The L3C – Facilitating Socially Beneficial Investing

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In April 2008, Vermont became the first state in the U.S. to enact a law enabling the formation of Low-Profit Limited Liability Companies. Also known by the abbreviation "L3C," this new kind of business entity is designed to give socially oriented businesses greater access to capital.

An L3C is a for-profit limited liability company that is organized primarily to pursue some social or charitable purpose. It is taxed like any other for-profit entity, but it has an important advantage over other for-profit entities: It can accept program-related investments from private foundations.

An example will help illustrate how the L3C organization structure might be used. ReCycle North is a Burlington-based 501(c)(3) non-profit corporation that reuses household waste, construction materials and household goods. It provides individuals in transition with job and life skills training, and it makes available household furnishings and building materials to individuals and families in need. Some of its operations generate revenue, and some of its operations need on-going funding. ReCycle North is evaluating whether it can expand its operations into the Montpelier area by forming an L3C to purchase a facility that would be renovated and used as its base on operations in Montpelier. Such an expansion would both increase its revenue-generating operations and help achieve its mission. The L3C would be a subsidiary of ReCycle North, would use a combination of foundation funding and, possibly, for-profit investment to fund the purchase of the facility and its fit-up. The L3C would then lease the facility to ReCycle North at below market rent.

The ReCycle North example illustrates how a revenue-generating part of a non-profit's operations can be used to expand the scope of its operations. This example has the key elements of a successful L3C: a charitable mission that takes precedence over maximization of profit, revenue from operations, a financial model that contemplates funding from foundations and others, and an entity that has owners with an economic stake in the enterprise (in contrast to a non-profit whose members do not have an economic stake).

Program-Related Investing

At the core of the L3C lies the concept of program-related investment ("PRI") by private foundations. Generally speaking, private foundations are required under tax law to make grants to charitable programs of at least 5 percent of the foundation's net assets. These grants are typically charitable contributions with "no strings attached" and offer little in the way of oversight by the foundation. As an alternative to a pure grant, tax regulations allow private foundations to satisfy the 5 percent requirement by making program-related investments.

Stated briefly, a program-related investment is one in which: (a) the company receiving the investment significantly furthers one or more charitable or educational purposes, (b) no significant purpose of the company is the production of income or the appreciation of property, and (c) no significant purpose of the company is to accomplish one or more political or legislative purposes.

Historically, program-related investments have been primarily in the form of low interest loans to non-profit corporations – typically in the range of 1 to 3 percent per annum. While the IRS has issued private letter rulings stating that equity investments in socially beneficial for-profit corporations can qualify as PRIs, there is an inherent inconsistency between the duties of officers and directors of a for-profit entity to maximize shareholder value and the IRS regulations providing that recipients of program-related investment must not have as a "significant purpose" the production of income or the appreciation of property.

<u>The L3C Act</u>

The concept of the L3C was developed, in part, as a solution to the clash between the duties and responsibilities of officers and directors of a for-profit entity, and the PRI regulations. Additionally, this concept brings greater visibility to the benefits of program-related investment.

An L3C is a limited liability company organized under the laws of the State of Vermont that meets the following criteria (upon formation and continuously during the life of the organization):

> (A) The company significantly furthers the accomplishment of one or more charitable or educational purposes, and would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
>
> (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that the company produces significant income or capital appreciation is not, in the absence of other factors, conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
>
> (C) The company is not organized to accomplish one or more political or legislative purposes.

The language of the L3C Act comes directly out of the U.S. Treasury regulations relating to program-related investments. And, while an L3C does not have any special tax status under the Internal Revenue Code or regulations, it eliminates the conflicting duties that were present in for-profit entities and signals to prospective charitable investors that the purposes for which the L3C were formed are consistent with the PRI regulations.

<u>Advantages to Private Foundations</u>

Private foundations are constantly looking for ways to maximize the value of their contributions. They are less concerned about return on investment than with the accomplishment of the social and charitable programs they are funding. The L3C is a compelling model because the foundation's contribution is likely to be part of a broader financing strategy designed to build and expand the L3C's social mission. Recipients of program-related investments will be operating with a secondary purpose of generating income to repay debt and/or a return for investors. This is likely to lead to more business-minded management, and, ultimately, an organization that is financially self-sustaining.

