LEAFFER LAW

LEADERS IN NONPROFIT LAW

# Social Enterprise and PRIs:

## Private Foundation Funding Issues and Opportunities

Becky Farr Seidel

CSU College of Business

April 25, 2013

# Agenda

1. Overview
2. Program-Related Investments (“PRIs”)
3. Hybrid Entities
4. Nonprofit/For-Profit Combinations

LEAFFER LAW

# Overview

# Overview

- **Key Investment Terms**
  - **Socially responsible investments**
    motivated by return on investment, and
    general social/ethical objectives
  - **Mission investments**
    motivated by return on investment, and
    specific link to organization's mission
  - **Program-related investments**
    motivated primarily by organization's charitable purposes,
    with no significant investment motive *(more on this later!)*

# Overview

## Socially Responsible/ Mission Investments

Social/Ethical Mission Objectives

Investment Purpose

## Program-Related Investments

Investment Purpose

Charitable Objectives

# Overview

- **Key Investor Terms**
  - **Charitable / 501(c)(3) organizations**
    - Organized and operated exclusively for charitable, educational, religious or scientific purposes, and
    - No private inurement, no political activity and no excess lobbying
  - **Public charities (subset of 501(c)(3))**
    - Public in nature (e.g., churches, schools and hospitals), or
    - Relies on substantial public support (e.g., donations or program revenues)
  - **Private foundations (subset of 501(c)(3))**
    - Relies primarily on investment income or donations from a few donors

# Overview

**Charitable Organizations**

**Public Charities**

Lots of public input
and support =
less IRS oversight

**Private Foundations**

Little public input
and support =
more IRS oversight

# Overview

- **Private Foundation Rules and Interplay with PRIs**
  - **Imprudent, risky investments are prohibited**
    - PRIs are exempt
  - **Excess holdings in a business enterprise are prohibited (> 20 percent, less the holdings of insiders)**
    - PRIs are exempt

# Overview

- **Private Foundation Rules and PRIs**
  - **Annual payout equal to 5 percent of value of investments is required**
    - PRIs count toward payout requirement, and are not included in investment value
  - **All non-charitable expenditures are prohibited**
    - PRIs are subject to "expenditure responsibility," an elevated grant underwriting and oversight process, and are subject to special reporting requirements

# Overview

- **PRIs are of significant consequence and interest to private foundations**
  - Compliance with rules
  - Avoidance of penalties
- **But also highly relevant to public charities**
  - Guidance on how to approach

# Program-Related Investments

# Program-Related Investments

- **Brief History**
  - PRIs have been recognized as appropriate investments for private foundations since 1969, when Congress enacted the private foundation rules *(discussed earlier)*
  - PRIs have not been widely used due to lack of clarity about investments permitted and potential for penalties, should an investment not qualify as a PRI
  - However, PRIs have been used since early on by more established private foundations, e.g., Ford Foundation

# Program-Related Investments

- **Renewed Focus**
  - PRIs are growing in popularity with the rise of social enterprise
  - PRIs are gaining momentum as philanthropy shifts more from traditional grant-making to more innovative approaches
  - Both investor and investee win with PRIs in a struggling economy
  - PRI purposes wide-ranging
    (housing, media, environment, child care)

# Program-Related Investments

- **Three Elements of a PRI**
  1. Investment is made primarily to further charitable purposes
  2. No significant purpose of the investment is to produce income
  3. No lobbying or political purpose for the investment

# Program-Related Investments

- **Made primarily to further charitable purposes**
  - Investment significantly furthers the accomplishment of the foundation's charitable activities; and
  - Investment would not have been made but for the relationship between the investment and the charitable activities

# Program-Related Investments

- **No significant purpose is to produce income**
  - Would private investor (motivated primarily by profit) be likely to make same investment?
  - *Note*: investment can qualify as PRI even if investment has produced (or could produce) significant income or capital appreciation, if other factors indicate absence of significant investment purpose

# Program-Related Investments

- **Past Examples Recognized by IRS**
  - Below-market loan to small business in deteriorated urban area, owned by economically disadvantaged minorities
  - Below-market loan to publicly traded, profitable company to build new factory in deteriorated neighborhood

# Program-Related Investments

- **Concerns with Past Examples**
  - **Nature of investment:**
    focus on below market loans and leases, what about
    other types?
  - **Nature of activities:**
    focus on urban blight and economically disadvantaged people,
    what about other charitable activities?

