Convergence into Emergence: Hybrid entrepreneurship

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Typical forms between businesses traditionally have been limited partnerships and S-corporatations, for example, which support both entities in their objectives. Beginning in 1998 the concept of Limited Liability Companies (LLC) became a legal form. Over a decade later a new form is becoming common, Low Profit Limited Liability Companies (L3C's) and B-corporations that are essentially known as hybrids.

Hybrid type relations are normally viewed as a cross-sectoral relationship between companies, in this case when nonprofits and for-profits work together, create partnerships and even merge to form new entities. As the economy keeps changing and businesses become more competitive new ways are being sought out to get an edge on competition causing creative solutions to be established. Companies of both the nonprofit and for-profit world are finding it advantageous in a variety of ways to collaborate in varying degrees. The information and analyses presented throughout this paper will explain what a hybrid is, how I classify them and where they should be expected to be found in the economy.

Changes in strategies to cope with the business environment don't always have smooth transitions. Whenever there are new approaches issues and concerns will arise. A major struggle is how to adopt new plans and strategies to incorporate new activities into the market that improve business competition. It is important to recognize trends that prove to be substantial in the future, such as nonprofits and for-profits collaborating on a more integrated level. Recognizing that hybrid organizations are on the rise and that they will become more established as the economy continues to grow is essential for entities to be on the competitive frontier. Weisbrod, Cordes and Salamon show data that represents increases in 'hybrid activities' over the past decades. I will explain what benefits these hybrids create and what it means for the economy in the future. By addressing the emergence of a new sector, the 'barrier to entry' of these entities can be reduced. Once more specific legal restrictions and constraints for hybrids are created these businesses can be run appropriately and without the appearance of deceptive practices. Denying the existence of this evolution of business will only slow down the process not prevent it. By acknowledging these new entities with progressive thought and effort a new better business structure can be established.

The material presented will describe different types of hybrids, which have not been discussed before. I classify hybrids based on their size, complexity and organizational structure. It is difficult to clearly articulate what specifically hybrids are. I, however, will explain certain attributes that will allow the division of the fourth sector into subsections of hybrid entities. Being able to classify a new entity and see where it fits in the economy will create a cross-section of the business entities present in the economy. With this knowledge I can illustrate where this fourth sector fits in our economy, how it benefits the economy, and what it means for the future.

Thesis Statement

The emergence of hybrids have been increasing throughout our economy, however since the 1980's hybrids have increased to a point where they are becoming much more collaborative and into each organization. Why are these hybrid organizations being created? What is causing them to be more predominant today and does this warrant a new organizational form which would result in the emergence of a fourth sector?

I will go about this analysis by focusing on an established hybrid to distinguish why the partnership works, what it does and what are the benefits from such a relationship. To get a better understanding of why this emergence is occurring I will offer economic trends, tax laws and government decisions that push towards these business arrangements. Finally I will get to the implications of these new structures, how they affect our environment and why a fourth sector should be established. The reasoning behind such events will be backed by economic theory. By showing why hybrids are being created and explaining why these changes make sense.

Literature Review

The literature below relates to nonprofit and for-profit cooperation between organizations and trends that are starting to be more dominant in the market. Much material has been found that suggests organizations working between the for-profit and nonprofit sectoral lines provide evidence of this increased trend and presents how the hybrid behavior is benefiting for-profits and nonprofits alike. *Heerad Sabeti* (2008) examined how activities in the private and social sector are becoming more similar to each other. For example, for-profits are starting to become more like nonprofits due to activities such as: socially responsible investing, community relations and corporate philanthropy, while nonprofits are becoming more like for-profits, participating in activities such as: accountability, measurable impact, earned income and privatization. This change in behavior by nonprofits and for-profits has permitted a representation of how each sector (social, private, public and now fourth) fit relative to their purpose (maximizing profit vs. maximizing social benefit). The idea of different business entities adopting other business forms has provided ground work for me to establish a graphical representation of types of hybrids within the fourth sector.

The notion of a for-benefit organizational model was presented which had core attributes found in nonprofit and for-profit entities, such as a social purpose with a business method that was socially and environmentally responsible. Sabeti also expanded into how the environment was supportive of this movement through markets that are expanding and businesses that are trying to capture a larger or new market. These trends are naturally leaning towards more interactions between separate sectors. I use this for-benefit concept as a tool to begin differentiating the differences in hybrids, based on their attributes, so that they could be appropriately categorized and placed within the fourth sector.

Cordes and Steuerle (2009) present much supporting information on hybrid activities such as: why hybrids are becoming a more common structure, types of legal boundaries introduced by these new hybrid behaviors, the value behind this new hybrid structure and how this potentially affects the economy in the future. Specifically Cordes and Steuerle mention the three main economic motivations behind a hybrid structure which I use to support why hybrids should be used. The three main motivations are supply/cost, demand/revenue and strategies that respond to competition. When a nonprofit tries to expand its mission and the creation of a for-profit subsidiary is being discussed, deciding if a reduced cost and an improved product will result in the decision is a supply/cost motivation for hybrids. Demand/revenue motivations involve strategies where a product from a nonprofit is a compliment of a for-profits product. Producing complements in the market increases demand and revenue. These types of economic motivations make the decision for entities to participate in hybrid activities easier to make.

Colombo (2002) studied how commercial activity within a nonprofit organization affected charitable tax-exemption. He went on to elaborate what type of tax issues were involved with non-profits having for-profit subsidiaries, such as unrelated business income tax and what level of taxation is appropriate for a hybrid organization. Consequently this relates to hybrid activity since commercial activities are an aspect of most nonprofits and provides tax advantages in hybrids because of collaboration with for-profits. This advantage occurs because nonprofits are tax exempt. In this type of hybrid relationship the partnership is a “pass-through” entity meaning that if the for-profit invests in the nonprofit, corporate taxes would be avoided. Hence, the double-taxation problem for the private sector is avoided by partnering with nonprofits. Due to current tax laws, hybrids can take advantage of the system and capture tax premiums (percent of the income saved by avoiding the corporate tax).

Part of Colombo’s research included why hybrids are created in the first place and how they benefit from various laws. He then presents ideas on ways to potentially solve the discrepancies’ involved, such as mission drift and unfair competition. His main solution was of eliminating Unrelated Business Income Tax (UBIT) that potentially solves some issues that hybrids have and implicitly supports the 4th sector, there are however multiple potential solutions and the best course of action is yet to be determined. Colombo’s main point of research and conclusion was on differing ways to solve this tax issue and this was used to provide tax implications and supporting details for hybrid creation.

Salamon (2002) writes about social ventures and the reasoning behind commercialization, listing six propelling factors that NPO’s are facing. These factors as environmental evidence are propelling nonprofits to integrate into the market, the factors are: fiscal squeeze, expanded demand, increased for-profit and nonprofit competition, more availability of corporate partners and increased demand for accountability. The fiscal squeeze refers to revenue streams diminishing due to decreasing government grants and charitable giving. This is causing nonprofit organizations to seek other methods of receiving revenue. Expanded demand from customers wanting more from a company means that a single nonprofit entity now needs to provide more services or products before to maintain consumer loyalty and satisfaction. Nonprofits seek collaboration with for-profits that have similar services or products to meet these new demands. Increased competition between the for-profit and nonprofit sectors causes the two entities to become more similar. This occurs because competition forces each organization to be more efficient which eventually drives them to similar practices that are optimal for their business. These types of situations increase the possibilities of hybrids occurring and consequently emerging into a 4th sector.

