

**ROCKY MOUNTAIN TAX SEMINAR  
FOR  
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**THE ALPHABET SOUP OF NONTRADITIONAL INVESTMENT AND  
GRANT-SEEKING VEHICLES – MRIs, PRIs, L3Cs, AND B CORPs:  
WHAT ARE THEY AND WHEN DO THEY MAKE SENSE?**

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# **THE ALPHABET SOUP OF NONTRADITIONAL INVESTMENT AND GRANT-SEEKING VEHICLES – MRIs, PRIs, L3Cs, AND B CORPs: WHAT ARE THEY AND WHEN DO THEY MAKE SENSE?**

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In recent years, new acronyms have abounded in the social enterprise sector. In 2008, Vermont became the first state to enact legislation creating a new class of limited liability company – the “low-profit limited liability company,” or “L3C,” as it is commonly known. Since then, at least seven other states and two Native American tribal nations have adopted some version of legislation recognizing the L3Cs, and legislation is being contemplated in a number of other states.<sup>1</sup> We also have “B” corporations – entities that are certified by B Lab as having public purposes and meeting other requirements.<sup>2</sup> These are not to be confused with “benefit corporations” established pursuant to legislation passed first in Maryland in 2010<sup>3</sup> and more recently in Hawaii, Virginia, Vermont and New Jersey.<sup>4</sup> California, not to be outdone, is considering legislation to establish the “flexible purpose corporation.”

While the rest of the charitable and parts of the business sector are waking up to the concept of “social enterprise”-- the idea that philanthropy and business can partner to achieve outcomes for the public good -- this is certainly not a new concept for private foundations. Program-related investments, or PRIs, codified in 1969 in Section 4944(c) of the Internal Revenue Code, have been used successfully by private foundations for more than four decades as a vehicle to make below-market loans and equity investments in for-profit companies to fund business endeavors undertaken for charitable purposes. And some foundations also make market rate mission-related investments, or MRIs, that are intended to direct some portion of their investment portfolios into investments that have some mission alignment.

The challenge for foundations today is to understand these new investment vehicles and to consider whether they offer any additional flexibility in terms of tools for carrying out their charitable purposes. This outline provides a brief summary of these various forms of investment and comments on how they may align with private foundation programmatic and/or investment strategies.

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<sup>1</sup> See the website of Americans for Community Development, [www.americansforcommunitydevelopment.org](http://www.americansforcommunitydevelopment.org). This organization was formed to support the development and use of L3Cs.

<sup>2</sup> See [www.bcorporation.net](http://www.bcorporation.net).

<sup>3</sup> Maryland Corporations and Associations Article 5-6C-01- 08.

<sup>4</sup> See [www.bcorporation.net/publicpolicy](http://www.bcorporation.net/publicpolicy) for a list of states that have adopted benefit corporation legislation and where legislation is pending.

## **I. Social Enterprise Investment Vehicles**

### **A. Program-Related Investments**

Program-related investments are investments made by private foundations to accomplish charitable purposes. Under Treasury Regulation 53.4944-3(a), an investment qualifies as a PRI if it meets the following requirements:

- (1) the primary purpose of the investment is to accomplish one or more charitable purposes;
- (2) no significant purpose of the investment is the production of income or the appreciation of property; and
- (3) no purpose of the investment is for lobbying or political campaign intervention.

If the PRI is made in an organization that is not a public charity, Treasury Regulation 53.4945-5 requires the foundation to exercise expenditure responsibility on the investment.

Investments that meet the PRI requirements will not constitute jeopardy investments and are not subject to the excess business holding limitations under Section 4943. PRIs can be counted as a qualifying distribution under Section 4942 when made (and will increase the distribution requirement when repaid).

### **B. Mission-Related Investments**

Mission-related investments are investments made by private foundations that are intended to generate market rate returns and are therefore do not meet the PRI requirements. The types of MRIs made by private foundation vary widely. Some foundations designate a portion of their investment portfolio for market rate investments that align with their mission. These are typically private equity investments in fields of interest to the foundation. For example, a foundation whose mission involves the promotion of health may make MRIs in bioscience companies that are intended to develop drugs or devices to promote health. Similarly, a foundation whose mission involves economic and community development may make MRIs in certain companies to help induce them to locate in areas needing revitalization. Other foundations simply impose mission-related “screens” on their investment portfolios. For example, they may refuse to make investments in companies that market tobacco products, or that exploit child labor.

