# 3.7 HYBRIDS

## ADVANTAGES

- ✓ Provides versatility in adapting business form to the desired goals of the entrepreneur
- ✓ Facilitates scaling of mission-driven entities by allowing revenue generation, thereby freeing such entities from reliance on charitable donations alone
- ✓ Allows access to widest pool of capital, including equity investments and charitable donations
- ✓ May increase ability to attract and incentivize talent through equity incentives for employees

## DISADVANTAGES

- ☒ May be difficult and costly to establish and maintain
- ☒ Organizational structure may be complex
- ☒ Requires continual documentation regarding the flow of funds, services and personnel between the entities, to avoid negative tax consequences from private inurement and unrelated business income

## CASE STUDIES

**Greyston Foundation and Greyston Bakery**

Greyston Foundation and Bakery present a prime example of a thriving hybrid model. In 1982, a Buddhist monk and former NASA engineer opened the Greyston Bakery in an effort to address poverty in his community. Greyston was built upon an open-hiring model, offering employment to individuals on a first-come, first-served basis, without an interview or background check, regardless of their education, job experience or criminal or drug records.

As the bakery grew, the corporate structure evolved as well. Greyston Bakery is a for profit entity with over $20 million in annual revenues, supplying brownies to Ben & Jerry's and Whole Foods, among others. The bakery's success sustains the charitable work of Greyston Foundation, which includes multiple poverty-eradication initiatives. While the non-profit is directly supported by the revenue from the for-profit, the for-profit benefits as well from its non-profit parent. Greyston's non-profit social impact commitment has enhanced the bakery's reputation, creating loyalty with other mission oriented corporations and consumers. For more information, please visit https://greyston.org/about/.

**Medicines360 and Alliance Partners360**

Medicines360 is a California nonprofit and Section 501(c)(3) tax-exempt charitable organization. Its mission is to improve access to women's health products both domestically and globally. Medicines360 researches the health needs of women to identify gaps and barriers in healthcare access, and then it develops health products and forms partnerships to bring the products to market. Medicines360 reinvests all proceeds from its partnerships into advocacy, education and additional product and partnership development. Medicines360 created a for-profit subsidiary, Alliance Partners360, that works with a major pharmaceutical company to market and sell its women's reproductive devices commercially, enabling the nonprofit to fulfill its mission. Whereas the non profit focuses on providing reliable and safe birth control devices to low-income women with a concentration on the developing world, the for-profit subsidiary commercializes the same products in the developed world. Through this hybrid partnership, Medicines360 is able to achieve greater scale and impact than would otherwise be possible. For more information, please visit http://medicines360.org.

## CASE STUDIES

**Embrace Innovations.**

Embrace Innovations is an offshoot of Embrace, a federally tax exempt non-profit organization. The organization develops disruptive healthcare technologies aimed at reducing infant and maternal deaths in emerging markets. Specifically, the company created the Embrace Warmer as an alternative to expensive infant incubators for premature babies. Founded in 2008, Embrace announced a new hybrid organizational structure in January 2012. Embrace Innovations was spun out as a separate for-profit social enterprise focused on product design, manufacturing and sales/distributions to governments and private clinics in emerging markets. Embrace Innovations also adopted research and development responsibilities. For each warmer sold, the for-profit arm pays a royalty to the nonprofit, which owns the intellectual property. The nonprofit then sets up partnerships with nongovernmental organizations and government entities in under-resourced communities and distributes warmers for free to clinics and hospitals that have limited access to modern technology. For more information, please visit http://embraceglobal.org.

**Digital Divide Data**

Digital Divide Data, or DDD, is a federally tax exempt non-profit corporation formed under the laws of California. Its mission is to create better futures for disadvantaged youth in developing countries through employment in a financially sustainable business. Founded in 2001, DDD identifies and recruits bright, motivated youth who would not otherwise have access to good jobs or higher education. It then trains and employs them at a fair wage, while offering them scholarships to attend university. The employment is in a social business that delivers high-quality, cost-effective, enterprise digital solutions to clients, while creating opportunity for some of most disadvantaged people on the planet. In 2010, DDD formed its wholly owned subsidiary Digital Divide Data Ventures LLC, or DDD Ventures, a for-profit Delaware LLC, for purposes of operating for-profit businesses that are consistent with its exempt purpose as a charitable organization. Such operations are intended to facilitate the creation of sustainable jobs and educational opportunities for individuals throughout the world. DDD Ventures owns for-profit enterprises located in Kenya, Laos and Cambodia. For more information, please visit http://www.digitaldividedata.org.