Upon his discussion Salamon concludes that a new form is needed to accurately explain the concept of these hybrid organizations, which he calls social purpose enterprises. He also supports the hybrid notion by using the term “new governance” to describe a solution for the trend of nonprofits and for-profits collaborating together. Implicitly this term represents the concept of an emerging 4th sector through the hybrid entity.

Weisbrod (2000) introduced a possible revenue constraint model to explain how non-profits decide how to maintain revenue streams. By suggesting a behavioral model that explained that NPO's have three outputs that allow the organization to determine the type of revenue production. The first two outputs are mission related, such as a preferred collective good (basic research, Medicare for the poor) or a preferred private good (access to higher education). The third output is a nonpreferred private good, which is solely used to generate revenue either of the preferred goods. Each NPO has a preference of what preferred good they want and Weisbrod recognized that even though some revenue types (nonpreferred private goods) are undesired, the benefits from it outweigh costs. Every NPO has some diverse revenue stream and this revenue constraint model attempts to interpret how NPO's choose which combination of goods they prefer.

Weisbrod also explains the reasons behind partial conversions which coincide with my hybrid concept in this paper. Mainly, hybrids are found to diminish trade-offs between a business which is strictly for-profit or nonprofit, meaning nonprofits do not have access to capital while for-profits do not have access to donations. Weisbrod then explains how commercialization is becoming more predominant because of outside forces and higher demand of NPO's to provide to those in need. The reasons for why nonprofits choose commercialization implicitly suggests where 'hybrids' would most likely occur in industries. Which I can focus on to better support this emergence of a fourth sector and procure a theory that explains where hybrids should be expected to be seen.

Schmidt (2010) researched hybrids in Vermont and found them to be Low Profit Limited Liability Companies (L3C's) which represents a true hybrid legal entity. An example of why an L3C was formed is seen by an entrepreneur who wants to create a business but does not want to commit to a for-profit that has to maximize profit, or a nonprofit that has restrictions such as not being able to distribute profits. A L3C would be chosen in this case that would enable the owner to have a mission and still make a profit. Information on the benefits of a L3C focused on the flexibility of the new form. The flexibility comes from the relatively simple business form that provides limited liability protection and pass-through tax treatment. A primary flexibility advantage is that this L3C form allows the company to create an operating agreement to whatever specification they want within the constraints of still being mission driven. Increased autonomy due to the simple design and not being strictly for-profit or nonprofit allows creative problem solving as well.

L3C's are an example of a true hybrid for small businesses. Schmidt also gave supporting evidence of the emerging hybrid sector by his explanation of L3C's. These are typically for start-up companies and fit into the cross-section of my hybrid representation. This insight helped in the classification of hybrids; therefore, a small true hybrid is considered a L3C.

Keatinge (2009) presented the history of evolving business forms and described hybrid organizations as the advent of new forms and structures. These were designed to combine economic returns with non-economic objectives that may be organized for a purpose that is neither exclusively for-profit nor exclusively non-profit. He also distinguished between C-corporations that have taxed income and S-corporations where the income of the corporation passes through to the exempt organization. This is how hybrids are able to 'capture the premium' that I later refer to under benefits of hybrids. More information that was presented was the GCM 39005 which legally allow hybrids if they meet two criteria: exempt purposes of charitable organization are furthered and the charitable organization is not prevented from acting exclusively and does not confer a substantial private benefit for the for-profit. Discovering the GCM 39005 meant that legislation has already been made to support the hybrid form, which furthers my argument for an emerging fourth sector.

This paper included specific situations where a hybrid would work and then gave a counter example of where it wouldn't work. Describing where a hybrid would make economical sense helped form my theory of where they should be expected. A significant find was the idea of B-corporations, which are hybrid organizations if they can obtain a certificate from B-lab. This B-lab has a criteria check list that if passed earns the B-corporation label which is synonymous with hybrid. Their website was made available and this engine provided examples of hybrid organizations, such as Alchemia Consulting. Keatinge specified that the drafting of the operation agreement was critical to the hybrid form being created. An operation agreement written to maintain majority control to the nonprofit also allows the nonprofit to maintain its tax exempt status. Lastly, he presented the GIIRS ratings and analytics system which is a potential vehicle to measure impact investing and is in use today. The GIIRS is a key find because it eliminates the argument that social investing cannot be measured. At this point we now see new forms being created, new laws for the forms, a measuring system and economic conditions that all support the emergence of a fourth sector.

Information & Language

The term hybrid does not fully describe what an organization is and what types of relationships exist within a hybrid. There are three types of relationships that may be structured: joint ventures, licensing agreements and formal partnerships. I will be focusing primarily on ventures and partnerships. Nonprofits and for-profits alike use the term ‘partnerships’ and ‘ventures’ freely. Traditionally these terms refer to corporate philanthropy, cause-related marketing and co-operative behavior[1], according to Dawans. It is important to differentiate both terms when discussing a hybrid form however.

A joint venture is a contractual arrangement between two companies which focuses on undertaking a specific task. Ventures may join companies together for the development of a certain cause; this is common for research and development because it helps reduce costs of R&D. Biotech firms using university research labs and professors are less costly than creating their own research facilities and hiring researchers. These companies support this hybrid notion (nonprofits working directly with for-profits for mutual benefits). If the companies don’t create a new organizational form but do maintain a relationship, they will be considered only a hybrid. Partnerships involve an agreement where the two parties agree to share profits and are liable for any losses incurred. The partners are co-owners of this new hybrid structure (often a nonprofit parent that shares control with a for-profit), aimed at making a profit and maintaining a mission where a portion of the profits are used to further the mission. This is what I would deem a true hybrid, the two companies invest assets and adjust their traditional structures to account for their new goal and a new hybrid organizational form is created. These two terms are rather similar and are interchangeable for most situations, but a partnership in the language of this paper will represent an extension of a joint venture, essentially a longer term relationship relative to a joint venture where the two companies evolve and become interdependent which creates a more complex system.

Another important term is structure; because all businesses can be structured uniquely structure affects how hybrids achieve proposed goals through ability to acquire resources, how services are organized, risk management, legal standings and public perceptions. There are many types of structures to choose from. The most common forms of business are partnership, corporation, S-corporation, LLC, recently

[1] Dawans, Vincent, and Lindsay Miller. *The Four Lenses Strategic Framework*. Rep. Virtue Ventures LLC. Web. 23 Oct. 2011. P. 1

L3C in limited states and potentially hybrid. There are two types of partnerships, general and limited. A limited partnership has both general and limited partners. The general partners own and operate the business (NPO) while the limited partners serve as investors only (PMO). With that being said, the term structure refers to legal forms businesses use to conduct business, the number of entities involved, and the relationship among them[2].The health care sector particularly exemplifies the modern charitable organization in a complex structure. Complex refers to multiple entities with interrelated activities. This leads to Low Profit Limited Liability (L3C), which represents a true hybrid form legally. A L3C must significantly further the accomplishment of charitable or educational purposes, and cannot have the production of income as a primary goal and it cannot influence any legislation or political change. [3] "The L3C was created for organizations that want to operate at the intersection of mission and for-profit".[4]

Lastly, corporate activities supporting NPO's is labeled as their corporate social responsibility. However, in hybrid relationships, corporate activities resulting from nonprofit collaboration will be described as a cross-sectoral relationship; meaning any formal relationship between a NPO and PMO to pursue a social objective in ways that will yield strategic or tactical benefits to both parties[5]. This definition primarily is used during the discussion for evidence of a 4th sector.

