By Thomas H. Moody

The Promise of the L3C

This new entity, recently born in Vermont, could facilitate socially beneficial investing

In April 2008, Vermont became the first state in the United States to enact a law allowing for the formation of low-profit limited liability companies. Also known as L3C, this new business entity is designed to give socially oriented businesses greater access to capital.

Similar legislation has been pushed in Georgia, Michigan, Montana and South Carolina. But only South Carolina actually had a bill introduced; it did not pass.

Vermont's L3C act has national importance because an L3C organized under Vermont law can do business nationally, even internationally, under ordinary foreign entity qualification statutes.

Applicability

An L3C is essentially a for-profit limited liability company (LLC) that is organized primarily to pursue a social or charitable purpose. In a sense, it is a hybrid of a for-profit and non-profit organization, and has characteristics of each. Like a non-profit, it must be formed to pursue some charitable purpose. But, unlike a non-profit (and like a for-profit entity), it can have equity owners that have a right to distribution of profits and appreciation of the value of the business entity.

Accordingly, the L3C is an entity that allows for side-by-side investment by private foundations seeking to maximize a charitable outcome and ordinary financial investors seeking both a charitable outcome and a return on investment.

The rules governing the L3C's management structure and the capital structure are found in Vermont's LLC act that, like most states' LLC statutes, allows for a great deal of flexibility.

The L3C is taxed like any other for-profit entity, and would not qualify as a tax-exempt entity under Internal Revenue Code Section 501(c)(iii).

Consequently, it's suitable for a fairly narrow segment of socially responsible organizations that:

(1) have a social or charitable mission as their primary purpose,

(2) believe they can attract program-related investment, and

(3) expect to have sufficient revenue or capital appreciation to generate a positive after-tax return for its equity holders.

An organization that has the first two characteristics but is not confident that it can be profitable on an after-tax basis should probably be a non-profit corporation. An organization that has a social or charitable mission as its primary purpose and could make a profit but is not able to attract program-related investment, should be an ordinary for-profit entity.

In the few months since Vermont made these new entities possible, about fifteen L3Cs have been formed. They

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cover a wide range of industries, including health care, education and land conservation. My firm has assisted clients in forming many of the L3Cs organized to date. The social entrepreneurs who created these entities have come to us with creative plans to carry out noble social and charitable missions while generating some financial return for their owners. Most have charitable/business concepts they've been working on for years. They see the L3C structure as a way to bring together foundation funding and financial investors to finance their projects.

Program-Related Investment

At the core of the L3C lies the program-related investment (PRI). Briefly stated, a PRI is an investment by a private foundation in which:

(1) the company receiving the investment significantly furthers one or more charitable purposes;

(2) no significant purpose of the recipient is the production of income or the appreciation of property; and

(3) no significant purpose of the recipient is to accomplish one or more political or legislative purposes.

Generally speaking, private foundations are required to make grants to charitable causes of at least 5 percent of the foundation's net assets. These grants are typically charitable contributions with no strings attached and 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 PRIs. PRIs necessarily involve a continuing financial relationship between the foundation and the charitable organization. The PRI regulations require a degree of continuing oversight by the foundation.

A PRI can be made in the form of a low-interest loan or an equity investment. Historically, most PRIs have been made in the form of loans to non-profit corporations. While the IRS regulations describing PRIs include examples of PRIs being made in the form of equity investments, any such equity PRI would necessarily have to be made in a for-profit entity, because non-profit corporations cannot, as a matter of corporate law, have equity owners.

Conflicting Duties

At least part of the reason foundations have shied away from making PRIs in for-profit entities is an inherent conflict between:

(1) the duties of officers and directors of for-profit entities to maximize shareholder value and

(2) IRS regulations that provide that PRI recipients must not have as a "significant purpose" the production of income or the appreciation of property.

The L3C concept was created by a foundation executive and a former director of the IRS Exempt Organizations Division.

That's where the L3C comes in. Because Vermont law requires L3Cs to be organized primarily for a charitable purpose, the officers and managers of an L3C are not faced with this conflicting mandate. They can manage the L3C to accomplish the charitable mission as the primary objective of the organization—and thereby remain consistent with both the PRI regulations and their corporate duties. In this way, the L3C structure eliminates an obstacle to foundation funding of socially oriented for-profit organizations.

The concept of the L3C was developed by Robert Lang Jr., chief executive of the Mary Elizabeth & Gordon B. Mannweiler Foundation, and Marcus S. Owens, formerly director of the Internal Revenue Service's Exempt Organizations Division. They conceived of a new type of entity that would be specifically designed to attract PRI and to eliminate the conflicting duties facing officers and directors of for-profit entities seeking PRI funding.

The Vermont legislature was taken with the concept of social entrepreneurship and approved the legislation in the first session following its introduction.

Vermont's L3C Act

The Vermont L3C Act contains language taken directly from the IRS regulations on PRIs. The act provides that an L3C is an LLC organized under the laws of Vermont that meets this criteria (upon formation and continuously during the life of the organization):

(1) 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 accomplishing the charitable or educational purposes.

(2) No significant purpose of the company is the production of income or the appreciation of property; however, if the company does produce significant income or capital appreciation this is not, in the absence of other factors, conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(3) The company is not organized to accomplish one or more political or legislative purposes.

Why Form an L3C?

Private foundations are constantly looking for ways to maximize the value of their contributions. They are less concerned about financial return on their investments and more focused on whether the charitable organizations they fund are achieving the foundation's goals and mission. 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.

The L3C will operate with a secondary purpose of generating enough income to repay debt and/or to provide a return for investors. This secondary goal 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 (be it in the form of a low-interest loan or equity investment) is that the foundation's loan or equity investment creates an ongoing relationship with the charitable organization. A foundation seeking some measure of influence over the activities of the charitable organization would be able to exercise 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.

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 that enables the L3C to get 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 then would 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.

Great Promise

The advent of the L3C creates 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 as well as 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.

Of course, it will be very interesting to see in the coming years how this promise plays out. TE