



# The Future of Philanthropy

## Hybrid Social Ventures

Roxanne Phen

An Americans for Community Development Publication



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“While business advertises, charity is taught to beg. While business motivates with a dollar, charity is told to motivate with guilt. While business takes chances, charity is expected to be cautious. We measure the success of businesses over the long term, but we want our gratification in charity immediately. We are taught that a return on investment should be offered for making consumer goods, but not for making a better world.”

***-Dan Pallotta, Uncharitable***

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# Chapter One

## The Problem

In June of 2009, the North Shore Music Theatre, a Massachusetts nonprofit created in 1955, was forced to close its doors. Once the largest regional theatre group in New England, North Shore attempted a last ditch fund raising effort that was insufficient to save the organization. The theatre, which brought high quality productions to the community for decades, once had 10,000 subscribers. At its closing, the theatre had 4,400 subscribers for the recently renovated 1,580 seat theatre (Leighton 2009). When the North Shore Community Arts Foundation went bankrupt, the residents of Beverly, Massachusetts were left without a major arts institution and community landmark (Edgers 2009). Late 2009 brought some hope for the return of musical theatre to Beverly, although the new owner of the North Shore Music Theatre planned to run a “leaner organization” (Leighton 2009).

As a result of \$14 million in losses in 2008, the Seattle Post-Intelligencer, the city’s oldest business, was put up for sale. However, when 60 days passed without a buyer, the Hearst Corporation decided to stop publishing its newspaper print edition and switch to an online format. (Richman and James 2009). The 146-year-old Post-Intelligencer was not the first or only newspaper that faced such a fate. It joined the Denver Rocky Mountain News and other major publications across the country in ceasing to produce a daily newspaper because of a number of funding difficulties, including a decrease in advertising revenue and increasingly fewer readers (The Guardian 2009).

Every day, socially beneficial nonprofit organizations and for-profit businesses such as these are being forced to cease operations. Our current system of financing social good is insufficient to fund many worthy causes that straddle the nonprofit and private sectors, so these unique organizations often fall through the gaps. Arthur Wood, the former Global Head of Social Financial Services of Ashoka and current Chairman of the World Sanitation Financing Facility (WSFF), explains the current situation in the following way: “The current funding structure of philanthropy...has really only two positions to invest: namely a ‘for-profit’ with social impact (say, 6 percent plus); or a grant model where the money is given away (at a return of negative 100 percent)” (Wood, A New Social Contract for Philanthropy 2010). As Mr. Wood explains, “there is a range of positions between -100 and +6. But there are no structures that actually allow you to operate within that framework” (Wood, A New Social Contract for Philanthropy? 2010).

The nonprofit landscape is not adequately equipped to accommodate these organizations with potential revenue streams, and the market often will not sustain these efforts as for-profit businesses. Little in the current economic environment leaves room for the possibility that financing social good does not always necessitate a market return or an act of charity. The existing structure is insufficient to fund consistently diverse social goods like the North Shore Music Theatre, the Seattle Post-Intelligencer and countless other endeavors. If we determine that such endeavors are indeed worth sustaining, then we must turn to new solutions to maintain these goods and create others that will advance social good.

Today, even social causes that fall directly into the nonprofit world face the problem of under capitalization, and the issue appears to be getting even more serious. In times of economic prosperity, nonprofits spend time and resources pursuing grants and donations from charitable foundations and individuals. The very process of seeking funding squanders funds. Money that could be used for programs or organizational improvement is instead dedicated to researching grants and foundations, writing letters of inquiry that often go unanswered and submitting grants to foundations that receive thousands of similar requests. It has been estimated that, in the nonprofit sector, the cost of acquiring capital is between 22 and 43 cents on the dollar, ten times the cost of the same action in the private sector (Wood, *A New Social Contract for Philanthropy?* 2010).

In tough economic times, the situation worsens, and as endowments lose value, foundations are forced to scale back their grant making. In 2008, US foundation endowments faced an average 26 percent devaluation (Preston 2009). This steep drop in endowments not only negatively affects current grantees, but other nonprofits looking to make connections with foundations that have not funded them in the past. It becomes almost impossible to connect with new funding sources when the foundations can barely afford to continue funding programs with which they already have a previous affiliation. The drop in foundation endowments has made it significantly more difficult for nonprofit organizations to continue their work. Social service organizations raised 16 percent less in 2008 than in the previous year, while 54 percent of them reported an increase in the need for their services. Moreover, a recent survey found that 60 percent of organizations were subsequently forced to lay off workers or curtail services (Wasley 2009).

Even in 2011, as foundations are gaining back assets, “foundation endowments remain roughly 17 percent lower than before the recession” (López-Rivera and Preston 2011). As organizations suffer and the people they serve struggle, it becomes all too clear that a solution to the under capitalization of traditionally nonprofit causes is necessary.



## A Possible Solution: Hybrid Social Ventures

While not all traditionally nonprofit causes can be aided by hybrid social ventures, they do provide one possible solution for socially beneficial endeavors with a revenue stream. These hybrid, low profit companies fall somewhere in between the nonprofit and for-profit spheres, utilizing the flexibility of a for-profit business for a nonprofit cause. For years, creative individuals and organizations have created makeshift hybrids, attempting to combine the best of both worlds for a social cause. Only recently have attempts been made to create a specific legal structure identifying organizations that are eligible to receive funding from the nonprofit, for-profit, and governmental spheres simultaneously because of their socially beneficial activities.

In the United States, one such structure is garnering attention: the low-profit limited liability company (L<sup>3</sup>C). This variation of the preexisting limited liability company (LLC) structure was first passed in Vermont in April 2008 and has since been passed in Utah, Michigan, Wyoming, Illinois, Maine, Louisiana, North Carolina, the Oglala Sioux Tribe and the Crow Indian Nation of Montana. By definition, the L<sup>3</sup>C is a for-profit business with the “primary goal of performing a socially beneficial purpose” (Americans for Community Development n.d.). The structure allows for funding to come from private, nonprofit or government sources that are often mutually exclusive. Foundations, government entities, nonprofits, private investors and others all may invest in an L<sup>3</sup>C.

Before this new structure was introduced, foundations were permitted to make investments in for-profit businesses as program-related investments (PRI), but they had to endure a long and arduous process to ensure that investments in profit making ventures for social good complied with the Internal Revenue Code. Written with that very code in mind, the L<sup>3</sup>C legislation encourages foundations to invest in L<sup>3</sup>Cs and have the possibility of getting a return on their investment. The tranching investment structure of the L<sup>3</sup>C would allow foundations to take the riskiest position in the venture and a smaller rate of return, making it a more attractive investment for private investors, corporations and governmental groups.

The L<sup>3</sup>C is not the only type of hybrid social venture imaginable, or even the only type in existence. The United Kingdom also has a similar legal entity called the Community Interest Company, which has been in existence since 2005. In the United States, the B Corporation is another effort at combining the nonprofit and for-profit worlds, although it approaches this task in a different way than the L<sup>3</sup>C. Both of these structures will be considered later in this paper.

## Considerations

In the coming chapters, this paper will address a number of considerations associated with hybrid social ventures and recommend a course of action for struggling social causes with access to a revenue stream.

### ■ The need for hybrid social ventures

As discussed previously, a number of existing nonprofits and for-profit businesses are strong candidates for hybrid social ventures. The newspaper industry is merely one example of the good that hybrid social ventures could do, but this example alone makes a compelling case for this low-profit structure. Between 2007 and 2008, advertising revenue decreased by 23 percent across the newspaper industry and in 2008 alone, almost 16,000 newspaper employees and journalists lost their jobs (Pickard 2009). Proponents of the L<sup>3</sup>C structure have indicated that it could be the best solution to save these public goods. While newspapers may no longer thrive as for-profit businesses, they could continue to be profitable, if only marginally. A newspaper financed primarily by a foundation and then by private investors could be the future of this form of media.

L<sup>3</sup>Cs and other hybrid social ventures could be applied to theatres, museums, symphonies and any number of other organizations with a revenue stream. The possibilities are endless. One excellent candidate for the L<sup>3</sup>C structure is a unique gang prevention nonprofit based in Los Angeles, Homeboy Industries. This nonprofit operates a number of small businesses that employ former gang members who are looking to get their lives back on track. In addition to businesses like Homeboy Bakery and Homegirl Café, Homeboy Industries provides services, such as mental health counseling, legal services and tattoo removal, to individuals seeking to leave their gang participation behind them. The organization has faced financial hardship in the recession, making it difficult to continue operations and provide these services (Bolderson 2009). Converting Homeboy Industries to an L<sup>3</sup>C could allow it to meet its funding needs without relying solely on foundation support.

There are undercapitalized worthy causes with a revenue stream that would benefit from hybrid structures for social good. This is not to say, however, that all social goods can be sustained, even with the introduction of hybrid social ventures into the picture. In order for a nonprofit or hybrid to survive, it must have a sufficiently high social return to warrant the funding.

### ■ What qualifies as a hybrid: A look at existing solutions

Numerous configurations already exist that combine nonprofit and private structures to promote social good. For the purposes of this paper, however, a hybrid social venture is defined as one entity that combines the methods of the nonprofit and for-profit sectors with the possibility of receiving funding from either. There are a number of structures that already exist that combine for-profit businesses with nonprofit goals. Corporate foundations, nonprofits with business subsidiaries and for-profit businesses paired with non-governmental organizations (NGOs) utilize different structures, but it is not useful to consider these structures as hybrids. Each structure will be discussed in more detail, but since these all utilize preexisting structures, they will not tell us more about the effectiveness and efficiency of a structure that, by itself, can receive funding from nonprofit and private sources.

### ■ The effect of hybrids on nonprofits

The hybrid structure is not appropriate for all nonprofit causes. If no aspect of the organization lends itself to for-profit activities, then the hybrid structure as it currently stands would not be a viable option. However; this does not mean that hybrid structures could not still be beneficial to those organizations that remain fully nonprofit in structure. Since legal structures for hybrid social ventures are in their nascent stages and their impact still small in comparison to the US nonprofit sector generally, it is difficult to forecast how the introduction and success of hybrid structures such as the L<sup>3</sup>C will affect the funding landscape for traditionally nonprofit causes.

The hybrid social venture, through its effect on foundation endowments, could either funnel additional funding toward causes traditionally addressed by nonprofits, or siphon money away from those targeted activities. This paper hypothesizes that the former condition will hold, and that the existence of hybrid social ventures is good not only for the causes they serve, but for nonprofit organizations as well. In so doing, it also examines the effect hybrid social ventures could have on foundations.