An example of a true hybrid for a large organization is Omidyar Network. This is a company that was originally nonprofit, Omidyar is a legal 501(c)(3) entity. Omidyar became a true hybrid when they created a subsidiary, Omidyar Network Services LLC as an affiliated for-profit entity. Omidyar is a philanthropic investing firm that is a private equity and venture capital firm which invests in both profit and non-profit companies. It makes investments and grants in areas including microfinance, emerging market ventures, and property rights. Within media it invests and provides grants in social marketing, trust, reputation and identity. The company has a managing and investing partner to help further their mission. Omidyar works with for-profit managing and investment firms. A subsidiary for the foundation, Omidyar Network Services LLC is an affiliated entity which provides program and general administrative support to and paid for professional legal costs on behalf of the foundation. This is a company that is a true hybrid. Their mission is furthered by the foundation and maintained by subsidiaries affiliated with

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[2] Howard P. Tuckman. *Nonprofits & Business.* 1st ed. Washington, DC: The Urban Institute Press, 2009. 1-267. Print. P. 129

[3] Schmidt, Elizabeth. *Vermont's Social Hybrid Pioneers.* Vermont Law School, 2010. P. 168

[4] Schmidt, (Rick Zwetsch – interSector Partners) P. 168

[5] Alan R. Andreasen. *Nonprofits & Business.* P. 157

Omidyar, but also have partnerships with investing and managing firms to make their goal and mission possible. This is a complex structure with multiple entities converging for a common purpose. An important woman to this company is Paula Goldman whose title is director; she manages cross-sector partnerships and strategies for the company.

An example of another true hybrid but for a smaller organization is an L3C known as InterSector partners. This company was designed to give consulting and education service to help nonprofits become more sustainable and for for-profits to become more socially responsible. InterSector focuses on furthering this mission while creating value for their shareholders. Socially responsible financial institutions are sought out to work with the company in a close relationship. The nature of this company being a low-profit liability company is that it was specially created to be hybrid as opposed to forging a partnership and merging. These types of companies are becoming more common and recognized throughout the United States.

From the above examples of hybrids it is seen there are two types of hybrids. A hybrid does not create a new organization but rather alters the structure of the two existing entities; this is done either through contractual agreements, subsidiaries working towards the same goal and cross-sectoral agreements. The true hybrid creates a new organization and structure to incorporate new entities, this occurs through separate organizations coming together such as a partial conversion or a complex partnership. True hybrids also are created from a nonprofit creating a for-profit subsidiary to control certain aspects of business, this is common in joint ventures. Lastly true hybrids do not necessarily require two entities to be created. For example, L3C's and B-Corporations are created at the beginning. These business entities are specifically structured to have aspects from both a nonprofit and for-profit entity.

Types of hybrids and many like this could be construed as a: social enterprise focused around innovation that has a social entrepreneur who uses a combination of NPO's and PMO's to push forward a more successful mission, these convergences and alterations of separate organizations expand mission success. This definition applies to Omidyar Network, structurally it is considered hybrid because its creation consisted of at least one PMO and a NPO[6]. Next the focus on why these organizations are coming into existence.

[6] Tuckman. *Nonprofits & Business.* 129

2.1 Why do we see these hybrid firms and what evidence is there of a 4th sector?

There at least three main reasons that any organization would want to become cross-sector allied. First, due to the extent of the word "charitable" in Code Section 501(c)(3), commercial activities a NPO would perform are considered charitable activities. A simple example would be any NPO that charges a basic fee-for-service to enough people to have a community benefit. (Hospitals, Habitat for Humanity, Universities)[7]

When commercial activities do not apply to the main mission of a NPO there are two other incentives to participate in them. Before getting into that, consider what options an exempt charity has with its excess capital. Charities could invest capital, passively, mainly by accruing interest, buying bonds, securities or paying off debt. A charity could also invest directly into a related commercial activity that would create more funds for their mission. We should then see each hybrid choose based on which financially benefits them the most, meaning if passive investing had greater financial returns than direct, the charity would choose passive. With this idea, the only hybrids we should see using direct financing are those that can 'capture' the benefit in the market that is larger than passive investing. Or as Colombo describes it, "a charity will choose to operate a commercial activity directly only when the financial returns from such activity involve a 'premium' over what the charity could earn in a passive investment"[8].

The final two incentives are ways that hybrids can capture such premiums. The second incentive is mainly for larger organizations because it involves economies of scale. Capital investments made for charitable missions are used to produce revenues at costs lower than PMO's. (Puget Sound does this, renting out the rotunda, allowing markets to be held in the gym, or leasing the stadium to teams over the summer and the many camps over the summer where people stay in the halls)

Lastly, even if a hybrid is not large enough to experience economies of scale there still are tax incentives in our current tax policies. This is caused by corporate taxes, which means corporate commercial activities are taxed twice with equity investments. However, with partnerships when a PMO distributes funds allocated to the NPO the money is only taxed once, this is commonly seen with S-corporations.

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[7] Colombo, John, Commercial Activity and Charitable Tax-Exemption. MA thesis. University of Illinois College of Law, 2002. Social Science Research Network, 2002. p. 28

[8] Colombo p. 29

The premium the NPO captures is the difference between the tax rate on a dollar invested as equity for a PMO (roughly 60%) and a dollar invested into a PMO (roughly 40%)[9].

2.2 Conversions and related forms

When companies decide to work together sometimes conversions start to occur, a conversion between a for-profit and nonprofit or conversion to for-profit status, is a full conversion that involves any change in control over assets or responsibility for liabilities from the NPO to the PMO. However, if the NPO does not want to give up control they have the option to contract with PMO's for a service, such as management services, where only partial control would be transferred. The key to the hybrid form is that the nonprofit maintains the locus of control. Blue Cross has traditionally been nonprofit, however it is moving towards a mutual-benefit nonprofit (hybrid).In order for Blue Cross to accomplish this mutual-benefit nonprofit a partial conversion is needed. Blue Cross works with PMO's and relinquish some control, but Blue Cross still maintains the majority of it. Because total conversion essentially disbands the nonprofit, therefore stopping their mission, partial conversions are becoming more established. Similar forms of these are joint ventures, partial buyouts and complex Interorganization contracts[10]. These terms are synonymous with hybrid.

What is the motivation behind such conversions? It would be easier to answer this question if we could model organizational behavior as the maximization of an objective function subject to constraints.[11]Unfortunately such a model is difficult to represent all variables that play into an organizations decision. Partial conversions occur because a NPO and PMO have different constraints imposed by the legal system and markets. When managers need to decide which sector their company will join the managers need to assess their values and preferences along with what is best for the company. However, when market constraints change or organizational goals are altered, the form the company is currently in may not be what is needed. If the changes are significant enough any nonprofit would convert to a for-profit if it furthered its mission, this typically is too drastic of a move. A partial conversion allows an entity to maximize their objective but still maintain the benefits of being nonprofit. These hybrid forms essentially diminish the trade-offs for managers because benefits from both sectors are captured. This type of scenario is becoming more common as constraints continue to change within the economy.

[9] Colombo p. 30
[10] Weisbrod, Burton. *To Profit or Not to Profit*. 1st Ed. .England: Cambridge University Press, 2000. P. 132-133
[11] Weisbrod p. 133

A specific relevant scenario involves the American Cancer Society (ACS), a nonprofit whose long run goal is to either generate positive net revenue or be revenue neutral. If the company were to focus on positive net revenue they would threaten their 501(c)(3) status. This was recognized by the managers and in their 1995 annual report they stated that, "forging a new breed of partnership with corporations…" will allow them to create profit and also maintain their mission. The company did not want to convert to for-profit however, their goal was taking them in that direction, and so ACS's partial-conversion tactic was to gain for-profit partnerships to support positive change and a sustainable company.