Another significant difference between a charitable gift and an investment in an L3C (in the form of a low interest loan or equity investment), is that, in the latter case, the foundation's loan or equity investment creates an on-going relationship with the charitable organization. A foundation seeking some measure of influence over the activities of the charitable organization would be able to exercise such influence in a variety of ways, including having a representative on the board, providing periodic input on the organization's operating plan, and/or retaining approval rights with respect to certain activities that are outside the normal course of the organization's operations.

Strategies for Using L3Cs

While there are a wide variety of ways in which the L3C structure could be used, at a very high level, I anticipate that we will see L3Cs used in the following ways: (i) newly created L3Cs, (ii) existing taxable non-profits and for-profit entities converting to L3Cs by merger, (iii) L3Cs being created as spin-offs of a portion of the operations of existing tax exempt non-profits, and (iv) the formation of social or charitable-focused investment funds.

A. Newly Created L3Cs

It is likely that many organizations will form L3Cs as new projects are developed or operations of an existing charitable organization are expanded. An example of this might be the creation of an L3C by an affordable housing development company for a new affordable housing project. In this industry, project companies are already a common means of holding and funding a discrete project. Another example might be a tax-exempt charitable organization that wants to expand by adding a new operation that is wishes to fund with program-related investment.

B. Conversion to L3C

While probably less common, we may see taxable non-profits and for-profit entities converting to L3Cs because (i) they are only marginally profitable and (ii) they believe they can attract more capital through the L3C model than a for-profit model. Such a conversion would be accomplished by merging the existing entity into a Vermont L3C.

C. Spin Offs

The third model – the spin off – is likely to be used widely by existing tax-exempt organizations that do not want to lose the stream of contributions from their existing donors, but have identified a revenue-generating part of their operations that could be expanded, and potentially become profitable, with additional investment capital. An example of this might be a recycling company that believes that it could generate substantial revenue from the sale of recycled metals – copper, bronze – if it had the resources to expand its collection and sales efforts. The non-profit entity would transfer the assets relating to the recycled metals part of the operation into an L3C that is formed as a subsidiary of the non-profit. This structure would enable the L3C to explore a variety of capital structures to attract capital from private foundations in order to expand the mission of the non-profit with PRI funding.

D. Socially Oriented Investment Fund

We will also see L3Cs organized as investment funds created for the purpose of making program-related investments. Such funds would be managed in a way that satisfies the mission objectives of its fund participants and satisfies the criteria for program-related investment. These funds would be created as L3Cs. Fund investors would be members of the L3C with membership interests similar to any other limited liability company. As such, they would have limited liability and pass-through tax treatment. Such funds would take the members' pooled investment capital and make below-market interest rate loans and/or equity investments in companies falling within the mission of the fund participants. The L3C would, in all other respects, function like an ordinary private equity fund. It would add a measure of convenience to managers of foundations who do not want to evaluate and monitor individual PRI alternatives on a company-by-company basis. A socially-oriented L3C venture investment fund would serve the very useful function of creating a pool of PRI capital to be deployed for the benefit of important social and charitable causes.

Leveraging Foundation Investment

Perhaps the most compelling case for the use of L3Cs lies in the prospect that private foundation funding will help attract angel and venture capital investment, and even bank loans, on market terms. Used in this way, foundation investment is not simply applied to operating expenses. Instead, foundation investment helps create an equity cushion enabling the L3C to bring in additional capital from more conventional lending and equity sources. In such instances, the foundation investment could be in the form of a subordinated loan or junior equity investment. Commercial lenders or venture investors would then come in on market terms. There are many possible capital structures that could be devised to accommodate differing levels of risk and differing levels of expected financial return.

The kind of outside capital that would be attracted to a low-profit company would in part be a function of the industry and possible exit scenarios. For example, a company doing R&D on a groundbreaking drug would be a candidate for venture investment – by virtue of the possibility of a significant liquidity event in the future. By contrast, a low-profit company in the recycling industry would more likely be a candidate for a below-market-rate loan from a foundation which is used to leverage commercial bank debt – because its revenue stream is likely to be from operations, not from a future sale of the entity.

Conclusion

The advent of the L3C holds the promise that we will see more investment capital flowing to charitable organizations that are able to offer a "double bottom line" – a social benefit and a financial return. Private foundations and donor-advised funds will be most interested in investing in companies that are well managed, effectively advance their social mission, and have thoughtful financial plans for leveraging foundation capital. The companies that are able to create this kind of leverage will be giving private foundations the kind of long-term return they want to see – the possibility of some financial return, but, more importantly, long-term social benefits that will result from the organization's expanded operations and greater financial self-sufficiency.

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