### ■ The effect of hybrids on foundations

Given the ease of making program-related investments (PRIs) in low-profit limited liability companies (L<sup>3</sup>Cs), it is possible that we will see a shift in how foundations allocate the five percent of their endowments that they are required by law to distribute. Currently, most foundations distribute this money in the form of grants rather than perform the due diligence required to make an informed PRI in a for-profit entity. Currently, it is customary for foundations to give away money with no hope of any return on their investment other

than social good being done. If a foundation were to use some of its five percent to invest in an L<sup>3</sup>C, there would be at least the possibility of a return on the investment, even if turned out to be small. In theory, this could change the way foundations do business. This paper analyzes whether a shift from grants to PRIs is likely, and advisable..

### ■ The effect of hybrids on other investors

Next, this paper will examine the scenario from the perspective of a private investor – a corporation or individual who chooses to become an investor in a low-profit company. We will examine whether the possibility of a small return on the investment is enough for individuals to become partners at the mezzanine level of investment and how socially responsible investing impacts an individual's willingness to accept a smaller return on an investment

### ■ The effect of hybrids on the social cause

Finally, this paper will address the impact that introducing a profit will have on traditionally nonprofit causes. This is a concern that some individuals have expressed: that “‘market’ values may supersede charitable ones, causing organizations to judge their activities by what they are worth, rather than whether they are worthwhile” (Lenkowsky 1999). While many nonprofits are currently run by individuals knowledgeable about the cause or population they are serving, a different class of individuals might be the ones needed to run these converted hybrids in a way that turns a profit. While the primary goal of a low-profit hybrid is the social good, it is unclear if and how much profit will affect the organizational operations and structure.

## A look forward

In the past, a response to issues typically addressed by nonprofits has been the introduction of more nonprofits. This paper suggests not only that other options exist for bringing about social good, but that, for some types of organizations, better options exist in terms of structure and financing. Innovation is not limited to the for-profit world. Creative and business savvy solutions are available to organizations with socially conscious purposes, but only if nonprofits and foundations are open to fundamentally changing the way that they do business.

## Chapter Two

### What is a Hybrid Social Venture?

The hybrid social venture was not an idea that emerged overnight. For many years, innovative individuals and organizations have been experimenting with new business forms that combine aspects of nonprofit and for-profit organizations.

In order to fully understand the implications of the hybrid social venture and its most common form in the United States, the low-profit limited liability company (L<sup>3</sup>C), it is important to be aware of the continuum of this marriage of business and philanthropy and where the hybrid social venture falls on that spectrum. While the following list is by no means exhaustive, it gives a good indication of the types of organizations that incorporate nonprofit and business efforts together and better clarifies what a hybrid social venture is by showing what it is not. It is worth noting that there may be some variation as to where these structures lie within the continuum, but nonetheless their relativity to each other remains somewhat constant.

On one end of the spectrum are traditional for-profit companies that make no explicit effort to pursue social causes beyond the profit maximizing advantage and goodwill that motivates this pursuit. Some for-profit businesses will sacrifice a degree of profit to pursue these social causes. **Socially committed private enterprises** are still primarily concerned with profits, but they do address social issues in one way or another, either through education or funding. An example of a social enterprise is Ethos Water, the bottled water company with the social mission of “helping children get clean water” by donating a portion of the revenue to programs that support safe water (Ethos Water 2008).

Ethos Water was founded in 2003 by Jonathan Greenblat and Peter Thum, who were inspired to form the company after working on a consulting job in South Africa. The company donates \$0.05 for every \$1.80 bottle of water that is sold to support projects around the world in Bangladesh, the Democratic Republic of the Congo, Ethiopia, Honduras, India and Kenya (Dahm 2006). Ethos Water was purchased by Starbucks in 2005, which has led to even greater profits and contributions made from the sale of the water. The classification of Ethos Water as a socially committed private enterprise is still not entirely clear without an extensive analysis of the company. It may be possible that the company’s promise to give helps to brand the company in such a way that it actually has higher revenues than it would without the social cause.

A **corporate foundation** is a charitable organization associated with a corporation. These foundations are usually formed to create positive change in their communities and, in some cases, to illustrate to the public the company's commitment to social good. The closeness of the foundation and company is highly variable and depends on the individual organization. When categorized by "total giving," the largest corporate foundation is The Bank of America Charitable Foundation, which is a separate legal entity from the Bank of America Corporation (Foundation Center 2009). This foundation is loosely connected to the Bank of America Corporation and concentrates its giving in areas where the bank does business through small local grants. Other foundations, like the Ford Foundation, were once connected to a corporation but have since become entirely independent (The Ford Foundation 2009).

Sometimes, a for-profit company partners with a non-governmental organization (NGO) to form a **collaborative effort for social good**. The company's primary goal remains a profit, while the NGO has a primary goal of promoting some element of socially beneficial outcome. One example of such a partnership is the relationship between brewer SAB Miller and CARE International. SAB Miller has produced a new beer that is made from sorghum, a crop common to Uganda. Local farmers are growing the crop for the brewery, which is helping to provide an income to the farmers and also taking over the beer market in the country. Assisting with this effort, CARE International is aiding the farmers with their farming and business skills (Inspiris Limited 2006).

Some nonprofit organizations engage in activities that bring in some amount of revenue into the organization. **Nonprofits with revenue streams** have a primary purpose that is not a profit, but revenue is pumped back into the organization. For example, museums may be nonprofits but generate revenue through ticket sales. The primary source of funding for these types of organizations, however, is often foundation grants. Some **nonprofit organizations** do not have a revenue stream, but provide goods or services to advance some sort of charitable cause. They receive funding through private donations or foundation grants. Currently these are the structures least associated with business, although some nonprofit leaders might run their nonprofits with a businesslike approach.

Even though the above examples illustrate the interaction of business and nonprofit causes in some capacity, only the hybrid social venture, as defined in this paper, allows for the combination of funding from nonprofit and for-profit investors in one legal entity. This will prove to be the distinguishing factor that separates hybrid social ventures from previous attempts to combine these two areas.

In the United States, the most prevalent hybrid social venture is the low-profit limited liability company (L<sup>3</sup>C). However, other hybrid structures exist in other countries, such as the Community Interest Company (CIC) in the United Kingdom.

One might ask why a new business form is needed when other alternatives already exist that combine nonprofit and for-profit forces. While the forms previously described have had their successes, they are not appropriate in all circumstances. Let us reexamine these forms and why some valuable ventures fall through the cracks despite their presence.

**1. Socially committed private enterprises** – These organizations are for-profit businesses, and many publicly held organizations have obligations to their shareholders. This eliminates a fair amount of organizations that have a revenue stream but cannot bring in enough money to survive in the market without subsidization.

**2. Corporate foundations** – Corporate foundations provide many nonprofit organizations with grants for programs. Unfortunately, these grants have limitations and cannot provide funding to all causes that activists believe ought to be funded. Even when funding is provided to an organization, it is often for programs rather than operating expenses. Finally, corporate foundations are limited in how they can spend their funds. They often limit their funding to nonprofit organizations and in most cases do not fund for-profit enterprises that promote a social good.

**3. Collaborative efforts for social good** – This term could apply to a variety of different partnerships, so it is difficult to conclude that partnerships between businesses and nonprofits cannot fill the void that the hybrid social venture seeks to occupy. There are, however, some difficulties that suggest that another form might be more effective for new or small efforts for social good. Many partnerships entered into by for-profit businesses are with large and well-established nonprofit organizations. One such example is the partnership between American Express and the Statue of Liberty – Ellis Island Foundation, Inc. The credit card company launched a campaign that increased card usage and raised \$1.7 million for the restoration of the statue so that it could be reopened to the public (Sinclair and Galaskiewicz 1996-1997). Since these partnerships are helped by name recognition and a track record of legitimacy, such partnerships are nearly impossible to achieve for small, local organizations, or organizations just forming. This is not to say that these partnerships cannot be used to address a number of funding deficiencies for social causes, however the difficulties for small organizations makes one think that another form might better achieve the task in some cases.

**4. Nonprofits** – Nonprofits with and without revenue streams face the problem of under capitalization. Since these organizations are self-contained, they do not benefit from for-profit funding unless they are engaged in a partnership. As discussed previously, some nonprofit organizations are not getting the funding they believe they need from foundations and individuals donors to serve their communities. According to Arthur Wood, the current nonprofit system pits organizations against each other for the same funding. He notes that “competitive advantage for capital is about coming up with a clever idea, at least in the foundation world, and not collaborating with the very people you should collaborate with” (Wood, *A New Social Contract for Philanthropy* 2010).

Despite the existence of the above forms, newspapers, local theaters and other organizations are slipping through the funding gap. Since the existing forms do not cater to the needs of such organizations, one foundation CEO, Robert Lang, saw it necessary to create a form that did.

## Low-profit Limited Liability Companies

### ■ Structure

The structure that exists for hybrid social ventures in the United States is the low-profit limited liability company (L<sup>3</sup>C). The L<sup>3</sup>C is a form of limited liability company (LLC). The LLC is a hybrid all on its own: a combination of the corporation and partnership. The LLC is a fairly new legal structure in its own right. While the LLC was first introduced in Wyoming in 1977, the structure did not become popular until the Internal Revenue Service (IRS) classified the LLC as a partnership for tax purposes in 1988 (Ribstein 1995, 3). It was not until 1994 that the Uniform Limited Liability Company Act (ULLCA) was passed (Bishop 1995, 51). The L<sup>3</sup>C simply amends state law to expand the definition of the LLC. This means that the L<sup>3</sup>C is the same legal structure as the LLC with the caveat that it must exist primarily for a socially beneficial purpose that must be included in its state charter (Mannweiler Foundation 1). The Vermont law sets forth three requirements for a company to qualify as an L<sup>3</sup>C:

(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 IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) 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 IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D) (State of Vermont 2010).

Since the LLC is a flexible business form, there are many ways that an L<sup>3</sup>C could be structured. An L<sup>3</sup>C could be formed, for example, in one of the following ways.

