

Morgan Lewis

IMPACT INVESTING DESKBOOK SERIES

Catalytic Capital: Recoverable Grants

Catalytic capital is capital that is used to spur on – i.e., catalyze – the additional investment of conventional market return seeking capital into an impact investment. It does so by de-risking investments by absorbing a disproportionate risk of loss, demonstrating potential, funding technical assistance, bridging a gap in funding or accepting below-market returns. Catalytic capital can take many forms, including subordinated debt, junior equity, financial guarantees, technical assistance grants, and the oxymoron that is the recoverable grant.

Why Are Recoverable Grants Used?

A recoverable grant, like the name implies, is a grant (typically made by a Section 501(c)(3) private foundation for one or more charitable purposes), all or part of which has the potential for being returned to the donor (i.e., recovered) if certain defined impact goals of the grant are achieved by the grantee, including generating sufficient returns or earnings to enable the return of the grant. Once returned, the original donor can reuse the capital to support other charitable activities, potentially creating a virtuous cycle multiplying the cumulative impact of the donor's capital – much like in the context of program-related investments. Recoverable grants can be used in many different settings, including as catalytic capital in the impact investing space. The potential catalytic aspect of the recoverable grant in the hands of the recipient coupled with its potential multiplier effect for the grantor if returned make the recoverable grant a popular and flexible tool for supporting impact investments.

How Are Recoverable Grants Structured?

Recoverable grants are structured as regular grants with a recovery feature, so that donors have the potential to recover granted capital, in whole or in part, if the recipient meets predetermined financial and impact objectives. A recoverable grant agreement carefully sets out the repayment provisions, including the purpose of the funds' expenditure, the timing of the recovery, and the triggers or objectives for recovery of funds. Some recoverable grants may include an interest component (while others are content with the return of the grant amount). The agreement would also state that if the recipient does not meet its objectives, it is under no obligation to repay the funds. It is critical that a recoverable grant is not structured like a loan.

Significantly, a recoverable grant cannot be structured or even referred to as a repayable grant. If the grant, or even a portion of it, is required to be repaid by the grantor under all circumstances, there is a risk that such grant will be treated as a loan, which carries legal and tax consequences. For example, this could lead to (i) violating existing loan covenants (the grant agreement can specify that repayment of the grant is subordinated to other debt obligations) or (ii) running the risk of having made a jeopardy investment, which could result in penalties against the foundation and possibly, in rare cases, the foundation managers personally.

Notwithstanding careful structuring of a recoverable grant to avoid debt treatment in the hands of the recipient, some accountants will nonetheless treat a recoverable grant as debt for accounting and financial purposes, which could have adverse consequences for the grantee. Therefore, it is important for the grantee to understand in advance how a particular recoverable grant will be treated by its accountants to allow the organization to structure and plan accordingly.

What Are Examples of Recoverable Grants Being Used as Catalytic Capital in Impact Investments?

In Blended Capital Structures: Recoverable grants can act as the first loss capital in a capital stack of a fund, a financing vehicle or a company, thereby de-risking the investment and enabling the financing of projects that would otherwise be eschewed as too risky by traditional lenders and investors.

- *Finance Vehicle:* A philanthropic foundation provides a recoverable grant to a fund investing in off-grid solar energy projects in sub-Saharan Africa. The grant is structured as first-loss capital, providing a protective buffer for the other traditional investors in the fund. The fund can then attract senior private debt and equity because the recoverable grant has reduced the risk for those investors. If the solar energy projects are productive, the returns from the solar projects enable the return of the recoverable grant after other senior investors receive market returns on their investments.
- *Impact Fund:* A nonprofit sponsors a fund to finance safe and decent housing in low-income communities. A foundation provides a recoverable grant to the nonprofit sponsor to be used as first-loss capital in the fund, allowing the fund sponsor to attract additional investment from other sources. The risk-tolerant foundation capital helps secure conventional funding, multiplying the fund's impact and profitability.
- *Small Business Lender (CDFI):* A nonprofit organization supporting agricultural enterprises uses recoverable grants to back its lending to small-to-medium enterprises. The recoverable grants act as a buffer, enabling the nonprofit lender to offer more flexible and lower-cost financing to high-risk, high-impact businesses, particularly those led by women and young people. With this support, the nonprofit lender can attract additional funding from commercial lenders that would not otherwise invest in these enterprises.

As Technical Assistance: Recoverable grants can fund technical assistance (TA), which helps enterprises build capacity and become "investment-ready," a key step for unlocking larger tranches of traditional capital. Repayment can be tied to the enterprise successfully raising follow-on funding or achieving specific financial milestones.

- *Capacity Building:* Supporting small and medium enterprises: A fund in Appalachia provides TA to prepare businesses and community projects for investment. Recoverable grants and conditional repayment loans are used for non-extractive financing of low-wealth borrowers. The TA can cover services like business planning, accounting support, or impact measurement, which are often unaffordable for early-stage ventures. By covering these upfront costs, the grant enables a company to secure a larger, more traditional investment down the line, with the TA grant potentially being repaid from the proceeds of future investments.
- *Funding Technical Diligence:* A nonprofit uses recoverable grants to fund technical diligence and early-stage development for breakthrough climate technologies. This philanthropic capital helps innovations that are too risky for conventional venture capital to cross the "valley of death" between R&D and commercial viability. The grants support critical technical and business planning, allowing the technology to prove its potential for gigaton-level emissions reduction. If

the technology is successful and attracts venture capital, the grant may be returned for reinvestment in other innovative projects.

- *Proving Investment Viability:* A nonprofit-sponsored fund focuses on supporting refugees receives a recoverable grant to pilot its lending program for displaced people. The grant provides the initial, catalytic capital to prove the fund's lending model's viability. By successfully demonstrating that refugees are investable and can generate returns, the recoverable grant helps the nonprofit unlock more traditional forms of capital and scale its efforts.

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