The L^{3}C

the for profit with a nonprofit soul

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The L^{3}C is a project of

The Mary Elizabeth & Gordon B.

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The following represents some thoughts regarding the concept of The L^3C. They are by no means complete or final. The parties receiving copies are asked to respond with their ideas and comments. It is asked that this proposal be kept confidential among the parties who receive copies of this proposal.

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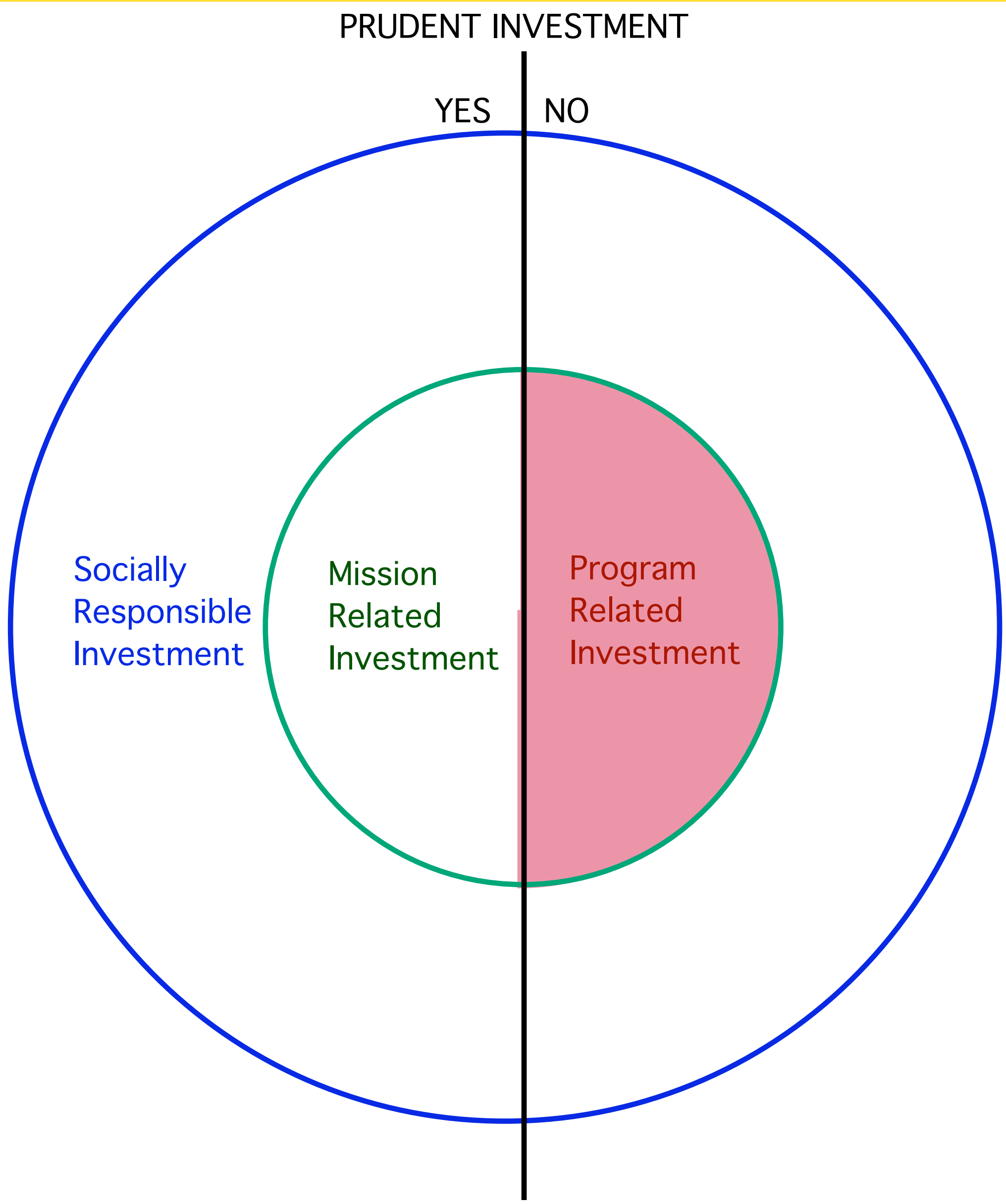

Are US foundations anything other than closed end investment trusts that must spend their surplus on social causes? Of course, they receive tax benefits in exchange for serving the public good through grants they make or the programs they fund. In the US, most are required by law to distribute or spend an amount equal to 5% of their total assets each year.