1. Foundation investment: In this scenario, a private foundation becomes the primary investor in the L<sup>3</sup>C. When a foundation makes a program-related investment (PRI), they assume a high risk and the possibility of a low financial return on their investment. The next class of investors has a higher return on their investment, and eventually a class of investors makes market returns.
2. Government grant: When a government grant becomes the first investment, the foundation enters in a less risky position and will likely need to lower its interest rate in order to make an allowable PRI. For-profit investors will follow with a higher rate of return. Alternatively, an L<sup>3</sup>C might only have government and private members.
3. For-profit investment: In another scenario, a for-profit investor agrees to make an investment that is contingent upon the hybrid obtaining funding from additional sources. This does not mean that the for-profit investor will then receive a lower rate of return because of its status as the first investor. The nonprofit funder, when identified, will still receive the lower rate of return.

The above list is by no means exhaustive. As of May 2011, proponents of the L<sup>3</sup>C are exploring a number of other funding structures as alternatives to the ones listed above: the Donor-Advised Fund (DAF) and the New Markets Tax Credit (NMTC).

1. Donor-Advised Fund: A DAF is a “separately identified fund or account that is maintained and operated by a section 501(c)(3) organization, which is called a sponsoring organization” (Internal Revenue Service 2010) and contributed to by private donors. In this scenario, a donor would make a tax-deductible donation to a Donor-Advised Fund, which he would advise to make a PRI in an L<sup>3</sup>C.

2. **New Markets Tax Credit: The Community Development Financial Institutions (CDFI) Fund** awards a tax credit allocation to an organization that qualifies as a “community development entity” (CDE). L<sup>3</sup>Cs engaged in community development activities would apply to receive a portion of the awarded allocation that it could use to attract investors (Briscoe 2011).

An L<sup>3</sup>C does not need to have foundation, government or even private members other than the founder in order to exist. Some L<sup>3</sup>Cs might elect to function much like traditional LLCs for a number of reasons. It’s possible that additional funding is not needed, and the branding of being a charitable business is desired.

### ■ Program-Related Investments

The program-related investment (PRI) exception was created by the Tax Reform Act of 1969. That piece of legislation made “jeopardizing investments” by foundations fineable offenses. If an investment has the possibility of “imperil[ing] the foundation’s ability to carry out its charitable activities,” it is not permitted, with one exception: the PRI (Carlson 2006). Before the law took effect, the only action that a foundation could take to satisfy the 5 percent disbursement requirement would be to issue a grant to an organization. The PRI, which would be a jeopardizing investment if a part of the foundation’s endowment, became acceptable as another tool to carry out the foundation’s charitable purpose. In order for an investment to count as a PRI, it must meet three standards:

1. The investment’s primary purpose must be to advance the foundation’s charitable objectives.
2. Neither the production of income nor appreciation of property can be a significant purpose.
3. The funds cannot be used directly or indirectly to lobby or for political purposes (Carlson 2006).

PRIs can take a number of forms such as equity investments, below-market loans or loan guarantees. According to Luther Ragin, Vice President for Investments at the F.B. Heron Foundation, there are two schools of thought about what makes a PRI not significantly for the purpose of producing income. The first functions under the assumption that a PRI with a low return (one to two percent) will not be seen by the IRS as an attempt to use an investment for the production of income. Foundations operating under this assumption, like the Ford Foundation, sometimes even cap their returns at two percent. Other foundations, like Ragin’s, seek below-market returns on a risk adjusted basis, believing that PRIs should

be compared to what a socially indifferent market-rate investor would expect as a return (Ragin 2010).

Despite the fact that PRIs have been in existence for over 40 years, grants are still the method of choice for meeting the disbursement requirement. Approximately \$90 billion of distributions are made by foundations each year, yet only about \$1 billion of those distributions are made in the form of PRIs (Ragin 2010).

### ■ History

Robert Lang, the CEO of the Mary Elizabeth and Gordon B. Mannweiler Foundation, introduced the concept of the low-profit limited liability company (L<sup>3</sup>C) in 2005 (Schwister 2009). Since then, eight states and two sovereign Indian nations have passed L<sup>3</sup>C legislation. Vermont was the first, passing the legislation in April of 2008. As of September 24, 2009, 77 L<sup>3</sup>Cs were registered in the state of Vermont. As of May, 2011 that number had jumped to almost 150. The first L<sup>3</sup>C, L<sup>3</sup>C Advisors, L<sup>3</sup>C, was created in Vermont by Robert Lang to promote the new structure and to aid others in beginning their own L<sup>3</sup>Cs. Many of the L<sup>3</sup>Cs incorporated in Vermont do not operate within that state, but operate in states in which the L<sup>3</sup>C legislation has not yet passed.

The types of causes that L<sup>3</sup>Cs are addressing are varied. Rethink Impact is a website, set to launch in June, which matches nonprofits and L<sup>3</sup>Cs with foundations looking to award grants and make PRIs. Nonprofits and L<sup>3</sup>Cs may join free of charge, while foundations can subscribe for premier features. Each nonprofit/L<sup>3</sup>C makes a short video in the format suggested by Rethink Impact, and foundations search for organizations that match their funding guidelines. After watching the short videos that the organizations make, foundations invite possible matches to apply for a funding (Andrews 2011). Maine's Own Organic Milk Company (MOO Milk) is a Maine-based L<sup>3</sup>C that serves a very different purpose. MOO Milk was formed after ten dairy farmers in Maine were dropped by their distributor. The farmers joined together to save dozens of jobs in the community and provide organic milk to their state. Their stated purpose is "to promote farm preservation and economic development in Maine by marketing and distributing 100 percent Maine organic milk." As of March 2010, MOO Milk was being sold in over 150 stores in Maine, New Hampshire and Massachusetts, including Whole Foods and Wal-Mart. One L<sup>3</sup>C actually incorporated and based in Vermont is Faithful Travelers, a company that organizes service trips for schools, churches and other groups to locations around the globe. It is evident that the L<sup>3</sup>C structure can, and already is, being used in a wide variety of ventures.

In January of 2009, the L<sup>3</sup>C legislation was passed in Michigan. As of May, 2011, eighty-six

L<sup>3</sup>Cs were in existence, or in the process of being approved by the state. As of the same date, Utah had thirty-three and Illinois had fifty-nine L<sup>3</sup>Cs incorporated in their states, while Wyoming had twenty-three L<sup>3</sup>Cs incorporated there. The two states which have most recently passed L<sup>3</sup>C legislation, North Carolina and Louisiana, have twenty and eight L<sup>3</sup>Cs registered, respectively. One L<sup>3</sup>C has been incorporated in the Oglala Sioux Tribe. The L<sup>3</sup>C legislation has been passed in Maine, doesn't take effect until July 1, 2011.

### Are the Causes Pursued by Hybrids Worth Pursuing?

If an organization cannot be funded to the necessary degree in either the nonprofit or for-profit sector, then one might question whether it should be funded at all. Many organizations that meet this description are funded via subsidy because they fall into one of two categories: 1) distributions or 2) public goods. In both cases, the market fails to sustain activities which society deems worthy of existing even though individuals often will not pay for these activities on their own.

At first glance, hybrid social ventures do not fall into either category. In all cases, these organizations have a revenue stream and are not purely distributional. While hybrid social ventures are certainly capable of producing public goods, in many cases they provide private goods. However; many organizations that do not traditionally fall under one of the above two categories should be sustained even when they cannot exist as fully for-profit businesses or nonprofit organizations. Some possible hybrid social ventures might have distributional qualities while retaining their status as a business. One example is the aforementioned Homeboy Industries. If that organization, currently organized as a nonprofit, were to become a hybrid social venture, its primary purpose would be a socially beneficial one: lowering the recidivism rate by providing a steady job and income to individuals who have been in gangs. While Homeboy Industries would not be distributing food or money to the individuals directly, it is providing job opportunities to a specific segment of the population that is less likely to be hired by employers. Therefore, this type of organization should be sustained despite its inability to function on its own as a for-profit business because of its pseudo-distributional qualities. Other types of hybrids that do not have any distributional qualities might be more susceptible to criticisms about the need for their existence.

If a hybrid social venture provides a private good and, in the long run, revenue is exceeded by costs, then it should cease operations and shut down. An arts organization that fits these criteria, according to this view, is not sufficiently valued by the market, and its resources

should be put to better use. Weisbrod (1964) suggests that a closure of the business is not always the choice that optimizes utility. He argues that private goods can have qualities of public goods that make them, in some cases, worthy of subsidization because of what he calls “option value.” According to this idea, even if the individuals contributing to the revenue of the business are not consuming enough of the good to sustain the business, there are other consumers who are not currently contributing to revenue but value the option of being able to do so in the future. These people are not accounted for in a traditional economic analysis of a firm, and may not even become users despite their intentions. Even so, Weisbrod argues that these people “will be willing to pay something for the option to consume the commodity in the future” (Weisbrod, 472). He acknowledges that this idea could apply, in theory, to any good or service, but does not mean that every business is necessarily worthy of being sustained via subsidization. He concludes that the idea of the “option value” does provide a reason to question whether an unprofitable organization providing a private good should close.

While Weisbrod applies this theory to national parks, hospitals and public transportation, Cameron classifies local theaters as “option goods,” because their closing would diminish the “value obtained from knowing that one could use something if one wanted to” (Cameron, 244). It could be argued then, that at least some museums, theaters and other hybrid social ventures that derive their revenue streams from private goods are worthy of being sustained despite their inability to succeed with only nonprofit or only for-profit funding.

# Chapter Three

## Organizational and Financial Feasibility

In a traditional business, success is usually evaluated monetarily. Nonprofits face a more complicated situation in which they must try to measure their impact against their stated social cause, often involving intangible metrics. While this may be difficult, the nonprofits can look to their achievements and say whether or not they have met their goals. Hybrid social ventures present an interesting case. Their success cannot be measured by profits or impact alone. These two factors must be examined together in some way, however. Brooklyn Law School Professor Dana Brakman Reiser has said, “The boundary between charity and business has become a moving target” (Brakman Reiser 2010).

In order to determine whether L<sup>3</sup>Cs have the capacity to be successful socially and financially, the organizational structure and financial model must be assessed.

## Organizational Structure

Since hybrid social ventures do involve profit-making, what separates them from traditional businesses must be determined. It seems as though the main difference is the existence of an additional requirement on the business, indeed its primary requirement, which is to pursue some type of social good. One factor that must be examined is if and how the interaction of nonprofit and for-profit investors in a hybrid social venture affects the mission and operations of the business.

