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# URBAN ENTREPRENEURSHIP AND THE PROMISE OF FOR-PROFIT PHILANTHROPY

VICTOR FLEISCHER\*

## INTRODUCTION

The entrepreneurial spirit is universal. Challenges to raising capital vary from region to region, however, making a comparative analysis of entrepreneurship a potentially fruitful inquiry. The focus of the conference, of course, is on urban entrepreneurship, which I understand to mean start-up businesses in economically disadvantaged urban areas. Entrepreneurs seeking investment for projects in urban areas face unusual barriers in raising capital. The chief problem, I think, is that many urban projects, even profitable ones, are slow-growth projects; traditional venture capital seeks out investments in new technologies that promise to disrupt existing product markets, thereby generating the outsized returns that support the venture capital business model. Traditional solutions to the urban-entrepreneurship challenge include community networks, investments from nonprofits, and investment tax credits, but, as I explain, each of these solutions suffers from significant limitations. A promising alternative is emerging, however: *for-profit philanthropy*—altruistic investments guided by the discipline and accountability of for-profit venture investing.<sup>1</sup> While no panacea, for-profit philanthropy may supplement the other efforts necessary to make urban environments more conducive to entrepreneurship.

### I. THE ENTREPRENEURIAL SPIRIT IS UNIVERSAL

Evidence of the entrepreneurial spirit is tucked away in all sorts of places, from locales we normally think of—like Boulder

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\* Associate Professor, University of Illinois College of Law. This Essay is based on my remarks at the Current Issues in Community Economic Development Conference held at the Western New England College School of Law on March 30, 2007. I thank my research assistant, George Green, for his assistance in preparing these remarks.

1. On the desirability of for-profit charities as institutions, albeit outside the entrepreneurship context, see generally Eric A. Posner & Anup Malani, *The Case for For-Profit Charities* (Univ. Chi. Law & Econ., Olin Working Paper No. 304, 2006), available at [http://ssrn.com/abstract\\_id=928976](http://ssrn.com/abstract_id=928976).

and Silicon Valley—to large cities like Los Angeles and New York. The entrepreneurial spirit also thrives in rural areas of the United States, as well as throughout Europe and Israel, in India and China, and in Africa and Latin America.<sup>2</sup> Urban areas of the United States are no exception, of course.

Differences in human capital exist. For example, a CEO in a struggling inner-city environment in the Rust Belt may have to devote more hours to training workers than a CEO in Silicon Valley.<sup>3</sup> But I am skeptical of explanations of entrepreneurship that place too much weight on vague descriptions of entrepreneurial culture or attitude. Culture in this broad sense may also prove difficult to change, at least in a positive direction, through government regulation.

Nor should we ignore the importance of venturesome consumers.<sup>4</sup> Consumers who are locked into comfortable patterns, or who are distrustful of change, present an additional obstacle to entrepreneurs seeking to disrupt product markets. For the remainder of this Essay, then, I will focus on regional variations in seeking investment capital.

Consider the barriers to raising investment capital. In general, investors have two needs: (1) a legal regime that makes them comfortable investing in a venture managed by someone else, and that is relatively free from corruption and confiscatory taxes; and (2) a belief that they will achieve a satisfactory return on their investments relative to the risk of loss.<sup>5</sup> The United States has a legal regime that, for the most part, is supportive of entrepreneurs. This is generally true in urban environments, as well as in Silicon Valley. The greater challenge facing urban entrepreneurs is convincing investors that they will receive a sufficient return on their investment.

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2. See generally NIELS BOSMA & REBECCA HARDING, GLOBAL ENTREPRENEURSHIP MONITOR, GEM 2006 SUMMARY RESULTS (2007), available at <http://www.gemconsortium.org/download.asp?fid=532> (describing the results of a cross-country entrepreneurship study of forty-two countries).