# Program-Related Investments

- **New Proposed IRS Regulations**
  - Foreign activities can be considered charitable
  - PRIs are not limited to situations involving urban blight or economically disadvantaged groups
  - PRI recipients need not be in charitable class, if they are instruments for furthering charitable purpose
  - Potentially high rate of return does not prevent PRI status
  - PRIs can be made to variety of recipients, including individuals, nonprofits and for-profit businesses

# Program-Related Investments

- **New IRS Examples**
  - **For-profit company initiates project to develop vaccine for disease that primarily affects poor in developing countries**
    - Cost and low rate of return deter private investment
    - Foundation makes equity PRI
    - Requires distribution of vaccine in developing countries at affordable price and publication of results and other information (after opportunity to secure patents)
    - Primary purpose of investment is to advance science
    - Expected rate of return is much lower than market rate for investment of similar risk

# Program-Related Investments

- **New IRS Examples**
  - **For-profit company in developing country, which produces significant recyclable solid waste, starts business that collects waste and delivers it to recycling facilities**
    - Some commercial investors with environmental concerns invest, but insufficient volume of investment to launch
    - Foundation makes equity PRI on same terms as the commercial investors (risky but potential high rate of return)
    - Primary purpose of investment is fighting pollution
    - Investment has no significant investment motive (despite potential for high return)

# Program-Related Investments

- **New IRS Examples**
  - **For profit company purchases coffee from low-income farmers in developing country**
    - Foundation makes below-market loan to induce company to provide training to the farmers on efficient water management, crop cultivation, pest management and farm management
    - Company wouldn't provide training without the loan.
    - Primary purpose of PRI is education for farmers that can improve their economic well-being
    - No significant profit motive

# Program-Related Investments

- **New IRS Examples**
  - PRI to business employing low-income individuals to enable it to operate after a natural disaster
  - PRI to low-income individuals in developing country to enable them to start small business
  - PRI to enable arts organization to finance new space
  - Deposit agreement or guarantee to finance new exempt child care facility

# Program-Related Investments

- **Why foundations are using them**
  - Help prove credit-worthiness of organization, and open up additional capital
  - Help build management expertise
  - Shift grantmaking goals and efficiency of process
  - Extend financial resources
  - As a “first step” in mission investing

# Program-Related Investments

- **Pre-award inquiry and diligence materials:**
  - PRI application/proposal: What does PRI seeker want to accomplish with funds?
  - Financial statements and budget
  - Description of attempts to obtain conventional financing
  - Credit questionnaire
  - Certified articles of incorporation or other organizing document, along with bylaws
  - Management information

# Program-Related Investments

- **Deal documents (for loan):**
  - Term sheet or commitment letter
  - Loan agreement
  - Promissory note
  - Security agreement or guarantee
  - Officer's certificate

# Program-Related Investments

- **Legal opinions:**
  - Reliance on reasoned legal opinion that investment is a PRI can protect foundation managers from penalties
  - May require valuations or fairness opinions
  - Proposed regulations may make it easier for legal counsel to arrive at stronger position (i.e., “should” comfort level)
  - IRS private letter ruling possible if certainty is required, but this is <u>very</u> expensive ($10,000 filing fee) and time-consuming

# Program-Related Investments

- **Monitoring and restructuring:**
  - Similar activity reporting as for grants
  - Additional reporting on key financial indicators, personnel, programs etc.—define upfront
  - If in trouble, consider restructuring
  - BUT remember that PRI is not a grant in disguise