Given that the hybrid social venture is a relatively new structure, few scholarly critiques have emerged to challenge its effectiveness. There is extensive literature, however, on the blending of nonprofit and for-profit structures generally. While this literature does not specifically address organizations that receive funding from both nonprofit and for-profit sources, it does examine the benefits and costs of pursuing traditionally nonprofit causes with a businesslike strategy.

In the late 1990s, the idea of venture philanthropy was introduced. Two articles published in the Harvard Business Review in 1997 and 1999 prompted a discussion in the philanthropic world about the place of business in nonprofit operations. Letts, Ryan and Grossman (1997), argue that foundations should adopt some of the practices of venture capitalists in order to make a larger impact on their respective causes. They continue to say that

foundations' work often "comes even before a grant is made – in screening applications or seeking new ideas" (Letts, Ryan and Grossman 1997). In approaching the grant making process from the venture capital perspective, foundations would focus more on building relationships with the nonprofit they are funding. This would include ensuring that results are being measured and funding the nonprofit consistently so that they can continue to build strong and effective programs after the first few years. The authors conclude with questions that foundations and nonprofits should ask themselves about the way they were currently doing business.

Letts, Ryan and Grossman's ideas about applying business practices to philanthropy prompted additional examinations of this potentially beneficial relationship between business and nonprofits. In 1999, Porter and Kramer wrote, "Instead of competing in markets, foundations are in the business of contributing to society by using scarce philanthropic resources to their maximum potential. A foundation creates value when it achieves an equivalent social benefit with fewer dollars or creates greater social benefit for comparable cost" (Porter and Kramer 1999). They proposed that foundations adopt a strategy and apply it rigorously to their giving.

Many scholars have been wary of introducing business practices into the social sector. These early treatises on venture philanthropy were followed by critiques of the combination of for-profit and nonprofit methods to promote social good. Eikenberry and Kluver argue, "A corporate model, which stresses the values of strategy development, risk taking, and competitive positioning is incompatible with the nonprofit model, which stresses the values of community participation, due process, and stewardship" (Eikenberry and Kluver 2004). These values, however, can in fact coexist in an organization.

Concerns about competing nonprofit and for-profit interests in an organization are usually of the general sort: that the introduction of profit into the nonprofit cause might de-emphasize justice and fairness and impact the nonprofit's mission. Some scholars, such as Young (2002), have introduced scenarios that reveal possible problem points. Young provides examples of how business and nonprofits have interacted with unfavorable outcomes in the world of higher education. His scenarios, however, only show the potential problems in an ill constructed partnership between a nonprofit and for-profit cause. In the cases he examines, for-profit interests play a major role in the sacrificing of the nonprofit mission at a private university. In all likelihood, the problems he raises could have been avoided if the roles and responsibilities of both the nonprofit and for-profit parties were decided before moving forward. These examples do not show the fundamental incompatibility of business and nonprofits. While the current literature does not address these concerns as they apply

to hybrid social ventures specifically, this paper examines possible concerns about the competing interests that could exist within such an organization and how they could be addressed.

A foundation's primary interest is promoting its mission through the funding of programs, while a traditional business's primary objective is to make a profit. Of course, these goals do not always coincide. If they did, there would be no need for the social sector; what would promote the social good would also be profitable. Since that is not the case, conflicts between these two competing interests could possibly manifest in three areas in a hybrid social venture: content, prices and people.

### ■ Content

Conflicting interests concerning content would in many cases be found in arts organizations. While one content set might align better with the organization's mission, another might lead to greater profit. Take the case of a hypothetical nonprofit classic movie theater.

Play it Again is a hybrid social venture that educates the public about classic film through frequent movie screenings at its theater. The individuals who started the venture are concerned with showing more obscure films that many people unfamiliar with classic film have not likely come across. These films, however, may not bring in as many viewers as better known classic films such as *Casablanca* and *Psycho*. While these films will likely bring in more revenue for the theater, they may not align as closely with the mission of the organization. Should content be decided by the mission, or by what films will result in the highest returns for the private investors?

### ■ Prices

The second instance in which the nonprofit and for-profit interests might conflict is in regard to prices. Problems could arise from the pricing of goods, but also from wages paid to individuals. Consider Fresh Start, another hypothetical hybrid social venture.

Fresh Start is a laundering and dry cleaning service that employs women just released from prison. The main purpose of the organization is to provide these women with marketable skills that would help them keep a steady job and stay out of prison. The venture is organized as an L<sup>3</sup>C and has nonprofit and private investors. Since the mission of the organization is to provide women with the means to support themselves without turning back to crime, it would follow that the organization would strive to provide women with a wage that would enable them to do so. From a profit perspective, this may not be the optimal choice. The women of Fresh Start would benefit from a higher wage, but the



investors would not receive as high of a return on their investment. Who decides the proper wage?

### ■ People

Another point of contention between the nonprofit and for-profit interests could be in the individuals hired to carry out the day-to-day business of the hybrid social venture. In many nonprofit organizations, the individuals running daily operations are often connected to the cause in one way or another. Sometimes these people are more likely to know about the client and their needs than up and coming business practices. On the other hand, for-profit investors might prefer that the business in which they invest is being run by professionals with the proper training to run a business successfully.

### ■ Solutions

The problems presented are real. Each of these issues and countless variations on them could arise in hybrid social ventures. What is important to acknowledge, however, is that the perpetuation of these problems is avoidable. The predetermination of roles and responsibilities is vitally important in the success of the hybrid social venture. Failure to effectively plan prior to the formation of the venture could result in conflicts such as those previously discussed. The operating agreement made at the time of formation should hold the answers to a number of questions:

1. What will be the method for determining content?
2. How will wages and the prices of products and services be determined?
3. Who make decisions about personnel?

If these questions were addressed in the situations previously presented, the conflict could have been avoided in one of two ways. If the interests of the for-profit and non-profit investors were irreconcilable, the two parties would simply agree to not enter into a hybrid social venture together. Alternatively, the two parties could anticipate possible problems and arrive at solutions before they actually arose.

Take, for example, Play it Again, the hypothetical classic movie theater. The question of who determines which movies will play should have been examined prior to an agreement being finalized. Given that the theater intends to keep showing films for an indefinite period of time, it would be overly burdensome for the two groups of investors to agree on a list of specific movies. Some classification system could be created, however, based on current popularity as measured by DVD sales or some other means. The funders could agree that a certain

number of films from each category be played every week, or every month. An agreement could be made that certain classes of films are played at certain times or on certain days. The specific structure that is chosen is of secondary importance to simply having a system to adjudicate such disputes. The price scenario could be similarly approached. The for-profit and nonprofit funders of Fresh Start, the hypothetical dry cleaning service, would have to agree not only on a wage for employees, but also how those wages will change over time to adjust to inflation and the cost of living. As long as this agreed to from the inception of the business, this type of conflict could be avoided.

The most complicated situation is the last – conflicting interests concerning personnel. If the individuals who will be running the hybrid social venture on a day-to-day basis are determined prior to complete capitalization of the organizations, funders may simply not enter into an agreement if they feel that those running the business are not qualified to do so. If this is not the case, both sides could work together to choose mutually acceptable individuals to run the business.

It is not realistic nor possible to foresee every problem that could arise within an organization. For example, in the personnel situation, it may be the case that an employee agreed upon by both sides at the beginning of a partnership leaves the organization. Finding a replacement might be problematic if the non-profit funders would prefer an individual with field related experience while the for-profit funders prefer someone with more extensive business experience even at the cost of experience working with the cause the organization is addressing.

It could very well be argued that, since every scenario cannot be accounted for in preliminary discussions between the different funders of a hybrid social venture, the problem of conflicts between the two parties will always be a problem. While it is true that conflicts may remain, the major points of contention will have been worked out at the formation of the organization, or upon the entrance of an additional funding source. Any problems that arise unexpectedly will be dealt with in the context of the previous agreements, leaving the situation to look like one that may be present in any sort of for-profit business. In any organization there are differing opinions about business decisions, for instance, who should be hired. The fact that a hybrid social venture still faces problems such as these does not indicate the incompatibility of business and nonprofit causes, especially when the magnitude of these problems is lessened by extensive planning and contracting.

Despite the expectation that adopters of the L<sup>3</sup>C structure will construct appropriate operating agreements that attempt to balance the goals of social benefit and profitability, some, like Brooklyn Law School Professor Dana Brakman Reiser, are concerned that this

will not always be the case. She notes, “First, none of this is mandatory. The hallmark of the L<sup>3</sup>C is its flexibility. An L<sup>3</sup>C form allows its adopters to adopt this technique in the operating agreement but they need not undertake any mechanism to enforce their dual mission in order to adopt the form” (Brakman Reiser 2010). Brakman Reiser also suggests that since the IRS will enforce the social mission and foundation investors and will err on the side of caution so as to not incur fines, the blended enterprises will fall more on the side of being charitable than profitable. Some of Brakman Reiser’s thoughts are made under the assumption that foundations’ “interest in profits is either remote or nonexistent” (Brakman Reiser 2010). She notes that this might not always be the case, but sees it as the prevailing position of foundations.

While foundations should not, and cannot, under the law, have profit as their primary motive in making an investment in a hybrid social venture, it is reasonable to assume that foundations would like to see a return on their investment. Program-related investments (PRIs) in most cases would necessitate more care and attention than the distribution of a grant. If a foundation goes through this extra effort to make a PRI, then either the foundation recognizes that substantially more good can be done by making an investment or that in exchange for the extra effort, they could get a return on their investment. While the incentives of foundations to enforce the dual mission of a hybrid social venture might not be of the sort to perfectly balance profitability and social good, they could be better enforcers of the dual mission than Brakman Reiser suggests.

Brakman Reiser instead proposes that the hybrids like the L<sup>3</sup>C will need to be refined over time: “Establishing some method for enforcing a dual mission either by fiat through enforcement of specialized fiduciary obligations or structurally by requiring governance rights to be cited by some appropriately incentivized group, I believe would improve the L<sup>3</sup>C’s claim to be a home for blended enterprise” (Brakman Reiser 2010). While, in time, regulations might be established that make the L<sup>3</sup>C look more like the British hybrid social venture, the Community Interest Company, for now it seems as though L<sup>3</sup>Cs have a motive to stay true to a blended mission. Err too far on the side of charity, and market-rate investors may not have an interest in the L<sup>3</sup>C; err too far on the side of profit maximization and L<sup>3</sup>Cs might not garner the foundation support that they need. Brakman Reiser says, “this may ultimately be a choice between enforcement and capital access,” but up to this point, there has been no evidence that the two are mutually exclusive.

