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SPOTLIGHT ON THE GOOD COMPANY

The For-Benefit Enterprise

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by Heerad Sabeti

Spotlight

ARTWORK Sarah Morris, *Alpine Coil [Knots]*, 2009
Gloss household paint on canvas, 214 x 214 cm

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Heerad Sabeti is a serial social entrepreneur and a cofounder and trustee of the Fourth Sector Network.

The For-Benefit Enterprise

WE ARE IN A NEW ERA. For-profit businesses are tackling social and environmental issues, nonprofits are developing sustainable business models, and governments are forging market-based approaches to service delivery. Out of this blurring of traditional boundaries, a different model of enterprise is emerging, driven by entrepreneurs who are motivated by social aims.

When these entrepreneurs begin to create an entity to carry out their ideas, they often face a crippling and seemingly arbitrary question: whether to be a for-profit or a nonprofit. To some readers the distinction may seem straightforward, but a growing number of entrepreneurs chafe under those classifications. How, for example, would you label the commercial car-sharing service I-GO in Chicago, which is structured as a nonprofit? What about China's Qifang, an online platform dedicated to giving low-income students a way to pay for their education, which is structured as a for-profit?

Neither of these enterprises is strictly for-profit or nonprofit; both could be called "for-benefit." That's the term entrepreneurs are increasingly using to describe organizations that generate earned income but give top priority to an explicit social mission. The hybrid approach they employ can already be found across a wide range of industries and in pursuit of myriad important goals: eliminating homelessness, fighting drug addiction, reducing deaths from malaria, producing renewable energy.

Many more such enterprises would exist, except that most entrepreneurs haven't been able to choose "for-benefit" as a legally recognized organizational structure. Most countries' legal and economic systems allow either for-profit or nonprofit activity, not a blending of the two. Many socially minded entrepreneurs end up shoehorning their vision into one structure or the other and accepting burdensome trade-offs in the process.

All this is destined to change. For-benefit enterprises will become more commonplace as entrepreneurs learn to better navigate existing constraints, and as an ecosystem of specialized support—including public policy, financial markets, accounting standards, and professional services—develops around them. The even bigger news is what will happen then. With formalization of the for-benefit structure, we will see the emergence of a fourth sector of the economy, interacting with but separate from governments, nonprofits, and for-profit businesses. The rise of that sector is likely to reshape the future of capitalism.

To understand the kinds of gains the new sector will make possible, let's take a look at the breakthrough solution offered by a for-benefit structure in one important arena.

A Healthful Compromise

In the 2009 debate over U.S. health care reform, proponents of the "public option"—a government-run health insurance plan—were pitted against those who wanted to maintain the status quo of private insurance. Neither side won, but out of the tension a new idea was born: The Patient Protection and Affordable Care Act included an innovative compromise provision encouraging the creation of "community operated and oriented plans." Hoping to intensify the competition in markets served by incumbent for-profit and nonprofit insurers, a bipartisan group of lawmakers crafted the provision for this entirely new kind of health insurance entity, appropriated $6 billion in start-up loans, and set a goal of each state's having at least one COOP by 2014.

COOPs combine the best of nonprofit, for-profit, cooperative, and public models. They are private, consumer-governed health plans designed to serve the social purpose of furthering the well-being of their members. They are exempt from federal income tax. Like other insurers, COOPs must attract customers, charge premiums, and generate profits in order to maintain solvency and grow their membership. But their profits must be directed toward improving benefits, enhancing quality of care, reducing premiums, or otherwise advancing their mission.

Very quickly the COOP provision attracted attention from various groups interested in alternative health insurance models. Take, for example, the Freelancers Union, a New York–based nonprofit dedicated to developing a social safety net for independent workers. Its founder, Sara Horowitz, sees the COOP model as a perfect fit for an organization whose membership, numbering in the tens of thousands, constitutes a risk pool that can be insured at a reasonable cost. She and other proponents believe that COOPs can play a significant role in fostering higher quality of care, greater cost efficiency, and broader access throughout the U.S. health care system.

