The L^{3}C

A Hybrid Entity: *Both For-Profit and Nonprofit*

The L3C - low profit limited liability company
A Social Venture Legal Structure

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What is an L3C?

- A type of LLC. L3C = Low Profit Limited Liability Company
- The L3C is a for-profit entity – it is NOT a charity or nonprofit entity
- The L3C is a flexible LLC designed to allow a mix of foundations, trusts, endowments, pension plans, individuals, corporations, and governmental entities to partner in order to achieve social objectives while operating in a for-profit business structure.
- Just like any LLC, an L3C has the liability protection of a corporation and the flexibility of a partnership.
- Unlike the standard LLC, it is explicitly formed to further a socially beneficial purpose and qualify as a Program Related Investment for private foundation partners.
- This flexible structure allows for greater financing structures to be utilized in structuring social ventures.

The L^{3}C – Documentation

- The L3C is formed under state law by filing Articles of Organization with the applicable State Corporation Commission.
- Under the States which have enacted L3C Statutues, the Articles must state that the L3C is organized and operated for:

The company must "significantly further the accomplishment of one or more charitable or educational purposes," and would not have been formed but for its relationship to the accomplishment of such purpose(s). (For example, Vermont requires that the L3C must satisfy "one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986").

"No significant purpose of the company is the production of income or the appreciation of property" (though the company is permitted to earn a profit). (Vermont adds 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").

The company must not be organized "to accomplish any political or legislative purposes."

Finally, if the L3C ceases to satisfy any one of these requirements after its formation, it shall cease to be a L3C but shall continue to be a traditional limited liability company under state law.

The L^{3}C – Documentation

- The L3C is simple to form and simple to use
- It is virtually identical to a standard LLC
- The L3C must generally contain the words "L3C" in its name.
- The L3C's operating agreement specifically outlines the social purposes for which its being formed which will help any nonprofit partner or private foundation to maintain its tax exempt status.
- The L3C has flexible membership rules that allow all the partners to structure the company in such a way as to satisfy their unique needs.
- The L3C can actively market memberships to market driven investors as well as other foundations, trusts, pensions, and individuals, making it easier for socially-motivated investors to locate the L3C that fits their needs.

The L3C is an LLC

- As a special form of a LLC, the L3C enjoys the same flexible rules that have made the LLC so successful, including:
  - **Simple Legal Structuring: The LLC combines liability protection with the flexibility of a partnership.**
  - **Flexible Ownership and Management Rules: Ownership rights under an L3C can be adjusted in a number of ways, ensuring each member enjoys a role that fits their unique requirements.**
  - **Pass Through Entity Election: Tax Items of profit, deduction, expense and loss flow through the L3C to its members and are taxed according to each investor's particular tax situation, making it easier for non-profits and for-profits to partner together.**
  - **State Based: Since only a handful of states have adopted the L3C legislation, it can be formed in one of the adopting states and used throughout the United States and its territory.**
  - **Allows for a tiered investment and financing structures for private foundations, investment banks, banks and investors.**

The Low Profit Limited Liability Company (L3C)

- Members of an L3C create and adopt an operating agreement (similar to Bylaws or a partnership agreement) which governs the day to day operations and management of the L3C.
- The L3C operating agreement will include provisions that incorporate one or more charitable purposes for the entity and its social venture or social enterprise.
- Other Advantages:
  - Management flexibility: Members may participate in management or they may be completely passive.
  - Ownership Flexibility: Each operating agreement can be tailored to meet each member's own particular needs – profits may be allocated in proportions that are different from capital contributions.
  - Financial Flexibility: Both nonprofit and for-profit entities, individuals, governments, private foundations and more can be members in an L3C.

The L^3C – Financing Advantages

- The L^3C was enacted to provide an investment vehicle for the Program Related Investments of Private Foundations (the Bill Gates Foundation, the Coors Family Foundation)
- By assisting Private Foundations to invest its PRI funds into the L3C, it leverages limited foundation dollars to access trillions of market driven investment dollars through tranched (tiered) investing because the private foundation gets both social return on investment AND return on investment, it can take a lower tiered, more risky, less return position in the finance structure.
- The ability of the foundation to invest at less than the market rate while embracing higher risk levels, lowers the risk to other investors while increasing their potential rate of return.
- The L^3C is a profit-making entity with a social mission. As such, it has the ability to operate in a territory with a profit/risk profile that would scare off normal investors.