## Financial Model

Even if business and charity can, theoretically, coexist to pursue missions that include profit and social benefit, whether these entities will be funded is another question entirely. Since the low-profit limited liability company (L<sup>3</sup>C), in its ideal form, receives capital from private foundations and for-profit investors, the incentives to invest for each group becomes vitally important. If, for some reason, the structure of the L<sup>3</sup>C is not conducive to investment by foundations and private investors, it will not be able to meet its intended potential and may not be a solution to the undercapitalization of traditionally nonprofit causes.

### ■ Do foundations have an incentive to invest in L<sup>3</sup>Cs?

While much of the talk around the low-profit limited liability company (L<sup>3</sup>C) involves foundations taking an equity stake in the entity, there are a number of ways in which a program-related investment (PRI) can be made. GrantCraft, a project of the Ford Foundation intended to provide knowledge and resources to grant writers, lists six ways in which foundations can make a PRI: common loans, certificates of deposit, linked deposits, common stock, preferred stock and loan guarantees (Carlson 2006). Using any of these methods, the best outcome for a foundation, given IRS Code restrictions, is a below market-rate return on their investment and a maximization of the social good that is accomplished by the investment. Of course, the optimal scenario may not always be the one that comes to be. Foundations must examine the opportunity costs of these PRIs to determine whether they are the best uses of the foundation's resources. A PRI could unfold in a number of ways, most of which are variations of the two scenarios outlined below.

**1. L<sup>3</sup>C becomes insolvent** – This scenario assumes that an L<sup>3</sup>C that becomes insolvent has also not succeeded in carrying out its social purpose. Even if the organization produced more of social benefit than financial benefit while it was in existence, the inability to continue this social benefit in most cases means that the organization has fallen short of achieving its social purpose. The opportunity cost in this case is a grant that could have been made, or perhaps a more appropriate PRI. While it is possible that a grant might have been more successful in furthering the foundation's mission, most grants can only sustain a social benefit for a fixed amount of time before another influx of capital is needed. While a foundation should take into account the trade-off between making a PRI and awarding a grant, a situation in which a foundation, in practice, makes a grant by losing 100 percent of its investment is one that would, in all likelihood, not happen to a conscientious foundation. Foundations should plan for this scenario by securing collateral and only making PRIs in organizations that they trust. While not every PRI will be a successful one for the foundation, a properly formulated PRI will still not result in a 100 percent loss as compared to a grant.

**2. L<sup>3</sup>C produces below market-rate return** – In this case, the foundation, through a disbursement, is actually expanding its grant making capability. Since returns on PRIs must be re-distributed, more money will be cycled into socially beneficial causes either through new PRIs or grants to nonprofit organizations. Again, the investment must be examined from a programming perspective to determine if the social mission of the organization is best served by a PRI. This, however, has little to do with the financial model of the L<sup>3</sup>C. Some PRIs will have a larger impact than grants and vice versa. From a purely financial position, a well-thought-out PRI is beneficial to the private foundation.

At the inception of a PRI making program at a private foundation, there may be costs associated with training the existing foundation staff or hiring outside individuals to manage these investments. However, after the foundation has the human capital to approach PRIs confidently, the making of PRIs has the potential to expand the pool of money that foundations can disburse. For a foundation with the motivation of looking to maximize its social benefit, there is substantial incentive to make PRIs in L<sup>3</sup>Cs.

#### ■ Do private investors have an incentive to invest in L<sup>3</sup>Cs?

Even if an L<sup>3</sup>C receives a program-related investment (PRI) from a private foundation, the L<sup>3</sup>C model assumes private investment from individuals or companies looking for a market-rate return. While the alternative for foundations to a below market-rate return from an L<sup>3</sup>C is a 100 percent loss, market-rate investors are choosing between investing in an L<sup>3</sup>C and a traditional business in which they can expect a market-rate return. Brakman Reiser asks the question “If I am a market-rate investor and I can invest in anything that’s providing market-rate returns, why do I invest in something that’s being run by a charity?” (Brakman Reiser 2010).

The first answer may be that this is an oversimplification of how most L<sup>3</sup>Cs would be run. While, in many cases, a foundation might have substantial decision making ability on the L<sup>3</sup>C’s board of directors, this is not a requirement of the structure. Additionally, the foundation will not be running the company on a day-to-day basis. A team of executives will, at larger and more established L<sup>3</sup>Cs, run the company, with members of the L<sup>3</sup>C voting on major decisions. A market-rate investor likely will not invest in a company in which the management is not qualified to successfully run a business. Simply because a company is an L<sup>3</sup>C does not mean, however, that the executives lack the requisite business skills to provide the investors with a market-rate return.

Even if one concedes that an L<sup>3</sup>C is a business “run by a charity,” one must not confuse a private foundation with the typical nonprofit organization. Private foundations are, in

essence, private investment funds that use some of their endowment to promote the public good. Private foundations employ individuals who are knowledgeable about investing, and, despite their charitable purpose, would also prefer to see a return on their investment. Their interest is in seeing the company succeed in its charitable and business purposes.

Another answer to why individuals and companies may choose to invest in an L<sup>3</sup>C as opposed to a traditional company with a comparable return can be found in the investor's expression of his or her preferences. Dunn (2006) proposes a model that is a variation on Markowitz's Modern Portfolio Theory and includes three factors that investors take into account: risk, return and impact. Dunn suggests that the assumption of rationality might sometimes lead to conclusions that are not supported by our actual actions which may be impacted by emotions. Taking these emotions into account, "optimization is a function of risk and return, plus a function of impact" (Dunn 2006) [Emphasis in the original].

Impact, however, is not always as easy to measure as risk and return. Each individual's preferences are distinct, so one person's optimal portfolio might not be the same as someone else's, even if they are both concerned with advancing the public good with their investments. Despite the fact that impact is difficult to express generally, it is reasonable to assume that each individual investor might take his or her preferences into account when deciding between two investments which will provide market-rate returns. If an investor with an interest in eradicating lung cancer is deciding between investing in a tobacco company with a six percent return and a company that is producing drugs for cancer patients with a comparable return, it makes sense that an investor would choose to invest in the drug company.

While it can be argued that not all investors take into account personal feelings about the companies they are investing in, human nature suggests that enough individuals will hold opinions so that there will be incentives for individuals to invest in hybrid social ventures like L<sup>3</sup>Cs. According to Dunn, "Assuming the risk and return characteristics of two portfolios are equivalent, the portfolio that is better aligned with its owner's desire for impact is a better portfolio" (Dunn 2006). Some L<sup>3</sup>Cs will undoubtedly align with the preferences of investors, attracting them to a hybrid social venture over a traditional company.

The organizational and financial structure of the L<sup>3</sup>C does not preclude it from being successful. As with all forms of business, there will be L<sup>3</sup>Cs that fail. This does not mean that the structure is unsound. The L<sup>3</sup>C is a useful tool within an arsenal of business solutions and holds the promise of success.

## Chapter Four

### Evaluating the L<sup>3</sup>C

The low-profit limited liability company is still in its infancy. New L<sup>3</sup>Cs are emerging every day, and with every day make possible new and innovative solutions to serious social problems. As with any new idea, there are complications that will undoubtedly arise in the course of the L<sup>3</sup>C's growth. When seeking to assess and understand the L<sup>3</sup>C structure, there is perhaps no better place to start than with the L<sup>3</sup>Cs themselves; what they are doing, how they are doing it, and with what results. These early L<sup>3</sup>Cs could set the tone for the L<sup>3</sup>C structure and predict how the form will evolve in the coming decade.

### L<sup>3</sup>C Experiences

Despite the fact that the L<sup>3</sup>C legislation has only been passed in a handful of states, these companies are emerging all across the United States. The reasons for incorporating as an L<sup>3</sup>C are just as varied as their charitable purposes. While some initiators of L<sup>3</sup>Cs intended to incorporate as either an LLC or nonprofit, when they saw the L<sup>3</sup>C option on the website for their Secretary of State, they decided to choose the L<sup>3</sup>C structure (Schmidt 2010). Some of these individuals did so without full knowledge of the possibilities of program-related investments and foundation support. Many even did so without consulting an attorney (Schmidt 2010). Some incorporated with the intent of attracting capital from the private and nonprofit sectors while other L<sup>3</sup>C founders noted that simply being designated a for-profit business with a charitable purpose was all they expected to derive from the L<sup>3</sup>C structure. These companies intend to use the designation to differentiate themselves as businesses that are doing social good in their communities.

No two L<sup>3</sup>Cs are completely alike. From Vermont all the way to California, L<sup>3</sup>Cs are using the structure to further different causes in unique ways. The four profiles below examine three L<sup>3</sup>Cs that have incorporated and one nonprofit considering the structure. While all have, or expect to, benefit from the L<sup>3</sup>C structure, they have also faced real challenges as the leaders in an emerging business structure.

### ■ Radiant Hen, L<sup>3</sup>C

Radiant Hen is a Vermont-based publishing company formed by a group of educators and artists. Its mission is “to publish books for children and adults that encourage good citizenship, kindness to all living things, environmental awareness and debate and raise awareness of where food comes from and sustainable agriculture.” In addition to these goals, the company seeks to “incubate new, promising authors and artists, offer reasonable compensation and support to all who work for or partner with Radiant Hen and provide community service via donations of books, workshops and other services” (Radiant Hen Publishing 2009).

In 2010, Tanya Sousa, an author and one of the founders of the company, shared that, if given the chance to reincorporate, she would again choose the L<sup>3</sup>C structure despite the difficulties she has faced in operating the business. Sousa has been the only person to contribute capital to Radiant Hen, although the company has been generating some revenue from the sale of its books. In fact, as of February 2010, all employees other than the authors and illustrators were working on a volunteer basis. While the company has partnered with a number of nonprofits, these relationships have been merely for the purpose of promoting the company's mission and not for bringing more capital into the organization.

Radiant Hen has sought PRIs from foundations, but as of May 2011, had not received any. Ms. Sousa laments that “foundations just do not recognize [L<sup>3</sup>Cs] at this point.” Still, she thinks that the L<sup>3</sup>C structure has potential once foundations become aware of it. Even without foundation funding, Radiant Hen has recognized that there are benefits that come with the L<sup>3</sup>C structure. According to Sousa, when she talks to people about the new business form, “their eyes kind of light up.” It signals to those with whom she interacts that she is running a socially responsible company (Sousa 2010).

