Is law normalizing Hybrid Organizations? Putting profit-with-purpose corporations into historical perspective

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IS LAW NORMALIZING HYBRID ORGANIZATIONS? PUTTING PROFIT-WITH-PURPOSE CORPORATIONS INTO HISTORICAL PERSPECTIVE

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ABSTRACT

Among other challenges, hybrid organizations face a legal one as the law divides organizations into nonprofit and for-profit structures. For a few years however, new legal forms of corporations have emerged, whose claim is to overcome this challenge: profit-with-purpose corporations (PPCs), such as the Benefit Corporation. In this paper, we investigate how these innovative legal provisions have been designed to help solving this legal challenge, in a two-step process. First, we re-examine the origins of the legal divide through an historical analysis of the separation of UK and US corporations into two legal categories. We show that although early corporations were, in essence, profit-with-purpose organizations, business corporations have difficulties today to defend a public interest orientation because of a major shift in corporate governance that occurred in the 19th century: the disappearance of corporate charters demanding public interest purposes, which led to hand the control of corporations over to shareholders through the generalization of fiduciary duties imported from unincorporated businesses' governance. Second, we exhibit the design process of PPCs to help solving this divide. We show that PPCs propose a way to "shift back", yet not by restoring control by the State, but by reintroducing the corporate purpose into legal documents, and designing accountability mechanisms to control multiple purposes. We argue that studying the emergence of legal structures for profit-with-purpose organizations may open new avenues for research on hybrid organizations.

Keywords: Profit-with-purpose Corporations, Hybrid organizations, Corporate law

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INTRODUCTION

Over the last years, the concept of "hybrid organization" has known an astonishing escalation in attention from legal and management scholars, increasingly viewing these organizations as potential alternatives that may teach us interesting features for a new model of the firm, at times where traditional categories are more and more questioned.

Although combining social or responsible ambitions with a traditional profitable objective is far from being a new phenomenon, this increase in attention follows a booming empirical phenomenon over the last decades that has been described as the rise of "social enterprises" (Defourny and Nyssens 2006, Jones and Keogh 2006, Kerlin 2006, Kelley 2009), "for-benefit enterprises" (Sabeti 2011), or a "fourth sector", distinct from the traditional for-profit, nonprofit, or public sectors (Sabeti 2009, Murray and Hwang 2011). These are organizations that systematically integrate a social purpose with typical business features (Rawhouser, Cummings et al. 2015), borrowing characteristics from both for-profit and nonprofit organizations at the same time (Haigh and Hoffman 2012). As such, they are neither typical charities nor typical businesses: they "combine multiple, existing organizational forms" (Lee and Battilana 2013).

Hybrids are neither for-profit nor nonprofit organizations. As such, they face specific challenges that are already well described in management literature (Battilana, Lee et al. 2012, Haigh and Hoffman 2012), such as organizational governance challenges (Ebrahim, Battilana et al. 2014, Mair, Mayer et al. 2015), "mission drift" (the risk of forgetting the social aspects by taking profitable opportunities), and the problem of conflicting goals (Ashta and Hudon 2012, Hai and Daft 2016). At the root of those challenges lies a legal issue, generally described as the necessity for entrepreneurs to "box" their hybrid project into an existing legal category (Addae 2013) – either nonprofit or for-profit statutes – that does not

satisfactorily meet their ambition of integrating a simultaneously social and profitable purpose.

Until very recently, there were no other solutions to the legal problem than complicated legal arrangements juxtaposing both types of organizations (Battilana and Dorado 2010). Managerial tactics were also required to minimize the drawbacks of each form and solve induced organizational challenges (Battilana and Dorado 2010, Jay 2012, Pache and Santos 2012). In this article, though, we study new legal forms of corporation (Reiser 2013, Ebrahim, Battilana et al. 2014), which we refer to as "profit-with-purpose corporations" or PPCs (Prior, Cohen et al. 2014), such as the *Benefit* and *Social Purpose* corporations that have been enacted in the US since 2010. The proponents of these corporate forms claim that they have been designed to solve the legal challenge hybrid organizations face (Clark Jr and Babson 2011, Mac Cormac and Haney 2012, Clark and Vranka 2013). We analyze the grounds and implications of this claim.

First, we contribute to the literature on hybrid organizations by investigating the origins and the progressive development of the legal dichotomy that has been said to cause struggle to the entrepreneurs sustaining hybrid projects for decades. To do so, we first reconstituted a history of the legal implementation of the corporate purpose, and especially of the definition of its purpose, thanks to second-hand data from historical papers from the eighteenth century to today. This allows us to shed a new light on the process undergone by the corporate form in law, which has led to the current dichotomy. We show that although early corporations were, in essence, profit-with-purpose organizations, business corporations have difficulties today to defend a public interest orientation because of a major shift in corporate governance that occurred in the 19th century: the disappearance of corporate charters demanding public interest purposes, which led to hand the control of corporations over to shareholders through

the generalization of fiduciary duties imported from unincorporated businesses' governance. This historical analysis points out two pivotal features of governance that were used to promote simultaneously private and public interests: the explicit formulation of the purpose in legal documents, and the organization of a public monitoring to ensure that this purpose is effectively fulfilled.

Second, we exhibit the design process followed by the promoters of two novel forms of PPCs introduced in California between 2010 and 2012 to help solving the legal challenge raised to hybrid organizations because of this governance shift. We gathered all documents, debates and explanatory guides framing the legislative process of adoption of the *Benefit* and *Social Purpose* corporations in California, which we completed with interviews of some of the promoters of these forms in the San Francisco Bay Area. Comparing these solutions with the two governance features previously unraveled, we show that these PPCs indeed propose a way to "shift back", yet not by restoring control by the State, but by reintroducing the corporate purpose into legal documents, and designing accountability mechanisms to control multiple purposes. Consequently, we identify three governance mechanisms introduced by these new forms that could help answering to some of the managerial challenges identified by management literature: a legal process to define the purpose, a legal commitment to "lock" this purpose in time, and new accountability principles dedicated to the purpose.