What is a Program Related Investment (PRI)

- The Internal Revenue Code allows private foundations to directly invest in for-profit ventures under limited circumstances.
- To qualify, these investments – called Program Related Investments – must have a socially beneficial purpose and be consistent with and further a foundation's mission.
- A PRI can enjoy profits, but profit cannot be the primary motivation for the investment. The risk/reward profile must be outside that of a normal, market-driven investment. Thus, the social benefit is more important to the PRI than the return.
- Traditionally, PRIs were usually structured as grants and we not attractive investments for the foundation because of the difficulty in structuring the investment and ensuring the safety of the tax exempt status of the private foundation.
- The L3C has made the PRI much easier to structure because this for-profit investment entity MUST also benefit a social purpose.
- PRI's apply towards a foundation's five percent annual payout requirement.

The L3C – Investment Vehicle

- Private sector investment capital comes in two types:
  - **For Profit Sector Resources: Market Driven - making money & building wealth - normally require rate of return of +7% or more to be an attractive ROI**
  - **Nonprofit Sector Resources: Market incentives are inadequate or non-existent - rate of return of 0 to -100%**
- Challenge: How do social ventures access the vast pools of market driven wealth to invest in ventures that fall into the gap between the 0 and +5?
- By linking, PRIs and tiered financing for social ventures.

Social Ventures – Social ROI + Financial ROI

- Many worthy causes can be self-sustaining in the 0 to + 5% zone as social ventures.
- They offer a return on investment but the return is insufficient to attract most market driven investors.
- They fall into the gap between the for-profit and nonprofit worlds – the "Low-Profit Zone."
- The L3C was designed to bridge the gap between for-profit and nonprofit – it is in the Low-Profit Zone.
- The L3C is dedicated to a social purpose (charitable tax-exempt purposes) but it can also earn a substantial profit

PRIs – A Few Examples

- Low-interest loans to students in the form of student loans.
- Equity investment or loans for low-income housing projects.
- Low-interest loans to minority or disadvantaged business owners.
- Environmental cleanup and land conservation.
- Direct investment in businesses, non-profits and property in distressed neighborhoods.
- Job creation.
- Relief of the poor and charitable, educational and other charitable purposes of social ventures.

Current Challenges to PRIs

- Does the investment qualify?
  - To address this uncertainty, many foundations either forego the investment or spend valuable time and resources seeking a Private Letter Ruling from the IRS.
- How to attract market driven capital?
  - PRI transactions are often one off situations. Market capital likes repetitive, easily identifiable, brandable opportunities.
  - Lack of certainty

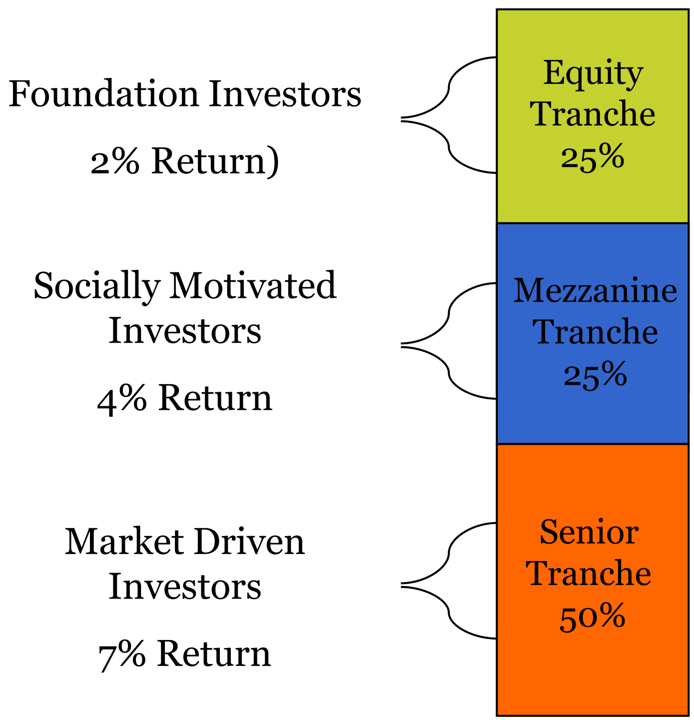
An L3C Example– The Problem

- A paper mill closes a furniture factory in a small town and puts 1,000 people out of work. The business bases its decision on the ultimate cost of keeping the factory open compared to the other uses for their capital:
  - Factory Investment: $10 million capital investment with an expected 2 percent rate of return ($200,000).
  - Alternative Investment: Similar risks with an expected 7 percent annual rate of return ($700,000).
- The company invests in the Alternative Investment at 7% and the 1,000 jobs are lost.
- This situation could be avoided by restructuring the financing and identifying the social/charitable purposes of this company.

