

Creative Capitalism

a conversation

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The missing middle

What would the cross between a charity and a corporation look like?

By Loretta Michaels

The debate around development, and especially aid versus investment, tends to assume that this world is divided into two camps, the non-profit, charitable sector with its focus on “good” causes, and the for-profit, free market-driven world of business with its focus on, well, profits. Firmly supporting this bipolar division are the many rules and regulations governing what foundations, private investors, pension and endowment funds, and other pools of funds may do with their money. As a result charities are scrambling for limited funds, while there are vast pools of market-driven wealth that may be interested in socially responsible investments but are prohibited from doing so because the return on that investment is inadequate. And sitting in the middle are lots of worthy causes that are capable of being self-sufficient; they just don’t offer enough of a return to attract for-profit investors, particularly in their early days.

A new Vermont law, signed April 30 by Governor Jim Douglas, seeks to address this issue by creating what is essentially a charity hybrid, a tax-exempt entity that is able to attract and generate private capital for its initiatives. The low-profit, limited liability corporation, or an L3C, seeks to combine the features of a limited liability company, or LLC, with the socially beneficial aspects of a non-profit. The law is a result of three years of effort on the part of the Mary Elizabeth & Gordon B. Mannweiler Foundation, in conjunction with Americans for Community Development, whose goal was to create a way to make charities self-sufficient, rather than having to rely on donated funds alone to stay afloat.

A key element of the L3C is the Program Related Investment (PRI), an IRS sanctioned investment made by foundations in for-profit business ventures to support charitable activities. While such investments are allowed to generate income and appreciation, such growth cannot be the intended outcome. So the foundation can invest funds in a charitable venture, and have those funds count as a grant for tax purposes, in areas that would not normally be acceptable for the main endowment of a foundation. The criteria for qualifying as a PRI are spelled out in Section 4944c of the tax code, but basically say that the investment must further a charitable purpose and involve no lobbying or political campaigning, it must further the foundation’s exempt purposes, not have income or property appreciation as a main purpose, and be such that a foundation would not normally invest there because the risk/return profile would likely be classified as a jeopardizing investment. PRIs haven’t been used more widely to date, at least for socially beneficial purposes, because there hasn’t been a clearly defined vehicle for receiving PRIs. Absent such a vehicle or uniformity of process, foundations that wanted to make a PRI have had to seek IRS guidance in the form of Private Letter Rulings, which can take months or years to attain and cost thousands of dollars.

In terms of structure, the L3C is a variant form of a limited liability company, organized under state law, that already complies with IRS regulations regarding PRIs, so there is no need to seek out IRS private letter rulings or other such assurances. The L3C standardizes PRI investments, streamlining the process for large foundations as well as allowing for smaller foundations and investors to become part of a PRI without having to invest time and money they don’t have.

What this all means in practice is that a private organization operating as an L3C can seek out investments from several types of investors, and allocate risk and reward according to the specific investor, with foundations assuming higher risk and lower rates of return. As a result, private capital could invest in separate layers, or tranches, of funding that guarantee market rates of return, thus opening the door to vast amounts of money, such as pension funds, which are currently

unavailable for socially beneficial purposes. And of course there can also be middle, or mezzanine, tranches for investors willing to invest at lower rates of return for philanthropic reasons, for example a bank wishing to fulfill its community reinvestment requirements.

The types of endeavors that would be attracted to an L3C structure would include low-income housing projects, rural development initiatives, and environmental projects, where there's an interest in serving the local community but also a need for additional private capital to make it work. A foundation could invest in an ownership stake that delivers a very low or no rate of return, while allowing its ownership interest to be subordinate to the other investors, who would receive market rates of return. A good example demonstrating the concept is cited on the Americans for Community Development website [describing](#) the L3C:

- The Mannweiler Foundation has been approached by one group seeking to convert an existing food bank food-processing facility into one that would also process and pack locally grown produce for a high-end retail line, the profits from which could help pay food bank operating expenses. Combined with other unique aspects of the program the L3C that would be formed would have the state, the food bank, one or more foundations, and outside investors as members of the LLC.

The potential for the L3C is enormous, and the law is generating a great deal of interest across the country. The ability to bring together foundations, private investors, non-profits and for-profit entities, all with their different risk requirements, to achieve common goals will pave the way for many worthy causes that would otherwise languish. Instead of endlessly debating whether government, charity or industry should be solving a particular problem, interested parties and stakeholders can design solutions that meet everyone's needs.

Loretta Michaels is a partner and co-founder of HMS Wireless, a consulting firm that works with network operators and service providers, equipment vendors, financial institutions, development agencies, and local and regional authorities to provide low-cost communications services and mobile applications in emerging markets, with a particular focus on the unique opportunities available in underserved rural areas. HMS Wireless intends to incorporate as an L3C in the coming weeks.

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