

Morgan Lewis



Charitable Investment Funds

The Social Investing Continuum

- **Social Investing**
 - Considers social and environmental factors when making investment decisions
- **Mission Investing**
 - Focuses on investments/activities that further and are consistent with an organization's charitable mission
 - Narrower subset of social investing
- **Program-Related Investing**
 - Vehicle for private foundations to engage in "charitable" (and nonmarket) investment activities without violating the rules on jeopardizing investments
 - Term is often used by public charities to refer to similar types of investments; however, the same tax restrictions do not apply

Examples of Social Investing

- **Screening:** Using a set of criteria to guide investment decisions
 - May be done actively or through a socially responsible fund
 - Screens can eliminate undesirable activities/outcomes or emphasize desirable ones
- **Shareholder Advocacy**
 - Proxy voting, shareholder resolutions, and advocacy with management

Examples of Mission Investing

- Investments that directly further mission
 - Equity, loans, guarantees, deposits
 - Made directly to a variety of entity types or through intermediaries (both taxable and tax-exempt)
 - May be market rate or below market
- Trend toward market-focused activities
 - Private equity and venture capital funds that have (and follow) a distinct charitable purpose
 - *Charities can invest*
 - *Charities can sponsor*

Primary Legal and Tax Issues for Charitable Investors

- Fiduciary Obligations
 - Prudence
 - Risk
 - Portfolio concerns
- Private Foundation Excise Tax Concerns
 - Jeopardizing Investments/Program-Related Investments rules
 - Excess Business Holding
- Unrelated Business Income Tax (UBIT)

Fiduciary Obligations

- The fiduciary obligations of directors (trustees) of nonprofit organizations are a function of state law
 - Duty of care
 - Duty of loyalty
 - Duty of obedience
- Investment decisions subject to standard of prudence
 - Organizations in some states are governed by the Uniform Management of Institutional Funds Act (UMIFA)
 - Uniform Prudent Management of Institutional Funds Act (UPMIFA) (now enacted in a majority of states) provides more robust guidance on prudence, reflecting whole portfolio management practices
 - *UPMIFA's standards explicitly do not apply to the deployment of program-related assets (defined as assets held by an institution primarily to accomplish charitable purposes); however, comments to the model act note that if program-related assets serve in part as an investment, the charitability of the investment should be documented*

Jeopardizing Investments

- Section 4944 imposes a tax on “jeopardizing investments” of private foundations
- An investment will be considered “jeopardizing” if it was not made with ordinary business care and prudence
 - Determined on a case-by-case basis, taking into account the portfolio as a whole
 - The IRS will not employ hindsight
 - *The determination is a function of the facts as they existed at the time of the investment decision*
 - Under the (antiquated) Treasury Regulations, certain investments will be more closely scrutinized
 - *Margin trades, futures, short selling, puts, calls, and straddles*

Program-Related Investments

- The jeopardizing investment rules do not apply to “program-related investments” (PRIs)
 - i.e., certain investments that are related to a foundation’s charitable purposes
- Three characteristics
 - Primary purpose must be to carry out one or more “charitable” purposes
 - No significant purpose of the investment is the production of income or the appreciation of property (“gain” on exits okay)
 - No purpose of the investment is to influence legislation or participate or intervene in a political campaign on behalf of any candidate for public office

Program-Related Investments

- PRIs count as qualifying distributions
- Normal “taxable expenditure” rules apply
 - Exercise expenditure responsibility over a PRI to a nonpublic charity
 - *E.g., an equity investment in a for-profit microfinance institution to encourage lending to the poor*
 - Expenditure responsibility is not required for a PRI to a public charity
 - *E.g., a loan to a Section 501(c)(3) public charity in connection with an affordable housing development*

Excess Business Holdings

- Under Section 4943, a private foundation may generally not own more than 20% of the voting stock of a corporate business enterprise
 - Similar rules are applied in the context of noncorporate enterprise forms, such as partnerships
- A foundation's holdings are aggregated with the holdings of all disqualified persons
- In some cases, the ownership threshold may be increased to 35% if effective control is not in the hands of disqualified persons
- 2% de minimis rule creates a safe harbor
- These rules do not apply to PRIs or functionally related businesses
- There is no limit to the amount of nonvoting shares that a foundation may own, so long as the foundation and all disqualified persons do not exceed the permissible thresholds of voting stock

UBIT (and Unrelated Business Taxable Income—UBTI)

- Social (and mission) investments may generate unrelated business taxable income:
 - Leverage
 - Operating business enterprises
 - Real estate
 - Corporate vs. flow-through entity portfolio companies

