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Carol Liao

**Disruptive Innovation and the Global Emergence of Hybrid
Corporate Legal Structures**

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Disruptive Innovation and the Global Emergence of Hybrid Corporate Legal Structures

CAROL LIAO, PHD/SJD CANDIDATE, UNIVERSITY OF BRITISH COLUMBIA AND UNIVERSITY OF TORONTO, AND INCOMING ASSISTANT PROFESSOR, UNIVERSITY OF VICTORIA*

1. TRANSFORMING THE CONCEPT OF CSR

The incredible power of corporations to exert pressure and influence over societal flourishing frequently leads to calls for reform, as the ongoing pursuit for greater profit often conflicts with sustainable performance. It is clear that shareholder primacy needs to change – but how? Critical ideas on how to transform the modern day corporation must press forward, as contributions to this Special Issue can attest. But achieving true corporate ‘reform’, which by definition means to improve upon what currently exists, is a complex and multifaceted exercise. In addition to social, political, and economic barriers that arise, reform efforts invite incrementalism and satisficing,¹ and may encounter regulatory capture² and other factors that contribute to path dependence³ and complacency. In order to overcome these effects, destabilizing innovations may be necessary.

While the expansion of Corporate Social Responsibility (CSR) in recent years has been effective in tempering some of the negative externalities that arise under shareholder primacy, the movement is evolving within the private sector. Large multinational corporations are still catching onto CSR, but the leaders at the forefront of the movement are transforming the concept of CSR into one of ‘social innovation’ and the integration of business practices with social activism. The growth of the social enterprise, a definition with no legal meaning that commonly refers to either a for-profit corporation trying to do social good, or an enterprising non-profit organization, is beginning to generate statutory responses in several countries. Legislators are beginning to create new corporate forms with legal features that support this burgeoning field.

This article promotes an atypical reform proposal that focuses on how a growing trend in corporate law may enable disruptive, bottom-up innovations in the marketplace that, in combination with top-down regulatory reform, will contribute to an environment where sustainable companies become the norm. The global emergence of corporate hybrid legal structures blending both for-profit and non-profit legal characteristics in their governance design marks the beginning of a new chapter in corporate law. Community and social benefit purposes, restrictions on dividends, community purpose asset locks, and benefit enforcement proceedings to protect stakeholder interests are only some of the interesting governing features within these models. With correct strategic implementation, these corporate hybrids may have the potential to challenge the status quo and pressure mainstream corporations to change how they operate.

2. GLOBAL TREND OF CORPORATE HYBRIDITY

Corporate hybrids as legal innovations have received little analysis from scholars to date because they are very new institutional phenomena, and even less so in terms of their social change capabilities. There is no formal definition of what a ‘hybrid’ constitutes. For the purposes of this article, a hybrid is a corporate entity that embodies legal tools which require and/or encourage the pursuit of dual economic and social mandates within businesses.

By converting into a hybrid, former charities and non-profit organizations may attract venture capital and make a profit, lessening their dependence of public funds and enabling better use of the market to disseminate social products and services. On the

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1 Incrementalism and satisficing are not negative attributes per se, but incremental reforms may never provide the substantial change that reformers seek, and along with satisficing may even deter the development of innovative ideas. Herbert A Simon, *Models of Man: Social and Rational* (John Wiley and Sons, Inc. 1957) (where satisficing is described as a settling for an adequate but not optimal solution); see also Cristie Ford, *New Governance in the Teeth of Human Frailty: Lessons from the Global Financial Crisis*, 2 Wisc LR 101 (2010) (for a modern day discussion of satisficing in relation to regulatory reform).

2 See George Stigler, *The Theory of Economic Regulation*, 2 Bell J. Econ. & Mgt. Sci. 3, 3 (1971) (‘... as a rule, regulation is acquired by the industry and is designed and operated primarily for its benefits’); George Stigler, *Can Regulatory Agencies Protect the Consumer?* in George Stigler, *The Citizen and the State: Essays on Regulation* 183 (University of Chicago Press 1975).

3 Lucian Bebchuk and Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 Stanford L. Rev. 127, 139 (1999).

other hand, profit-conscious businesses that convert into a hybrid are presumably better able to integrate stakeholder interests, social mandates, and sustainable practices into their business models well beyond what is tolerable under shareholder primacy.