In hindsight, the COOP solution seems obvious: It's a market-based approach that addresses concerns about government bureaucracy and inefficiency, yet is driven by a social purpose and has a governance structure that puts the health of members before the maximization of profits. So why wasn't the solution obvious all along? Because it required reimagining entrenched organizational structures that many considered immutable.

For-benefit models have broad applicability throughout the economy, but bringing their potential to life depends on just such reimagining, on two fronts: organizational architecture and ecosystems of support.

Creating a For-Benefit Enterprise

What, exactly, does it mean to be a for-benefit? Two primary characteristics distinguish these organizations: a commitment to social purpose and a reliance on earned income. Most for-benefits also have one or more secondary characteristics (see the sidebar "The Anatomy of a For-Benefit Organization").

The first step in forming a for-benefit enterprise is to be explicit about the fact that one is doing so. Because the law usually forces a nascent for-benefit to organize as a for-profit or a nonprofit, the enterprise defines itself accordingly. This can lead to confusion, mistrust, and low credibility among stakeholders—which is why many for-benefits attempt to distinguish themselves through branding or product messaging, invoking terms such as "social enterprise," "sustainable business," "fair trade," and "green."

Rare is the entrepreneur who devotes much thought to organizational architecture—the rules, incentives, roles, and systems at the heart of an organization's operations. Entrepreneurs tend to be excited about the new products or services they will offer, or the better way they will meet customers' needs, or the underserved market they will reach. When it comes to administrative details, they are usually happy to rely on experts—legal counsel and accountants who have served many entrepreneurs before them.

Architecture can be implemented through a variety of elements, including legal form, governance structure, ownership design, performance-assessment tools, and contracts with investors, employees, suppliers, and other stakeholders. The right architecture is critical for the success of any organization; for-benefits face unique challenges, however, because their default choices come from either for-profit or nonprofit norms. A for-benefit entrepreneur who is ready to form a legal entity will typically consult either a corporate or a nonprofit attorney, and thus be channeled into one body of law and legal options or the other. The choice of legal form will dictate the type of capital the enterprise can easily

Idea in Brief

A new type of entity is appearing in many mature economies: the "for-benefit" enterprise, so called because it operates like a traditional business in many ways, but is founded primarily to provide social benefits rather than to maximize financial returns.

For-benefits would be more plentiful if socially minded entrepreneurs were more aware of the consequences of architectural decisions they make at the start, and if they had access to a more supportive ecosystem.

With new legislation granting legal status to for-benefits, those barriers are falling. Specialized law and accounting practices and other resources are focusing on the challenges of blending financial and social value. Indeed, for-benefit enterprises are emerging as a whole new sector of the economy—one powerful enough to change the course of capitalism.

access: private investment in the case of a for-profit, philanthropic funds in the case of a nonprofit. Although there are exceptions, most for-benefit entrepreneurs find themselves in a binary world that forces them to compromise their objectives, complicate their organizational structures, and waste resources.

Socially minded entrepreneurs should realize that they don't have to accept convention. They have license to be inventive and to question advice that seems inconsistent with their objectives. Form should follow function. Imagine starting out as an enterprise builder with no preconceived notions about structure. How might you create a reliable system for tracking social and environmental impacts throughout your supply chain? Could you build an investment structure that provides what economists call a "satisficing" level of return—sufficient to incentivize investment—without giving away perpetual ownership rights? Would a structure that allowed anyone to benefit from selling your offering make more sense than one that assumed a captive or formally contracted sales force? These questions merely hint at the range of possibilities. Coloring outside the lines requires more imagination, effort, and expense than a start-up typically requires, but it can maximize the potential for achieving financial, social, and environmental objectives in the long run.

The following items should be given priority on any for-benefit entrepreneur's agenda:

Stakeholder value. Whereas for-profits emphasize shareholder value, for-benefits pay more attention to their impact on all stakeholders. After identifying the groups that are essential to the organization's success, and clarifying the value proposition for each, entrepreneurs should feel free to negotiate unconventional roles, responsibilities, and incentives that will increase stakeholders' engagement with the mission. The British start-up Riversimple, which makes cars powered by hydrogen fuel cells, allows all its stakeholders to have a voice in the governance of the business and a share in the profits. The company licenses its designs to an independent, open-source foundation, which makes it possible for engineers, designers, and manufacturers anywhere in the world to help develop and produce the cars.