3. See generally Edward L. Glaeser, *Entrepreneurship and the City* (Harvard Inst. of Econ. Research, Discussion Paper No. 2139, 2007), available at <http://ssrn.com/abstract=1001108> (finding a strong connection between area-level education and entrepreneurship).

4. See Amar Bhidé, *Venturesome Consumption, Innovation and Globalization*, Paper for a Joint Conference at CESifo and the Center on Capitalism and Society: Perspectives on the Performance of the Continent's Economies 1 (2006), available at [http://www.bhide.net/bhide\\_venturesome\\_consumption.pdf](http://www.bhide.net/bhide_venturesome_consumption.pdf).

5. For a useful discussion, see Pranab Bardhan, *Corruption and Development: A Review of Issues*, 35 J. ECON. LITERATURE 1320 (1997).

In seeking to overcome this challenge, urban entrepreneurs face an enormous information barrier. Entrepreneurs have to somehow convince investors that their business plan has greater growth potential than other small business proposals. This is a greater challenge in the urban context because many urban business model ideas don't fit the traditional venture capital paradigm. Venture capital-backed entrepreneurship tends to focus on technologies that have the potential to disrupt existing product markets and generate enormous returns.<sup>6</sup> It's these spectacular home run investments that can justify "nosebleed" valuations and allow investors to swallow the losses from the significant number of investments that will fail.<sup>7</sup> Many urban start-ups, by contrast, are looking for success on a smaller scale. This doesn't necessarily diminish their importance to social welfare, but it does reduce their chances of finding traditional venture capital.

## II. NO CLEAR PATH TO CASH

There are untapped product markets and underutilized labor markets in urban areas,<sup>8</sup> and it's possible for venture capital-backed entrepreneurs to reach a portion of these markets. There's no intrinsic barrier to funding; nor is there a conspiracy that makes profit-seeking venture capitalists turn away from urban markets. I recently saw a pitch by a company called GoUrban.net, which wants to be an Internet portal and online retailer for the urban market.<sup>9</sup> I think it will find traditional venture capital funding—but only if it can convince the venture capitalists that the business is truly disruptive of existing product markets. If, on the other hand, the portal only looks like it facilitates the entry of new users into the web commerce arena who would rather spend their cash elsewhere, GoUrban.net will have trouble finding funding. But, in that sense, the challenges facing GoUrban.net are not fundamentally different from other technology companies.

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6. See Joseph Bankman, *The Structure of Silicon Valley Start-Ups*, 41 UCLA L. REV. 1737, 1764 (1994) (discussing and defining the "home run mentality" in venture capital investing as receiving a return that is greater than two times the investment); Victor Fleischer, *The Missing Preferred Return*, 31 J. CORP. L. 77, 90 (2005).

7. Fleischer, *supra* note 6, at 90.

8. See, e.g., Lee Romney, *Retailers See Gold in Poor Areas*, L.A. TIMES, May 12, 2001, at 1; Robert Sharoff, *Book Chain Taps Underserved Neighborhoods*, N.Y. TIMES, Feb. 25, 2004, at C6 (describing Borders Books and Music's efforts to place stores in untapped urban areas).

9. GoUrban.net, <http://www.gourban.net/about.php> (last visited Apr. 7, 2007).

The tougher challenge is for slow-growth companies, like smaller retail businesses, grocery stores, bakeries, laundromats, clothing stores, for-profit educators, and many service providers. Many of these companies can provide incremental improvements over the status quo, but it's unlikely that they will disrupt entire product markets. In this context, the more logical sources of capital are traditional corporations that extend incrementally into new markets through franchises or by opening stores in new areas, as companies like Wal-Mart, Target, and Starbucks are trying to do.<sup>10</sup>

For example, suppose there's an entrepreneur who wants to open a new store on 125th Street in Harlem that will sell a line of upscale men's shoes primarily to the African American consumer market in the area. Should she make a pitch to traditional venture capitalists? Probably not. Venture capitalists simply are not likely to supply the needed capital to this market. No matter how impressive the entrepreneur, venture capitalists won't make the investment because the business model—upscale men's shoes—isn't inherently disruptive. Without the promise of a home run product, slow-growth companies simply won't attract traditional venture capital. Unless she can pitch the company as the next Crocs<sup>11</sup>—and who saw that one coming?—the road to venture capital will be a long haul. As with any other market, there's a huge information gap between the entrepreneur with the idea and the investors with the capital.