2.3 Conditions for Hybrids and Mixed Mode Settings

What type of environment would one expect to provide sufficient attributes to attract a company to become hybrid? First, a company needs to be participating in commercialized activities. Competition is not enough, though, for a company to focus on commercialization. There are four conditions that if met a company will most likely choose to have commercial activities, which then increases the probability it will become a hybrid. The four conditions are: the nonprofit must feel a need for additional revenue and the sales will provide means to realize its goals, the nonprofit governing board must decide the pursuit of sales doesn't cause mission drift, suitable products for the marketplace must be for sale and customers must be willing to purchase these products[12].

These conditions when presented along with competition cause a mixed-mode marketplace. Organizations look for ways to penetrate or expand their market base and one way to do this is to attract new businesses to a community or region. For example, in Richmond Virginia, a group of for-profit companies sponsored the Greater Richmond partnership in an effort to build the reputation and job base of the area. This type of collaboration helps both NPOs and PMOs while having positive externalities on the community. The behavior of these firms of seeking marketplaces traditionally dominated by either for-profit or nonprofit is causing more hybrid organizations so that the new entity can control the market and have a leading advantage over firms that stay strictly nonprofit or for-profit. Primarily we see this in healthcare however it also is occurring among colleges, health clubs and biotech industries.

[12] Tuckman. *To profit or not to profit.* P. 36

Adjusting to commercialization comes in the form of changing the mix of goods and services and how nonprofits organize production and distribution. Taking form as structural change in corporate form, hence the introduction of hybrid organizations. There are a variety of strategies that can be used, at least three for holding companies and four for joint ventures. Coevolution is the notion that by working with direct competitors, customers, and suppliers a company can create new businesses, markets, and industries.[13] The following strategies will be considered coevolutionary arrangements made by converging entities with similar goals:

Holding companies have 3 strategies, strategy 1 and 2 have unrelated passive income and passive investment respectively and are associated with hybrids. Strategy 3 which pertains to true hybrids involves active investment and revenue producing. This is where a nonprofit involves itself in both development and operation of its acquired subsidiary. The active interest of the parent is justified by the fact that the for-profit activity is consistent or part of the parents' mission[14].

Joint ventures are partnerships between NPO's and PMO's where this newly formed entity has certain restrictions. Neither the for-profit partner nor lenders of capital have access to the assets of the nonprofit in the event of financial failure. The main draw of a joint venture stems from the ability of the parties to come together in a formal legal alliance without changing their own organizational structures if it's not necessary for survival. The creation of a joint venture involves establishing a new, for-profit legal entity that can sell ownership shares. In private-corporate form the joint venture has limited liability and a limited partnership allows the owners to take advantages of tax shelters, tax credits and pass-throughs, which are common advantages seen in hybrids. Two of the four strategy options apply directly to the coevolutionary hybrid notion: ancillary service ventures and third party contracting ventures. Ancillary service ventures are where the partnership is designed to provide services that are shared in common (Bio-tech company research with universities). Third party contracting ventures are where specialized for-profit firms provide discounted services in return for increased customer volume[15]. Trends of this nature are occurring more and more as our economy is advancing and becoming more experimental with changing variables. In appendix 1 you will find a specific situation where the agreements made in the partnership are suitable for a hybrid.

[13] Tuckman. *To profit or not to profit.* P. 41-42
[14] Tuckman. *To profit or not to profit.* P. 40-41
[15] Tuckman. *To profit or not to profit.* P. 41

2.4 Commercialization and blurring differences

Activities that nonprofit organizations are participating in have now become more commercialized. These changes do not occur without consequence. Revolutionary development and changes in traditional behavior is an expansive process that is affectively blurring distinctions between nonprofit and private firms. Examples of this commercialization can be seen in many industries. The Field Museum of Natural History holds afterhours cocktail parties, a nonprofit hospital in Nashville Tennessee built and operated a $15 million training-field complex and rented it to football teams[16]. These decisions to create additional revenue from off mission activities offer real advantages. The integrated relationships between universities and private-sector firms have made significant scientific advances from cooperating together. Colleges and hospitals that increase commercialism are efficient relative to cost structure because there is little marginal cost due to resources that are already available from mission related activities, this has allowed nonprofits to enter certain markets at a lower cost creating competition against for-profits in the related market.

Nonprofits are also able to produce certain outputs that can expand its mission-related output by increasing revenue and decreasing costs. This is similar to how PMO's operate. Substitution of more productive inputs allows the company to advance further in their mission. Because of increased commercial activities NPO's are starting to hire professional managers from the private sector to more effectively pursue its mission. National Geographic is a valid example of blurring the sectoral lines. In order to further its mission of education National Geographic developed a commercial cable television partnership with NBC. In order for this to be successful private sector managers where hired to make the relationship play out smoothly.

2.5 Where commercialization should be expected and why

If nonprofit organizations are altruistic and prefer not to maximize profit, then why do we see them involved with commercial activities? Commercialization growth is occurring where legal constraints on sales revenues are being lifted, which reveals large new opportunities. These opportunities are motivating NPO's who are able to capture the benefits to alter their behavior with the belief that they can further their mission. But NPO's will only participate in this 'cross-subsidization' if donations and government grants are not efficient to support their cause[17]. There seem to be three main areas where

[16] Weisbrod, *To Profit or Not To Profit,* p. 288
[17] James, *To Profit or Not To Profit,* p. 272

cross-subsidization, commercial activities and blurred sectoral lines are occurring. This can be seen in the health industry (hospitals), higher education (nonprofit university research and private firms, specifically in the biotech area) and social services[18].

The industries that we see the most commercialism growth due to partnerships and conversions tend to be industries where institutional or technological change has made exclusion and price financing more realistic. Along with tax and subsidy advantages due to lifted constraints on nonprofits that have allowed them to behave more like PMO's[19]. The trends mentioned above implicitly explain where hybrids would be expected to emerge from primarily. Areas that have newly formed constraints that are enabling new beneficial behavior to both parties are good incentives to create new structures that can maximize the benefits that are available.

2.6 Changing Economic Factors

With incentives naturally occurring in the environment and nonprofit organizations seeking innovative ways to be sustainable, it was only a matter of time before managers began to recognize opportunities that enable them to be more efficient with their resources at hand. Beginning in the 1980's, during President Reagan's term, nonprofits started to look for alternate forms of funding. Reagan's reduction of government expenditures on social services triggered the need for nonprofits to become more creative. Nonprofits are being pressured towards greater integration into the markets. Six factors in the economy that are occurring naturally and propelling nonprofits to become more effective in the market are: fiscal squeeze, expanded demand, increased for-profit competition, growing competition among nonprofits, broader availability of corporate partners and increased demands for accountability.

The fiscal squeeze nonprofits are experiencing comes from cutbacks in government support and reliance on charitable giving. Before the 1980's nonprofits had a massive surge of growth due to a significant expansion of government involvement. Nonprofits found themselves to have as much as 30% of their revenue coming from the government. When Reagan became president and his cutbacks occurred, nonprofits no longer had that kind of funding. Even though nonprofits receive charitable giving and donations, this could not replace the magnitude of money the government had offered. Charitable

[18] James, *To Profit or Not To Profit,* p. 277-278
[19] James, *To Profit or Not To Profit,* p. 279

giving rarely exceeds two percent of the nations' gross domestic product and during the 1980's it was 1.78%. Consequently nonprofits found themselves in commercial-type relationships to stay afloat.[20]

Nonprofits are experiencing higher demands for their services, primarily coming from the poor and disadvantaged, but also from other segments of the population that can pay for the services receive. Specifically demand for a variety of elderly care services have increased because of the baby boomers generation getting near their retirement age. Similarly, the traditional role of women has changed and there is a higher participation rate. Meaning social services such as daycares and related services are in greater demand. These are only a few examples but trends throughout our environment are putting more emphasis on services that nonprofit organizations provide. In order to handle this influx, more nonprofits are collaborating with for-profit institutions[21].

