the not-for-profit who are volunteers or comprehensive fundraisers who receive no commission or special compensation based on the donations received.[100]

These exemptions and exclusions do not completely deregulate the securities of not-for-profit organizations.

> [D]ue to concerns for actual or potential investment fraud or mismanagement in conjunction with the sale of securities, nonprofit

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[96] *Id.* at 474 (footnote omitted); *see also* Bradley J.B. Toben & Carolyn P. Osolinik, *Nonprofit Student Lenders and Risk Retention: How the Dodd-Frank Act Threatens Students' Access to Higher Education and the Viability of Nonprofit Student Lenders*, 64 BAYLOR L. REV. 158, 185–86 (2012) ("[A] number of other laws also provide nonprofit organizations with more funds and easier access to capital. For instance, tax-exempt nonprofit organizations that issue securities may do so without being constrained by many provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934." (footnote omitted)).

[97] *See* Horner & Makens, *supra* note 92, at 478–82.

[98] 15 U.S.C. § 77c(a)(4) (2006 & Supp. V 2011); 15 U.S.C. § 78*l*(g)(2)(D) (2006).

[99] Horner & Makens, *supra* note 92, at 481 (footnote omitted); *see also* 15 U.S.C. § 78c(e)(1) (2006).

[100] 15 U.S.C. § 78c(e)(2) (2006); *see also* Horner & Makens, *supra* note 92, at 481.

> organizations are never exempt from the anti-fraud provisions of the federal and state securities laws. Each issuer of securities is required to make full and fair disclosure to its investors and is prohibited from engaging in manipulative, deceptive, or fraudulent conduct in connection with the sale of securities.[101]

Accordingly, while the mandatory disclosure regime under federal securities law (effectuated through the registration and reporting requirements of the 1933 Act and 1934 Act) and certain forms of substantive regulation (including proxy, going-private, and tender-offer regulation under the 1934 Act) may not apply to not-for-profits who issue exempt securities, antifraud rules exist to help protect investors in those securities from, for example, the inaccurate and incomplete disclosure of material facts in connection with investment transactions in the securities.[102] These antifraud rules exist under both the 1933 Act and the 1934 Act, and claims may relate to registered or unregistered securities.[103] In general, these fraud rules encourage not-for-profit issuers of exempt securities to produce offering materials (e.g., a private placement memorandum or offering circular) to help ensure the accurate and complete disclosure of all material facts in connection with offers and sales of securities.[104]

The policy rationale for the light regulatory treatment of securities issued by not-for-profit entities is somewhat unclear. In discussing the exemption from 1933 Act registration, one group of coauthors offer a helpful explanation:

> Various policy justifications may support this exemption. Arguably, individuals do not "invest" in eleemosynary organizations and therefore are not in need of extensive disclosures about the economic aspects of the operations of such issuers. Further, to subject nonprofit organizations to the costs of registering securities offered to the public would severely limit the ability of the organizations to raise capital needed to achieve the purposes for which they were formed.[105]

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[101] Horner & Makens, *supra* note 92, at 474–75; *see also id.* at 528 ("[E]ven if the program is exempt from all registration requirements, nonprofit organizations are never exempt from the anti-fraud provisions of the federal or state securities laws.").

[102] *Id.* at 479 ("Section 3(a)(4) provides only an exemption from registration of securities. It does not provide an exemption from the anti-fraud provisions of the Securities Act."); *id.* at 480 ("The exemption under sections 12(g) and 3(a)(12)(A) are only exemptions from registration. The anti-fraud provisions of the Exchange Act continue to apply to the purchase and sale of securities that are exempt from registration.").

[103] *See id.* at 489 (describing, generally, the nature of antifraud protections under the 1933 Act and the 1934 Act).

[104] *Id.* at 528.

[105] JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 432 (6th ed. 2009); *see also* SEC v. Children's Hosp., 214 F. Supp. 883, 891 (D. Ariz. 1963) ("Section 3(a)(4) of the Securities Act is intended to facilitate the raising of funds by eleemosynary

Generally, these policy justifications reflect an "unstated premise that the eleemosynary character of the issuer obviates the need for disclosure to investors"[106] and a prioritization of the social good of nonprofits over the need for enhanced disclosure to investors—disclosure in excess of that required for not-for-profits under federal tax law, state entity law, and state charitable donation regulation (as applicable). These rationales may apply with almost equal force to social enterprise firms organized as for-profit entities.

For example, funders of for-profit social enterprise ventures, like funders of public charities, may not understand themselves to be investors in the classic financial sense. The return that they seek typically is not wholly pecuniary. The psychological and emotional benefits of investing in the public good are usually a driving force and may, in fact, be the funder's primary motivation. The possibility of a financial return may be a secondary—even an incidental—motivation for the investment. Accordingly, these funders may not need the same type or extent of disclosures about the financial condition and results of operations of the firm that investors in non-social enterprise for-profit ventures require.

This may be especially true for social enterprise investors whose financing is provided through innovative investment contracts like unequity.[107] Unequity includes a profit-sharing or revenue-sharing interest and is, therefore, a security.[108] But the profit-sharing or revenue-sharing interest exists over a short term—a few years at most—and does not include any governance (management or voting) rights. In the run-up to the passage of the JOBS Act (signed into law in April 2012), crowdfunding web sites and the projects they promoted innovated a number of different types of financial interests. Some of the crowdfunding interests offered at this time were unequity and other forms of investment contract. These interests were securities, and the offer and sale of them should have been registered under then-existing federal law. Some crowdfunding interests offered at that time did not offer a financial return to funders, preferring instead to solicit financial contributions in the form of donations (with or without a product, product discount, or other reward as an incentive) or interest-free

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issuers."); Kevin E. Davis & Anna Gelpern, *Peer-to-Peer Financing for Development: Regulating the Intermediaries*, 42 N.Y.U. J. INT'L L. & POL. 1209, 1254 (2010) ("[C]harities are exempt from disclosure and registration aspects of securities laws in part because the cost of compliance is out of proportion with nonprofit finances.").