**Pacific Community Ventures, Inc.**

Pacific Community Ventures, Inc. is a California non-profit and Section 501(c)(3) tax exempt charitable organization. Its purpose is to create jobs and economic opportunity in low-income communities through the direct support of small businesses as well as by advocating for systemic change to increase investment in these communities. In support of this purpose, Pacific Community Ventures, Inc. provides business advising services and debt capital to small and high-growth businesses that create jobs and opportunities in lower income communities, offers impact evaluation services to investment and philanthropic institutions and undertakes policy research in the areas of impact investing and small business needs to drive capital and resources to underserved communities. Pacific Community Ventures, Inc. also manages for-profit investment funds that invest in California businesses that bring significant economic gains to low to moderate income employees through its wholly owned subsidiary, Pacific Community Management, Inc., a for-profit Delaware corporation, and its affiliate, Pacific Community Ventures, LLC, a for-profit Delaware LLC (see the case study in Section 2.4 above). For more information, please visit http://www.pacificcommunityventures.org.

**RSF Social Finance**

Rudolf Steiner Foundation, Inc. (dba as RSF Social Finance), a New York non-profit corporation, is a financial services organization dedicated to transforming the way the world works with money. In partnership with a community of investors and donors, RSF Social Finance and its affiliates (RSF) provide capital to non-profit and for-profit social enterprises addressing key issues in the areas of food and agriculture, education and the arts and ecological stewardship. Since 1984, RSF has made over $500 million in loans, grants and investments to non-profit and for-profit social enterprises. RSF offers investing, lending and giving services that generate positive social and environmental impact while fostering community and collaboration among participants. RSF provides such services directly and through its for-profit and non-profit affiliates, including RSF Capital Management, Inc., a for-profit Delaware corporation and certified B Corporation, which provides senior working capital and subordinated term debt to businesses meeting a rigorous social enterprise profile, and RSF Social Investment Fund, Inc., a non-profit California public benefit corporation, which provides loans to non-profit organizations and makes investments related to RSF's mission. For more information, please visit http://rsfsocialfinance.org/.

### a) Hybrid Synergies

At their best, hybrids enable social enterprises to reap the benefits of both for-profit and non-profit legal forms. Through the for-profit entity, the organization can generate revenue, raise capital through traditional capital markets, distribute returns to investors and offer equity incentives to attract and retain talent. The non-profit entity, on the other hand, enjoys a range of benefits associated with being a charitable organization, including often tax-exempt status, social legitimacy and access to donations of money and resources (e.g., pro bono legal services).

When working well together, the combination of for-profit and non-profit entities creates synergies that reinforce the mission of each entity ideally, leading to a whole that is greater than the sum of its parts. For example, the charitable organization benefits from a steady source of capital contributed by the for-profit, freeing it from reliance on fundraising alone. It also benefits from access to talent that might otherwise be drawn to the purely for-profit sphere. While donations to the non-profit cannot be used for the benefit of the for-profit, or any private purposes, the work of the non-profit reinforces the mission of the for-profit, and a close relationship lends legitimacy and goodwill to the mission-orientation of the for-profit. For example, consider the Greyston case study above. The for-profit entity has clear marketing and reputational advantages due to its relationship with and commitment to the charitable mission. A socially conscious consumer would be more inclined to buy a brownie from Greyston Bakery, as compared with a competitor, if she knows she is supporting the mission of Greyston's non-profit.

Another reason for social entrepreneurs to consider hybrid entities is to lock in the mission of the for-profit entity. For example, a valuable piece of intellectual property may be assigned or maintained at the non-profit, with a license to the for-profit to use the intellectual property. The licensing agreement would contain provisions to lock the for profit into the prescribed mission of the corporation. If the for-profit violates such provisions, the non-profit may either increase royalty rates or terminate the license.

### b) Unique Challenges of Hybrids

Hybrids also present unique challenges from an operational perspective. Entities considering a hybrid structure should engage legal, accounting and tax advisors familiar with the complexities of hybrid structures. There are number of issues to consider, both at the outset when first structuring the hybrid and on an ongoing basis as the organization matures. Parties must carefully consider control and board composition, avoiding private benefit (particularly for insiders) and conflicts of interest, unrelated business income tax issues and issues relating to respecting corporate separation. In particular, a hybrid structure requires ongoing monitoring and documentation regarding the flow of funds, services and personnel between the entities to avoid negative tax consequences from private inurement and unrelated business income.

