Social Entrepreneurs Use Low-profit Limited Liability Company (L^3C) To Implementing University Research

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ABSTRACT. This paper describes the exploration of a new business entity, the Low-profit Limited Liability Company (L^3C), for use with university intellectual property. Many states and Indian tribes have joined Vermont in embracing this new business entity. The L^3C is considered a hybrid business entity that bridges the gap between nonprofit and for-profit organizations. The new business classification complies with the tax code and offers foundations an easier way to invest using program-related investments. Operating the L^3C provides protections and flexible ownership with the option of receiving foundation investments at a low rate of return in the first risk tranche (layer). Universities are investigating the opportunity to use the L^3C for early stage university intellectual property often considered too risky for commercial investors but have high social value. Thus, the L^3C may be very well suited for early stage research.

RÉSUMÉ. Cet article décrit l'étude de la possibilité d'utiliser un nouveau type d'entreprise, la L^3C, pour *low-profit limited liablility company* (entreprise à faibles profits et responsabilité limitée) pour les propriétés intellectuelles universitaires. Plusieurs États américains et tribus indiennes se sont joints au Vermont en adoptant ce nouveau type d'entreprise. La L^3C est un modèle d'entreprise hybride qui fait le pont entre les entreprises à but lucratif et celles à but non lucratif. Cette nouvelle classification d'entreprises est conforme au code fiscal et offre aux fondations une façon plus simple d'investir sous la forme d'investissements liés aux programmes. L'exploitation d'une L^3C offre des protections et une structure flexible de propriété ainsi que l'option de recevoir des investissements des fondations avec un faible taux de rendement dans la première tranche de risque. Les universités étudient la possibilité de faire appel au modèle L^3C en ce qui a trait aux recherches préliminaires pour les propriétés intellectuelles universitaires. Celles-ci sont souvent considérées comme étant trop risquées pour les investisseurs privés, mais sont hautement valorisées sur le plan social. Donc, les L^3C pourraient bien être tout indiqués pour ces recherches préliminaires.

Introduction

Bruce Alberts, Editor-in-Chief of *Science* (April 2008) noted, "…Developing a sound platform of knowledge to address such critical [societal] issues will require harnessing research of the highest quality, both in the natural and social sciences. And for this research to be effective, scientists will need to develop much deeper connections with the rest of society."[1] These are the words that reflect the spirit of social entrepreneurship. Social entrepreneurs combine the tools, expertise, enthusiasm, dedication and energy, and then

1 Purdue University, *New Synergies* – Strategic Plan 2008-2014. Goals: Launching Tomorrow's Leaders, Discovery With Delivery, Meeting Global Challenges

mix them together in an effort to improve society, especially for those individuals who are marginalized and poor.

New Synergies, the concept of connections, is the focus of Purdue University's new seven-year strategic plan (Purdue University Board of Trustees, 2008). The vision is to "set the pace for new interdisciplinary synergies that serve citizens worldwide with profound scientific, technological, social, and humanitarian impact on advancing societal prosperity and quality of life." This concept is not new to the Social Entrepreneurship Initiative (SEI) at Purdue. Over the years, SEI has expanded to engage students, faculty and staff from many disciplines, universities and countries to explore the potential for commercialization of projects with high social benefits. Building and collaborating with established programs across the universities, SEI has been able to create new venues and opportunities for social entrepreneurship, with the aim of product implementation. The successful adoption of the L^{3}C in the states of Vermont, Utah, Michigan, Wyoming and Illinois, along with the Crow and Oglala Sioux Indian Tribes, may prove to be a good option for some university research that has great social potential but carries high risk or low economic return. SEI's challenge is to explore the opportunities that the L^{3}C may provide and embrace the potential as the next adventure on the road to mission-driven product implementation.

Universities around the country are researching the L^{3}C as an opportunity to address issues in these tough economic times.