### III. COMMUNITY NETWORKS, NONPROFITS, AND TAX CREDITS: THE TRADITIONAL SOLUTIONS

There are a handful of traditional solutions for finding capital for urban entrepreneurship. The first is community networking. Frequently, this just means informal associations of friends and family that provide capital to small business owners, even when the return on the investment is quite uncertain.<sup>12</sup> They rely on noncontractual methods to guard against shirking and other moral hazard

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10. See, e.g., Craig Harris, *Starbucks Wants to Open 40,000 New Stores*, SEATTLE POST-INTELLIGENCER, Oct. 5, 2006, available at [http://seattlepi.nwsource.com/business/287643\\_sbuxgrow05ww.html](http://seattlepi.nwsource.com/business/287643_sbuxgrow05ww.html); News Release, Target Corp., Target to Open 60 New Stores (Oct. 7, 2005), <http://investors.target.com/phoenix.zhtml?c=65828&p=irol-newsArticle&ID=765407&highlight=>; *Wal-Mart Sees Room for Over 1,500 New Stores*, MSNBC.COM, Feb. 8, 2006, <http://www.msnbc.msn.com/id/11233081/>.

11. Crocs, Our History, <http://www.crocs.com/company/history/> (discussing how Crocs went from merely "boating/outdoor" shoes to a "bona-fide phenomenon").

12. See Gideon Parchomovsky & Peter Siegelman, *Selling Mayberry: Communities and Individuals in Law and Economics*, 92 CAL. L. REV. 75, 116 (2004) (asserting

risks.<sup>13</sup> Historically, these networks have tended to be ethnically homogeneous, and often, but not always, centered around immigrant groups.<sup>14</sup> In New York, for example, there are—just to name a few—Korean grocers, Orthodox Jews in the diamond district, and African American bakeries in Harlem. But, family and ethnic ties only extend so far, and the model becomes less useful as our urban communities become more heterogeneous. Further, as a matter of public policy we cannot count on financing from friends and family to generate the optimal level of economic activity.

Some nonprofits try to pick up where community networks stop. Examples include the New Hampshire Community Loan Fund,<sup>15</sup> the Minority Business Enterprise Center,<sup>16</sup> and the Self-Help Ventures Fund,<sup>17</sup> each of which provides start-up financing to underserved communities. The trouble is that nonprofits have a tendency to suffer from a lack of accountability because nonprofit managers are agents without principals. Without the profit motive to guide behavior, there's a greater risk that nonprofit managers choose suboptimal projects.<sup>18</sup> Similarly, it's difficult for donors or investors to monitor what's going on.<sup>19</sup>

Tax credits offer another, albeit limited, method of moving capital to urban entrepreneurs. Under the New Markets Tax Credit, for example, investors can receive a tax credit, staggered over seven years, for up to thirty-nine percent of their investment in low-income communities through government-certified intermediaries.<sup>20</sup> While the scheme likely lowers the cost of capital

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that “[t]he presence of community may be especially important for the poor who rely on it as a form of insurance or risk sharing”).

13. See Barak D. Richman, *Firms, Courts, and Reputation Mechanisms: Towards a Positive Theory of Private Ordering*, 104 COLUM. L. REV. 2328, 2351-52 (2004) (describing how community networks can serve as robust private law mechanisms for enforcing industry norms).

14. *Id.* at 2344-45 (describing the ethnic homogeneity of cotton-mill owners and the even greater homogeneity of Orthodox Jewish diamond dealers in New York City).