There has been some controversy over whether MRIs made in the form of private equity investments that are expected to generate returns at the lower end of the market rate spectrum might be considered imprudent if they carry lower returns than other types of investments. In this regard, the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which has now been adopted in virtually all states, provides that one of the relevant factors to be considered in managing institutional funds is an asset’s special relationship or special value, if any, to the

charitable purposes of the organizations.<sup>5</sup> The comments to UPMIFA provide that “a prudent decision-maker can take into consideration the relationship between an investment and the purposes of the institution and of the institutional fund in making an investment that may have a program-related purpose but not be primarily program-related.” Investments made primarily for program-related purposes are not subject to the UPMIFA prudent investment standards.<sup>6</sup>

### C. Low-Profit Limited Liability Companies

L3Cs, or “low-profit limited liability companies,” are described by Robert Lang, the creator of the concept, as “the for profit with the nonprofit soul.”<sup>7</sup> In point of fact, L3Cs are limited liability companies formed pursuant to a state statute that establishes a specialized form of a limited liability company. While the statutory language varies somewhat from state to state, the Vermont statute is typical. It provides as follows:<sup>8</sup>

L3C or "Low-profit limited liability company" means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements.

(A) The company significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. Section 170(c)(2)(D).

(D) If a company that met the definition of this subdivision at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit LLC, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company.

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<sup>5</sup> Uniform Prudent Management of Institutional Funds Act, drafted by the National Conference of Commissioners on Uniform State Laws (November 8, 2007), Section 3(e)(1)(H) available at [http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final\\_act.pdf](http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006final_act.pdf).

<sup>6</sup> UPMIFA Section 2(5)(A).

<sup>7</sup> See statement of Robert Lang on the website of Americans for Community Development, [http://www.americansforcommunitydevelopment.org/TDE\\_CMS/database/userfiles/file/What%20is%20the%20L3C%20071711-1.pdf](http://www.americansforcommunitydevelopment.org/TDE_CMS/database/userfiles/file/What%20is%20the%20L3C%20071711-1.pdf).

<sup>8</sup> T.11, Ch. 21, Section 3001(27).

In general, the organizational and operational structure of an L3C is similar to that of an LLC; however, an L3C uses that suffix at the end of its name, rather than LLC.

Proponents of the L3C form of social enterprise have advocated the adoption of legislation that would make it possible for private foundations to rely on the L3C organizational structure to satisfy the PRI requirements. There does not seem to be support for such legislation, however, and so private foundations contemplating a PRI investment in an L3C need to exercise the same level of due diligence as in the case of any other PRI in a for-profit company.

#### **D. B Corporations**

Certified B corporations, or “B Corps,” are described on the B Corporation website as “a new type of corporation which uses the power of business to solve social and environmental problems.” The website further states that B Corps are “unlike traditional businesses because they (i) meet comprehensive and transparent social and environmental performance standards; (ii) meet higher legal accountability standards; and (iii) build business constituency for good business.” See <http://www.bcorporation.net/about>.

B Corps are a concept developed by B Lab, a 501(c)(3) organization. B Lab developed the concept of certified B corporations to make it easier for all of us to tell the difference between "good companies" -- those meeting specified social criteria -- and those that just market themselves as socially beneficial. Another initiative of B Lab is the development of the Global Impact Investing Ratings System (GIIRS) for global private equity investments.

#### **E. Benefit Corporations**

Benefit corporations are a new class of corporations, advocated by B Lab and others, that may pursue socially responsible purposes in addition to business purposes. Maryland was the first state to enact legislation recognizing this new corporate form, and at least four other states have followed suit. The applicable Maryland act, codified in Maryland Corporations and Associations Article 5-6C-01 – 08, sets the following requirements for establishing and maintaining a benefit corporation.

(i) The corporation must be formed for a general public benefit, which is defined as a “material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote a combination of specific public benefits.” The “third-party standard” is defined as a standard for defining, reporting, and assessing best practices in corporate social and environmental performance developed by an independent entity (such as B Lab).

(ii) The corporation may have a specific public benefit, which includes the following:

- (a) providing individuals or communities with beneficial products or services;
- (b) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business;
- (c) preserving the environment;

- (d) improving human health;
- (e) promoting the arts, sciences, or advancement of knowledge;
- (f) increasing the flow of capital to entities with a public benefit purpose; or
- (g) the accomplishment of any other particular benefit for society or the environment.