Nik Rokop, Managing Director, Illinois Institute of Technology–Knapp Entrepreneurship Center, Chicago, IL, believes, "The L^{3}C structure provided our group [Urban Wood Exchange] with the opportunity to develop a business case and target constituents that support social entrepreneurship. There is great interest in this format as an alternative to traditional non-profit as a way to effect change."[2]

Tom Mason, Professor of Economics and Director-M.S. in Engineering Management Program at Rose-Hulman Institute of Technology, Terre Haute, IN, notes: "The L^{3}C form of business is a policy innovation that is right for the realities of our 21st century economy. It is a fiction to say that economic activity is neatly divided into profit and non-profit ventures. Innovation is critical to our economic growth, and the L^{3}C extends the availability of investment in innovative ideas to a whole new sector of important contributors to our economic and social well-being. The L^{3}C form can lead to growing low-profit enterprises that will both do good and provide jobs that are valuable in all sense of the word."[3]

Ed Coyle, Arbutus Chair for the Integration of Research and Education and Georgia Research Alliance Eminent Scholar, is "…researching the potential for this type of business [L^{3}C] to jump-start commercialization of ideas in his research area."[4]

Brett R. Smith, Founding Director–Center for Social Entrepreneurship at Miami University says, "The L^{3}C represents an important contribution to the field of social entrepreneurship. It offers socially focused organizations an opportunity to align their organizational form and their organizational mission while providing credibility to a range of stakeholders."[5]

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2 Illinois Institute of Technology – Knapp Entrepreneurship Center www.knappcenter.iit.edu

3 Rose-Hulman University and Rose-Hulman Ventures, http://www.rhventures.org/about.htm

4 Georgia Institute of Technology- Center for the Integration of Research and Education http://www.cdee.gatech.edu/

5 Miami of Ohio University, http://www.fsb.muohio.edu/centers/social-entrepreneurship

RickWartzman, Executive Director-The Drucker Institute at the Claremont Graduate University believes, "The L^3C is a powerful paradigm because it recognizes on its face that human beings aren't one-dimensional. As Peter Drucker wrote and as Muhammad Yunus has expressed so eloquently, there is something artificial about structures that force us to stick all 'commercial activity' in one box and 'social good' in another. By combining the effectiveness of the marketplace with explicit social aims, the L^3C is much truer to the way most people think and act."[6]

Background

The Social Entrepreneurship Initiative at Purdue University is a multidisciplinary program that provides students and faculty information on the merits of social entrepreneurship and social enterprise. The program offers mentorship and venues for student projects by researching the possibility of commercialization. Team projects must address social problems such as the environment, assistive technologies for individuals with disabilities, education, and health. The student teams form alliances with third-sector organizations, such as non-profit and non-governmental organizations (NGOs). Drucker (1991) describes the third sector as the counterculture of the American knowledge society. By building these alliances, students are provided the opportunity to think critically when identifying specific problems which can result in alternative solutions for their partner's problems.

The Social Entrepreneurship Initiative currently provides tailored mentoring in a two-tiered process. The students are first offered the opportunity to participate in the Purdue Idea-to-Product®[7] Competition for Social Entrepreneurship. Typically held in March, this competition is held exclusively for Purdue students. Prior to the event, SEI offers workshops, lectures, and tutorials to help students meet the criteria established for the competition. Individuals with specific expertise share tips and techniques such as John Calvert, administrator of the Inventor Assistance Program for the U.S. Patent and Trademark Office, gives an overview for searching the USPTO patent website (Calvert, 2007). The Purdue University libraries' faculty provides students helpful hints for researching market information using various business databases. They also offer a hands-on workshop for creating effective presentations. Patent Attorney, Brion St.Amour, gives an annual patent law lecture (and serves as one of the judges for the competition). Hollister Inc (www.hollister.com), our corporate sponsor, provides monetary support for the competition at the national level. SEI also offers individual student support and mock competitions, giving students feedback on their presentations. The top Purdue team then moves on to the National Idea-to-Product® Competition for Social Entrepreneurship[8], where they compete with other social entrepreneurship student teams from across the country for cash awards. The ultimate goal is to build on each tier in an attempt to move the product towards implementation, while educating the next generation of social entrepreneurs.