However, the US has one exception to the grant rule. According to IRS regulations US Foundations may make an investment instead of a grant if that investment has socially beneficial purposes in keeping with the mission of the foundation and if the risk/reward ratio is such that it would normally not be considered a prudent investment. This type of investment is known as a PRI or Program Related Investment

To understand this better we might relook at SRIs, MRIs and PRIs. Think of the entire set of Socially Responsible Investments as a circle with a vertical line cutting it in half. All investments to

the left of the line we would consider prudent, those to the right will not meet the standards for prudent investment even if they are socially relevant. Now let us place a smaller concentric circle within our circle of Socially Responsible Investments and call it Mission Related investments. I think we will all agree that by definition all our Mission Related investments are also socially relevant. Once again some of our MRIs do not meet the standards for prudent investing and therefore we cannot make them. But because of that little quirk in US law, foundations in the US can make an investment in the portion of the MRI circle considered imprudent and it is called a PRI.

As a result US foundations actually have an existing incentive, and have since the late 1960s, to make Mission Related Investments that are not prudent. The incentive is that they are required to expend a portion of their assets every year on either grants or PRIs. If they spend it on PRIs there is a good chance that they will not lose the money in the same way they would if they gave it away.

So why do 95% of the US foundations never make PRIs? There is one flaw. There was always someone who asked if a particular situation exactly matched the laws and regulations of the IRS. The IRS has a mechanism for evaluating whether or not something will comply with its regulations. It is called a private letter ruling. For any specific instance the IRS will decide in advance whether or not a particular situation as proposed will meet its criteria. But it costs a lot in legal fees ($25,000–$50,000) and the IRS has a fee (currently $8,700). And it can take 6 – 18 months to get a ruling that is only good for that one instance.

But private letter rulings are not required under the law. A nonprofit may go right ahead and engage in a PRI without a ruling if it feels it is complying with the law. The problem is that since everyone involved is in essence a fiduciary there is no gain in their sticking their necks out so they ask the opinion of legal counsel. Why should the legal counsel stick their necks out? So they often recommend a private letter ruling.

Another problem is organization. In every state the laws regarding business entities have tended to require shareholder interest to be the primary objective. This obviously runs opposite to the concept of a low profit enterprise.

The good news: By incorporating PRIs into a prevalent vehicle, the limited liability company, we can drastically reduce their startup costs and jump-start their use— thereby compounding the social good. We call our social changemaker a "low profit limited liability company," or L^3C. The rationale for forming an L^3C is to perform one or more social missions at the lowest cost possible with the most efficiency, and maximum leverage—and with as much revenue as possible being used to further the social good.

The L^3C is in the process of being written into law. It is pending in both houses of the North Carolina legislature and other states have expressed interest. Under the US system of law, by virtue of a doctrine known as the Full Faith and Credit Clause, only one state out of the 50 states need pass a bill legalizing an L^3C to make it viable in the entire United States.

To grasp just how our new social catalyst works, you first must understand a few other things about PRIs. It is acceptable for these investments to generate income and to appreciate in value. That simply must not be the primary reason for making them. The tax rules regarding returns are simple: any gains must be given away or reinvested in another PRI within one year of receipt.

PRIs can also take many forms: the purchase of stock or memberships interest-free or ultra low-interest loans, low cost leases, —even loan guarantees. It's worth noting, however, that most fiduciaries, other than those running foundations, cannot make most of these investments since the motive for making them must be primarily mission-related, not financial, in order to qualify as a PRI.