This paper is, to our knowledge, the first one to present a historical interpretation of the adoption of new profit-with-purpose corporate forms, providing a longer term explanation of this emergence and comparing it to previous legal frameworks in history that were already enabling hybrid corporations. We think that this theoretical work will help further empirical research to clarify the impact of change in corporate law to the structure of hybrid corporations.

Why are "Hybrid Organizations" called "hybrid"?

The fact that organizations such as the average firm face daily decision-making between conflicting interests or objectives is not a novel thing. It is considered part of strategy building, and of day-to-day management to deal with compromises, uncertainty towards the future, and conflicting demands from internal and external stakeholders. Also, every firm selling products to interested customers may be considered to be contributing to social good: it produces and distributes products that meet demands from society, and makes it a source of revenue (Mackey 2011).

Some organizations, however, seem to stand out from the mass. These organizations are difficult to describe in a unique sentence. They blend conventional for-profit structures or business models with objectives, partners or customers that stand out from the common base of for-profit ventures. These organizations, called "hybrid organizations" (Battilana, Lee et al. 2012, Haigh and Hoffman 2012, Battilana and Lee 2014, Hai and Daft 2016), indeed seem to shatter the traditional classifications that society has created to categorize them.

Hybrid organizations struggle to bridge territories – or institutional logics (Battilana and Dorado 2010, Besharov and Smith 2014) – that are usually considered to be conflicting. For example, they combine profit-seeking strategies with social welfare objectives, bring together conventional private equity investors and nonprofit organizations around a single project, or engage in technological research while contributing to the development of local communities. In doing so, they "combine multiple, existing organizational forms" (Lee and Battilana 2013) that are usually described with different vocabularies.

Entrepreneurs creating such organizations would not necessarily depict their enterprise as "hybrid". According to them, their mission is not two-legged: it is a single consistent goal, which requires gathering appropriate resources to meet a social demand that would benefit

from an entrepreneurial approach (Dees 1998, Dees and Anderson 2006, Defourny and Nyssens 2010). For Galaskiewicz and Barringer (2012), following the work by Hsu, Hannan et al. (2009), these organizations are however generally qualified as "hybrid" because they do not fall into the categories to which norms and institutions refer, with distinctive rules and features that help discriminating between different types of organizations. These categories, presenting a number of consistent features – such as level of profits, targets of the activity, etc. –, have been progressively "naturalized", that is, considered as natural bundles of features for organizations. From this point of view, "for-profit" and "nonprofit" organizations may well be considered as different species: they each possess a set of consistent traits that can be used to differentiate each other and from other possible types of organizations. Then, people are disturbed if they observe features that do not consistently belong to one particular species, but appear to fall within several distinct ones. In that case, the undisciplined creature would be labeled as hybrid.

Managerial challenges of hybrid corporations

Management literature, through extensive empirical work and numerous qualitative case studies, describes how following two competing logics create specific challenges (Hai and Daft 2016) that require innovative managerial tactics to be alleviated.

Mission drift

One of the most well-known and well-studied challenges of organizations simultaneously pursuing for-profit and nonprofit-like purposes is called "mission drift". In essence it is the "risk of losing sight of their social missions in their efforts to generate revenue" (Ebrahim, Battilana et al. 2014). Some business opportunities might indeed help those organizations sustaining their economic performance or their durability, but at the expense of the short or

long-term respect of their social or environmental purposes. This risk has for instance extensively been studied in microfinance organizations (e.g. Christen and Cook 2001, Battilana and Dorado 2010, Mersland and Strøm 2010, Armendáriz and Szafarz 2011, Ashta and Hudon 2012). In practice, some decisions involve making a choice between favoring social or financial goals (Rawhouser, Cummings et al. 2015). And profitability and social value creation are often described as sustaining "competing logics" (Jay 2012, Mair, Mayer et al. 2015), a competition that hybrid organizations might not have the appropriate tools to deal with.

A specific situation in which such a competition between the purposes is prevalent is the one of change of control. Haigh and Hoffman (2012) call this situation the "dilemma of being acquired". The widely discussed acquisition of Ben & Jerry's in 2000 is an archetypal case of this dilemma (Page and Katz 2010). On the one hand, selling out a social enterprise showing good results to an interested acquirer might be a very profitable operation, which could even directly help starting new other hybrid projects. On the other hand, there is no reliable way to ensure that the acquirer will keep on pursuing the initial social purposes, a hypothetic operation we can call "anchoring the mission" (Mac Cormac and Haney 2012). Within for-profit structures, law might even require directors to sell the enterprise to the highest bidder, regardless of the engagement of the latter in pursuing the mission once the change of control effective (Mac Cormac and Haney 2012).

Accountability

Not unrelated to the mission drift problem, the question of accountability in hybrid organizations is at the root of a second lineage of challenges. According to Ebrahim, Battilana et al. (2014), hybrid organizations face two main governance issues: "accountability for dual performance objectives and accountability to multiple principal stakeholders", which they refer to as "accountability for what?" and "accountability to whom?" issues. The first

one intersects traditional debates on the difficulty of accountability in a "triple bottom line" objective. In particular, the question of the contents of the reporting activity and the means to report it beyond traditional financial accountability reflects the complexity of social and/or environmental phenomena to account for. There are still vivid debates about the relevance of assessment standards or the "Social Return on Investment" approach (see for example Mac Cormac and Haney 2012), and overall there is no consistent guidance on the question, especially in for-profit structures.

The second issue also builds on the competition of logics within the organization, because the duality of purposes generally involves a duality in the community of stakeholders directly interested in these purposes. The balance of competing interests of stakeholders here exacerbates the problem of contradictory demands towards the board (Besharov and Smith 2014), and may create "mission conflicts" (Ashta and Hudon 2012). Although the problem of "serving multiple masters" is matter of debate in the literature (e.g. Tyler 2010, Haigh and Hoffman 2012), it is clear that the multiplicity of stakeholders requires a high level of quality in governance, which may quickly appear as problematic within traditional structures (Bacq, Janssen et al. 2011, Mair, Mayer et al. 2015).