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6 The Drucker Institute at Claremont Graduate University is a think tank and action tank whose purpose is to stimulate effective management and ethical leadership across all sectors of society. It does this, in large part, by advancing the ideas and ideals of Peter F. Drucker, the father of modern management. www.druckerinstitute.com

7 Idea-to-Product® and the I2P™ are registered trademarks of the University of Texas at Austin.

8 The National Idea-to-Product Competition for Social Entrepreneurship is organized each year by the Social Entrepreneurship Initiative at Purdue, but the event takes place at different universities. Purdue hosted in 2009, Georgia Tech in 2008, Princeton in 2007, San Jose State University in 2006, and Purdue in 2005.

The process of commercialization is the second tier of services provided by SEI. We believe that commercialization is the most efficient means to move products to the end users. The "process" for delivering products created for not-for-profit organizations is not much different than for for-profit organizations, except in the mission and the management structure of the organization. Once the students have participated in the Idea-to-Product Competition for Social Entrepreneurship, SEI encourages the Purdue teams to move on to a business plan competition using the I2P experience as the framework. SEI also begins to mentor the teams on intellectual property (IP) protection for their projects. This is critical because the competition represents "first public disclosure" and thus starts the one-year clock for patent protection. Ownership of the IP for the Purdue projects depends on the funding mechanism used for the research. The IP may be owned by the university or considered to be the team members' personal property. SEI helps identify ownership and mentors the teams through the disclosure process. SEI works closely with the Purdue Office of Technology Commercialization and has negotiated a unique licensing agreement for products created by students enrolled in the EPICS[9] program. EPICS is a for-credit class where student teams combine engineering practices with service-learning and community partnerships.

The L^{3}C

The L^{3}C has been described as a hybrid form of business that is run as a for-profit company and may be financed in part by Program-Related Investments (PRIs) from private foundations. It is merely a variation of the Limited Liability Company (LLC) that has been adopted by every state. The L^{3}C provides an opportunity to attract PRI funds that can then be leveraged to secure additional loans or private investments. By design, this business option allows ventures to be established with low economic returns but high social benefits.

The L^{3}C was created by Robert M. Lang Jr., CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation (with many years of corporate and nonprofit management experience), and carefully refined with the assistance of: Marcus Owens, a partner in Caplin & Drysdale, the preeminent Washington DC tax law firm (former director of the exempt division of the IRS for 10 years); Arthur Wood, the Director of Social Financial Services for Ashoka (over 20 years of financial experience at upper level management positions with leading UK financial institutions); and other individuals and organizations.

On April 30, 2008, Vermont became the first state to adopt the L^{3}C. The Legislature passed bill H.775 that "provide[d] for the organization of the low-profit limited liability companies under Vermont's corporate code." The State of Vermont (Vermont Legislation, 2008) added additional language to their Sec.1.11V.S.A § 3001 (23) and referenced compliance to the Internal Revenue code of 1986, 26 U.S.C. § 170(c)(2)(B) The states

9 EPICS stands for Engineering Projects In Community Service. It was created over 10 years ago at Purdue. The EPICS program has spread internationally to more than 18 universities and has spun-off a high school program.

of Illinois[10], Michigan[11], Wyoming[12], Utah[13], the Crow Indian Nation, and the Oglala Sioux Tribe. Other states interested in similar pending legislation include Maine,[14] North Carolina,[15] New York, Montana, Georgia, Oregon, N. Dakota, Ohio, Kentucky, Tennessee, Arkansas, Virginia, Washington State, California, Massachusetts, Florida, Colorado, Montana, Nebraska, and Maryland. A federal bill, the PRI Promotion Act of 2009, has been proposed. It would provide for a federal registration of PRIs to facilitate their use.

Private Foundations and Program-Related Investments

The private foundation classification was established as a result of the US Tax Reform Act of 1969.[16] As part of this reform, activities relating to private foundation were identified and defined. As stated in the US Internal Revenue Code 508 § 4942, "a private foundation must make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated" (Internal Revenue Service, 1999).