15. N.H. Cmty. Loan Fund, Coos County Entrepreneurial Investment Program, <http://www.nhclf.org/news/Tillotson.pdf> (last visited Apr. 9, 2007).

16. Minority Bus. Enter. Ctr., About Us, <http://www.mbecwa.com/about/index.html> (last visited Apr. 9, 2007).

17. Self-Help Ventures Fund, Commercial Lending, <http://www.self-help.org/commerciallending/index.asp> (last visited Apr. 9, 2007).

18. See generally, e.g., Symposium, *Who Guards the Guardians?: Monitoring and Enforcement of Charity Governance*, 80 CHI.-KENT L. REV. 543 (2005) (discussing law enforcement and reform).

19. See generally *id.*

20. Cmty. Dev. Fin. Inst. Fund, U.S. Dep't of Treasury, New Markets Tax Credits Program, [http://www.cdfifund.gov/what\\_we\\_do/programs\\_id.asp?programID=5](http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=5) (last

for certain projects, it's difficult to assess whether the best projects are getting funded.<sup>21</sup> Further, it's not clear to what extent the tax credit is, in fact, causing an increase in investment in low-income communities.<sup>22</sup> The Byzantine planning requirements provide multiple opportunities for rent seeking and hardly suggest an efficient structure.<sup>23</sup>

Entrepreneurs must also develop specialized human capital to acquire tax credits—either by learning the process themselves, or finding intermediaries such as nonprofits and lawyers who can assist them with the funding process. Just as urban entrepreneurs may not be familiar with the path to traditional venture capital, they also may be unfamiliar with the tax credit world, placing them at a comparative disadvantage with seasoned businesses. In the real estate context, for example, we often observe repeat players applying for low-income housing tax credits.<sup>24</sup> This suggests that the complexity of the tax credit programs creates its own unique barrier to entry.

I don't mean to suggest that community networks, nonprofits, and tax credits can't be useful sources of support for urban entrepreneurship. But there seem to be significant limitations, particularly for new entrepreneurs and for ambitious companies that seek faster growth rates.

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visited Apr. 5, 2007); see U.S. GOV'T ACCOUNTABILITY OFFICE, TAX POLICY: NEW MARKETS TAX CREDIT APPEARS TO INCREASE INVESTMENT BY INVESTORS IN LOW-INCOME COMMUNITIES, BUT OPPORTUNITIES EXIST TO BETTER MONITOR COMPLIANCE (2007) [hereinafter GAO TAX POLICY], available at <http://www.gao.gov/new.items/d07296.pdf>.

21. For a discussion of government intervention in venture capital markets, see Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 STAN. L. REV. 1067 (2003).

22. GAO TAX POLICY, *supra* note 20, at 53 (“[GAO’s] statistical evidence may only establish an association between the credit and increased investment, not that the program causes the increase. In any case, the indication that the program increases investment is not sufficient to support conclusions about the program’s effectiveness . . .”).

23. *Id.* at 7. “The process of making a [ ] [New Market Tax Credit] investment involves several steps and a number of stakeholders.” *Id.* The report then goes on to describe the elaborate process by which an intermediary can become certified to provide tax credits to its investors, the process by which applicants can seek capital from these investors, and the method for evaluating the suitability and worthiness of applicants. *Id.*

24. See Nestor Davidson, *Values and Value Creation by Lawyers in Public-Private Transactions* (2007) (unpublished manuscript, on file with author).

#### IV. FOR-PROFIT PHILANTHROPY AS A USEFUL ALTERNATIVE

For-profit philanthropy, while no panacea for urban problems, might be a valuable (and currently underutilized) alternative source of capital for urban entrepreneurship. As I use the term here, for-profit philanthropy means an investment guided by traditional, for-profit principles of accountability and return on investment, but where the primary motivation for the investment is altruistic. These ventures might generate a profit, but if so, it's just gravy. The real motivation is giving something back to the community, and this philanthropic impulse helps investors stomach greater uncertainty and take on greater risk than they would otherwise take, given the expected returns. The following are three examples of for-profit philanthropy.