Organizational identity

The third main set of challenges identified by management literature is related to organizational identity. The hybrid nature of the purposes indeed generally calls for skills and values that may not be consistently found on the labor market for instance. Battilana and Dorado (2010) have shown the difficulty of bridging different pools for recruitment in the microfinance field, where financial skills and social inclination were not simultaneous traits of candidates. Further, this also questions the building of organizational culture and the management of "talent development" (Battilana, Lee et al. 2012) over time, when dual performance calls for very firm-specific profiles. At the same time it might become difficult

for workers in the organization to make sense of these competing objectives, which can create opposed interpretation of a "success" or "failure" within the organization itself (Jay 2012).

Financing

Finally, access to reliable financing is also difficult for hybrid structures as traditional sources of financing for nonprofit or for-profit organizations cannot be combined and are less prone to invest in hybrids (Battilana, Lee et al. 2012). On the one hand, although specific sources such as "impact investing" or "socially responsible" funds are dedicated to firms with social or environmental purposes, classical external investment in private equity is impaired i) by the commitment of the organization towards multiple purposes, and ii) by the complexity of the governance structure to sustain these purposes. The first element can be seen as an economic risk that this organization might be much less profitable (and less durable) than other potential investments, especially when this organization is at the origin of a new competitive sector where big players, not committed to equivalent purposes, might take the lead (Haigh and Hoffman 2012). The second element is a legal risk caused by the novelty of governance, which investors might not want to introduce in their investment portfolio (Mac Cormac and Haney 2012).

On the other hand, hybrid organizations cannot claim advantageous tax regimes as soon as their commercial activities exceeds specific thresholds, and nonprofit financing based on grants or donations is i) intrinsically limited compared to what is generally required for business development, i.e. the challenge of "scaling up" (Haigh and Hoffman 2012), and ii) inappropriate in a situation where other investors request a return on their investment.

Different "species" in law: the legal issue for Hybrid Organizations

Several papers have outlined interesting paths to ease the management of these difficulties within hybrid organizations. These include for example an appropriate management of the relationship with various stakeholders, which is necessarily more fruitful for hybrids, as well as the revision of internal policies, or even the request for assistance by other hybrid organizations within the same communities (Haigh and Hoffman 2012). Some authors have also highlighted the importance of identity building, be it thanks to selective coupling, employee training, or hiring policies, of socialization policies (Battilana and Dorado 2010), and of governance schemes (Bacq, Janssen et al. 2011).

However, very few of these proposals deal with an underpinning issue constituting one of the main roots of these challenges: the issue of the legal framework, often considered to be an input for management, rather than a managerial question per se. Yet, current legal frameworks play an important role in dividing up territories. When engaging in a project mixing social and commercial goals, entrepreneurs are indeed faced with a choice between legal forms that are always on one side of a "legal divide" between for-profit and nonprofit organizations (Haigh and Hoffman 2012). Hybridity comes thus from the necessity to cope with legal differentiation, and to deal with several objectives when law clearly favors one. "*Despite the hybrid nature of their organizational goals, social enterprises are forced to 'box' themselves into existing organizational forms by legally incorporating as either a non-profit or for-profit organization*" (Addae 2013).

This divide makes it particularly difficult for entrepreneurs to build structures with two simultaneous but different types of purposes: social impact and profitable activities (Battilana, Lee et al. 2012). The nonprofit side of law and jurisprudence is well gifted with tools to deal with missions and general interest. It offers nonprofit organizations tax benefits, and provides them with access to donations and volunteering work. However, it is very ill-

equipped regarding profitable activities, which are amongst the main sources of revenue for hybrid entrepreneurs: these are strictly framed and might easily disqualify the organization from having a nonprofit statute. It is also impossible for hybrids boxed in nonprofit structures to attract private equity to scale up their activities, as profit distribution is, by definition, impossible. On the other side, entrepreneurs pursuing non-profitable goals within for-profit structures also face legal risks: their directors may engage their personal liability according to their fiduciary duties. Normally, the presumption under the Business Judgment Rule (Bainbridge 2004) that directors make decisions in the interest of the corporation should protect those who don't take action towards the short-term shareholder value. However, "*because the litigation in this area is prevalent, directors and their lawyers tend to apply risk-averse constructions even when judicial guidance favors an expansive interpretation*" (Mac Cormac and Haney 2012). Either way, business corporation law does not provide adequate tools to protect a non-profitable objective because engagement in a mission beyond shareholder value is not part of the usual contracts and there is neither guidance nor criteria to take judicial decisions in this domain. Finally, with this structure, access to grants, donations or volunteering work is also strictly controlled.

According to Kelley (2009), until the recent adoption of new multi-purpose corporate forms, the legal process to create hybrid organizations appeared as trying to "cobble together complex structures", juxtaposing both types of organizations "to create a legal scaffolding" (Kelley 2009). The case of microfinance organizations studied by (Battilana and Dorado 2010) shows a good example of double structures composed of nonprofit organizations with commercial for-profit branches, which support each other. Thanks to this arrangement, managers of these double structures hope to benefit from the advantages of both legal statutes, but at the expense of a complicated management and high legal risks. These structures are indeed "expensive to create, burdensome to maintain, and, due to their novelty,

legally insecure" (Kelley 2009). Overall, although, as Battilana *et al.* explain, "*it is clear that the independence of social value and commercial revenue creation is a myth"* (Battilana, Lee et al. 2012), it seems that the legal categorization of organizations along these lines is a strong factor explaining the difficulties of hybrids.

The emergence of new corporate forms

In the end, there is a need to address the legal question itself. It is this question that this paper is investigating, by studying the emergence of a new legal class of corporations, whose claim is precisely to overcome the legal challenge. New corporate forms have indeed recently emerged, recently labeled as "profit-with-purpose corporations" (Prior, Cohen et al. 2014), which claim to bridge a gap in corporate law, and to offer social entrepreneurs a new and appropriate legal vehicle for their business. In 2012, two forms of corporation have joined the range of possible legal statutes for Californian entrepreneurs: the *Flexible Purpose* (now relabeled *Social Purpose*) and *Benefit* corporations (Mac Cormac and Haney 2012, Reiser 2013). These examples are part of a global movement towards new corporation forms specifically designed for hybrid projects. In the United States alone, the *Benefit Corporation* was adopted in nearly 30 states[1], the *Low-profit Limited Liability Company (L3C)* in 9 states[2], and the *Social Purpose Corporation (SPC)* in three states. Other countries have enacted similar legislations: the *Community Interest Company (CIC)* was introduced in 2006 in the United Kingdom[3], as well as the *Société à Finalité Sociale (SFS)* in Belgium as early as 1995[4].