Specific requirements were established for private foundations in regard to PRIs, which will replace a grant as a qualifying distribution. The US Internal Revenue Service standards are: (1) the primary purpose of the PRI is to accomplish one or more of the foundation's exempt purposes; (2) the production of income or appreciation of property is not to be the significant purpose of the investment; and (3) there should be no use of funds to influence legislation or benefit political campaigns from the investment. They must also be investments that would not have been made otherwise except for their relationship to the exempt purposes, in other words, high risk, low return or both. Programs will not be considered in violation of PRIs if income is produced in the course of meeting the mission as long as it was not the primary purpose.[17] Private foundation's "qualifying distribution" amount is currently set at an annual minimum of approximately 5% of the fair market value of the foundation's assets.[18] This payout includes program-related investments.

At the 2007 Council on Foundation Conference (COF)), social enterprise and the options available for mission-related income were major topics. COF offered a seminar specifically addressing program-related investments titled "The Advanced Legal Seminar" (Tagaki, 2008). It featured: Lisa Johnsen of Kirkpatrick & Lockhart Preston Gates Ellis;

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10 http://www.ilga.gov/legislation/BillStatus.asp?DocNum=239&GAID=10&DocTypeID=SB&LegId=40822&SessionID=76&GA=96

11 http://www.legislature.mi.gov/(S(3onvzjut42tybdrptsf4lvfn))/mileg.aspx?page=getObject&objectName=2008-SB-1445

12 http://legisweb.state.wy.us/statutes/statutes.aspx?file=titles/Title17/T17CH15.htm

13 http://le.utah.gov/~2009/bills/sbillamd/sb0148.htm

14 http://www.mainelegislature.org/legis/bills/display_ps.asp?LD=1265&snum=124

15 http://www.ncga.state.nc.us/Sessions/2009/Bills/Senate/PDF/S308v3.pdf

16 7.26.1.1 (02-01-1999) the Tax Reform Act of 1969 introduced the classification of "private foundation" into the Internal Revenue Code and added a wide array of restrictions, requirements, taxes, and penalties affecting organizations so classified (and certain people associated with them).

17 http://www.irs.gov/charities/foundation/article/0,,id=137802.00.html

18 "Minimum investment return" is defined in IRC 4942(e) and generally means 5% of the fair market value of the foundation's assets, other than assets used (or held for use) directly in the foundation's exempt functions, less related acquisition indebtedness.

Marcus Owens of Caplin & Drysdale and former head of the Exempt Organization Division of the [US] IRS; LaVerne Woods of Davis Wright & Tremaine and Chair of the American Bar Association Section of Taxation Exempt Organizations Committee; Janne Gallagher of the Council on Foundations; and Dan Moore of Guidestar. The experts referenced two Internal Revenue Service Private Letter Rulings (PLRs) on the subject—PLR 200620020[19] and PLR 200603031[20]—that helped clarify the use of program-related investments.

Comparing LLC and L^3C

The LLC is a type of business that identifies its investors as members. It provides the liability protection of a corporation and the flexibility of a partnership. Essentially, they start with a blank piece of paper and a pencil to create a contract amongst themselves called an “operating agreement.” The agreement replaces articles of incorporation and bylaws and specifies how the LLC will operate, thus combining the best features of a partnership and a corporation by providing the liability protection of a corporation and the flexibility of a partnership.

As a special form of LLC, the L^3C enjoys the same flexible rules that have made the LLC so successful, including:

- Flexible Ownership Rules: Ownership rights under the L^3C can be adjusted an infinite number of ways, ensuring each partner enjoys a role that fits their unique requirements.
  - Management flexibility: Members may participate or may be completely passive.
  - Ownership Flexibility: Each operating agreement can be tailored to meet each member’s own particular needs—profits, tax credits, etc. may be allocated in proportions that are different from capital contributions.
- Pass-Through Entity: If selected, profit and loss flow through the L^3C to its members and are taxed according to each investor’s particular tax situation, making it easier for nonprofits and for-profits to partner together.
- State Based: The L^3C, just like any LLC, can be formed in any state that has adopted the law and used in any US state or territory, or wherever US LLCs are accepted.
- Like the LLC, the L^3C members create an “operating agreement.” However, the L^3C operating agreements include provisions that define and fundamentally guarantee the charitable or public benefit orientation of the enterprise.
- The L^3C is more than just a vehicle for program-related investment programs—it

19 PLR 200610020 - IRS ruled that a foundation’s proposed capital contributions to a limited liability company would qualify as a PRI because the primary purpose of such contributions was to enhance social welfare, support community improvement, eliminate prejudice and discrimination, and provide economic self-sufficiency by serving, or providing investment capital for, low-income communities, or low-income persons by making investments in, or providing technical assistance to, portfolio companies located in low-income areas and owned or controlled by members of disadvantaged populations.