# Program-Related Investments

- **Avoid common mistakes:**
  - Taking on too large a stake
  - Funding nonprofit on its last legs
  - Funding in unfamiliar field
  - Not setting red-flag warning mechanisms

# Hybrid Entities

# Hybrid Entities

- **Two types**
  1. Low-profit limited liability company (“L3C”)
  2. Benefit corporation

# Hybrid Entities

- **L3C: Background and current status**
  - Variation on standard LLC; grafted onto state's LLC statutes
  - Currently adopted in 9 states and two tribes
  - Designed to try to increase use of PRIs by private foundations
  - Many practitioners have expressed concern about form, and its adoption has slowed as a result (more on that later)

# Hybrid Entities

- **L3C: Requirements for entity**
  - Organized for a business purpose, and
  - Operated at all times to satisfy three requirements:
    1. Significantly furthers charitable purposes and would not have been formed but for its relationship to such purposes;
    2. No significant profit purpose
    3. No lobbying or political purpose

*Note similarity to PRI rules!*

# Hybrid Entities

- **L3C: Concerns with concept**
  - Potential confusion in marketplace
    - L3Cs have no special tax status (no safe harbor or presumption)
    - But some foundations may incorrectly think L3C has special status and not conduct proper due diligence
    - Entrepreneurs may lock themselves into low-profit model, thinking that PRIs will be plentiful
    - Individuals may rely on L3C in name as indicator of good will, which could be exploited by wrongdoers

# Hybrid Entities

- **L3C: Concerns with concept**
  - Private benefit concerns with tranched investing
    - Promotional materials have focused on foundations taking high-risk, low-return position, with higher returns for other, private investors
    - PRIs often used to leverage other funds, but private benefit analysis should be conducted—is benefit incidental?
    - Consider rulings (e.g., PLR 200610020) where foundation and private investors all invested below market; presumably, private parties there weren't primarily profit-motivated

# Hybrid Entities

- **L3C: Concerns with concept**
  - Securities and charitable solicitation laws
    - Profit-motivated investments could be securities
    - Examine registration and disclosure requirements
  - Conflicts with fiduciary duties
    - Different parties may have different expectations of how to prioritize the different purposes
    - Operating agreement should carefully address

# Hybrid Entities

- **Benefit corporation: Background and current status**
  - Variation on business corporation and will fit into existing statutory framework
  - Nonprofit B Labs developed concept and drafted model legislation;
  - 12 states have adopted so far
  - B Labs also certifies B Corporations as meeting certain social and environmental standards, but that is separate concept

# Hybrid Entities

- **Benefit corporation: Background and current status**
  - Designed to expressly clarify that directors can consider other interests beside profit
    - Traditional corporate law didn't allow for this although constituency statutes can alter this result in some circumstances
    - But constituency statutes would not <u>require</u> consideration of other interests; benefit corporation statutes do
  - Hasn't been criticized to the extent L3Cs have
  - Patagonia is well-known example

# Hybrid Entities

- **Benefit corporation: Requirements for entity**
  - Required corporate purpose to create general public benefit, defined as “a material positive impact on society and the environment, taken as a whole”
    - Optional specific benefit can be specified as well (e.g., improving human health, promoting arts or sciences)
  - Modified fiduciary duties of directors that require consideration of non-financial interests
    - E.g., interests of employees, customers, environment, community
    - Articles of incorporation can specify priority of interests

# Hybrid Entities

- **Benefit corporation: Requirements for entity**
  - Obligation to report overall social and environmental performance as assessed against third-party standard
    - Benefit director: independent individual who is required to issue opinions (included in benefit report) as to whether the corporation acted in accordance with benefit purposes, and whether directors/officers acted in accordance with duties
  - Right of action for certain parties to enforce benefit purpose
    - Derivatively by shareholders, directors, owners of 5 percent or more of company, other persons specified in articles or bylaws

# Hybrid Entities

- **Benefit corporation: Colorado debate**
  - Measures introduced in 2011 and 2012 that built off the model legislation
  - Bar association working for a more flexible approach
  - Critics call this “watered down”
  - To be continued!