Competition amongst nonprofits and for-profits in the traditional nonprofit field has been increasing in the past few decades. Evidence of this is seen by the reduction in nonprofit shares of certain services, such as: childcare and healthcare jobs, kidney dialysis centers, rehabilitation houses and health maintenance organizations. However, nonprofits are in competition with for-profits in their traditional fields. We are seeing this because certain advantages in each traditional field are available to either the PMO or NPO structures. Because of this competition more organizations are becoming similar and their goals are aligning. This increases the potential of both organizations to consider collaboration to increase their competitive advantage in the field they occupy[22].

Corporations are now more willing to cooperate with joint- ventures and partnerships with nonprofits. For-profit corporations realize that signaling quality and identity increases their sales and allows them to capture more of the market. Working with nonprofits improves the corporate image. In order for this to happen for-profits are not just being donors, they are becoming full-fledged partners, and have integrated such partnerships in their overall corporate strategies. The increased willingness of corporations wanting to work with nonprofits is drawing them into commercialization. Because there is more emphasis on collaboration between sectors and more competition it is important for nonprofits to be more accountable. Meaning attention is being focused on efficiency and effectiveness. This allows

[20] Young and Salamon. *The State of Nonprofit America.* 1st ed. .Washington, DC: Brookings Institution Press, 2002 p. 424-425
[21] Young and Salamon. *The State of Nonprofit America.* P. 426
[22] Young and Salamon. *The State of Nonprofit America.* P. 427-428

the nonprofit to compete better. Also, for-profit corporations need to measure nonprofit performance to determine if the partnership is worth it[23].

This evolution of market involvement of nonprofit organizations is starting to form a new image of the social sector. This self-propelled social problem-solving sector that no longer fits in any one category (nonprofit or for-profit) is composed of hybrids and true hybrids. The results of economic pressures and opportunities have caused a fourth sector to emerge and new types of businesses to be revealed.

2.7 A new structural type

The cause for market interaction between nonprofit organizations has been established to increase their income. However, nonprofits are deciding to integrate into the market to pursue their social mission in a m ore fundamental way. Meaning a venture would not be just a source of revenue, but an integral component of the foundations program, which directly relates to the pursuit of its mission. For example, Pioneer Human Services (PHS), a nonprofit in Seattle, Washington, operates a variety of business enterprises. These enterprises include aircraft parts manufacturer, food buying and warehousing services, and restaurants. PHS's mission is to provide job training, employment and rehabilitations of ex-offenders, chemically dependent individuals and those on probation or under court supervision. The enterprises mentioned are for-profit and are owned by PHS as a means to treat their clients. This is how PHS generates resources to sustain the organization while also pursuing their mission. Participating in the market is the best possible environment to allow the clients to recover and for the PHS to increase the scope of its operations[24].

Activities, such as the one listed above, does not fit the traditional nonprofit structure. This type of social enterprise is what I consider a true hybrid organization. A generic definition of a social enterprise is given by the Organization for Economic Cooperation and Development," Any private activity conducted in the public interest, organized with entrepreneurial strategy, but whose main purpose is not the maximization of profit but the attainment of certain economic and social goals, and which has the capacity for bringing innovative solutions to the problems of social exclusion and unemployment"[25]. This definition does not focus on a particular organizational form, but rather on intent.

[23] Young and Salamon. *The State of Nonprofit America.* P. 429
[24] Young and Salamon. *The State of Nonprofit America.* P. 432
[25] Young and Salamon. *The State of Nonprofit America.* P. 433

A new type of structural classification is needed to accurately capture socially driven business ventures and cross-sectoral activities amongst for-profits and nonprofits. The answer to this new type is a hybrid organization, one that has a nonprofit end but uses assets in both nonprofit and for-profit sectors to accomplish their goal. Salamon calls the growing reliance on fee income, expanded enterprise activities, broader partnerships with for-profit companies, adoption of management practices and increasing organizational complexity as a new governance[26]. This refers to a new approach to solving public problems where nonprofits and for-profits focus on opportunities for collaboration to carry out solutions. Thus a new structure and an emerging fourth sector is justifiable. Many researches are referring to these structures in different ways, either implicitly or explicitly. A new structure is here, the hybrid structure.

2.8 The Emerging Fourth Sector

Where would this new structure fit within the three sectors? The figure below graphically explains the trend of the two sectors converging together to form the framework of this new sector.

[26] Young and Salamon. *The State of Nonprofit America.* P. 440

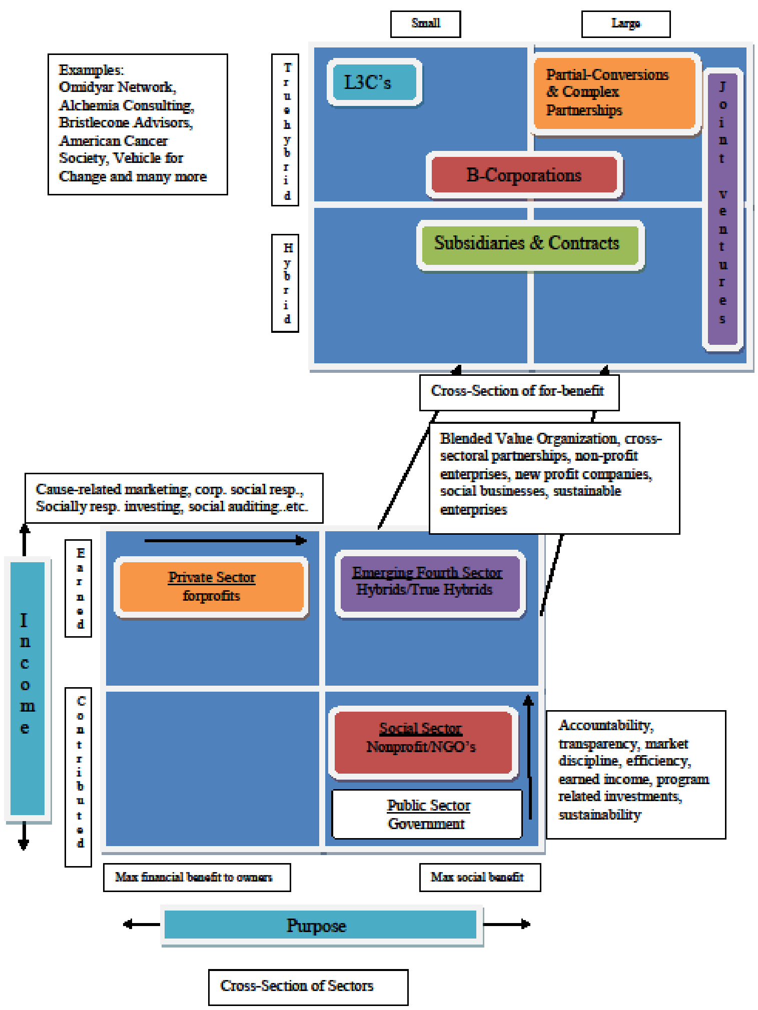

Figure 1: Patterns of Organizational Change: Emergence of a Fourth Sector[27]

The bottom figure represents our current sectors as they are today. They Y-axis refer to income based on if it is earned or contributed. The X-axis refer to purpose, either to maximize profits or to maximize social benefits. The private sector is furthest in the earned income direction and purpose of maximizing financial benefit. While the social and public sector is furthest in contribution income direction and purpose of maximizing social benefit.