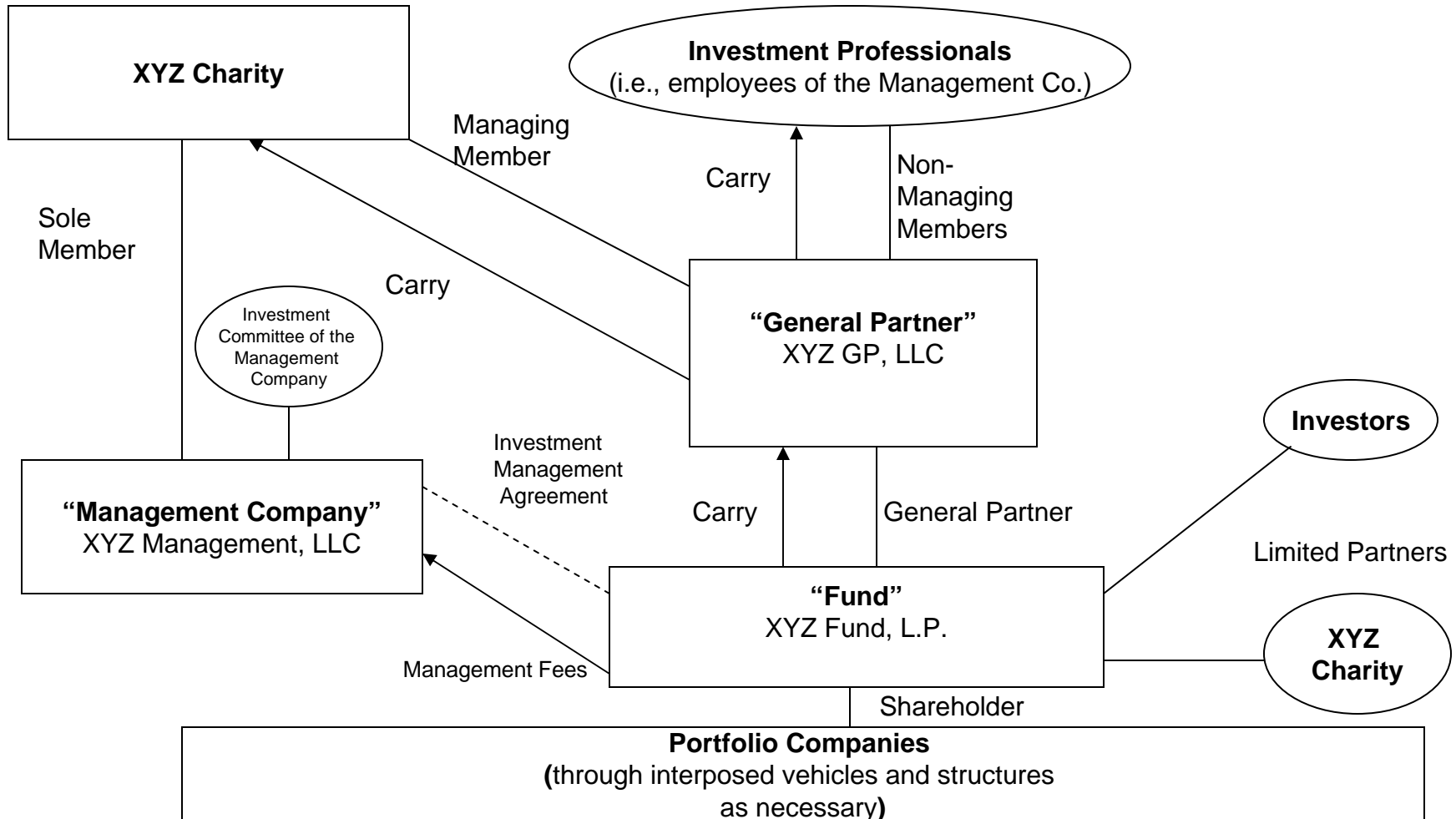
Charitable Investment Funds: Sponsor's Perspective

- Charities may invest in (or sponsor the creation of) private equity or venture capital funds to encourage direct investment in companies conducting activities that are consistent with or that further their mission
 - Examples:
 - *Green technologies*
 - *Economic development in distressed communities/regions*
 - *Land conservation*
 - *Commercialization of research-based technologies*
 - *Affordable housing*
- Charities typically invest as
 - LPs in the case of limited partnerships
 - Members in the case of limited liability companies (LLCs)

Fund Structure: Basic Considerations

- Jurisdiction
 - Fund
 - GP
 - Management Company
- Limited Liability
 - Limited Partnership
 - LLC
 - Other
- Properly restricted purpose of the fund
 - Charitable purposes
 - PRI restrictions