[1] See http://benefitcorp.net/state-by-state-legislative-status
[2] See http://americansforcommunitydevelopment.org/laws
[3] See http://www.cicassociation.org.uk/about/what-is-a-cic
[4] See (in French) http://www.belgium.be/fr/economie/economie_sociale/statut_juridique/societes_a_finalite_sociale/

These new corporate forms have aroused significant interest in the work of legal scholars who analyzed very early the potential loopholes or critical points in the legal provisions, so as to discuss legal guidance for the legislator or the judge – see for example: (Murray and Hwang 2011) about the L3C, (Reiser 2011, Munch 2012) about the *Benefit Corporation*, or (Plerhoples 2012, Reiser 2012) about the SPC. There is however very little work (e.g. Ebrahim, Battilana et al. 2014, Rawhouser, Cummings et al. 2015) in management literature on the impacts of these new legal forms. In particular, the strategy proposed by the proponents of these forms to solve some of the challenges faced by hybrid organizations has not been studied as such.

Research Questions and Setting

In this paper, we aim at contributing to the understanding of hybrid organizations by looking more closely at the actual causes for the separation in law that is observable today, and examining how the newly introduced "profit-with-purpose" corporate forms might tackle some of the legal and managerial challenges that hybrid organizations face. To do so, we first reconstitute the historical development of corporate law as it stands today, through the lens of the definition of the corporate purposes, to understand on which dimensions the US legal system might play to create the for-profit / nonprofit divide. This historical analysis is based on second-hand data drawn from historical papers from the eighteenth century to today. Then, we analyze in more details the legal context in which Benefit and Social Purpose Corporations have been introduced in California at the end of the 2000s. Indeed, the debates sparked by the introduction of new provisions in the legislative process in California to enable companies to follow various purposes starting from 2008 has forced legislators, lawyers and scholars to reconsider recent legal history in the US and UK.

These debates, which we have captured thanks to numerous legal documents, scholarly papers, archival data and written commentaries that have been published since 2008 (see

Table 1 for detailed reference on the material), help reenacting the fundamental legal problem underpinning the observable dichotomy between for-profit and nonprofit organizations. Based on this analysis, we then isolated design choices that were made during the drafting of the corporate forms to tackle these challenges. We categorized the motivations of the promoters of the new corporate forms, as well as issues generating discussion during the revision process of proposed legal provisions, questions, comments and answers brought up in the various debates, in order to identify the innovations proposed by these new forms aiming at bridging the previously identified legal gaps. This leads us to distinguish three major governance parameters proposed by these forms, and for each of these parameters, the specific setting chosen by each corporate form. We then reconstituted the rationale of the proponents of these forms behind the choice of each of these settings to specify how the latter can be supposed to help solving some of the managerial challenges previously described.

Texts of the legal provisions	California Corporations Code: • Sections 2500-3503 • Sections 14600-14631
Archival data from the legislative process	Assembly Bills n°2944 & 361 Senate Bills n°1463 & 201 Assemblies debates & Backing letters
Documents published by law firms	• Frequently asked questions on SPCs • White paper on Benefit Corp.
Semi-directive interviews	• 5 promoters of the legal forms • Involved entrepreneurs

Table 1 – Detail of the sources of empirical data on the adoption of new corporate forms in California

THE LEGAL FUNDAMENTALS BEHIND THE CHALLENGES OF HYBRID ORGANIZATIONS

Early corporations were profit-with-purpose organizations

What are the origins of the so-called legal divide between for-profit and nonprofit organizations? Has it existed since corporations exist? Corporations are the main economic

institution in the US, and may either refer to business corporations, charitable corporations, education colleges, hospitals etc. Despite a single name and some common legal provisions, these institutions are today regulated by very different sets of rules, what seems to explain the legal divide we highlighted earlier. This divide is recent however, and early corporations would be very likely to be described as "hybrid organizations" today: they were, in essence, profit-with-purpose corporations.

Since the 14th century, corporations have been created to unite many individuals into one common body with a legal existence, which would survive the death of its constituents, as opposed to usual partnerships (Williston 1888). This distinctive feature, enabling an association to be defined by a name and a place rather than by the list of its members, is at the root of the use of corporations for a very large variety of collectives. Initially, the constitution of a corporation required a specific royal charter (Fishman 1985), which authorized the conduct of some activities and granted privileges, in exchange for accrued monitoring from the government. Controls included the examination of the crown before the deliverance of a royal charter for each corporation to operate, a strict overview of the accumulation of property, and a right of visitation, which is the right for specified "proper persons to visit, inquire into and correct all irregularities that arise in such corporations" (Blackstone and Field 1827 [1765]).

Through the monitoring of the State, every corporation was considered a public agency: they had to include public purpose above everything else in their charter to obtain authorization (Handlin and Handlin 1945). If this is rather obvious for charitable corporations managing colleges, hospitals for the relief of the poor or municipal corporations managing various communities, it was also the case for early business corporations, which were confided the management of the production and trade of goods that were essential for daily life and the wealth of these communities. Corporations were thus partly agents serving a

public purpose (Veldman 2011), defined by the royal charter and controlled by the State, and partly organizations serving private interests, because membership of a corporation meant having rights to conduct trade within regulated and protected places, mutual assistance, access to specific services etc.

Two branches of corporate law were separated in the 19th century

The progressive globalization of trade and the discoveries of new worlds soon created the need for higher amounts of capital to sustain "adventures", that is to say, risky commercial expeditions to foreign countries and territories. This need was met through the creation of "Joint Stock", a financing technique gathering investments both from merchants of the corporation itself, and wealthy investors among the gentry who were willing to participate in the adventure financially (McLean 2004). Although these "companies" were still corporations with a dual mission, achieving a public purpose through the benefits of commerce for the wealth and power of the nations and the extension of a nascent colonial empire (ibid.), they introduced the role of investors, which were expecting a collective financial return on the operation, even if they were not members of the corporation (Kohn 2003).