# Hybrid Entities

- **Hybrid could be valid choice for entrepreneur**
  - Remember that getting PRIs won't be a slam-dunk
    - Foundations will still need to go through due diligence
    - PRI regulations may make foundations less hesitant
  - Choosing for-profit entity forecloses receiving deductible charitable contributions
  - For states that haven't adopted L3C statutes, you can use standard LLC that has been carefully crafted

# Nonprofit/For-Profit Combinations

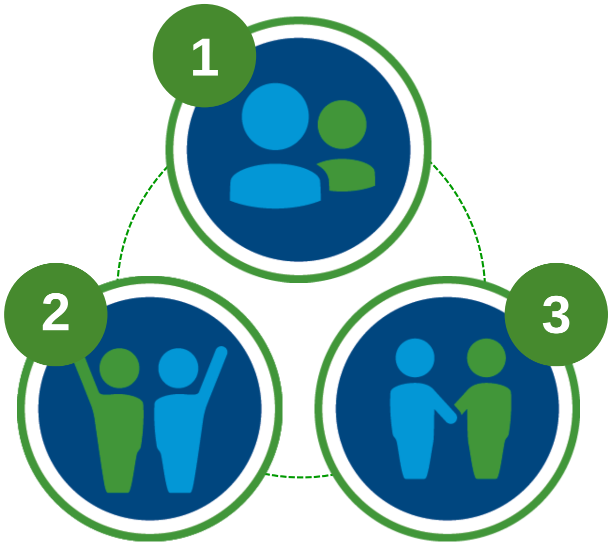
# Nonprofit/For-Profit Combinations

- **Background**
  - Startups may find that selecting a sole for-profit or nonprofit entity isn't the best fit
  - Hybrids haven't proven to be great fit either
  - Combining for-profit and nonprofit elements via different entities can be a good option
  - Combinations aren't new, but new uses are innovative

# Nonprofit/For-profit Combinations

## Three Options:

Parent-Subsidiary Relationship




Brother-Sister Relationship

Joint Venture (e.g., partnership)

# Nonprofit/For-Profit Combinations

- **Nonprofit parent with for-profit subsidiary**
  - Business corporation
    (taxed as C corporation; avoid S corporations!)
  - Single-member LLC
    (taxed as C corporation vs. disregarded entity)
  - Benefit corporation
    (taxed as C corporation; required to consider interests other than profit under state law)

# Nonprofit/For-Profit Combinations

- **For-profit parent with nonprofit subsidiary**
  - Traditional “company” foundation
    (classified as “private foundation” for tax purposes)
  - Newer company-affiliated charity
    (classified as “charity” for tax purposes; meets public support test)

# Nonprofit/For-Profit Combinations

- **Nonprofit and for-profit entities linked together by:**
  - Overlapping directors or management
  - Licensing agreements
  - Resource-sharing agreements
  - Joint operating agreements
  - Other agreements
- **Each entity serves active, distinct role in enterprise**
- **<u>No</u> sharing of net profits**

# Nonprofit/For-Profit Combinations


- **Nonprofit and for-profit entities enter into joint venture**
  - Partnership
  - Multi-member LLC
  - L3C
  - Other profit-sharing arrangements
- **Sharing of net profits**

# Nonprofit/For-Profit Combinations

- **Opportunities and concerns**
  - Can offer the most options for fundraising
  - But requires careful structuring, as combinations can implicate hot-button IRS issues such as:
    - Private benefit and inurement
    - Commerciality
    - Alter ego/independence of entities
    - Charitable purpose

# Agenda

1. Overview
2. Program-Related Investments
3. Hybrid Entities
4. Nonprofit/For-Profit Combinations

# Conclusion

LEAFFER LAW

LEADERS IN NONPROFIT LAW


**Becky Seidel, Esq.**
303.781.6899
bseidel@leafferlaw.com

1899 Wynkoop Street | Suite 275 | Denver, CO 80202
**LeafferLaw.com**