20 PLR200603031- IRS ruled that a private foundation’s grants, contracts or PRIs with private industry (the “Transactions”) would constitute qualifying distributions for purposes of Section 4942(g) of the Code, and not taxable expenditures for purposes of 4945(d) (5) of the Code, where the foundation entered into the Transactions to promote or accelerate scientific research and development of solutions to prevent, eliminate, or eradicate diseases disproportionately.

leverages limited foundation dollars to access market-driven investment dollars through layered investing. It also turns the normal venture capital[21] model on its head by actually providing the highest risk money at the lowest cost, making otherwise unsustainable projects sustainable.

- The ability of the foundation to invest at less then the market rate while embracing higher risk levels lowers the risk to other investors, thus increasing their potential rate of return and improving the credit of the remaining tranches or layers.
- The L^3C is a profit-making entity with a social mission. As such, it has the ability to operate in a territory with a profit/risk profile that would scare off normal investors.

Financing Advantages

Investors. For many firms and individuals, investing in the other layers or tranches, an L^3C is attractive because it carries a reasonable level of risk and a moderate return. Because of the social benefits, investors may be willing to trade some income and security for philanthropic satisfaction. These socially motivated investors can also assume different levels of ownership. The L^3C's flexible ownership structure allows for any number of ownership combinations.

Foundations. The L^3C provides foundations several advantages. It can guarantee that the endeavor is a PRI-qualifying investment. These PRI funds then can be used as leverage to attract additional capital and new partners with the expertise to make the investment work. It also provides the potential for the foundation to retain its investment while meeting the mission, plus offers the potential to enjoy capital gains and have a say in the management of the L^3C.

For-profit Investors. The L^3C can also offer investors a venue to explore socially motivated investments at a market-based risk and return. For-profit investors are able to structure the membership levels to reflect their priorities and participate as much or as little as they wish.

Governance

The L^3C is designed to operate as a private company, which helps to make the business self-regulating. Managers of the L^3C enjoy the freedom and flexibility of a for-profit enterprise with marching orders that ensure they maintain their nonprofit souls. The L^3C provides governing flexibility and gives the company the option to choose the best management structure, which ensures compliance with the goals set out by its founders and the "operating agreement."

The parties involved in the L^3C are encouraged to act in a manner that is consistent with nonprofit law. This ensures a level of transparency and creates an environment of trust. The L^3C can draw on the for-profit business strengths to help measure the effectiveness and impact created by the social purpose organization.

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21 Venture capital - money and resources made available to startup firms and small businesses with exceptional growth potential. Most venture capital money comes from an organized group of wealthy investors. (*oakridgefinancialgroup.com)*

Iconic Entrepreneurship

Transformational Innovation, Iconic Branding & Holitic Sustainability is a novel process for designing transformational social enterprises. Udaiyan Jatar, founder of the Blue Earth Network, created this novel process after years of new product development experience at companies like Coca-Cola and P&G. The basis of the process is an analysis of success factors behind the world's most iconic brands (Coca-Cola, Nike, Apple, Starbucks, Gatorade, Red Bull, etc.). An important factor behind these great brands is that rather than being created by large corporations, all of them were created by small entrepreneurs who came from outside the industries they transformed. Udaiyan has distilled six key success principles that were common to the creation, incubation and transformational success of all these iconic brands. One of the critical factors is the patience with which a lot of these brands were incubated—a luxury not afforded by the modern investment culture, which seeks disproportionately high and quick returns, and is focused on an "exit strategy" rather than long-term "value creation."