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Capitalization. A key challenge that for-benefits encounter is to design a structure that balances the financial interests of capital providers with the enterprise's mission and stakeholder commitments. This balance should be reflected in shareholder agreements, loan contracts, and other financial instruments. Upstream 21, a holding company in the Pacific Northwest, chooses its portfolio companies on the basis of their demonstrated concern for stakeholders and local communities, and provides them with both growth capital and assistance in improving their financial, social, and environmental performance.

Ownership and governance. Will subsequent CEOs, directors, and investors share the commitment that inspired the founders? Preservation of the social mission after an ownership transfer is one of the thorniest challenges that for-benefits face. It's often assumed that owners drive governance, but in fact ownership is a collection of legal rights that can be unbundled and repackaged in creative ways.

The Anatomy of a For-Benefit Organization

For-benefits are a new class of organization. Like nonprofits, they can pursue a wide range of social missions. Like for-profits, they can generate a broad range of products and services that improve quality of life for consumers, create jobs, and contribute to the economy.

Combining social and commercial ends is not new—think of hospitals, universities, arts organizations, Goodwill. But the for-benefit model does much more than that. It redefines fiduciary duty, governance, ownership, and stakeholder relationships in fundamental ways. Here are some key for-benefit characteristics that are being codified in new legal structures:

Primary

Embedded purpose. A commitment to mission is in the organization's DNA. Fiduciary duty is tied to purpose.

Earned income. Sales of goods and services generate most of the income.

Secondary

Inclusive ownership. Ownership rights are allocated among stakeholders in accordance with their contributions.

Stakeholder governance. Decision rights regarding information and control are distributed among stakeholder constituencies.

Fair compensation. Employees and other stakeholders are compensated in proportion to their contributions.

Reasonable returns. Limitations on investment returns protect the organization's ability to achieve its mission.

Social and environmental responsibility. Social and environmental performance is constantly improved throughout the stakeholder network.

Transparency. Social, environmental, and financial performance and impact are fully and accurately assessed and reported.

Protected assets. Social-purpose assets are preserved upon dissolution, conversion, or ownership transfer.

Thoughtful ownership and governance design can protect the mission over the long term and deepen stakeholder engagement. Cafédirect, the United Kingdom's largest fair-trade purveyor of hot drinks, was founded by a worker-owned cooperative, a public limited company, an international confederation of nonprofits, and an NGO. Since 2003 the producers that supply Cafédirect have been represented on the board and have held 5% of the company's shares.

Legal form and tax treatment. For-profit and nonprofit legal and tax models are not designed for the simultaneous pursuit of social and financial bottom lines. For example, when founders choose a for-profit form, they have no reliable way of ensuring commitment to the social mission. And board members, mindful of their fiduciary duty, may find it hard to prioritize social and environmental concerns over the interests of shareholders. The Danish pharmaceutical company Novo Nordisk, founded with a mission to rid the world of diabetes, avoided those difficulties. It has a publicly traded operating company that is controlled by a foundation—which prevents hostile takeovers, enables executives to focus on the long term, and allows profits to be used for humanitarian purposes.

Some jurisdictions have started to recognize various types of for-benefits: the "community interest company" in the UK and the "low-profit limited liability company" (L3C), "benefit corporation," and "flexible purpose corporation" (pending the signature of California's governor) in various U.S. states. Although these models may not withstand the test of time, they are a harbinger of more-sustained attention by lawmakers to the needs of for-benefit enterprises.

Performance measurement and reporting. The fundamental value proposition for a for-benefit requires that the organization be able to account for its total impact and performance—financial, social, and environmental. Few conventional accounting systems and metrics are designed for such reporting, but efforts are under way to create new tools. Last May the sports apparel company Puma announced the initial results of its Environmental Profit & Loss Account, which relies on emerging methodologies to calculate the impact of the company's operations and supply chain on greenhouse gas emissions and water consumption.