Until the 19th century, a legal divide thus existed between corporations and non-incorporated associations, such as partnerships, which were not granted the same rights, but not between for-profit and nonprofit organizations. Most of case law on corporations regarded charitable corporations, as they outnumbered business corporations. However, the use of joint stock to finance capital intensive works gave corporations a strong appeal during the 18th and 19th centuries. By the beginning of the 19th century, about 300 business corporations existed in the United States, mostly related to public improvements works as well as the organization of financing and insurance to support them (Fishman 1985). But

pressure from potential investors and entrepreneurs at that time rapidly led to enact legislations making corporations easier to create, without the need for a specific public charter, which was called the "generalization of incorporation" (Kornhauser 1990).

During the second half of the 19th century, a great deal of unincorporated associations and partnerships, which were not officially pursuing a mission of public interest, transformed into corporations (Sealy 1967). Charters having become unnecessary, the explicit public purpose of corporations, and the control associated with it, progressively disappeared. To compensate this lack of control, some of the fundamental rules used for unincorporated ventures, which were considered well suited for business, took the place and circulated: the most important one is the Fiduciary Duties, which became incumbent upon directors of corporations. Sealy (1967) explains that this generalization of incorporation led to forget that corporations were legal entities distinct from their members: *"some of the fiduciary principles still rest on this out-of-date assumption; and further, even although the separateness of the corporate entity is recognised, the economic advantage of the shareholders alone is still regarded as the measure of "the interests of the company" in which directors must act*".

A separate body of law started to frame business corporations at that time, differently from the charitable ones: "*Business corporations, whose function was to carry on business for profit, inevitably bred more litigation than incorporated churches, colleges, or orphanages"* (Fishman 1985). The available corporate law was thus becoming to be ill-suited to the increase in litigation prevalent in business organizations, and *"rules relating to non-stock entities were of little assistance in dealing with such nineteenth century corporate issues as the liability of shareholders to pay assessments, methods of transferring shares, or the rights of shareholders in earnings and assets of the corporation"* (ibid.). As a consequence, during the 19th century, the law of business corporations started to develop

independently of that of the charitable corporation, which led to two different branches in law.

For-profit corporations as corporations with shareowners

It is indubitable that there exist today different sections in US corporation codes for for-profit and nonprofit organizations. However, the relative youth if this separation in corporate law compared with the multi-secular features of corporations questions the grounds of this separation and, in turn, the reasons why hybrid organizations appear today as hybrid.

Figure 1 summarizes the process of separation the law progressively organized between for-profit and nonprofit organizations over the centuries. This analysis points out two elements that were historically used to maintain entities following simultaneously public and private interests:

- A *legal definition of the purpose* in the royal charters required to create a corporation, which would serve as the main justification for the rights granted by the State to the collective
- *State monitoring mechanisms*, and sanctions should the purpose not be fulfilled, one of them being the loss of the corporate form, through the refusal to revew the royal charter.

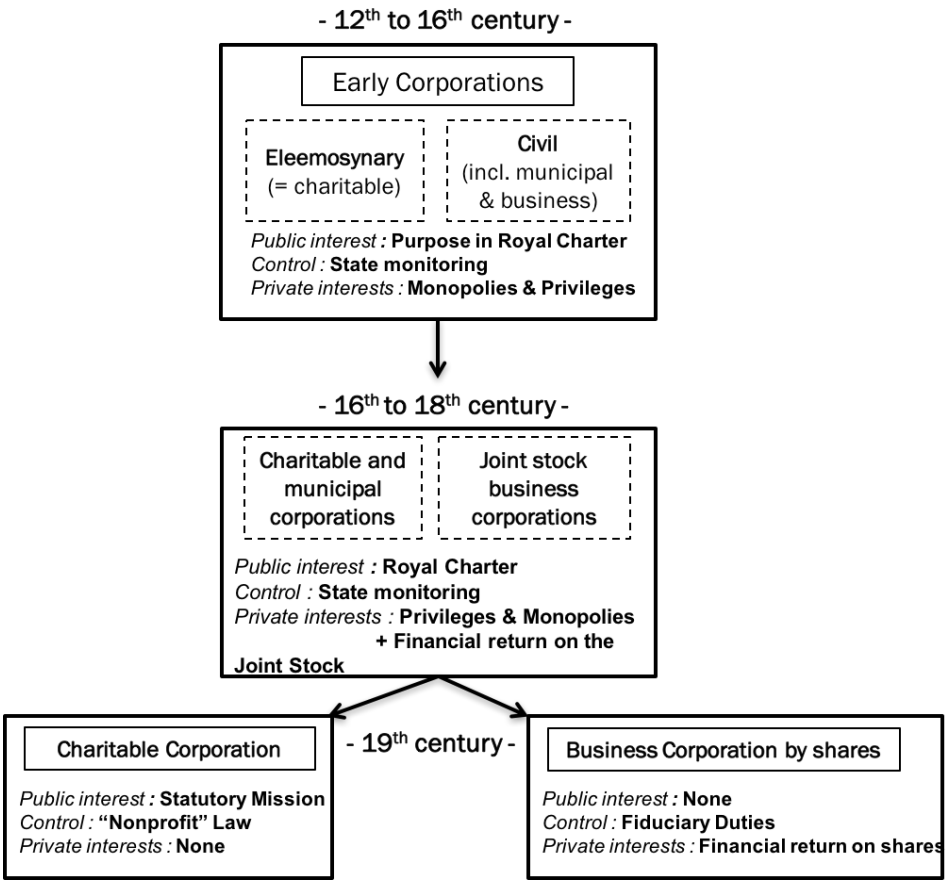

Figure 1 - The progressive separation process in law between business and charitable corporations

Following our brief historical analysis, it seems that the current widespread assumption that the main function of for-profit organizations is to distribute profit is the result of a combination of factors that are closer to misunderstandings than to careful analysis. First, the original *raison d'être* of the corporation was to articulate public and private interests within a long-lasting structure in which the purpose was explicitly formulated. As such, there is no need to postulate that public interest and profit are intrinsically opposite. Second, the separation between for-profit and nonprofit corporations' codes stems from the need of a functional differentiation of the judicial system because of specific litigation caused by the existence of shareholders, not because of a difference in objectives or purposes of the organizations themselves – as the focus on the social responsibility of business at the middle of the 20th century would easily demonstrate. Third, the focus on shareholders' interests in

business corporations has been imported from unincorporated businesses that had not a legal personality beyond those of their members, hence the difficulty to conceptualize a purpose or the interests of a corporation independently from those of its members – the shareholders.