The emergence and development of hybrid models provides a new institutional tool for the CSR movement. Hybrids are providing opportunities for entrepreneurs seeking to house social enterprises in legal structures that can support their needs while affirming that 'the independence of social value and commercial revenue creation is a myth'.⁴

The Community Interest Company (CIC) was the first model to appear in the new generation of hybrids.⁵ Implemented in the United Kingdom in 2005, CICs are established to trade goods or services for the community interest.⁶ The most noteworthy features in the CIC are its asset lock and dividend cap. The asset lock restricts CIC assets and profits from being transferred out of the CIC unless the transfer is for full fair market value (to ensure the CIC continues to retain the value of the assets transferred), or is transferred to another CIC subject to an asset lock or a charity, or is otherwise made for a community benefit.⁷ Dividends on CIC shares and interest on bonds are capped to ensure that profits are either retained by the CIC or used for a community benefit purpose.⁸ In addition to these features, CICs have annual reporting requirements where they must account for how their CIC has benefited the community and engaged stakeholders.⁹

In terms of its success, there are no statistics available on CICs' monetary contributions to the UK economy, the average size of

CICs, or total members. Simply based on numbers, the UK CICs doubled in 2011 and 2012 and at the end of 2013, there were over 8,700 recorded CICs.¹⁰ It is reported that over 100 new CICs are registered every month,¹¹ and a considerable number of CICs have survived the three-year mark. The perceived success of the UK CIC may be what has motivated other countries to follow suit. In Canada, the British Columbia provincial government announced the creation of the community contribution company in 2013, which is modelled after the UK CIC,¹² and the Nova Scotia provincial government has also announced the creation of its own community interest company. A few other countries have also indicated an interest in the CIC model, including Japan and South Korea.¹³

In addition to the CIC, other hybrid models have been explored internationally. The first American hybrid, the low-profit limited liability company, appeared in 2008 in the state of Vermont and has subsequently been adopted in eight other states and two federal jurisdictions, although its numbers have plateaued around the 800 mark.¹⁴ Another American hybrid, the benefit corporation, appeared in 2010 in the state of Maryland and has since been adopted in twenty states.¹⁵ Greece, as well, enacted the Law on Social Entrepreneurship and Social Economy in 2011, which introduced the social cooperative enterprise as the new sole form of cooperative belonging to its social economy.¹⁶ Denmark and Belgium and several other countries have also crafted laws supporting social enterprises within their borders, or are in the process of doing so.¹⁷

4 Julie Battilana and others, *In Search of the Hybrid Ideal*, Stanford Soc. Innovation Rev. 51, 52 (2012).

5 This article focuses on the new generation of corporate hybrids that have appeared within the last decade. It does not address other models prior to this date, such as the cooperative ownership model, one of the oldest corporate structures in the world, which may be regarded by some as a hybrid since the model provides members with the flexibility to pursue social, environmental, and/or economic mandates in a collaborative manner. The cooperative model can operate under the sole objective of profit maximization if agreed upon by its members, thus there may be disagreements as to whether it is appropriately regarded as a legal 'hybrid.' For a discussion on the linkages between sustainability and cooperative ownership, see Hagen Henry, 'Sustainable Development and Cooperative Law: Corporate Social Responsibility or Cooperative Social Responsibility?' [2012] University of Oslo Faculty of Law Research Paper No 2012-23 <http://ssrn.com/abstract=2103047> (accessed 6 Jan. 2014).

6 UK Companies (Audit, Investigations, and Community Enterprise) Act 2004, c 27, s 172; Community Interest Company Regulations 2005, No 1788.

7 UK Companies Act, sections 30, 31; CIC Regulations, Part 6.

8 UK Companies Act, section 51.94.

9 *Ibid.*, section 8.1.1. See Tineke Lambooy & Aikaterini Argyrou, *Improving the Legal Environment for Social Entrepreneurship in Europe*, 11 European Comp. L. 71 (2014), for more on the CIC and other legal forms for social enterprises in the EU.

10 Regulator of Community Interest Companies, 'Annual Report 2011/2012' www.bis.gov.uk (accessed 6 Jan. 2014), 13. 590 CICs were also dissolved, with key reasons for dissolution being 'lack of funding, no trading activity, and poor corporate governance'. See also the Office of the Regulator of Community Interest Companies on Twitter @TeamCIC for the latest number of CICs on public record.