An L3C Example – The Solution

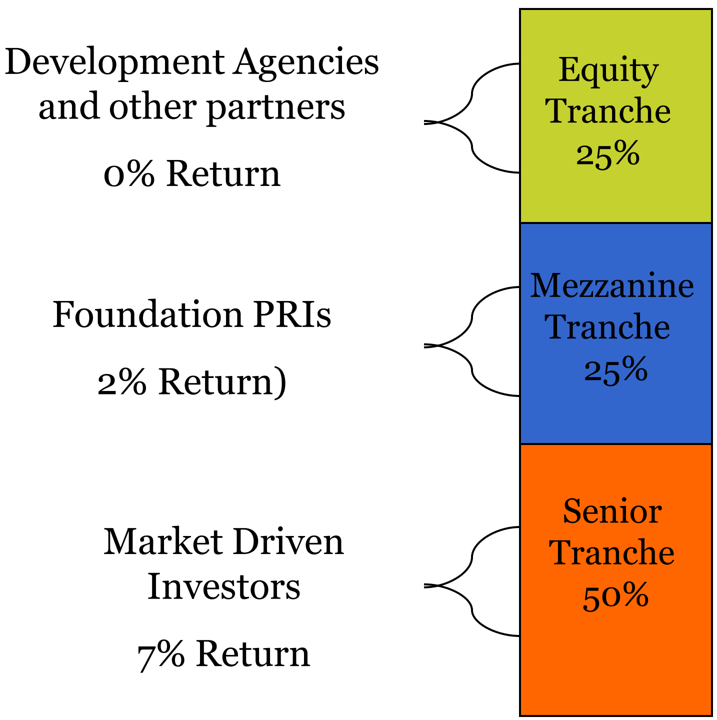
- A private foundation dedicated to serving the local community organizes an L3C specifically dedicated to buy the paper mill and save the jobs.
- The foundation's L3C membership stake provides for a very low rate of return (as little as zero) and is subordinate to the other investors..
- The remaining L3C memberships could then be marketed at rates of return and risk levels necessary to attract market based investors who require a higher ROI.
- The private foundation has met its charitable purposes and the PRI rules and regulations and the market based investors are happy to invest on the foundation of cheap capital provided by the private foundation.

A Tiered Investment Example



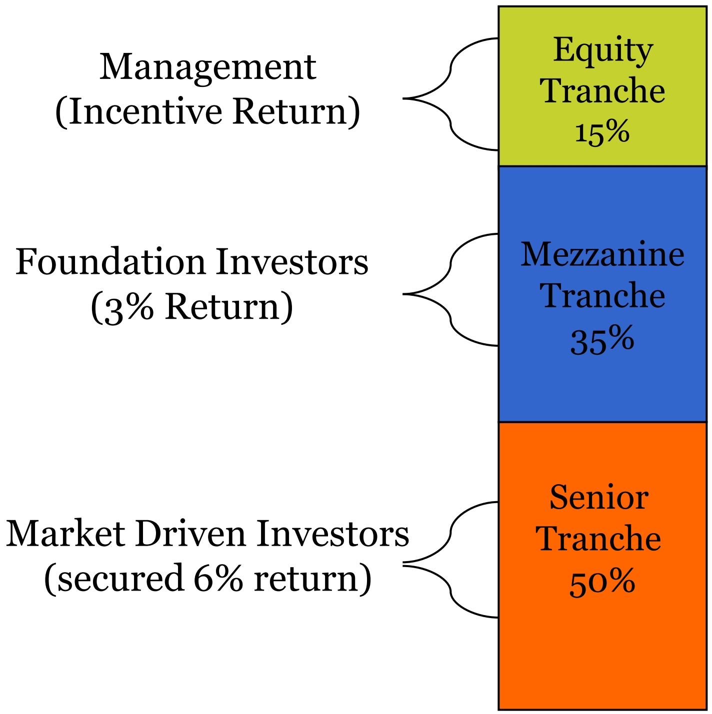
- Foundations make a 25% investment. They buy the first tier or equity tranche and receive a proposed 2% return.
- Mezzanine Investors (private investors, corporations, trusts, banks seeking to fill their Community Reinvestment Act obligations, and socially-minded investors who are willing to accept a lower ROI) accept the middle tier or Mezzanine tranche of ownership with less than market rates of return at a proposed 4%.
- Pension funds and other institutional investors and market based investors requiring less risk and market return invest at a proposed ROI of 7%.
- The blended rate of return is 4% which is within the capacity of the L3c to generate the needed income.