(iii) In determining what is in the best interests of a benefit corporation, directors should consider the effects of any action or decision on a variety of stakeholders. These include (a) the shareholders, (b) the employees and workforce, (c) the customers that are beneficiaries of the general or specific public benefit, (d) community and societal considerations, (e) the local and global environment, and (f) any other pertinent factors or the interests of any other group(s) that the directors determine to be appropriate.

(iv) The corporation must provide an annual benefit report to shareholders that describes the ways in which the corporation pursued and created the general public benefit and any specific public benefit, and includes an assessment of the societal and environmental performance of the benefit corporation prepared in accordance with a third-party standard applied consistently with the prior year's report (or explaining any reasons for inconsistency).

(v) The corporation must post a copy of its annual benefit report on its website and, if it does not have a website, provide a copy to anyone who requests it without charge.

(vi) The corporation must include the fact that it is a benefit corporation prominently at the head of the corporate charter. The election to be a benefit corporation can be revoked by amendment of the articles of incorporation.

## **F. Flexible Purpose Corporation**

In California, a working group of partners in law firms issued a proposal to amend the California corporate code to permit the establishment of the “flexible purpose corporation,” which is described as a corporation that has greater flexibility for combining profitability with a broader social or environmental purpose.<sup>9</sup> In 2011, legislation was introduced to establish the flexible purpose corporation.<sup>10</sup> According to California State Senator Mark DeSaulnier, the legislation integrates the for-profit philosophy of the traditional corporation with a “special purpose” mission that serves public purposes. Like benefit corporations established under Maryland law, flexible purpose corporations would be permitted to pursue one or more charitable or public purpose activities, in addition to creating economic value for shareholders. The provision, if enacted, would allow directors to take into account not only shareholder profits but also the impact of the business on other stakeholders such as employees, suppliers, customers, the community and society as a whole.

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<sup>9</sup> Frequently Asked Questions - Proposed Amendments to the California Corporations Code for a New Corporation Form: The Flexible Purpose Corporation, by W. Derrick Britt, R. Todd Johnson, Susan H. MacCormac, Co-Chairs, California Working Group for New Corporation Form (2010).

<sup>10</sup> California Senate Bill 201, introduced on February 8, 2011 by State Senator Mark DeSaulnier.

## II. Implications for Private Foundations

To comply with the “jeopardy investment” standards under Section 4944, all investments made by private foundations have to be either prudent investments or PRIs. The standards set forth in UPMIFA help modernize the standards and fill in the gaps for determining whether investments are prudent, and Treasury Regulation 53.4944-3 sets the standards for PRIs. Despite occasional claims otherwise, there are *no* special rules that apply to private foundation investments in MRIs, L3Cs, B Corps, benefit corporations, flexible purpose corporations, or any other new category of social enterprise.

What this means is that private foundations considering an investment in any of these forms of entity must approach the investment decision in the same way they would approach any other socially motivated investment. The first step is to determine whether the investment meets the PRI standards. This cannot be done simply by looking at the social purposes delineated in the company’s governing documents, and private foundations should not make general purpose, working capital PRIs to noncharitable organizations, even if they are formed as a social enterprise. Instead, foundations should examine the proposed activities of the business to which the PRI will be directed and carry out the same type of due diligence that would be required for any PRI. The Foundation should require the same type of PRI agreement and related documentation, and require the same type of reporting back from a PRI recipient.<sup>11</sup>

The new social enterprise vehicles may be appropriate for the conduct of the type of activities that private foundations may wish to support, in which case there is no reason to avoid making a PRI to a business formed under any of the new state statutes as long as the foundation follows the normal PRI rules. There are, however, some cases in which an investment in a new form of social enterprise may not serve the foundation’s long-term charitable objective. One such case is where the foundation is seeking to remedy a market failure by demonstrating that engaging in a particular type of activity can achieve a suitable level of profitability for businesses as well as social goals. In the U.S., examples include PRIs to induce financial institutions to reach underserved markets such as Native American tribes or to induce supermarkets to open stores in inner city areas. In the international arena, examples include PRIs to encourage businesses to serve small farmers in Sub-Saharan Africa or to offer mobile phone-based banking services in rural locations in African countries. In these cases, the longer-term objective is to induce other for-profit companies that do not have the “no primary profit motive” required for L3Cs, for example, to serve these audiences by demonstrating that they are reasonable business investments. In these cases, a traditional LLC or company may be a more appropriate investment vehicle.

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<sup>11</sup> See “L3Cs: Less Than Meets the Eye,” by David Chernoff, *Taxation of Exempts* (May/June 2010).