##### A. *Angels*

In the venture capital context, angel investors bridge the gap between financing a new business yourself (or with the help of family) and the first round of venture-capital financing. Angels are often former entrepreneurs with some knowledge of the underlying industry. For example, a software entrepreneur might look to founders of successful software companies to get some early funding. Angels typically take a minority equity stake in the new business and often serve formally on the board of directors or offer informal advice and mentoring to the entrepreneur. If all goes well, in a few months, or a year or two, the company will then seek venture financing, at which point venture capitalists will take over the lead role in counseling and guiding the company towards an initial public offering or other exit.

Angel investors are normally thought of as for-profit investors, not philanthropists.<sup>25</sup> But when you talk to angels, it becomes clear that many subscribe to a much broader mission.<sup>26</sup> Many are former entrepreneurs who see angel investing as a method of giving the next generation a hand up. As Professor Ibrahim has documented,

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25. For an analysis of angel investing that assumes a for-profit motive, see John L. Orcutt, *Improving the Efficiency of the Angel Finance Market: A Proposal to Expand the Intermediary Role of Finders in the Private Capital Raising Setting*, 37 ARIZ. ST. L.J. 861 (2005).

26. See Posting of Gillian Parrillo to Sacramento Executive, *What Kind of Angel Are You?*, [http://www.sacramentoexecutive.com/2006/02/what\\_kind\\_of\\_angel\\_are\\_you.html](http://www.sacramentoexecutive.com/2006/02/what_kind_of_angel_are_you.html) (Feb. 13, 2006, 12:39 PST).

many angels value the social benefits of angel investing.<sup>27</sup> Angels can participate in the excitement of being part of a start-up, and “stave off the boredom of retirement.”<sup>28</sup> Angels often invest close to home, so they can visit and consult with founders. Many invest in ventures that may generate broader social welfare gains, like greentech and cleantech, or that will produce jobs in the angel’s community.<sup>29</sup> “Psychic income” becomes an important factor.<sup>30</sup>

Once in a while, of course, an angel investment turns into millions of dollars.<sup>31</sup> The profit motive is often present alongside these other nonfinancial motivations. But that is precisely the attraction of for-profit philanthropy; it has become a method of providing both the money and discipline of venture capital to a start-up that isn’t yet ready to receive traditional venture capital.

### B. *Google.org*

Google.org is the “philanthropic arm” of Google.<sup>32</sup> It invests in projects such as providing market-based solutions to global poverty<sup>33</sup> and creating a better hybrid car.<sup>34</sup> By keeping the projects under the for-profit umbrella of Google, the Google founders and managers are likely to achieve more accountability than if they made a corporate charitable contribution to an outside nonprofit.

Additionally, it’s worth noting that, while it may seem counter-intuitive, Google still gets a pretty good tax break. In *For-Profit Charities*, Professors Eric Posner and Anup Malani suggest that we should allow for-profit entities engaging in charitable activities to receive deductible contributions of capital and operate free from an entity-level tax.<sup>35</sup> Google.org achieves the same improvement in

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27. See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors* 33 (Ariz. Legal Studies, Discussion Paper No. 07-16, 2007), available at <http://ssrn.com/abstract=984899>.

28. *Id.* at 32.

29. *See id.* at 33.

30. *Id.*

31. Jeanne Lee, *How to Fund Other Startups (And Get Rich)*, CNNMONEY.COM, May 31, 2006, [http://money.cnn.com/2006/05/30/smbusiness/angels\\_wealthbuilders\\_fsb/index.htm](http://money.cnn.com/2006/05/30/smbusiness/angels_wealthbuilders_fsb/index.htm) (describing some home run angel investments).