### ■ Univcity, L<sup>3</sup>C

Univcity, L<sup>3</sup>C, created by Mark Smith and Steeve Kay, was founded with the purpose of “developing and supporting software for the Humanitarian marketplace. [Its] mission [was] to develop enterprise class software as a service (SaaS) to help increase the effectiveness, efficiency and transparency of [its] client's missions.” In 2010, Mr. Kay emphasized that Univcity addressed human needs, like food, shelter, medicine, clothing and literacy, rather than mere wants. In fact, Univcity had been approached to support World Vision in setting up a disaster command center for the relief efforts and transition to development in Haiti.

Steeve Kay, who is also the chairman of the Kay Family Foundation, first remembered hearing about the L<sup>3</sup>C from his partner, Mark Smith, and a law firm specializing in nonprofits.



Univacity soon became the first L<sup>3</sup>C to incorporate in Wyoming, despite the fact that the company operates out of Orange County, California. At the outset, the company was associated with two nonprofit entities: it received a PRI from a private foundation (the Kay Family Foundation) and additional funding from a public charity (World Vision). There were two types of shares. The nonprofit members, which contributed capital, had A shares, and decision making authority on the board. The executives of the company received a salary and held a membership interest in the company in the form of B shares in lieu of a higher salary.

Since there was very little in the way of precedent as to how profits should be dispersed, Kay and Univacity did the best they could to interpret the low-profit nature of the structure. World Vision and the Kay Family Foundation, under the original operating agreement, received 10 percent less than the for-profit members.

Soon after the company was formed, Univacity did make an inquiry to the IRS about the status of L<sup>3</sup>Cs as Program Related Investments. When the IRS refused to rule, they decided to continue forward, confident that their charitable purpose was strong enough to qualify as a PRI. As the chair of the Kay Family Foundation, Mr. Kay recognized the benefits of making a PRI from the foundation perspective as well, saying that the arrangement would “leverage the grant making capability.”

At the time, Kay acknowledged that many questions remained due to the lack precedence in the L<sup>3</sup>C structure. For example, what does “low-profit” mean? How do you strike a balance between being a business and a charity? And how is charitable purpose defined? At the product level? At the profit level? He said, “The L<sup>3</sup>Cs here, we are blazing the trail that’s here and at times might push the envelope to what the IRS might see, but we don’t know. We just do it. We do have the L<sup>3</sup>C and the PRI and it’s not entirely in a vacuum. Some organizations will try to push the envelope. That’s always there” (Kay 2010).

In early 2011, a Univacity project, Project Bonfire, spun off into a separate L<sup>3</sup>C, led by Steeve Kay. Mark Smith continues to run Univacity, L<sup>3</sup>C, albeit with a greater focus toward venture capitalism. Univacity is focusing its efforts on its investment in Transversal, a Haitian IT company working in the mobile money space. Transversal teamed with Haitian carrier Digicel to implement a mobile money platform in the Haiti Mobile Money Initiative, a contest funded by the Bill and Melinda Gates Foundation. Digicel won first prize in the competition, and Transversal and Univacity will continue to play a role in the mobile money initiative throughout 2011.

### ■ Green Omega, L<sup>3</sup>C

Some L<sup>3</sup>Cs, like Jon Kidde's Green Omega, L<sup>3</sup>C found out about the structure when starting the incorporation process on the Vermont Secretary of State website. Mr. Kidde was looking to start a nonprofit or LLC focusing on restorative justice. While Mr. Kidde does not plan on taking advantage of the possibility of program-related investments in the near future, he thinks it might be a nice option.

Even though he has not enjoyed the benefits that a program-related investment could provide, he has encountered some obstacles that are unique to the L<sup>3</sup>C structure, at least at the current time. When Mr. Kidde was seeking insurance for his new business, he listed his company as an L<sup>3</sup>C. The insurance companies, however, had never heard of the structure, and even when he tried to explain, failed to provide him with insurance for his business. He was instead forced to purchase personal insurance.

To solve this problem, Mr. Kidde thinks that, since the L<sup>3</sup>C is so new, what needs to happen is for more people to start L<sup>3</sup>Cs and for them to be successful. He believes that it will "take time for it to really be accepted." As for Green Omega's plans, Mr. Kidde has enough contract work coming into his company to keep him busy for now. In the future, he foresees opening up a community justice center that addresses alternatives to the traditional handling of crime issues (Kidde 2010).

### ■ Uncommon Good

Uncommon Good is a nonprofit organization local to Claremont, California. The organization, which was founded in 2003 by Executive Director Nancy Mintie, seeks to "break the cycle of poverty" through three innovative programs. The first two are loan repayment programs for doctors and lawyers working in low-income areas, mainly in the City of Los Angeles. The third program is the Clinic to College mentoring program, which matches disadvantaged youth ages 9-15 with members of the community who become both friends and windows to the outside world. The program also provides extracurricular and leadership opportunities to the youth to help make them more attractive college applicants.

Since the goal of the program is to provide the youth with all the resources they need to successfully graduate high school and continue on to a four-year university, Uncommon Good also provides social services to needy families in the program. This sometimes includes food, clothing, and even help in situations in which families are facing eviction.

The current economic recession has taken a toll on the families whose children are in the Clinic to College program. Many parents have lost their jobs and are struggling to make

ends meet. Even though Uncommon Good was facing the same challenges as other nonprofits in raising funds for its programs, Nancy Mintie stayed true to her goal of providing these families with the resources they needed. She decided to try another method of directing funds towards the families that so desperately needed them.

Mintie envisioned an urban agriculture project that would provide fresh local produce to the Pomona Valley, help reduce carbon emissions and provide well-paying, steady, full-time employment to Clinic to College parents. Nancy Mintie immediately started forging partnerships with local organizations to create the Pomona Valley Urban Agriculture Initiative. Despite having a solid proposal and established partnerships with organizations like the US Green Building Council and the Draper Center for Community Partnerships at Pomona College, the project was not attracting the foundation support it needed to get the project off the ground. Looking for another solution, Mintie approached the Peter F. Drucker and Masatoshi Ito Graduate School of Management at Claremont Graduate University (part of the Claremont Colleges Consortium) to provide recommendations on how they should proceed with the project. When the class at the Drucker School recommended the L<sup>3</sup>C as a possibility for the urban agriculture project, something clicked for Mintie, who has been working in the nonprofit world for over 30 years.

She started researching the L<sup>3</sup>C herself, and enlisted those around her, including Uncommon Good's Development Director Michael Peel and Stanford University intern Jay De La Torre to learn as much as they could about the structure to determine whether it was a feasible option for the farm. In talking to board members and other connections in the Los Angeles nonprofit scene, Mintie and Uncommon Good have found that most people are not familiar with the L<sup>3</sup>C. Unlike some L<sup>3</sup>Cs, which may have the ability to incorporate and operate as a small business before receiving foundation support, Uncommon Good will need an infusion of capital before beginning their project. Instead of spending the time and money now to begin an L<sup>3</sup>C, the organization plans to wait until they can identify and partner with a foundation willing to make a program-related investment. It may take more marketing of the idea, or even the L<sup>3</sup>C legislation being passed in California. Either way, Mintie thinks the acceptance of the L<sup>3</sup>C structure in California is on the horizon. She plans to watch these developments closely so that she and the Uncommon Good team will be prepared as an early adopter of the L<sup>3</sup>C structure.

These cases illustrate the flexibility of the L<sup>3</sup>C and the interesting ideas already being put into action. Even these L<sup>3</sup>C pioneers have questions about the structure as it stands and how it will change in the future. The answers to these questions and how this knowledge is disseminated has potential to influence and augment adoption and sustainability of L<sup>3</sup>Cs.

## Will the L<sup>3</sup>C succeed in bringing additional capital to traditionally nonprofit causes?

The success of the L<sup>3</sup>C will be determined by its ability to attract investment from both the private and nonprofit sectors. During these formative times when L<sup>3</sup>C legislation has only been passed in a handful of states and foundation awareness is low, it is difficult to predict the long-term response and ultimate acceptance from foundations. There are signs, however, that foundations may come to embrace the L<sup>3</sup>C. In October 2009, The Bill and Melinda Gates Foundation awarded a grant to SEEDR, L<sup>3</sup>C, an Atlanta-based company, “to redesign and reengineer cold-chain containers used in global and domestic vaccine and disease-monitoring programs” (SEEDR, L<sup>3</sup>C 2009). More recently, the Ford Foundation awarded a grant to Disruptive Innovations for Social Change, L<sup>3</sup>C to “document & replicate an innovative model providing a continuum of services, including access to benefits, skills training, asset development & career development, to low-wage employees in Michigan” (Foundation n.d.).

The acceptance of the L<sup>3</sup>C by foundations will be affected by three important factors during this formative time: 1) federal legislation creating the low-profit limited liability company in all fifty states, 2) the IRS’s decision to extend the definition of PRIs to include L<sup>3</sup>Cs, and 3) the willingness of foundations to stray from their traditional grant making practices to make program-related investments.

### ■ Federal Legislation

In 2008, Americans for Community Development drafted the “PRI Promotion Act of 2008” with the intention of passing a bill that would make program-related investments easier to make for foundations. This bill did not specifically mention the low-profit limited liability company (L<sup>3</sup>C), but would have been conducive to that newly created legal structure. When the bill did not make any headway in Washington, Americans for Community Development drafted a new piece of federal legislation that they believed was more appropriate to what they were trying to accomplish. Robert Lang and Americans for Community Development believe that this piece of legislation, written by tax attorney Elizabeth Carrott Minnigh, better reflects the changes needed in the Internal Revenue Code to more easily accommodate PRIs and L<sup>3</sup>Cs. The Philanthropic Facilitation Bill proposes the following amendments, among others, to the Internal Revenue code and Treasury Regulations:

1. That the qualification of low-profit limited liability companies as Program-Related Investments is presumed.

2. The inclusion of a procedure by which organizations can apply for an IRS designation that the organization qualifies as a PRI for any foundation with a shared purpose.
3. Additional reporting requirements for organizations receiving PRIs.

The bill also proposes a number of amendments to treasury regulations, including an amendment that proposes:

1. Examples of L<sup>3</sup>Cs qualifying and not qualifying as Program-Related Investments (Americans for Community Development 2010).

Robert Lang is confident that Congress will address the legislation, although they may not do so until a comprehensive tax reform bill is introduced.