In the end, since for-profit corporations were only meant to be business corporations that distribute part of their profit to shareowners, they should have been the preferred vehicle to host organizations that aim at creating simultaneously public benefit and private profit. Therefore, there remains to assess where the legal challenge lies when it comes to "hybrid" or profit-with-purpose projects. The debates that took place a few years before the drafting of the *Flexible Purpose Corporation* – now *Social Purpose Corporation* or SPC – proposal in California offer an interesting base to understand what professional lawyers consider to be the main current challenge.

Recent developments in corporate law: control mechanism as a pivotal issue

The first introduction of the SPC bill in California in 2010 (SB 1463) followed a passionate debate created by the veto by the governor of a "Constituency Statute", adopted by both chambers in 2008 (AB2944) to authorize every director of corporations to consider the impacts on a large number of stakeholders when exerting their decisional power. Constituency statutes (Bainbridge 1991, Orts 1992, Keay 2011) are legal provisions first introduced in several states of the USA in the 1980s, in an era of high growth of mergers and acquisitions, which were favoring some of the most permissive states regarding corporate law (such as Delaware or California) at the expense of the others. Following antitakeover statutes (Macey 1988, Anjier 1990) introduced a decade earlier for the same purpose, which had been judged unconstitutional because they hampered the freedom of trade between states, they were written in a very general manner. They authorize directors to take the interests of a large variety of stakeholders into account when taking decisions, with the idea that mergers could

be prevented when they jeopardized employment in states suffering the most from the consolidation movement.

That such a provision increasingly appeared necessary to enable directors to make decisions in the interests of other constituencies than shareholders illustrates a radicalization in the interpretation of corporate governance over the 20th century. Fiduciary duties, which were originally a guarantee of control for the shareholders against opportunistic behaviors of managers, replacing the public monitoring, have progressively been interpreted as creating a risk for directors seeking to pursue value criteria that do not meet shareholder short-term interests (Mac Cormac and Haney 2012), thus potentially excluding some public interest missions (Greenfield 2008, Yosifon 2014). This is, in the opinion of lawyers having worked on Profit-with-purpose corporations in California, the main issue explaining the legal challenges of multi-purpose projects (Mac Cormac and Haney 2012, Clark and Vranka 2013).

However, according to the promoters of the SPC, merely weakening the fiduciary duties is not as good a solution it seems to be, what explains their call for a governor's veto on the constituency statute introduced in California. The governor's letter of veto mentioned that such a provision could have "unknown ramifications" for many organizations, including the risk that directors recover a discretion large enough to promote their own interests at the expense of both the corporation and its stakeholders. In practice, constituency statutes were virtually never used in courts in states where they had been adopted during the 1980s (Page and Katz 2010, Keay 2011).

Finally, it appears that the main issue explaining the difficulties for hybrid projects to find the appropriate legal form is one of control: since the disappearance of state monitoring, how to ensure that directors and managers of a business corporation will indeed work to fulfill a given purpose? And how to make so that fiduciary duties, established to restore a control in the absence of the State, do not prevent public interest initiatives?

Unlocking hybridization: the new avenues of profit-with-purpose corporations

At this stage, one could argue that a working solution to restore profit-with-purpose corporations would be to put the State back in charge of monitoring the purposes of the firms. This is not the one promoted by promoters of the newly adopted legal forms of PPCs. The solution that was adopted by the drafters of both the FPC and the Benefit Corporation is based on a novel articulation between fiduciary duties and public interest purposes. Indeed, the law proposes to integrate an explicit purpose of public interest within the sphere of control of the shareholders, and more precisely within the corporations' articles of incorporation signed by shareholders. In doing so, directors become responsible of both the financial return for the company and the respect of the social mission, while being allowed to create compromises when a decision requires mitigating one of the objectives to protect the other one.

Three innovations in governance with managerial implications

As we have seen, the two main elements used to enable public interest purposes in early corporations were the legal definition of the purpose, and the monitoring of the State. This conceptual grid enables to categorize the proposals that were discussed during the drafting and adoption of PPCs, which reveals three innovations of governance: the reintroduction of a legal definition of the purpose, the commitment of stakeholders towards this purpose, and new accountability mechanisms to ensure control. The Table 2 presents these innovations with the wording that is currently used in California Corporations Code (CCC in the table).

	Flexible Purpose Corporation	***Benefit Corporation (CA)***

1) Legal definition of the purpose	*"General Public Benefit", which is a "Material Positive Impact on Society and the Environment"* *CCC sec. 14601 & 14610*	*"Special Purposes"* • *Charitable or general interest* • *Positive short or long-term effect on constituencies* *CCC sec. 2602*
2) Mission-lock Shareholder commitment	"Minimum status vote" equivalent to 2/3 votes of each class of shares *CCC sec. 14601* Possibly enforced by shareholders	2/3 votes of each class of shares *CCC sec. 2700*
3) Accountability	"Third-party Standard", which is a comprehensive assessment of the impact of the business's operations *CCC sec. 14601*	Annual Management Discussion & Analysis + "Special Purpose Current Report" *CCC sec. 3500*

Table 2 - Three innovations in governance introduced by new corporate forms, illustrated by references to law texts

Legal definition of the purpose

The insertion of a purpose in the articles of incorporation is at the heart of the newly adopted corporate forms. Compared with early corporations, it is innovative to let shareholders write the corporate's public interest purpose themselves, in contrast with the intervention of public authorities. Although law did not prohibit considering an implicit mission between shareholders, it is the fact that this purpose is public and legally binding that changes its equilibrium with fiduciary duties. The legal definition of what purposes should be acceptable for the new corporations is however a strong point of discussion between the promoters of the two different forms. On the one hand the law demands that the additional purpose of the FPC, called "*special purpose*" either be:

- A charitable or public purpose that a nonprofit public benefit corporation is authorized to carry out, or
- The purpose of promoting positive short-term or long-term effects of, or minimizing adverse short-term or long-term effects of, the corporation's activities upon any of its

employees, suppliers, customers, and creditors; upon the community and society at large; or upon the environment.