32. Google.org, Welcome to Google.org, <http://www.google.org/> (last visited Apr. 9, 2007).

33. Google.org, Global Economic Development, <http://www.google.org/development.html> (last visited Oct. 10, 2007).

34. Google.org, Climate Change, <http://www.google.org/climate.html> (last visited Oct. 10, 2007).

35. 26 U.S.C. § 501(c)(3) (2000). The mechanics that would be used are unclear from the early draft of the paper. Posner & Malani, *supra* note 1, at 18.

accountability and significant tax benefits, but without creating the same sort of nightmare of administrative compliance that changing the tax code would require in this context. When Google puts money into its Google.org subsidiary, and the subsidiary spends the money on things like research and development, the .org subsidiary will quickly generate operating losses. Assuming the .org subsidiary remains part of the parent company's consolidated tax return, the operating losses will soak up income from Google's normal profit-making activities. Not all of the money contributed to the .org will generate immediate deductions—some investments will be capitalized, and some will later generate income. But each dollar contributed to Google.org might generate, say, twenty or twenty-five cents of tax benefits to Google, versus thirty-five cents, at most, for a corporate charitable contribution. At the same time Google.org can operate free from both the income tax charitable deduction adjusted gross income limitations and the definitional constraints of § 501(c)(3).<sup>36</sup>

The Google.org model is attractive in part because the .org subsidiary can draw on the resources and expertise of the rest of the Google team. Unlike traditional nonprofits, which for tax reasons must limit profit-seeking activities, the philanthropic arm of Google can blur the lines and draw on expertise from the entire organization.

### C. *Magic Johnson*

A third example, returning to the urban context, is Johnson Development Corporation.<sup>37</sup> The corporation and its founder, Earvin "Magic" Johnson, have succeeded in bringing retail centers and entertainment complexes to underserved urban markets, largely by forging partnerships with traditional for-profit corporations like Washington Mutual, Starbucks, and TGI Fridays.<sup>38</sup> The success of these various arrangements highlights the discipline and accountability of for-profit ventures.<sup>39</sup>

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36. See Miranda Perry Fleischer, *Why Limit Charity?* (Univ. Ill. Law & Econ., Research Paper No. LE07-020, 2007), available at <http://ssrn.com/abstract=993541>.

37. Johnson Dev. Corp., *Our Mission*, <http://www.johnsondevelopmentcorp.com/main.html> (last visited Apr. 9, 2007).

38. See *id.*

39. *Id.*; see also Johnson Dev. Corp., *Magic Johnson Theaters*, <http://www.johnsondevelopmentcorp.com/theaters/index.html> (last visited Oct. 11, 2007) [hereinafter *Magic Johnson Theaters*].

But I would be surprised if profit was Mr. Johnson's sole or even primary motivation when he first partnered with Sony Entertainment to build the Magic Johnson Theaters back in 1994.<sup>40</sup> At the time, there was significant uncertainty about whether the business model would work. Mr. Johnson was not just a founder and capital provider, but also an intermediary who could bridge the gap between the other capital providers and the urban community that the businesses served. I suspect that Mr. Johnson, like many successful entrepreneurs, was looking to give something back to the community, and the for-profit model has made that gift more successful than a straight donation would have been. For-profit philanthropy is the gift that keeps on giving.

#### CONCLUSION

Urban entrepreneurs operate under conditions of great uncertainty that make it difficult to raise money from traditional sources. Unlike technology entrepreneurs, who also operate under conditions of great uncertainty, urban entrepreneurs often cannot court venture capital with the dreams of disrupting entire product markets. Relying on friends and family, traditional nonprofits, and tax credits have proved insufficient to bridge the entire funding gap. For-profit philanthropy presents an exciting new model to create some of the most exciting urban ventures of the twenty-first century.

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40. Magic Johnson Theaters, *supra* note 39.