Scenario # 2 - Tiered Investment



- Another possibility is that development agencies and other governmental partners take the equity tranche at 0% return, essentially making a grant.
- The foundation takes the mezzanine tranche at a 2 % return.
- The balance is then marketed to outside investors at 7%.
- Again we have a 4% blended return.
- The membership rights of this portion can be adjusted to meet the needs of potential investors.

Scenario #3 - Tiered Investment



- Equity (management) tranche receives 15% ownership but only gets a financial return if profits exceed 6% of total capital.
- Private Foundation: The private foundation invests 50% of the needed L3Ccapital ($5 million) but its ownership stake is 35% and it is subordinate to the Senior Tranche.
- The market driven investors put up 50% ($5 million). Their ownership stake is 50% and is senior to the other shares. They receive all returns up to 3% of total capital ($300,000 or 6% of their investment) per year.

L3C Examples – Benefits

- The ability of the foundation to invest at less than the market rate and at higher risk lowers the risk to other investors while increasing their potential rate of return.
  - The foundation is able to further its mission while making an investment rather than a grant.
  - Entrepreneurs/management can have incentive opportunities.
  - The for-profit investor is able to make a market-driven investment where none existed previously.
  - Foundation leverages its capital to increase the overall investment.

L^{3}C Examples – Flexible Financing

- What about socially motivated investors?
- For many firms and individuals, an investment with a reasonable level of risk and a moderate return on investment – ROI - is attractive because they are willing to trade some income and security for philanthropic satisfaction – a social return on investment or SROI.
- These socially-motivated investors could assume ownership levels in a mezzanine position or second tier with at or below market rates.
- The L3C flexible ownership structure allows for any number of ownership combinations.
- One or more tiers of Investment are possible.
- This flexibility makes the L3C attractive for social ventures.

Advantages to the Private Foundation

- Confidence that its share of the L^3C is a PRI-qualified investment under the Internal Revenue Code.
- Leveraged its investment to attract additional capital to the project.
- Attracted new partners with the expertise to make the investment work – good, reputable partners.
- Retained its investment to further the foundation's mission in the future and potentially enjoy capital gains.
- Remember, the private foundation is used to making grants so the prospect of an ROI and an SROI is very attractive.

Expanding the Ability of Foundations to Invest in Social Ventures in the US and worldwide

- The L3C offers private foundations a powerful new tool to achieve their mission and further social ventures.
- It gives businesses and the investment world a wholly new vehicle to make socially responsible investments.
- It expands the capital available for foundations and other non-profits to continue their important work.
- It is the bridge betwwen the for-profit and nonprofit world.

Advantages to the For-Profit Investor

- The L3C offers a new world of potential investments to the individual investor with social purposes
- “Doing good and making money” by investing in a project that the investor really cares about.
- The L3C allows investors to make socially motivated investments at a market based risk and return.
- The L3C has a flexible management and ownership structure to meet the needs of the for-profit investor.
- The L3C offers limited liability and minimized risk

Corporate Governance and the L3C

- The L3C is designed to operate as a private business. This for-profit aspect of the L3C helps to make the business self-regulating and self-sustaining.
- Managers of the L3C will enjoy the freedom and flexibility of a for-profit with statute mandated charitable purposes that ensure they maintain the nonprofit nature of the venture.
- The L3C will operate with a board of managers, officers and members to help ensure it complies with the goals set out by its founders and its operating agreement.
- As a state based entity, normal state business laws apply to the L3C to promote good governance.

L3C Legislation and Your State

- On April 30, 2008, Vermont enacted the first law to authorize the formation of L3Cs. Since then. it has become law in Michigan, Wyoming, Utah, Illinois, The Crow Indian Nation and is pending in NC, ND, Oregon, Tennessee, Arkansas. California, Missouri, Montana and Washington State.
- Now that some states have acted, L^3Cs may be formed under their state laws to operate in all 50 states, the District of Columbia and all U.S. territories.
- While the L3C may not be adopted by your state, you can form the L3C in another state such as Vermont and then register in your state as a foreign LLC.
- Expect that more states will follow by enacting L3C legislation in 2010.