#### ■ IRS Decision on L<sup>3</sup>Cs as PRIs

In addition to the federal legislation that would facilitate the program-related investment process, there are a few other mechanisms to encourage the making of PRIs. Richard Schmalbeck, former Dean of the University of Illinois College of Law and Professor of Law at Duke University, sees three ways in which this might be accomplished. The first method is through the federal legislation. While currently foundations feel that they need to obtain private letter ruling from the IRS to approve their investments as PRIs, legislation could invert the process so that individual L<sup>3</sup>Cs receive determination letters that could be used to indicate to foundations that investments in their L<sup>3</sup>Cs would count as PRIs.

Alternatively, the IRS could simply change the way they handle PRIs by fast-tracking the process. If the IRS were operating under the presumption that investments in L<sup>3</sup>Cs generally qualified as PRIs, then the IRS could review the requests very quickly, while still having the ability to deny requests that were not appropriate. Lastly, the IRS could decide that an L<sup>3</sup>C would automatically qualify as an acceptable recipient of a PRI, although Schmalbeck characterizes this option as an unlikely scenario. Even these changes to the way the IRS operates would require some form of legislative process, which means that the assurances that foundations seek about investing in PRIs might not come quickly (Schmalbeck 2010).

Indications such as a letter from the American Bar Association Section of Taxation hold promise that when the Internal Revenue Code is examined, there will be little opposition from taxation lawyers. That letter, written in March, 2010, issued comments to Douglas Shulman, the Commissioner of the Internal Revenue Service regarding additional examples of PRIs. While the American Bar Association Section of Taxation does not endorse replacing the existing examples provided for in the code, they do believe that the additional proposed examples “reflect current grant-making philosophy and practices, international social and

economic realities, and forms of doing business that have emerged since 1972” (Lewis 2010). While these comments do not explicitly support the L<sup>3</sup>C, they do reiterate that LLCs have become more common vehicles for PRIs in recent years and that they “believe that, if a particular loan to, or investment in, an ordinary LLC would qualify as a PRI, then, a fortiori, a loan to, or investment in, an L<sup>3</sup>C should also qualify” (Lewis 2010). If a foundation were confident that its program-related investment fit the IRS requirements, then there is no reason to think that its structure as an L<sup>3</sup>C would in any way violate the Internal Revenue Code.

### ■ Are foundations willing to make PRIs?

Although program-related investments (PRIs) have been in existence since 1969, they are not a widely used method of meeting the IRS’s disbursement requirement for foundations. While PRIs have doubled over the last eight years, many foundations are not familiar with the concept, or are hesitant to start making PRIs. Luther Ragin of the H.B. Heron Foundation thinks that the shortage of PRIs is the product of three factors:

1. Lack of awareness among foundations about PRIs,
2. Discomfort with the underwriting of credit risk associated with PRI making, and
3. Bias that only grant making achieves high social impact (Ragin 2010).

Both Ragin and Niel Carlson agree that one problem is a lack of training of program officers at foundations and a general lack of awareness among this populace about PRIs. While these individuals are familiar with the grant making process, many are not trained to make and handle investments. While that knowledge does exist within the organization at the foundation endowment management level, that knowledge often does not filter down to those working with disbursements. If PRIs are to become more common, then these individuals will have to be trained to become capable of handling investments (Carlson 2006, Ragin 2010). Some foundations, like the H.B. Heron Foundation have been making PRIs despite these general trends.

The New York based H.B. Heron Foundation was formed in 1992 and has been an active PRI maker since 1997. The foundation’s mission is “dedicated to supporting organizations with a track record of building wealth within low-income communities” which they accomplish by providing “grants and investments in organizations that promote three wealth creation strategies [home ownership, enterprise development and access to capital] for low-income families in urban and rural communities in the U.S.” (H.B. Heron Foundation 2009).

Over the past 12 years, the H.B. Heron Foundation has made 77 PRIs totaling \$38 million. They have accumulated approximately \$4 million in income from these investments with a rate of return of 3.8 percent and a default rate just under one percent. In 2010, 30 percent of the foundation's PRI dollars were invested in an equity form with for-profit companies. While this means that the majority of the foundation's PRIs were made in the form of senior loans to mostly nonprofit organizations through intermediaries, PRIs are being made in for-profit businesses including Limited Liability Partnerships (LLPs), LLCs, cooperatives and community development banks.

Ragin contends that the structure of an entity receiving the PRI is not especially important. Even with the current laws governing PRIs, his foundation and some others have been able to use PRIs to help them advance their mission. While the current laws allow for this type of investment, the complexities of program-related investing coupled with a lack of knowledge about its benefits have limited the number that are using this tool. The H.B. Heron Foundation has made an effort to disseminate information about PRIs by founding the PRI Makers network, a group of 120 foundations "committed to best and emerging practices" (Ragin 2010). Robert Lang agrees that a new legal structure would not be necessary if all foundations had the level of understanding of the H.B. Heron Foundation. So while the current structure does not prohibit program-related investing, the L<sup>3</sup>C could serve the purpose of making the option known to both foundations and nonprofit and for-profit organizations looking to produce a social good. The L<sup>3</sup>C legislation could be the first step toward more widely promoting the use of PRIs and simplifying the ways that these partnerships could be accomplished. Luther Ragin recognizes that "resistance [to the use of PRIs] is lessening" (Ragin 2010).

Even if foundations are slow to adopt, alternative funding methods like Donor-Advised Funds and New Markets Tax Credits may prove successful in bringing funding to L<sup>3</sup>Cs and illustrate their promise to foundations.

#### ■ Will L<sup>3</sup>Cs attract private investors?

The ability of low-profit limited liability companies to attract market-rate investors may depend on whether they are able to attract foundations, or other investors willing to accept a below market-rate return. As discussed previously, there is no substantial reason to think that foundations or other below market-rate investors would not invest in L<sup>3</sup>Cs. Foundations or other below market-rate investors would not invest in L<sup>3</sup>Cs.

<sup>1</sup>One of these community development banks is a B Corporation.

## Additional Hybrid Alternatives

The low-profit limited liability company (L<sup>3</sup>C) is not the only hybrid social venture in existence. Other forms do exist, although the degree to which they can be considered truly a mixture between being nonprofit and for-profit is debatable. The alternatives to the L<sup>3</sup>C are also based on existing laws for for-profit entities: the company in the U.K. and the corporation in U.S. law. While each has its merits and also potential limitations the existence of other structures to combine social good and business will likely help, rather than hurt the cause of the hybrid social venture. With each structure, we can witness what is successful and what bears correction. Additionally, the forms below have distinct functions that have surprisingly little overlap with each other. While the L<sup>3</sup>C might be the ideal legal entity for some organizations, these other hybrids can serve useful purposes in their own rights.

### ■ Community Interest Companies

The Community Interest Company (CIC) is a hybrid business structure in the U.K. designed to provide a social good to the public. In order for a company to register as a CIC, it must meet certain requirements. A reasonable person test is used to consider whether the activities that are being carried out are for the benefit of the community. It must complete a community interest statement detailing how it will carry out its purpose before being issued a certificate of incorporation.

The CIC was the product of the collaboration of Stephen Lloyd and Roger Warren Evans. The two men recognized that there was “no safe place for a public purpose organization that was not a charity.” This problem, paired with the rise of social entrepreneurs gave rise to idea of the CIC. According to Lloyd, it was “difficult to imbed social purposes in a legal form because there was not an off the shelf, simple to use, legal entity ready for social enterprise unless you used these Industrial and Providence Societies,” which are cooperatives. Since those laws had not been updated since the 1960s, Lloyd, then working on his own, decided to “take company law and use it in a special way,” because laws pertaining to companies have been well-maintained in the United Kingdom.

Lloyd and Evans originally planned on calling their idea the Public Interest Company, but an initiative with a similar title forced the adoption of the term Community Interest Company for their creation. After running workshops in the House of Lords and at the London School of Economics and gaining the support of then Prime Minister Tony Blair, Lloyd’s idea was turned into law in July of 2005.



Since the CIC is modeled on traditional company law, it is possible for an existing company to transition from being a company to a CIC. Unlike in a traditional company, directors of a CIC have a duty to a number of different groups: the community, the shareholders, and the creditors. The CICs are controlled by a regulator, who sets the dividend caps that are hallmarks of the CIC structure. As of April, 2010, the maximum dividend that a shareholder can collect is 20 percent of the value of their shares at the time they were purchased. The CIC also has a cap for how much it can distribute: 35 percent of the distributable profits. In this structure, capital growth stays within the business, so when a shareholder decides to sell his or her shares, he or she receives only the original investment, not adjusted for inflation. Lloyd describes the shareholders as being more like bond holders. The CIC's asset lock protects against owners taking advantage of the structure by turning it onto a traditional company to collect higher profits.

The CIC regulator, hired by the Secretary of State, has a wide range of powers and does "what is necessary to maintain public confidence in the CIC brand." This includes initiating audits, starting civil proceedings, appointing and removing directors, taking control of the property and aiding in the dissolution of CICs. Every year, CICs must submit a report detailing how it has contributed to the public benefit.

As of February, 2010 there were 3,832 CICs operating in a variety of sectors such as Education, Agriculture, and Manufacturing. CICs grew at double the rate that the British government originally expected. Even with the number of CICs that have been formed and the structure's high rate of growth over the past few years, there are still unanswered questions. For example, some, like Lloyd, think that there should be more incentives for individuals to invest in CICs, including adjusting for inflation when considering the amount of money a shareholder can get when he sells his interest in the company. Others think that the 35 percent cap on dividends is too low. More general questions may still arise about what is in the public interest. Lloyd presents a hypothetical situation in which a company producing life-saving drugs is also a major polluter. Is that company providing a public benefit in the relevant sense? The CIC has already seen changes in its structure in the five years it has been in existence, and these questions and more will likely provoke the need for further clarification or regulation in the future (Lloyd 2010).

### ■ B Corporations

The Benefit Corporation, or B Corporation, is a new certification process that indicates that a business is socially responsible. Despite what the name indicates, B Corporations do not have to be legally incorporated as corporations, although legislation has been passed in two states. Many B Corporations are LLCs and partnerships as well. According to B Lab, the

501(c)3 organization that created the certification, B Corporations are different because they “meet comprehensive and transparent social and environmental performance standards, institutionalize stakeholder interests and build collective voice through the power of a unifying brand” (B Lab 2010).