While several types of exempt organizations may be involved in hybrid structures, most social enterprise hybrids involve charitable organizations, which are exempt under section 501(c)(3) of the Internal Revenue Code,[122] or public welfare organizations, which are exempt under section 501(c)(4) of the Internal Revenue Code. Both types of exempt organizations must be organized and operated exclusively for the exempt purposes set forth in Section 501(c)(3) or Section 501(c)(4), and none of the earnings may inure to any

122. Charitable organizations include both private foundations and public charities in hybrid structures due to strict IRS rules.

private shareholder or individual   i.e., the for-profit affiliate or founder. Charitable organizations are also restricted in various ways, and leadership must be careful to not run afoul of such restrictions. For example, a charitable organization may not attempt to influence legislation as a substantial part of its activities and may not participate in any campaign activity for or against political candidates.[123]

### c) General Requirements

Though hybrids vary in structure, there are some general best practices that apply to most forms. It is important that the for-profit and non-profit entities in a hybrid maintain an arm's-length relationship, with each entity represented by independent legal counsel. Further, the governing bodies of each entity should contain at least two disinterested directors or establish special committees of disinterested directors to negotiate transactions between the entities.

Hybrids should also take care to track and document flow of funds, assets, services and resources between the entities, ensuring the for-profit is always paying at least "fair market value" to the non-profit for services, resources and assets provided or at least "fair value" for any assets transferred or assigned.

Another consideration for hybrids to monitor is the compensation at executive levels. Non-profits in hybrid structures should take care to limit compensation for executives to a reasonable level as compared to other similarly-situated non-profits.

### d) Examples of Hybrid Structures

While hybrid structures can take various forms, the most common models include (i) a charitable organization as parent with a for-profit subsidiary; and (ii) a for-profit parent with a non-profit subsidiary (e.g., a foundation). In addition, some hybrid enterprises include separately owned for-profit and non-profit entities, working in tandem with their relationship governed by contract. The two most common structuring models are described below.

***Charitable organization as parent and for-profit entity as subsidiary***

Social enterprises may choose to form as a charitable organization and create a for profit subsidiary in order to create more flexibility. For example, a charitable organization may find that it would like to explore a variety of financing alternatives for certain activities it would like to engage in or may want to provide equity compensation to attract employees. However, the charitable organization may not be permitted to pursue those financing activities and maintain its tax-exempt status. The charitable organization could establish a subsidiary corporation in order to finance further growth in those areas. Depending on the nature of the subsidiary's activity, an LLC might also be used. The charitable organization would own shares of stock or hold membership interests in the subsidiary, which could also raise funds from other investors. The charitable organization would retain sufficient ownership in the for-profit entity to control the activities of the new entity.

Please see the Charitable Organization Guide for information regarding the formation of non-profit corporations and qualifying as a tax-exempt organization. Any subsidiary of the charitable organization would be formed as described elsewhere in this Guide.

123. Forming a non-profit corporation and obtaining federal tax-exempt status is a complex process. Organizations may also qualify for tax-exempt status through sections of the Internal Revenue Code other than Section 501(c)(3). For more information on these topics, please see the Charitable Organization Guide.

***Non-profit foundation of a for-profit entity***

Another option available to social enterprises is to form a for-profit entity (as described elsewhere in this Guide) and establish a non-profit private foundation to pursue a charitable purpose. These are commonly referred to as corporate foundations, although they can be created by any type of for-profit entity. A private foundation is a charitable organization with federal tax-exempt status under Section 501(c)(3) of the Internal Revenue Code. A private foundation may receive tax deductible donations, but unlike a public charity, it is not required to have a diversified donor base; typically, it is funded primarily by the related for-profit entity, its owners, and its employees. Unlike a public charity, a private foundation may be controlled by the sponsoring for-profit entity, although it is subject to restrictive rules, particularly with respect to transactions with the affiliated for-profit business. This structure frequently is used to provide a for-profit company with an avenue for pursuing charitable purposes.

Please see the Charitable Organization Guide for information regarding the formation of non-profit corporations and qualifying as a tax-exempt organization.