[27] Fourth Sector Network p. 3

The arrow above the private sector represents how for-profits are beginning to focus on a more socially beneficial purpose, due to cause-related marketing, corporate social responsibility, etc. The arrow next to the social sector represents how nonprofits are focusing more on earned income, due to increased accountability, transparency, market discipline, efficiency and subsidiaries. These two sectors will meet where income is earned and maximizing social benefit is the purpose of the business. This is where we will see blended value organizations, cross-sectoral relationships, non-profit enterprises, new profit companies, social businesses and sustainable enterprises. This is the new fourth sector where hybrids and true hybrids exist.

The top graph represents a cross-section of the fourth sector, which is called for-benefit. The Y-axis represents two categories, hybrid and true hybrid. The X-axis represents size, either small or large. The terms within the graph are the different types of business forms that exist today and which most accurately represent hybrids. For example, a L3C structure is most common with small businesses and has been determined to be a true hybrid. Partial-conversions and complex partnerships are true hybrids for large businesses and joint ventures are typically for large hybrid or true hybrid structures depending on the operation agreement.

Tuckman examines data from 2002 through IRS 990 to find evidence of the prevalence of hybrids. What he found was that there are increasing percents of hybrids in all mission categories, however size and mission was an important factor for hybrids. This is consistent with the natural benefits because smaller organizations may not have the means to capture economies of scale or have large enough transactions to benefit from tax advantages. The top three entity classifications that would fit the figure above would be: hospitals, education and social services[28].

The fourth sector is emerging and there is evidence on multiple levels supporting the emergence. Structurally we see these new corporations and services, such as the ones listed in the top graph of figure 1. There is also evidence in infrastructure and support activities. Legislation has been created that legally supports hybrids as a legal entity if the two part test is passed. The two criteria are: exempt purposes of charitable organization are furthered and the charitable organization is not prevented from acting exclusively and does not confer a substantial private benefit of the for-profit. There are also situations where hybrids are approved to be used in IRS private letter rulings. (situation offered in

[28] Tuckman. *Nonprofits & Business.* 146-149

appendix 1) The IRS also said that exempt organizations will not lose exemption status solely as a result of entering into a management contract with a private party, giving that party authority to conduct activities on behalf of the organization and direct the use of the organizations assets provided that: the organization retains ultimate authority of the assets and activities being managed; and the terms and conditions of the contract are reasonable[29]. This ruling is saying that if nonprofits and for-profits decide to work together, there are rules that have to be followed for the nonprofit to maintain its 501(c)(3) statues.

The reference to conditions of the contract is referring to the drafting agreement. Operating agreements establish what type of relationship nonprofits and for-profits have with each other. It defines the ordinary course of business, grants or restricts the power of managers and provides guidance on the duties of managers and others involved in the organization. If there is a board that oversees activities between a nonprofit and for-profit, the operating agreement describes the level of control each sector would have[30].

Other forms of evidence to support the fourth sector are measuring systems and increased class programs. More graduate school programs are now offering master degrees in nonprofit management. This is in response to the increased demand for more professional managers in the nonprofit sector. There is also a new measuring system that is known as the GIIR (Global Impact Investing Ratings System). GIIRS is a comprehensive and transparent ratings and analytics system that assesses the social and environment impact of companies and funds. The GIIRS was created to spark the impact investment movement by providing a tool that is intended to change investor behavior and unlock potential of this new class asset[31]. It was specifically designed for hybrid organizations and has been in use since 2004. Looking at the changes that have occurred over the past few decades we can see trends and activities that support this emergence of the hybrid structure.

3.0 Benefits to Firms & Models used to gain them

Environmental changes, incentives and financial pressures are not enough to convince an organization to create a hybrid structure or relationship. Specific benefits for both firms need to be present for a collaboration to exist. We have already touched on what a partnership is and why business would

[29] Keatinge, Robert. “LLCs and Nonprofit Organizations.” Diss. Suffolk University p. 13
[30] Keatinge, Robert p. 29
[31] B Lab, . "GIIRS|Global Impact Investment Rating System." . B Corporations, n.d. Web. 20 Nov 2011.

partner in general; here we will look at more specific economic motivations stemming from a successful partnership.

A good partnership consists of at least a social purpose and a business method with inclusive ownership. Under a ruling from the Internal Revenue Service a 'good' joint venture of a section 501(c)(3) organization may form and participate in a partnership and meet the operational test if participation in the partnership furthers a charitable purpose, and if the partnership arrangement permits the exempt organization to act exclusively in furtherance of its exempt purpose and only incidentally for the benefit of the for-profit partners[32]. With this condition the NPO can use its trustworthiness to have a competitive advantage in the market to increase resources for the mission while the PMO experience increased long run sales from reputation gained through partnering for a social cause.

3.1 4 models that incur benefits

Cordes, Poletz, and Steuerle created a case study analyzing different organizational models that represent types of hybrid structures. Four different examples were presented of how entities with a declared social purpose have embraced important features of business as elements of their core operating model. These examples support how nonprofits are beginning to move towards earned income as described in figure 1 above.

One model involves the operation of a commercial business as a direct means of fulfilling an organization's charitable mission. (PHS example is section 2.7) This model is most prevalent in the area of job training, rehabilitation and employment for the disadvantaged. Mission and income are closely related here, businesses are run as training schools and jobs are an integral part of the rehabilitation the nonprofit provides. A side financial benefit is that if the business generates a steady flow of earnings, the revenue stream can be leveraged through outside investment.[33] This is a true hybrid example where the for-profit business is an intermediate input in the production of the charitable activity.

Another model, the double-bottom-line social venture, is where the charitable mission and earned income are directly related through goods or services the nonprofit produces. The good or service has a commercial and private bottom line equal to the organizations profit from sale of goods and services in

[32] Evelyn, Brody. *Nonprofits and Business* p. 103
[33] Cordes and Steuerle, *Nonprofits and Business,* pg. 49

the marketplace. The social bottom line is equal to the social value of its activities that are not reflected in market sales. In other words the nonprofit provides a private good with external benefits. The business and social bottom lines create a double bottom line that is the blended value of the hybrid nonprofit organization[34].

Complex structures involve nonprofit subsidiaries, for-profit subsidiaries and partnerships with for-profit organizations. This complex structure is used as a strategic decision to reduce a nonprofits dependence on any single income source by diversifying. These complex structures represent a true hybrid which enables diversified income and legal ways for nonprofits to use their tax-exempt status, such as allocating costs and revenues among the multiple entities in the complex structure in ways that minimize taxes that might be owed on profitable earned-income opportunities[35].

Lastly, another relationship type occurs when nonprofits exploit certain unique assets for financial gain in collaboration with for-profit businesses. Cordes and Steuerle call this a quid pro quo relationship and it is where nonprofits use their signal of a trusted entity with goods of a certain quality that benefit society to increase for-profit sales because they are able to differentiate their brand[36].

These four examples of strategies and structures used represent how nonprofits are blurring organizational boundaries as a means to be sustainable and further their mission. For-profits also assist in this blurring by becoming more socially responsible businesses. For-profits involvement with nonprofits by allowing them to have active stakes in their business, by contributing preannounced shares of profits to charities and creating social programs explains how for-profits are moving towards being socially beneficial as described in figure 1 above.