In order to become a B Corporation, a business must take the B Survey, which asks questions about “social and environmental performance” (B Lab 2010). A score of 80 out of 200 points is necessary for a business to become certified. Next, the business must update their governing documents to take into account stakeholder interests. For states in which the law does not explicitly allow companies to consider interests other than those of the shareholder, B Lab suggests that a company reincorporate in a state more amenable to stakeholder interests.

B corporations must pay an annual fee based on sales. Companies that have annual sales under \$2 million are subjected to a \$500 fee, while the largest fee is \$25,000 for companies with annual sales over \$100 million.

There are four ways in which B Lab verifies that the companies it has certified are living up to the standards proposed by the organization:

- 1) To become a B Corp, each company must complete a Survey Review with a B Lab staff member to make sure that all answers accurately reflect the intention of the B Ratings System.
- 2) When a company becomes certified, they must submit documentation for approximately 20 percent of their answers to the B Survey.
- 3) 10 percent of B Corporations are audited every year - So in their two-year term, all B Corporations have a one in five chance of being audited. In an audit, B Corporations are asked to validate and prove each of their answers on the B Ratings System and their compliance with the B Corp Legal Framework. Typically, the audit results in a score adjustment. If the score falls below the passing grade of 80, B Lab auditors provide a 90 day cure period to cure as well as improvement recommendations. If the audit reveals that a company has filled out the B Survey has intentionally misrepresented aspects of their business, the company’s B Corporation Certification is publicly revoked.
- 4) Lastly, all B Corporations are required to submit a copy of their company’s governing documents amended with the B Corp Legal Framework. We provide a one year period for B Corps to obtain approval from the company’s board of directors and re file the amended articles with the secretary of state. (B Lab 2010).

So far, there are 255 B Corporations in 54 industries. Some well-known B Corporations include Seventh Generation and Better World Books.

### ■ How do these hybrids measure up?

One might ask whether there is a need for the B Corporation and the low-profit limited liability company (L<sup>3</sup>C), or if the L<sup>3</sup>C should resemble the UK's structure, the Community Interest Company (CIC). The truth is, these structures are operating within different spaces. While the proponents of each structure might be able to learn something from the others, it is not necessary for one of these solutions to prevail.

The CIC is necessarily different from the L<sup>3</sup>C because it arose out of a different legal structure, the UK's Company Act. The CIC, after five years of existence, is much more regulated than the L<sup>3</sup>C is now. Even at its inception, the CIC was regulated by the CIC Regulator. There are caps on the CIC that do not exist in the L<sup>3</sup>C legislation. While some, like Professor Brakman Reiser, believe that the L<sup>3</sup>C needs to become more regulated, the man behind the L<sup>3</sup>C thinks that the beauty in this new form is the flexibility and lack of stifling regulation that is so prevalent in the nonprofit world. However, even some L<sup>3</sup>C owners see some type of regulation of the L<sup>3</sup>C in the near future. Some, like Unicity founder Steeve Kay think that even if some L<sup>3</sup>Cs step out of line, "if you solve the problem by legislation, a policy maker will create a few more [problems] down the line" (Kay 2010). The extent to which L<sup>3</sup>Cs are regulated will be discovered as time passes and more companies incorporate with the structure.

In the United States, the L<sup>3</sup>C and B Corporation are being presented together as structures that are seeking to do the same thing. While each sounds like ways in which a business can structure itself legally, the B Corporation is, at its heart, a certification, while the L<sup>3</sup>C is a structure centered on attracting capital. The B Corporation does not necessitate that a business have a charitable purpose as defined by the Internal Revenue Code. While some B corporations might qualify as having charitable purposes, even regular companies that meet the standards of corporate responsibility set by B Lab can attain that certification. So, the conversation in the United States need not be about which form will eventually prevail. In fact, there is no reason that an L<sup>3</sup>C cannot also be a certified B Corporation. The B Lab is focused on building its brand, and the B Corporation designation might, in the next few years, be a recognized sign that a company is doing good. At this point, however, there still seems to be some confusion about what a B Corporation is in relation to the L<sup>3</sup>C and traditional business structures. Only when sufficient information is made available about both the L<sup>3</sup>C and B Corporation can each be recognized for the value it brings, despite the presence of the other form.

## Chapter Five

### Conclusion

The rules governing program-related investments (PRIs) are complex. The interaction of charity and business is new, and to many, frightening. There is a feeling of uncertainty as companies embark on this journey toward a new kind of solution to social problems.

The hybrid social venture and, more specifically, the low-profit limited liability company (L<sup>3</sup>C), raise new challenges and force us to reexamine our beliefs about the best ways to produce social good, but when deciding whether this is a good thing, we can ask three simple questions: Is it useful? Who should use it? And will they succeed?

To the first question, the answer is yes, although not for the reason one might think. The L<sup>3</sup>C is not useful because it allows foundations to do something they have never been able to before. It does not bring anything new to capabilities of traditional LLCs, either. What the L<sup>3</sup>C is doing, however, is taking an under utilized capability, the PRI, and bringing it out into the open. There has been more activity and discourse around the PRI since the creation of the L<sup>3</sup>C than ever before. In its current form, the L<sup>3</sup>C is encouraging individuals and groups to bring private sector expertise and theory to traditionally nonprofit causes. It is encouraging innovation and, slowly but surely, showing foundations how they can evolve and have greater impact.

All of these benefits can be seen today, before changes to the Internal Revenue Code have been made, before federal legislation has been passed, and after the L<sup>3</sup>C legislation has been passed in only a number of states. It is only a matter of time before some of these changes take place to make program-related investing a more efficient process, and when they do take place, the full usefulness of the L<sup>3</sup>C will become clear.

Currently, many individuals and organizations are incorporating as L<sup>3</sup>Cs in their respective states. It is not clear that all of these new L<sup>3</sup>Cs are necessarily perfect matches for the structure. The decision to incorporate as an L<sup>3</sup>C is a serious one, and one that should be given considerable thought. If someone is considering starting an L<sup>3</sup>C in its current state, they should, ideally, have a foundation or private investors willing to contribute capital, or have the financial resources to successfully run a small business. Without the support of a below market-rate investor, there is no difference in the operation of the company from an LLC. When making the decision to incorporate as an L<sup>3</sup>C, the company should make use of

an attorney specializing in nonprofit tax law when drawing up the operating agreement. L<sup>3</sup>Cs should also take care to remember that they will not be receiving constant support from the foundations that make PRIs in the L<sup>3</sup>C. While a foundation can infuse capital into the company so that it can begin operations, the company still must be able to make a profit without subsidization from the foundation.

The L<sup>3</sup>C is not a one-size-fits-all solution to every social problem. It is not even the solution for every organization that does not fit wholly in either sector. The L<sup>3</sup>C is a company, and some organizations are not prepared to run such a business. Those that should are nonprofits with revenue streams that could, after an infusion of capital, sustain the business. They are for-profit entities that cannot provide market-rate return to their investors, but provide a social benefit and a small profit. Mainly, they are organizations willing to do their research, collaborate with others, and critically examine their own ability to run a successful hybrid business.

Even if the L<sup>3</sup>C is a good idea, and a number of organizations would fit into the space that the legal entity creates, it will only be a success in the long run if foundations, nonprofits, private investors and individuals with ideas about ways to do good accept the structure. Although there is more and more talk about the L<sup>3</sup>C every day, not all of it is accurate, and not all of it is positive. It would be strange if such an idea combining business strategies with nonprofit causes did not arouse some suspicion, but these criticisms could affect how the L<sup>3</sup>C is accepted by the general public once the form gains popularity. Recently, Rush Limbaugh lambasted the L<sup>3</sup>C on his radio show, misidentifying it as the low-profit limited liability corporation. He criticized the Maine farmers who run MOO Milk as socialists for accepting a government grant as capital for their L<sup>3</sup>C (Limbaugh 2010). In some states in which the L<sup>3</sup>C legislation is in consideration, vocal opponents have come out against the form.

The best way for the L<sup>3</sup>C to respond to these attacks is to spread awareness about the structure and what it does and does not do. Americans for Community Development is a lean organization with limited resources which makes it difficult to promote the structure, advise L<sup>3</sup>Cs, and respond to questions and criticisms. There is, however, a team of dedicated individuals working to educate the public about the L<sup>3</sup>C and suggest new and creative ways to use the structure to do good. In February of 2010, some of these individuals were brought together at the Vermont Law Review Symposium, hosted by Vermont Law School in South Royalton, Vermont, which focused largely on the low-profit limited liability company. As the L<sup>3</sup>C gains more supporters in cities across the country, it will be easier to educate the relevant groups that might be interested in the L<sup>3</sup>C.

In the mean time, the best way for the word to spread about the L<sup>3</sup>C would be for existing L<sup>3</sup>Cs to be successful. If the pioneering L<sup>3</sup>Cs are accomplishing great social good and operating as profitable businesses, people will take notice. Even in the first few years of the structure, L<sup>3</sup>Cs are engaging in interesting projects that have the possibility of setting the tone for others to come. As Robert Lang realizes and we have often heard, it is only a matter of time.

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## Americans for Community Development Position Papers

The L<sup>3</sup>C creates a new paradigm for the execution of solutions to social problems. Almost everyone agrees that the present solutions leave something to be desired but many are reluctant to embrace new concepts like the L<sup>3</sup>C because of lack of information, fear of the unknown, or unwillingness to take the risk. We hope that this and other papers to follow will provide the information needed, for those contemplating the structure, to become more informed. We are grateful to Roxanne Phen for taking on the assignment of writing the first paper in this series and trying to cover the entire spectrum of the issues.



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Americans for Community Development was created for the purpose of fostering the passage of L3C legislation and the organization of the support services needed to help individuals and organizations incorporate and manage L3Cs. Membership is available to anyone who wishes to support the L<sup>3</sup>C. Our founder and creator of the L<sup>3</sup>C Robert Lang said the L<sup>3</sup>C is *The for profit with the nonprofit soul*. It is our mission to try to make sure that all L<sup>3</sup>Cs that are organized operate in that spirit.



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Mission Throttle is a Michigan based L3C focused on creating business tools to accelerate philanthropy forward. The firm is a concept generator brainstorming ways of creating systematic and positive change to speed the pace of assistance to our underserved populations. Our vision is to create added capacity and collaboration by changing the paradigms of growth, success and impact by developing strategies to rethink the tools that philanthropy will need in the future.

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