Besides, each *FPC* may adopt some additional purposes at the convenience of shareholders. Consequently, FPCs' shareholders have a large room for maneuver in defining the special purpose of the corporation. On the other hand, the purpose of all *Benefit Corporations* should be a "General Public Benefit", legally defined as a "material positive impact on the society and the environment, taken as a whole". Shareholders' might also add "specific public benefits" besides the general one. As a result, the definition of the Benefit Corporations' purpose is thought as a comprehensive public interest, which cannot be limited to some specific positive impacts. In addition, Benefit Corporations law requires that each director should take into account the impact of their decisions on the significant stakeholders of the firm.

The inscription of the purpose within the legal articles represents a commitment of the corporation towards its internal and external parties. Instead of the moral engagement of a charismatic leader towards a widely advertised but never written ideal, the legal status gives "teeth" to this commitment, which represents the basis for the governance structure that we will describe hereafter. In the FPC model, the general wording of the *special purpose* must be derived in operational objectives, which enable monitoring and controlling the possible drift and, if required, refocusing the firms activities towards the social purpose.

Shareholders' commitment: reinterpreting fiduciary duties

In both FPC and Benefit Corporation models, the legal status of the purpose relies on the commitment of shareholders, who vote for and sign the articles on incorporation including the purpose. As such, this purpose strongly differs from existing mission statements: legal provisions require a positive vote by two third of each class of shares to adopt, change or repeal the statute the corporation. Once enacted, a purpose is thus a mid- or long-term

commitment of the corporation. Conversely, both legal forms in California grant rights to shareholders that want to break away from the mission by ensuring that these shareholders can sell their shares at a fair value when they depart.

Shareholders' commitment is pivotal for protecting the variety of purposes the corporate directors are supposed to pursue. Indeed, the legal provisions ensure that during all the time that the purpose is written in the articles, the directors are legally protected for each of their decision that entails a compromise between profitability and respect to this purpose. It is therefore a true engagement for shareholders, who lose the capacity to sue directors as long as they act in the direction of this purpose. As such, the promoters of the FPC call this provision "creating a safe harbor" for directors. It is through this provision that directors' fiduciary duties are effectively transformed to take social purposes into account, and reducing mission conflicts in governance.

But shareholders' commitment also ensures that the mission is anchored in some change of control situations, where the acquirer does not have the possibility to buy more than two thirds of each class of shares. Indeed, the respect of the purpose, at the heart of the FPC or Benefit statutes, enables the corporate board to prevent a hostile takeover if the acquirer does not adopt a similar legal form with the same purposes.

Accountability mechanisms

Through shareholders' commitment, the PPCs is designed not to require monitoring from the State anymore: it becomes part of the most recent control mechanisms promoted by corporate governance to ensure that directors indeed fulfill the purposes adopted by shareholders. However, PPCs also include new accountability mechanisms to frame the evaluation and control of the directors' action towards the mission. Indeed, if tools exist to assess the corporation's efficiency in terms of profitability, new purposes might require new evaluation tools and criteria. For that matter, the *Benefit Corporation* has the most direct

approach: it requires choosing a third party comprehensive and independent evaluation standard to annually assess the corporation's results regarding its mission according to that standard. To attain the appropriate level of transparency, *Benefit Corporations* as well as FPCs have to publish these results in an annual report made accessible to the public. The FPCs' report also includes a discussion of the strategies followed during the year, the investments made, and the future strategies to be deployed for the year to come. Additionally, local reports might be required for significant decisions involving a compromise between profit and purpose. The FPC also requires deriving operational objectives from the *special purpose* in order to make it possible to evaluate the directors' actions according to whether they have met these objectives or not.

These provisions directly aim at dealing with the quality of governance and the fear of creating uncontrollable organizations because of the multiplicity of purposes. The specific reporting mechanisms created for the purpose aim at preventing managers to adopt an opportunistic behavior on the argument that maximizing shareholder value is explicitly not the main objective anymore. Along with mechanisms allowing shareholders to sell their shares if they disagree with a rewording of the purpose, these accountability principles are designed to fight shareholder potential distrust vis-à-vis a new legal structure impairing their fundamental rights. The promoters of the FPC also made clear that the whole point of creating a new corporate form in law – although contractual freedom in unincorporated companies would allow managers to write their purposes the way they desire – was precisely to minimize the legal risk bear by investors, which are reluctant to add companies with complex and not standard governance to their portfolio.

Also, the *Benefit Corporation* model adds the right to shareholders combining at least 5% of the shares to access a purpose enforcement procedure, consisting in suing the corporation if it can be proven that it does not take its commitment to create general public

benefit seriously. In contrast, the creators of the FPC decided that such an enforcement right could be hazardous to the corporation, especially if this right is given to any shareholder.

DISCUSSION & CONCLUSION: ARE PROFIT-WITH-PURPOSE CORPORATIONS NORMALIZING HYBRID ORGANIZATIONS?

In this paper, we aimed at providing tools for an interpretation of the contributions of the recently adopted corporate forms in the United States to deal with hybrid organizations' challenges. Although our analysis is a conceptual one and should be further complemented by empirical data on actual PPCs to ascertain whether the newly introduced governance mechanisms "work as they should", several elements in the design of these corporate forms seem to be of interest to advance both research and practice on hybrid organizations.