Basic Fund Structure



Overview of Fund

- The Fund makes direct investments in portfolio companies
- The Fund raises capital from LPs
- All of the Fund's actions are controlled by the General Partner (GP)
 - The Fund will generally not have any employees, rent office space, or otherwise engage in activities as an operating company
- The GP is controlled by the Managing Member; the GP will not have any employees
- The Management Company is the situs for all "Fund" operations and recommends actions to the GP for implementation, including investments in portfolio companies

The General Partner

- Because the GP controls the Fund, the Managing Member will be responsible for causing the Fund to take actions recommended by the Management Company
- The GP's role is to cause the Fund to enter into the Investment Management Agreement and to consider taking the actions recommended by the Management Company (subject to applicable fiduciary obligations)

The Management Company

- The Management Company
 - Manages all Fund operations
 - Generally receives a management fee from the Fund to cover operating expenses (including salaries, benefits, office space, etc.)
 - Will have its own employees, benefit plans, office space, books and records, etc.
 - May contract with its sponsoring organization for services and facilities pursuant to an arm's-length agreement
 - Will generally have an investment committee that will source, review, and make recommendations with respect to investments
 - ***This is not a committee of the sponsoring organization***
- The Management Company's duties and responsibilities will be set out in an Investment Management Agreement with the Fund

Relationship of Sponsoring Charity to the General Partner

- The sponsoring charity will generally serve as the Managing Member of the GP
 - It will therefore “control” its operations (the sponsoring charity may receive a “carried interest” through its membership in the GP)
- Non-Managing Members may include the investment professionals employed by the Management Company (who may also receive their “carried interest” through membership in the GP)
- The sponsoring charity may make its investment in the Fund as an LP or through the GP
- The sponsoring charity’s financial exposure with respect to the GP will (generally) be limited to the amount of its investment in the GP
 - As in the case of the Management Company, the sponsoring charity must take steps to ensure that the “corporate veil” of the GP is not pierced

Relationship of Sponsoring Charity to the Management Company

- The sponsoring charity will generally serve as the sole member of the Management Company
- The sponsoring charity may provide initial funding to support the Management Company's activities
- As a single member LLC, the Management Company will be a disregarded entity for tax purposes (but not for liability-protection purposes) and its activities and operations will be attributed to the sponsoring charity and reflected on the sponsoring charity's financial statements and tax reporting
- The sponsoring charity may provide services and facilities to the Management Company via contractual arrangements

Relationship of Sponsoring Charity to the Management Company

- To ensure maximum liability protection, the entities should observe the requisite corporate formalities to avoid having the Management Company's "corporate veil" pierced
 - The sponsoring charity may be involved in the overall governance of the Management Company in its capacity as sole member
 - It is best if control over the day-to-day activities of the Management Company is in the hands of an employee of the Management Company (not an employee, officer, or director of the sponsoring charity)
 - The Management Company must be adequately capitalized
 - The Management Company should maintain its own books and records, bank accounts, separate governance functions, etc.
 - Any services or facilities provided by the sponsoring charity to the Management Company should be pursuant to a written agreement with arm's-length terms

Relationship of Sponsoring Charity to the Management Company

- Absent a “piercing of the corporate veil,” the sponsoring charity’s liability with respect to the Management Company should be limited to its investment in the Management Company
- The Management Company must secure adequate insurance coverage
- Important to institute appropriate procedures to address utilization by the Management Company of the sponsoring charity’s resources and personnel

Relationship of Sponsoring Charity to the Portfolio Companies

- All investments in a portfolio company will be made through the Fund
- The Management Company will not have the authority to commit the sponsoring charity to any other relationship with a portfolio company
- The sponsoring charity will not have any authority to commit the Fund to any relationship or capital obligation with a portfolio company
- To the extent a portfolio company wishes to partner with the sponsoring charity, utilize any of the sponsoring charity's intellectual property, or otherwise enter into a direct relationship with the sponsoring charity, it will need to do so directly with the sponsoring charity in accordance with current (or specifically designed) policies and procedures
- Implement procedures to manage
 - interaction among the sponsoring charity, portfolio companies, and the Management Company
 - potential conflicts arising in the context of the relationship between the sponsoring charity, portfolio companies, and the Management Company
 - potential conflicts arising in connection with investments by the sponsoring charity's directors, officers, or substantial contributors

Charitable Investment Funds: Investor's Perspective

- Legal Due Diligence: In light of the fiduciary duties to which most tax-exempt investors are subject, it is critical to understand the terms governing a private investment fund before investing
- Market Knowledge: Understanding the terms of a private investment fund is not helpful unless you have a deep knowledge of the market in order to give context for a fund type, size, and experience