11 CIC Association, 'What is a CIC?' <http://cicassociation.org.uk/about/what-is-a-cic> (accessed 6 Jan. 2014).

12 Bill 23 – 2012, Finance Statutes Amendment Act (British Columbia); Bill No 135, Community Interest Company Act (Nova Scotia); BC Ministry of Finance, 'BC Introduces Act Allowing Social Enterprise Companies' (5 Mar. 2012) www2.news.gov.bc.ca/news_releases_2009-2013/2012FIN0011-000240.htm (accessed 6 Jan. 2014).

13 Regulator of Community Interest Companies, 'Annual Report 2012/2013' www.bis.gov.uk (accessed 6 Jan. 2014), 35.

14 Vt Stat Ann tit 21, section 3001(27) (2009). Early drafters of the low-profit limited liability company had hoped for a blanket Internal Revenue Service (IRS) private letter ruling acknowledging this hybrid, but to date the IRS has not provided one. Two attempts to pass legislation in US Congress have since failed and the model has been relatively unsuccessful as a result. Mannweiler Foundation Inc, 'The Program-Related Investment Promotion Act of 2008: A Proposal for Encouraging Charitable Investments' www.cof.org (accessed 6 Jan. 2014); GovTrack, 'H.R. 3420 (112th) Philanthropic Facilitation Act' www.govtrack.us/congress/bills/112/hr3420 (accessed 6 Jan. 2014).

15 Corporations and Associations, Md Code Ann tit 5 section 5-6C-01 (2010); Benefit Corp Information Center, 'State by State Legislative Status' www.benefitcorp.net (accessed 6 Jan. 2014).

16 See Ioannis Nasioulas, *Social Cooperatives in Greece: Introducing New Forms of Social Economy and Entrepreneurship*, 2 (2) Intl. Rev. Soc. Research 165 (2012); Tineke Lambooy, Aikaterini Argyrou & Rosemarie Hordijk, 'Social Entrepreneurship as a New Economic Structure that Supports Sustainable Development: Does the Law Provide for a Special Legal Structure to Support Innovative and Sustainable Non-Profit Entrepreneurial Activities? (A Comparative Legal Study)' [2013] University of Oslo Faculty of Law Research Paper No 2013-30, 18-22.

17 See Lambooy, *supra* n. 16 for a comparative study of economic structures supporting social entrepreneurship across several countries.

3. INNOVATIVE POTENTIAL

What is to be made of the rapid global development of corporate hybrid legal structures? It is early in the process – as a dynamic and evolving phenomenon, it is still undetermined what, if any, significance hybrids will have on sustainable practices and socio-economic growth. It is quite understandable for most to regard the development of hybrids as simply addressing a niche sector of the market – it is very likely that corporate hybrids will operate more as a small supplement relative to the mainstream corporate model rather than as one that may one day overtake it. But this article seeks to promote a different and somewhat novel perspective by suggesting that this growing trend in corporate law may actually increase the amount of ‘disruptive innovations’ entering the marketplace, providing a back door mechanism for reformers seeking transformative corporate change.

The concept of disruptive innovation was first coined by Joseph L. Bower and Clayton M. Christensen in 1995. While the concept is often used to refer to technological advances, it is not isolated to that industry. Bower and Christensen first classified innovations into two categories: sustaining and disruptive.¹⁸ Sustaining innovations are incremental improvements to products and services that provide better quality or greater functionality to consumers in the higher tiers of the market.¹⁹ Companies are drawn to sustaining innovations because they have been proven to be profitable. Companies attain the greatest profit margins when they charge high prices to the most demanding and sophisticated customers at the top of the market. The issue with this practice, however, is that companies unintentionally open the door to disruptive innovations. Because lower tiers of the market offer ‘lower gross margins, smaller target markets, and simpler products and services’, they are unattractive to other firms moving upward in the market, ‘creating space at the bottom of the market for new disruptive competitors to emerge’.²⁰

A disruptive innovation allows a new population of consumers to access a product or service that was previously only available to wealthy or skilled consumers. Disruptive innovations ‘improve a product or service in ways that the market does not expect . . . first by designing for a different set of consumers in the new market and later by lowering prices in the existing market’.²¹ In fact, Christensen and a group of other scholars went on to describe a

subset of disruptive innovations that specifically address social change. These innovations share five qualities: they (1) create systemic social change through scaling and replication; (2) meet a need that is either overserved (because the existing solution is more complex than many people require) or not served at all; (3) offer products and services that are simpler and less costly than existing alternatives and may be perceived as having a lower level of performance, but users consider them to be good enough; (4) generate resources, such as donations, grants, volunteer manpower, or intellectual capital, in ways that are initially unattractive to incumbent competitors; and (5) are often ignored or disparaged by existing players for whom the business model is unprofitable or otherwise unattractive and who therefore avoid or retreat from the market segment.²²