3.2 Economic strategies that create benefits

Each sector has its own strength and weakness. Nonprofits, due to the nondistribution constraint, have an easier time securing donations, grants and contributions relative to for-profits. Unfortunately nonprofits do not have access to equity capital and encounter resistance from lenders for debt financing because the lenders prefer not to treat donations and grants as bankable revenue. For-profit strengths and weaknesses are the opposite of nonprofits. Seeking profits for the owners limits access to

[34] Cordes and Steuerle, *Nonprofits and Business,* pg. 50
[35] Cordes and Steuerle, *Nonprofits and Business,* pg. 50-51
[36] Cordes and Steuerle, *Nonprofits and Business,* pg. 52

contributions and donations but capital markets and retained earnings are accessible. Another disadvantage is that potential customers with hard-to-verify quality dimensions will trust nonprofits over for-profits. Because of the different features of each organizational form a 'gains from trade' option occurs. By matching the advantageous features of the for-profit form with the nonprofit form, a better hybrid form can be created. Cordes and Steuerle call this "organizational arbitrage", nonprofits retain trust and gain access to capital markets while for-profits are able to use this trust to move into new markets and increase sales[37].

Engaging in a hybrid structure allows nonprofits to support its strategies and help overcome environmental constraints. Three categories of economic strategies are identified that enable the hybrid structure to give nonprofits benefits. The three categories are supply and cost, demand and revenue, and strategies that respond to competition.

The supply and cost category focuses on how costs affect production. A decision a single nonprofit must make is whether creating multiple subsidiaries can reduce costs. This can happen by increasing access to consumers or by reducing operating, tax and other costs. A hybrid structure will be chosen if costs are cut and a product is improved from a for-profit subsidiary. Specifically when nonprofits are trying to decide if they want to partake in a new commercial activity, they need to consider if their new business will perform better as a central entity (hybrid structure) or a stand-alone business.

When a hybrid structure is used nonprofits will experience lower costs of production, this is due to the presence of economies of scale and scope. If the nonprofit adds a new entity to the structure, the nonprofit can collaborate and lower their production costs by increasing their joint volume, such as sharing activities. This describes economies of scale. Economies of scope occurs when the nonprofit and businesses they are working with produce a range of cost savings because multiple products can share part of the cost structure. A common source of economies of scale for hybrid structures is when operations can be centralized by the nonprofit parent entity. For example if the nonprofit parent can provide accounting, advertising, financing, human resources and problem solving services for each subsidiary then considerable savings occur[38].

[37] Cordes and Steuerle, *Nonprofits and Business,* pg. 53
[38] Cordes and Steuerle, *Nonprofits and Business,* pg. 131

A demand and revenue strategy involves ways to use one service to build demand for another service. A nonprofit and for-profit will decide to work together if their services or goods are complements of each other or if they can differentiate their products, which enables certain products to be charged at a premium. The effectiveness of the hybrid structure in delivering goods and services is partially determined if the nonprofit and for-profit can offer an array of products and services that can increase sales and draw customers in with high quality goods. The hybrid structure also enables the nonprofit to reduce business risk, this effectively stabilizes revenues because the parent can implement financial strategies specific to the industry to offset downturns in one revenue service by creating an offsetting revenue source.

The ability to respond to competition is another benefit the hybrid structure allows. This competitive advantage comes from greater organizational diversification, a larger product line, more resources for potential use and economies of scale and scope. If the assembled structure has achieved strategic fit then costs of transferring key skills, expertise and managerial solutions are significantly reduced. These types of benefits are good incentives to create a hybrid structure.

3.3 Organizational advantages

From the creation of hybrid structures with for-profit subsidiaries creates additional organizational advantages other than the previous mentioned. Nonprofit organizations that have a weak asset base are cautious about their assets and need the assets to be protected. If the nonprofit is participating in an unrelated business-income-generating activity then a for-profit enterprise will be formed which legally isolates the financial risk to the for-profit entity instead of the nonprofit parent.

Another benefit stems from segregation of assets, which is helpful in attracting donors who are worried about how their donations will be spent. For example, if a nonprofits mission was to enable higher education opportunities for high school graduates and a donor specifically wanted their donations to support those on financial need basis. The nonprofit could then create a new nonprofit subsidiary which specifically focuses on supporting potential students on strictly a financial need basis that is overseen by a subsidiary board of directors. This ensures the donor that their donation is spent appropriately.

Lastly, the hybrid form allows the nonprofit to separate employees with different talents, skills and career goals. Because the environment in a nonprofit organization is different than a for-profit subsidiary establishing different incentive structures make sense. This enables people with similar skills to accumulate in a specific section of the business enabling management to establish appropriate policies specific to the area of work the employees are in.

3.4 Specific Benefits

There are two separate types of benefits. Gourville and Rangan call them 1st and 2nd order benefits. First order benefits are those that entities earn immediately, such as a percentage of sales off a for-profit product given to the nonprofit partner. Second order benefits are such that improve performance in the future, such as customers improved perception of a company[39].

When two organizations are determining if a hybrid relationship is a good business decision, the organizations seek certain conditions. For-profits look for: credit on collateral materials, category exclusivity, program title, tickets and hospitality at nonprofit events and information from nonprofit databases. Nonprofits seek increased revenue, impact on mission, enhanced visibility of the nonprofits message, access to new audiences, connections to corporation networks and expertise in marketing or strategy development. All of these conditions create benefits of both orders to each company. The primary focus is on improvement of future performance[40].

Once the nonprofit and for-profit have decided to collaborate and become a hybrid structure certain benefits are received by each company. Some first order benefits received by both corporate and nonprofit organizations are: sales-related transactions, licensing and joint product marketing. Licensing refers to for-profits paying a fee to the nonprofit for the use of its name or logo. Nonprofits receive additional revenue while the for-profit gain additional motivation to purchase their product. Joint product marketing refers to for-profit and nonprofit collaborate to introduce a product or service that benefits both parties. These benefits are experienced in the short run and only affect sales[41].

More long term benefits, second order benefits, are seen in the form of: pro bono advertising collaboration, strategic volunteering, board service, goodwill building partnerships and mixed programs. Strategic volunteering refers to corporate employees who volunteer their time for a specific cause which have increased sales potential in the future. For example, Intel employees provide science education

[39] Andreasen, Alan, *Nonprofits and Business,* pg. 158
[40] Andreasen, Alan, *Nonprofits and Business,* pg. 158
[41] Andreasen, Alan, *Nonprofits and Business,* pg. 164

classes to students so that in the future the students will use Intel-driven computers. Volunteering also positively affects employee turnover and loyalty. Board service refers to corporate executives serving on nonprofit boards, which leads to the provision of informal opportunities to network with executives. This creates the potential for relationships to be formed that in the future can positively affect business[42].

Corporations are interested in second order benefits especially those which affect reputation and brand name. Due to the pressure of global competition and economic factors reputational capital is at a premium because it creates a competitive advantage in the market so that corporations can attract customers, retain high-level staff and ensure public support. Because of these potential benefits corporate involvement with nonprofits entails the provision of equipment, space, contacts, sponsorship, complex royalty, licensing agreements and joint ventures. These strategic relationships occur because it is believed by corporations and nonprofits alike that each strategic mission gains something of value[43].

4.0 Hybrid issues

Hybrids do offer benefits and improve business for both nonprofit and for-profits. However, it is important that the creation of the hybrid is done properly. As of any new business form, concept or idea issues do arise. Complex organizations that are fundamentally different yet have similar goals will have friction when the integration process occurs. The first step to solving potential problems is to recognize what they are.