Care and Loyalty

- Typically, the GP has no liability for anything above gross negligence, willful misconduct, or fraud
- Devotion of time by key persons
- Requirements to present investment opportunities to the Fund
- Restrictions on investments by the GP, key persons, and their affiliates in certain conflicts-of-interest situations
- Restrictions on investments by the Fund in certain conflicts-of-interest situations

Big Picture Protections

- Removal of the GP:
 - Without cause (aka No-Fault) – typically requires supermajority
 - With cause – typically requires majority
- Termination of the commitment period:
 - Without cause (aka No-Fault) – typically requires supermajority
 - With cause – typically requires majority
- Avoid requirement for “final judicial determination”
- Key person provisions:
 - Suspension or termination of commitment period
 - LP approval for replacement of key persons

Advisory Board

- Composition
- Role
- Governance
- Liability/Indemnification

Tax Matters

- Covenant to avoid UBTI
- Protection against amendment of UBTI covenant
- GP covenant to provide information for LP tax filings
- GP covenant to obtain exemptions, reductions, and refunds of withholdings from non-U.S. jurisdictions
- PTP issues addressed appropriately

ERISA

- Covenant regarding VCOC status or avoiding significant “benefit plan investor” participation
- VCOC opinion and annual certification
- Withdrawal rights and excuse provisions for regulatory reasons
- Address “Similar Law” issues
- Restrictions on transfers
- Protection against amendments to ERISA provisions

Standard Investment Restrictions

- Limit on amount and purpose of borrowing
- Limit on aggregate bridge financing
- Limits on lending and guarantees
- Limit on concentration in single portfolio company
- Geographic limits
- Limit on reinvestment of proceeds
- Limit on investments in public securities
- Limit on hostile takeovers
- Limit on investment in other investment vehicles

The Economic Deal

- Management fees: 1%-3% depending on fund size
- Carried interest: 5%-30%, depending on fund type and prestige
- Preferred return: 8%-10%
- GP catch-up: from 50/50 to 100%
- GP clawback: Protect economic deal and preferred return

Economic Tricks

- Significant nuances to the economic deal:
 - Net vs. Gross Carried Interest
 - Aggregate or Deal-by-Deal waterfall (typically, quasi-deal-by-deal)
 - Return *all* capital contributions first. If not, return of capital should include all realized capital, including recapitalizations
 - Preferred return as true IRR
 - Unrealized investments written down
 - Carried Interest should exclude current income from unrealized investments
 - Clawback pre- or post-taxes: If post-taxes, reduction for taxes on all distributions to determine available amounts for clawback (not a reduction of clawback amount by taxes thereon)

Distributions

- Distributions
 - Mandatory vs. discretionary
 - Deadlines to force distributions
 - Tax distributions
 - In-kind distributions
 - Tax withholdings deemed to be distributions
 - LP clawbacks
 - *Limit on time period: typically either 3 years following any given distribution or 2 years following termination of the Fund*
 - *Dollar cap: typically lesser of 25-50% of commitments or total distributions received*
 - *Limit reason to indemnification*

Management Fees

- 1%-3%, depending on size of fund
- Inside vs. outside the commitment
- Step-downs
 - End of commitment period
 - Formation of new fund
 - Lower of cost or FMV
- Offsets: 50%-100% of advisory fees, investment banking fees, monitoring fees, broken-deal fees, etc., received by GP or Management Company
- Management fee waiver mechanisms

Expenses

- Clearly identify fund expenses vs. GP/Management Company expenses
- Inside vs. outside of commitments
- Cap on organizational expenses

Later-Admitted LPs

- Treatment of late entrants:
 - Investors' interests not aligned if they have not all invested at same time
 - Late entrants charged interest
 - Late entrants allocated fees and expenses as if admitted on initial closing
 - Late entrants participate in existing deals as if admitted on initial closing

Time Periods

- Life (term) of the fund:
 - Typically ten years plus extensions
- Commitment/Investment Period:
 - Typically five years, but varies

Closing Opinions

- Closing Opinions:
 - Limited Liability
 - Private Placement (Securities Act of 1933)
 - Exempt Investment Company (Investment Company Act of 1940)
 - Due Formation; Valid Existence; Good Standing
 - Authorization; Enforceability
 - Status under U.S. IRC

Miscellaneous

- Most Favored Nations provisions
- Side Letters
- Coordination with parallel funds
- Default provisions
- Reports and confidentiality
- Right of first offer with respect to transfers

Additional Information

For more information on the issues discussed here, please contact your Morgan Lewis [Private Investment Funds Practice](#) attorney.

The Private Investment Funds Practice

Morgan Lewis has one of the nation's largest private investment fund practices and is ranked the Second Most Active Law Firm in the United States based on the number of funds worked on for general and limited partners by *Dow Jones Private Equity Analyst* (2009).

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