Disruptive innovations may include sustainable products or services that are made more affordable to the bottom tiers of the market, eventually displacing unsustainable products that presently dominate, as well as other goods and services that promote a more inclusive society while operating within planetary boundaries. Christensen et. al. cite specific examples such as affordable insurance, walk-in medical clinics, and microlending.²³

Could hybrids become the best organizational structure to promote disruptive innovations that promote social change? Hybrid businesses may have an advantage in developing innovative products and services that open up the bottom tiers of the market, addressing social needs that are unmet through traditional corporate practices due to low margins or other profit-driven limitations. They may serve as a live experiment putting to test ongoing research informing business leaders that long-term vision, sustainable purposes, and multi-stakeholder collaboration are essential for the long-term success of the firm.²⁴ Despite mounting evidence, modern corporations still find it incredibly difficult to be unchained from pressures to hit quarterly earnings targets.²⁵ Corporate hybrids should free businesses from this type of short-termism. Investors in hybrids will be made aware of the social mandates embodied within these entities and the particular legal limitations regarding financial upsides, if any, meaning that hybrid investors, by nature, will be social investors.²⁶ Thus, the pressure for greater return at the expense of sustainable practices seems to be heavily dampened. It is therefore not unreasonable to project that hybrids are better positioned to produce sustainable products

18 Joseph L. Bower & Clayton M. Christensen, *Disruptive Innovations: Catching the Wave*, 73 *Harvard Bus. Rev.* 43, 45 (1995).

19 *Ibid.*, 44.

20 Clayton M. Christensen, ‘Disruptive Innovation,’ www.claytonchristensen.com/key-concepts (accessed 6 Jan. 2014).

21 *Ibid.*

22 Clayton M. Christensen et al., *Disruptive Innovation for Social Change*, 84 *Harvard Bus. Rev.* 12 (2006).

23 *Ibid.*

24 See e.g., Dominic Barton & Mark Wiseman, ‘Focusing Capital on the Long Term’ Address to the Institute of Corporate Directors (22 May 2013) www.cppib.ca (accessed 6 Jan. 2014); Robert G Eccles, Ioannis Ioannou & George Serafeim, ‘The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance’ (14 Nov. 2011) Harvard Business School Working Paper No 12-035 (finding that high sustainability firms outperformed by 4.8% per year in an 18 year period).

25 See e.g., John R Graham, Campbell R Harvey & Shivaram Rajgopal, *Value Destruction and Financial Reporting Decisions*, 62 *Financial Analysts J.* (2006) (noting that 55% of CFOs would forego attractive capital investment project today if it meant even marginally missing quarterly targets).

26 If hybrids becoming increasingly popular, it is of course conceivable that traditional non-social investors will look to this new market.

and services that become disruptive innovations in the marketplace.

There are, of course, risks for any jurisdiction introducing a new hybrid into the roster of corporate alternatives. Hybrids may take away resources traditionally used by charitable and non-profit organizations, and there is ongoing concern of 'private sector intrusion into public service delivery'.²⁷ There is the risk that mainstream corporations may feel they have little obligation to consider social issues or environmental concerns, which are now supposedly left for hybrids and non-profit organizations to address (but of course, these corporations may already hold the view that environmental concerns should be resolved solely by the public sector, among other reasons). Corporate regulators may also be motivated to hold similar views. Hybrids may end up satisfying a niche market that, once saturated, is ineffectual at promoting change. These are all risks that legislators must be aware of when implementing hybrids into their statutory laws.

Nevertheless, the growth of international hybrids signifies that there is something amiss with the shareholder primacy norm embodied in the mainstream model. Hybrids are quickly filling a driving legal need to house social purpose businesses and enterprises. Legislators must examine the environment and design hybrids that significantly differentiate them from other alternatives, provide meaningful legal features to ensure dual economic and social mandates can coexist, and also meet the particular needs of social entrepreneurs to make the model attractive. With proper strategic implementation, hybrids may become the new corporate legal tool that fosters ongoing disruptive innovations in the market. The potential for hybrids to illicit transformative change in the marketplace cannot be discounted, and must continue to be explored.

²⁷ Regulator of Community Interest Companies, 'Annual Report 2011/2012' www.bis.gov.uk (accessed 6 Jan. 2014), 7.

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