First, in the light of our historical analysis, Profit-with-purpose corporations appear as an ingenious means to combine the control structure stemming from contemporary corporate governance with the objective pursued by the creation of early corporations. As such, they propose a sort of "shift back" in governance to early corporate forms that were designed to follow multiple purposes at the same time. However, they do so not by restoring a monitoring from the State – which would be a political question much beyond the scope of this paper – but by benefiting from decades of fine-tuning on corporate governance regarding the relationship between shareholders, directors and managers, and introducing a single pivotal element: the commitment of shareholders towards a purpose that is not limited to their financial interests. On paper, the legal issue of hybrid corporations would thus be solved by legitimating social or environmental purposes at the same level as financial ones, without weakening the monitoring structure. Compared with constituency statutes, the discretion gained by directors is strictly limited to the purpose accepted by shareholders.

Second, instead of affecting all Californian corporations, and creating a potential legal risk, the drafters of PPCs carefully propose to experiment new governance principles as an optional form for interested entrepreneurs. This legal provision is a specific form to be progressively disseminated, thus reducing the legal risk compared with a general provision for corporate law.

Third, PPCs seem to escape the problem of having "two masters" (Tyler 2010, Murray and Hwang 2011), an argument often used to justify why shareholders should be the only stakeholders to benefit from the directors' fiduciary duties, by specifying a purpose independently from the interests of specific stakeholder groups, and create with it a form of unilateral contract only signed by shareholders, but aiming at creating positive impacts on a variety of constituencies. This might be an interesting avenue to solve the problem of "competing logics" in hybrid organizations (Pache and Santos 2012): such a feature is designed to overcome the dependence on private interests of the members of the corporation by demanding members' commitment over a common purpose, which should drive the firm's activities.

An adjustable model for hybrid organizations

Putting in perspective two forms of PPCs in California with the history of early corporations enables to identify some generic features of a legal model of hybrid corporations, which can be generalized beyond the cases of the SPC and Benefit Corporations. Indeed, several debates have punctuated the legislative process between the two working groups, which show that although the three categories of governance principles define a generic model for Profit-with-purpose corporations, each of these categories open variables that can be adjusted to fit more closely the needs of targeted hybrid organizations.

For example, both statutes require that the purpose rely on a clear public interest to gain the appropriate legitimacy. However, questions remain regarding the appropriate standard to define such general interest. The drafters of the *FPC* have for instance made clear in their comments that in their opinion, requiring a material positive impact as evaluated by current extra-financial standards such as *SROI (Social Return on Investment)* seems too demanding, arbitrary and narrow to ground a long-term sustainable mission for the corporation, taking into account the potential evolution of environmental concerns, or of technological capabilities. On the contrary, *Benefit Corporation*'s designers fear that without comprehensive expression of the purpose, the mission might lead to rob Peter to pay Paul, or to make it possible to hide personal interests under altruistic outfits.

Similarly, it is debatable whether the process of adoption of the purpose should only involve directors and shareholders. This process could also define which stakeholders should be consulted to choose, modify or repeal the mission. Although statutes are *in fine* only voted by shareholders, several other parties may be invited to write the mission down. These processes may also define the circumstances involving the possible revision of the mission.

The Table 3 shows the major building blocks of such a generalized model for hybrid corporations. Instead of presenting only the specific settings chosen by the promoters of the two Californian forms we studied, we can further investigate new settings for the same governance parameters (definition of the mission, commitment and accountability). For example, it might be useful in some contexts to consider the commitment of a wider variety of stakeholders towards the purpose rather than financial investors only.

<table>
<tr><td rowspan="2">1) Legal definition of the mission</td><td colspan="2">Specific
Particular purpose towards specific beneficiaries</td><td rowspan="2">Comprehensive
General public interest for all stakeholders affected by the corporation</td></tr>
<tr><td>Liberal - Large leeway for definition</td><td>Restricted - Legal definition of public interest</td></tr>
<tr><td>2) Stakeholders' commitment</td><td colspan="2">Shareholders
Only shareholders' rights are legally affected</td><td>Multi-stakeholders
Other stakeholders' rights are affected</td></tr>
<tr><td rowspan="2">3) Accountability principles</td><td colspan="2">Internal
Assessment carried out by internal governance committees</td><td rowspan="2">External
Assessment carried out by external parties (e.g. third-party standard or public authorities)</td></tr>
<tr><td>Exclusive - Limited to shareholders</td><td>Inclusive - Including other stakeholders</td></tr>
</table>

Table 3 - Some building blocks of a general model for hybrid organizations in law

This generalized model is useful for three main reasons. First, it gives a generic grid to design a hybrid corporation model based on the main discussion points raised during the drafting and adoption of the forms we studied more specifically. This directly helps designing appropriate public policies for countries wishing to develop their own model of hybrid corporations. (Rawhouser, Cummings et al. 2015) have shown that specific features of the political or taxation contexts of states might be good predictors of the adoption of a multi-purpose corporate form. We aim to go further in providing these states a generic model to understand the main features of these multi-corporate forms, and extract what is replicable in the specific forms we studied.

Second, is has direct also managerial implications because it highlights the potential usefulness of such legal forms to entrepreneurs who desire to create their own hybrid organization, by helping them to identify the managerial and legal challenges that are likely to be dealt with by the governance model associated to the corporate form, and to choose the

appropriate form for their project, should they have the choice between competing models as it is the case in California.

Finally, on a theoretical point of view, we think this work should help further research to better qualify the difference between challenges that stem from an incompatibility of legal categories with hybrid projects from those which are due to conflicts between other structures of the socio-economic environment of such projects (education, ethical values, etc.), and which might not be relevant target for governance structures.

As such, the emergence of these new hybrid corporation forms in law raises a final question: as soon as a new legal category is created that matches the unique logic followed by the class of today's hybrid organizations, namely multiple purposes organizations, isn't this "hybrid" qualification bound to disappear for this class? Eventually, could this new class of organizations, which dispose of the capacity to define their own mission, even become the norm rather than the exception? Numerous models have already been published by researchers and practitioners to account for the specific logic of social entrepreneurs. Then specific labels were created to differentiate them from the archetypal nonprofit or for-profit organizations. Now, it is a whole new class of legal structures that is created to host these organizations. In the end, law might have solved hybrid issues in quite an elegant fashion: by making a new species out of hybrids.

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