Cautionary tales are associated with all five of these areas. Many of the pitfalls that for-benefits face as they mature can be attributed to flaws in their architecture. Entrepreneurs are well served by adopting a long-term perspective as they think through the consequences of key structural decisions.

Finding a Suitable Ecosystem

For-profits and nonprofits exist within supportive ecosystems consisting of well-established laws, accounting standards, financial markets, trained pools of talent, and customized tools and services. When an entrepreneur starts a conventional company, lawyers, accountants, investors, and consultants share an understanding of what that means and can provide tools and services that fit seamlessly together. For-benefit enterprises have had to rely mostly on these ecosystems—but now they can find resources and support that are better suited to their requirements.

For example, they can obtain specialized legal assistance through the Lex Mundi Pro Bono Foundation. Access to sympathetic sources of capital is becoming easier with the rise of so-called impact investors and the advent of intermediaries such as the Global Impact Investing Network. (The financial opportunity is certainly there: According to a 2010 J.P. Morgan research report, five sectors of the global bottom-of-the-pyramid market collectively offer the potential over the next decade for up to $1 trillion in invested capital and up to $667 billion in profits.) The management consulting world is beginning to address the technical challenges of delivering "blended value"; Bridgespan and the Monitor Institute are in the vanguard here. Duke University's Center for the Advancement of Social Entrepreneurship and other business school programs are developing high performers who want to work in a for-benefit environment. Fellowship programs at Ashoka, the Schwab Foundation for Social Entrepreneurship, and Harvard Kennedy School's Center for Public Leadership help further the careers of top-tier entrepreneurs who have a demonstrated commitment to leading social change. Assessment and certification tools include LEED certification for green buildings, ISO 14000 environmental management standards, and Green Plus and B Corporation certifications for small and midsize enterprises.

For-benefits can't replace the other three sectors of the economy; but they can fill the gaps.

Social Enterprise UK and Social Venture Network are among the better-established support networks; since their beginnings in informal relationships and best-practice swapping, they have taken on the trappings of professional societies and trade associations. Conferences like the Skoll World Forum on Social Entrepreneurship and SOCAP provide vital cross-pollination, bringing together entrepreneurs, funders, and service providers from around the world.

The Emergence of the Fourth Sector

In the past several decades a steadily growing number of innovators have been pushing against the boundaries that separate for-profits, nonprofits, and governments. Their activities go by various names: corporate social responsibility, sustainability, cause-oriented marketing and purchasing, venture philanthropy, social investing, microfinance, civic and municipal enterprise. When the for-benefit model is broadly recognized, all this innovation will constitute a large fourth sector—which has been there all along, though cloaked by conventional adherence to old categories. As governments, markets, and entrepreneurs adopt the for-benefit model, more light will be cast on the fourth sector. It will grow in proportion to the other three as a cadre of socially motivated entrepreneurs, supported by appropriate legal and market structures, create enterprises that combine a social mission with a business engine—and refuse to compromise on either front.

Our current model of capitalism has generated prosperity and improved the quality of life, but not without undesirable environmental and social consequences. Calls for its reform are getting louder, and many approaches have been put forth. Whatever their labels—creative capitalism, philanthrocapitalism, new economy, impact investing, blended value, shared value—these approaches are all rooted in the observation that no genuine reform can take place as long as profit-maximizing businesses remain the sole engine of capitalism. Governments and markets must recognize and support for-benefits as an equally legitimate model.

As entrepreneurs continue to prove that for-benefit organizations can balance economic, social, and environmental performance, demand for such organizations will grow. For-benefits cannot replace for-profits, governments, or nonprofits; a resilient, competitive 21st-century economy needs all four sectors. But they can fill the gaps created by the failure of the three-sector model. As their DNA takes hold, the entire system will evolve. It will become clear that in organizing their enterprises for benefit, entrepreneurs have been the architects of a new, more sustainable capitalism.

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