That said, one motive for making PRIs is indeed financial. Foundations must re-invest their PRI returns in either grants or more PRIs. PRIs allow foundations to extend their reach by increasing the dollars they have available for philanthropic purposes.

Take a hypothetical foundation with a $100 million endowment. If it conducts business as usual, it distributes $5 million per year in the form of grants. At the end of ten years, assuming the foundation's endowment does not grow, it will have spent $50 million on social causes in the form of grants.

Contrast that with a $100 million foundation that spends 100% of its grant money in the form of PRIs. Let's say it earns an annual return of as little as 2% on PRIs, which it substitutes for grants. Again, for the sake of simplicity, assume that the endowment does not grow. In the first year, it spends $5 million; the second year, $5,100,000—and so forth. At the end of ten years, that means the foundation will have spent $54,748,605 on social causes—an increase of about 9.5 %. On top of that, the money will still be there—ready to be spent on yet more social issues.

But, when it comes to extending the impact of foundation dollars that is not the end. The final key is a concept known as layering. In fact, various foundations in partnership with New York City used such an approach to build 40,000 new affordable housing units. The foundations provided $14 million ($1 million to $5 million each) in PRIs, and the city appropriated $8 million. As a result, the project includes $200 million in bank debt which otherwise would not have been available. That's a leverage ratio of 9:1.

But that's just the beginning. After all, is there any reason that such deals, properly structured, can't also include partners like pension funds and other fiduciaries? Or smaller foundations, for that matter—especially if we institutionalize the more user-friendly L^3C? If leverage of the foundation dollar in terms of social impact is what we want, in fact, the ideal PRI or L^3C could even be equity rather than debt.

Take our project in North Carolina, where 60,000 manufacturing jobs have been lost in the last five years due to competition from China in the form of low labor costs, looser environmental and labor laws, subsidized buildings and equipment etc. For many of these workers, these jobs are 3rd or 4th generation. It's not just jobs that are disappearing, but an entire culture. And as this culture disappears, entire communities are being destroyed.

As a small foundation, we want to level the playing field so these manufacturers can survive. After the North Carolina legislature adopts the L^3C, our first order of business is to form an L^3C with which to buy a factory where we will house a furniture manufacturing plant and furnish it with the greenest and most efficient cutting edge equipment possible. As a foundation making a "social investment" in a "low profit" company that replaces a grant, our goal is not to maximize profit. Therefore we can make long-term investments like green equipment.

The cheapest way to own the building, of course, is to buy it outright. Without a mortgage to pay, the L^{3}C can charge a furniture manufacturing company lower rent and equipment lease rate. This, in turn, reduces costs for the manufacturer, which puts it in a stronger position to compete —and thrive. The social benefit is saving jobs and a culture and promoting community economic development.

We estimate that it will be possible to lease the building and its equipment to the manufacturer at a low rate: about 2%, plus a 1% management fee. But there's no reason the return from the lease can't be split among different tranches of investors: 1%, or less, say, for foundations who treat this PRI in an L^{3}C as a grant by putting up, say, 20% of the total $10 million cost. And 5% for fiduciaries who must match market returns when making such investments. (The endowment side of a particular foundation could co-invest as a fiduciary.)

Is it really appropriate to use foundation dollars to make such high risk investments? The answer is: Does it really matter if the foundation loses money on an L^{3}C or PRI? Remember, these investments are intended as substitutes for grants, which foundations are required by law to distribute anyway. Think about it this way. When a foundation makes a grant, it loses the money forever.

In fact, the purpose of an "investment" in an L^{3}C (or any other PRI, for that matter) is not the profit on that particular tranche. The purpose is social impact. But the best way to compound the social impact is to use these marvelous tools as the anchor in a broader deal that, due to its participation, can attract partners with bigger firepower. In their most effective form, these tools are social catalyzers.

Is this program applicable world wide? As long as local regulations permit investment in place of grants why not? Call it by another name if you want but is there any reason a foundation cannot form the same structure elsewhere for the purpose of tranching investment?


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