Udaiyan Jatar and Robert Lang Jr. are collaborating to develop Transformational Social Enterprises using Blue Earth Network's "Iconic Entrepreneurship" innovation process under the L^3C legal structure and funding model. The L^3C model is ideal, not just because of its social objectives, but because its inherently patient capital is exactly what is needed to replicate the transformational nature of truly iconic brands. And thus, the combination of the innovation process and the L^3C structure is being used to design several scalable and transformational social enterprises.

Current Projects

There are many L^3Cs that have already been or are being established that cover a wide variety of ventures, including:

- **MOO Milk**, an organic milk distribution company created in Maine to help small organic dairy farms.
- **SEEDR L^3C**, a company to manufacture unique containers for vaccines and medicines shipped to remote areas.
- **YouPharma**, an L^3C fund to enable new ideas in biotech and medical research to be brought to proof-of-concept stage.
- **Endless Sky**, a food processing company managed by the Montana Food Bank Network.
- **Home Town Farms L^3C**, an urban, indoor, organic farm to be built in several cities.
- A mortgage company to rewrite mortgages in default for the poor.
- Several PRI funds for economic development.
- Several newspapers.
- Several L^3Cs to facilitate the development of alternative energy programs.
- Use of biomass processing to generate energy and eliminate waste.

Conclusion

The L^3C looks appealing to depressed areas that have experienced significant job loss. It can help create a variety of social enterprises that can be self-sustaining: medical research, alternative energy, improving the quality and supply of food, housing for low income individuals and the elderly, and other socially focused projects. The PRI funds from private foundations will be leveraged to lower the investment risk costs, thus making outside investment more appealing. The end result will be self-sustaining ventures that are taxpayers.

Social entrepreneurs know that lack of funding can be fatal for their programs. Globally, social entrepreneurship projects often utilize less sophisticated technologies that work best in remote areas where modern conveniences are scarce or nonexistent. Mature technologies hold no intellectual property protection, and thus offer little incentive for investment from the for-profit sector. Customers with limited resources and minimum scalability reduce the potential for high yield returns. Social entrepreneurship programs can utilize the L^3C status and leverage the PRI funding as incentives for projects such as:

- Pennsylvania State University's *Sustainable Windmill Energy*;
- Illinois Institute of Technology's *Clear Agua* (water purification device);
- University of Sheffield's *Developing the Ramirez Neighborhood through Waste Recycling*; and
- Kettering University's *Portable Incubator Kit*.[22]

The L^3C partnership may prove to be very beneficial working with organizations like *Cytometry for Life* (C4L), a non-profit organization created as a spin-off of university research. C4L has created a portable CD4[23] testing unit that can be used in remote areas of the world such as sub-Saharan Africa.[24] Assistive technologies for individuals with disabilities could benefit by using the L^3C as a mechanism to create small manufacturing and distribution companies that specialize in small niche markets here in the United States.

Universities may also see the L^3C as an opportunity to further develop research projects. Presently, much of the research done at universities gain initial funding from government grant-making organizations such as the National Science Foundation or the National Institute of Health. Although the research may have a market, barriers to entry can be enormous due to the high cost of refining and developing an actual product. The L^3C could offer an incubator approach that would nurture the development of this raw research into viable products. If successful, licensing the refined intellectual property might provide significant payback to the PRI. If these projects result in loss to the foundation, that too is acceptable, because the foundation made the program- related investment in lieu of a *grant*, which offered no possibility for a return.

The Social Entrepreneurship Initiative sees the L^3C as a new opportunity to move towards the third tier of the program, that of product implementation through commercialization. It is especially beneficial when used for those products in which the market would not produce enough income to attract commercial investment, or have limited niche markets that show promise for high social return but low economic return on investment. As an added bonus, this partnership could have a profound effect on our global society, while meeting the mission of both the university and the foundation.

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22 Examples of university projects that have participated in the Purdue University-sponsored National Idea-to-Product® Competition for Social Entrepreneurship.

23 CD4 T Cell testing is considered the gold standard for identifying the time in which a HIV positive patient should begin treatment.

24 Cytometry for Life (C4L) placed third in the Kelleher Chair in Entrepreneurship Challenge at the 2007 Global Idea-to-Product Competition sponsored by the University of Texas at Austin.

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