A hybrid structure, not including small businesses, involves a complex structure, including multiple subsidiaries, management groups and operations. More complexity means senior management must spend more time on activities unrelated to the mission. However, senior management already spends a majority of their time planning, budgeting, and solving operational issues related to both the for-profit and nonprofit elements of the business. It is difficult to determine how much time senior management should spend on for-profit business as opposed to nonprofit[44]. This concern introduces the diversion problem. Managers begin to divert their attention to off mission tasks to increase revenues. This leads to potentially displacing values and core beliefs in order to focus on the for-profit activities. This is not a huge problem because by focusing on off mission activities, the income generated creates more assets

[42] Andreasen, Alan, *Nonprofits and Business,* pg. 165
[43] Young and Salamon. *The State of Nonprofit America.* P. 434-435
[44] Tuckman. *Nonprofits & Business.* p. 142

to increase mission impact. Improving off mission activities allows the charity to produce better output that is more efficient. Managers also view profit maximizing strategies as inconsistent with their underlying charitable good, implying the managers will only focus on off mission activities until it no longer benefits the charity[45].

Another potential problem is public perception. The public and donors perception of a business structure determine how a hybrid is perceived. The public is mostly unaware of the internal structure of the nonprofit, mainly because it does not affect them. However, donors become reluctant to provide funding to a nonprofit that engages in unrelated commercial activity because of the culture that begins to focus on the bottom line. Even though this seems problematic, a small percentage decline of donations is made up by the increased revenues. It is important for hybrids to recognize that transparency is important to maintain the perception of trustworthiness[46].

Traditional issues with hybrid structures are unfair competition and erosion of the corporate tax base. For-profit providers of the same goods as charities that have entered the market claim that these charities have an unfair advantage in the market. The for-profits believe that because of the nonprofit tax exempt status the charity will be able to offer the same product at a lower cost that the for-profit cannot compete with. This idea is considered ‘predatory pricing’, and is caused by charities unfairly using their economic benefits to subsidize their commercial activity. The unrelated business income tax (UBIT) was created in 1950 to control unfair competition by taxing charities that participated in activities unrelated to their mission. Unfortunately UBIT is insufficient and easily side-stepped because it is difficult to define related vs. unrelated business activities. Also, if an activity is determined to be unrelated the charities will simply allocate deductable expenses and depreciation to the unrelated activity. This effectively negates the taxes owed. If UBIT does not effectively prevent unfair competition, then why is unfair competition not a problem today? Unfair competition is not a problem because nonprofits do not have incentives to participate in predatory pricing because the main purpose to originally compete with for-profits was to capture financial gains in the market. Charging below market prices negates that benefit, thus the nonprofits choose not to engage in predatory pricing[47].
Erosion of the corporate tax base is also a growing concern; another reason for creating UBIT was that commercial activities nonprofits engaged in would be taxed so a portion of the tax base could be

[45] Colombo p. 35-36
[46] Tuckman. *Nonprofits & Business.* p. 144
[47] Colombo p. 32-34

protected. However, because of the vagueness of related vs. unrelated business activities UBIT did not prevent the tax base erosion. The tax base argument does not hold once how charities spend their increased revenues is examined. Because charities use their increased revenue to further their mission and therefore increase mission impact, less tax dollars are needed by the government to support nonprofits. So, by taking the amount of dollars lost due to tax erosion and reallocating them to different areas of need, the tax erosion problem is solved. Issues will always occur when a new element is added to an existing environment. A majority of the problems that a hybrid structure potentially creates in the market can be solved relatively easily.

5.0 Determining Hybrid Behavior

An issue that hybrid organizations have (the nonprofit entity) relates to pursuing their social mission with financial constraints when additional resources may be available (collaboration with a for-profit) that distort the mission. A nonprofit organization will produce a particular output based on their mission and financial constraints. There are various options on how to raise revenues, such as: entering new markets, charging fees and avoiding certain high cost markets. Nonprofits want to raise revenues but still want to maintain the benefits of a 501(c)(3), the UBIT in particular is a tax that nonprofits try to avoid. Because nonprofits want to increase revenues but prefer to not participate in activities that incur the UBIT, a choice model for hybrid behavior can be derived.

The framework for a nonprofit behavioral utility model was developed my Estelle James then extended by Jerald Schiff and Weisbrod. The model views nonprofits as multiproduct organizations that can potentially produce three types of goods that contribute to the mission, either directly or indirectly. The nonprofit will choose a combination of each good that best serves their mission. The three types of outputs are: collective, preferred private and nonpreferred private goods. This model and the variables within it interact with each other accordingly to hybrid preferences and attributes. Collective goods and preferred private goods are preferred and increase the organizations utility. While the nonpreferred private good decreases the organizations utility[48].

A preferred collective good comprises the organizations output mission that is difficult to sell in private markets, such as research, medical care for the poor and cultural heritage. A preferred private good is incidentally related to providing the mission-related good and can be sold in private markets where

[48] Weisbrod. *To profit or Not To Profit* p. 85-86

nonprofits can make available to consumers independent of their ability to pay, such as access to higher education. Lastly a nonpreferred private good, which is unrelated or 'ancillary' to the mission, is produced solely for the purpose of generating revenue for the preferred good, such as paid advertisements[49].

Subject to constraints of competition and price a nonprofit can determine the amount of each good it will produce. It is also useful to categorize revenue sources because these sources affect which good output a firm chooses. The three categories are donations, user fees and ancillary activities. Depending on the industry and organization, each nonprofit will have different preferences for engaging in the 3 types of good output activities. Each nonprofit will also be affected differently depending on how revenue-generating activities affect external funders to give donations. Lastly the affects of revenue-generating activities may cause changes in costs of producing the mission-related output. This hybrid model is meant to explain how nonprofits within hybrid structures choose to further their mission while facing certain constraints.

Nonprofit and for-profit organizations have interacted amongst each other within the market for many years. Ever since the 1980's the relationship between these two entities has evolved. Their behavior is becoming interrelated and integrated to form a new business structure. This convergence of new behavior is most seen in the biotech industry, universities and hospitals. As these hybrid entities become more established their emergence into the fourth sector will be complete. Evidence supporting hybrid organizations either through measuring systems, legislation supporting hybrids or economic motivations has led to the conclusion that a new business structure, the hybrid structure, is a new element in the market. This emergence into the fourth sector should be viewed as the for-benefit sector where businesses strive to maximize social benefit while still being able to make a profit.

[49] Weisbrod. *To profit or Not To Profit* p. 48

Appendix 1

In this situation the LLC's governing documents provide that the LLC will be managed by a board of five people, three of whom are appointed by the exempt organization. The exempt organization intends to appoint community leaders who have experience with hospital matters, but who are not on the hospital staff and do not otherwise engage in business transactions with the hospital as its members of the board.

The governing documents specifically provide that the LLC will operate its hospital in furtherance of charitable purposes by promoting health for a broad cross section of the community and that the board must allow this duty to override any duty the board might have to operate the LLC for the financial benefit of its owners. In this respect, the operating agreement places the charitable purposes of the exempt member ahead of the board's fiduciary duties to operate the LLC for the benefit of its members. The governing documents could be changed only by the consent of both members, and all returns of capital and distributions of earnings made to owners of the LLC shall be proportional to their ownership interests in the LLC. The exempt member intends to use its share of the proceeds in furtherance of its exempt purpose.

The LLC enters into a management agreement with an independent management company to provide day-to-day management services. The management agreement is for a five year period, renewable for additional five-year periods by mutual consent. The management company will be paid a management fee for its services based on the LLC's gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term, are reasonable and comparable to what other management firms receive for similar services at similarly situated hospitals. The LLC may terminate the agreement for cause.[50]

[50] Keatinge, Robert. "LLCs and Nonprofit Organizations." Diss. Suffolk University p. 12 (Direct Excerpt from page)

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