[106] COX ET AL., *supra* note 105, at 463.

[107] *See supra* note 50 and accompanying text.

[108] *See generally* Heminway & Hoffman, *supra* note 33, at 890–905 (assessing the security status of investment contracts of this kind in the pre-JOBS Act era).

loans.[109] If for-profit social enterprise firms offer unequity (or other securities with minimal profit-making potential) to investors, whether through crowdfunding or otherwise, costly, time-intensive disclosures (including those associated with, e.g., 1933 Act registration) may discourage the formation of for-profit social enterprise entities.

Moreover, a social enterprise firm, like the archetypal not-for-profit public charity, exists in part for public benefit (half of its "double bottom line"). If that public benefit is to be promoted, policymakers should consider whether an exemption from the disclosure requirements under the 1933 Act and 1934 Act (like that provided to charitable entities) is necessary or desirable. In other words, the law may want to affirmatively encourage social enterprise by decreasing the cost of raising capital from the public.

This analysis puts pressure on at least two salient matters that arguably deserve more attention and robust debate: (1) the propriety and desirability of the existing regulatory exemptions applicable to not-for-profit issuers and securities, and, (2) assuming the appropriateness and value of the existing regulatory exemptions applicable to not-for-profit issuers and securities, the nature and extent of the public good served by for-profit social enterprise entities as compared to not-for-profit public charities. Both matters involve difficult—and arguably non-objective—judgments. It may be profitable, however, for advocates, detractors, and policymakers to focus on identifying and gauging the net social utility of not-for-profit public charities and for-profit social enterprise entities and comparing and contrasting them as a means of reaching reasoned judgments about the incentives and disincentives created by the existing system of securities regulation in this context. The hybrid nature of social enterprise, the blurred lines between not-for-profit and for-profit social enterprise entities, and the wide variety of statutes that may be used to charter social enterprise entities under state law make this task challenging. Not all not-for-profit entities or for-profit social enterprise firms are created equally, and social enterprise businesses (however organized) may not be easily comparable. Although the adoption by states of standardized forms of entity for social enterprises may better enable, over time, an assessment of whether securities issued by those entities should be treated more like standard not-for-profit or for-profit securities, difficult policy questions likely will remain.

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[109] *See* Bradford, *supra* note 33, at 14–15 (offering a taxonomy of different crowdfunding forms).

CONCLUSION

New hybrid forms of entity for use by social enterprise firms (e.g., L3Cs and benefit corporations) may or may not be a long-term part of our state-based system of entity law. As a general matter, however, social enterprise appears to be here to stay and continues to evolve in a space between the public and the private; between the traditional for-profit and not-for-profit forms of entity. This evolution is occurring in a broader environment of political, social, and economic transformation.

> Significant changes are occurring in the field of social enterprise, including major developments in the flow of funding, growing but often untapped philanthropic resources, and a shift in the role of government, as well as new social investment models and impact measurement tools. All of these phenomena are occurring against a larger backdrop of demographic and market change as boundaries blur among the traditional nonprofit, for-profit, and public-sector silos.[110]

The development of social enterprise entity law is important to the overall development of entity law as a means of differentiating for-profit social enterprise firms from traditional for-profit business ventures on the basis of, e.g., their corporate purpose and the substantive focus of managerial fiduciary duties.

The regulation of securities, together with entity law and tax law, affects the continued viability of these social enterprise entities through the incentives and disincentives it creates for different funding models and strategies. Given the evolving social enterprise landscape, legal counselors of all kinds are well advised to devote attention to the legal aspects of social enterprise finance, including the nature of the funding interests and instruments that individual social enterprise ventures offer and sell to investors and the regulation of those interests and instruments in context. These matters are important to *ex ante* advice on the appropriate legal form, capital structure, and acceptable risk profile for a social enterprise venture. They also are important to *ex post* assessments in advisory and advocacy contexts.

However, just as securities regulation influences social enterprise, social enterprise also impacts the regulation of securities. The changing nature of the firm, among other things, renders the very concept of a security somewhat elusive. In the brave new world of L3Cs, benefit corporations, and crowdfunding, the conception and regulation of securities is becoming increasingly complex. The current financial regulatory system depends on labeling interests and instruments by

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[110] V. Kasturi Rangan et al., *The Future of Social Enterprise* 9 (Harvard. Bus. Sch., Working Paper No. 08-103, 2008), *available at* www.hbs.edu/faculty/Pages/download.aspx?name=08-103.pdf.

their specific type as a means of determining the form and manner of regulation as well as the regulatory body that exercises control over the applicable rules of finance.

Yet the task of identifying and labeling securities in the age of social enterprise and crowdfunding is increasingly difficult. As new financial interests and instruments are created, the once-clear lines between different forms of instrument—debt versus equity, common stock versus preferred stock, etc.—become increasingly blurred. As policymakers consider restructuring the system of financial regulation in the United States, a more comprehensive understanding and analysis of the nature of securities issued by social enterprises will be valuable in locating these securities in the spectrum of regulated financial interests and instruments. This understanding and analysis is important not only to normalizing the establishment and funding of social enterprise, but also to solving the overall financial regulatory puzzle.