Social enterprises are mission-driven organizations that apply market-based strategies to achieve social good. Occupying the unenviable space between for-profit investing and philanthropy, but being neither, social enterprise often times is shunned by both.

This undesirable position is made worse by the colossal challenges facing the social sector. Government support has dried up as budgetary shortfalls divert resources toward basic services. And while the need is greater than it has been at any time in history, the recession has taken its toll on social funding. While the outlook seems bleak, social enterprise—and the hybrid structures being created to foster it—may be the answer to bridging the gap between for-profit investing and philanthropy.

Until recently, U.S. law didn’t provide a legal form to accommodate social enterprise. Classified as nonprofits, social enterprises had difficulty accessing capital and limited ability to distribute profits to investors. As for-profits, they were vulnerable to challenge if they used shareholders’ money for nonbusiness purposes. Social enterprises have existed between these two worlds as hybrid arrangements: nonprofits that create for-profit subsidiaries, for-profit companies that create corporate-giving programs, joint ventures between nonprofits and for-profits, financing agreements, licensing agreements, program-related investments, corporate sponsorships, and commercial co-ventures.

Each of these hybrids has played an important role in social enterprise, either alone or in combination, in pursuit of the dual objectives of social enterprise, but none has allowed a for-profit motive and a social benefit motive to co-exist easily in a single venture.

The new low-profit limited liability company (L3C), however, does allow the profit and social motives to easily co-exist.

**Low-Profit Limited Liability Company**

The L3C is legal in all 50 states as a result of legislation signed into law in Vermont in April 2008. The L3C is based on the limited liability company (LLC) structure, which gives the L3C the flexibility needed to cover a variety of social enterprises.

Indeed, the L3C is a special form of LLC with articles of organization that include the legal requirements for program-related investments (PRIs):

1. The entity must be organized for charitable purposes.
2. The production of income or the appreciation of capital can’t be a significant purpose of the enterprise, though there is no cap on either.
3. The entity may not influence legislation, or support or oppose a candidate for office.

The elegance of an L3C is that it is nothing more than a variation of an LLC, the business entity that combines the best features of a partnership with the best features of a corporation—liability protection and the ability to have multiple owners, each with different benefits and obligations. The L3C merely adds socially responsible investment. It is a for-profit entity organized to engage in socially beneficial activities; it is the for-profit with the nonprofit soul.

The LLC is a form of partnership and its investors are called members. Instead of bylaws, an LLC has a legal contract among members called an operating agreement. Operating agreements are specifically important to the L3C because they include the provisions that guarantee the charitable focus of the enterprise. Some of the other benefits of LLC structure shared by the L3C include the following:

- Both can be pass-through entities for tax purposes, which means no double taxation of revenues and that profits are applied to each investor according to the operating agreement.
- Both are structured by their operating agreements so each member can have an arrangement tailored to meet his/her own particular needs. Each member can enjoy different powers and privileges.
- Both offer flexibility in how they are managed; members may participate in managing the entity or may be completely passive. Management powers can be distributed and delegated without restraint.
- In both, profits may be allocated to members in proportions that are different from capital contributions. For example, a charity could be a member entitled to a fixed percentage of profit, guaranteeing the charity a source of revenue. Or a particular class of members can have preferential treatment regarding distributions so that their risk is less and their income is higher than that of members of another class.

The flexibility that has made the LLC a popular business entity will help L3C entities spur interest in social enter-
This massive loss of charitable assets will not be recouped any time soon. Foundations therefore must be creative in their giving, looking for ways to rebuild endowments while meeting charitable objectives.

$682 billion, a sum that declined nearly 22 percent to $533 billion at the end of 2008, and a further decline is expected for 2009, even given 2009’s positive stock-market performance. This massive loss of charitable assets will not be recouped any time soon. Foundations therefore must be creative in their giving, looking for ways to rebuild endowments while meeting charitable objectives. One way to achieve this is by making program-related investments—instead of grants—to the hybrid entities discussed above, thereby providing a return of funds to the foundation and creating a renewable funding stream.

Program-Related Investments
A PRI may be used when a foundation wants to provide financial support to a venture’s charitable purpose as an investment rather than a grant. PRIs are treated like grants by the IRS, and thus they help the foundation meet its IRS-dictated minimum distribution requirement, which can be simply thought of as 5 percent of average assets held during the previous year. A PRI can take the form of an equity investment, a loan, a guarantee, or virtually any other form of financial arrangement. If the PRI is successful, the foundation can recapture the full amount of the PRI (plus, if applicable, a reasonable rate of return), which it must then pay out again in the form of grants of more PRIs.

As with all good things the possibility exists for abuse. The L3C allows the use of charitable funds (grants and PRIs) to fund profit-making enterprises, but there are no limits on the amounts of profit earned or the uses of those profits. In fact, there is no test to determine whether an L3C has a charitable mission or benefits anyone. For these reasons, foundations and other entities that make grants or PRIs to L3Cs need to do their due diligence. As of today, however, about 100 L3Cs have been formed with no reports of abuse.

A Real-World Example
Let’s look at a real-world example of how foundations and L3Cs can work together to create social enterprises that benefit all involved. A foundation focused on education regularly makes grants for the upkeep of school facilities. These grants represent a 100-percent negative financial return to the foundation, which is having difficulty maintaining its previous levels of support. Rather than making facilities grants this year, the foundation will make a PRI to an L3C that will build solar/renewable energy systems at school facilities. The solar systems will provide renewable energy to the schools at a cost less than what they would pay otherwise for energy, providing environmental and financial benefits. Let’s examine the benefits from the perspectives of each participant.

L3C Perspective
The L3C has a charitable mission to provide renewable energy to nonprofits. It brings together for-profit investors (who can benefit from tax-based incentives for renewable energy) with socially responsible investors such as the education foundation. The foundation’s PRI provides below-market funding, which results in funding for a solar energy system that produces energy for the school at below-market cost. The L3C benefits because it fulfills its mission by helping install solar energy at the school.

Foundation Perspective
The foundation has a mission to support the maintenance of school facilities. It provides funding for the PRI-financed renewable energy system, which will provide cheaper and cleaner energy for schools for the next 20–30 years. Each year’s energy savings can be thought of as an annual “grant” made possible by that one-time PRI, which eventually is repaid to the foundation. The savings in energy costs over the 20–30-year life of the solar-energy system will far exceed the PRI and provide a continuing source of funds for the upkeep of schools facilities.

The foundation benefits through the repayment of its PRI. The improved cash flow because of the solar energy system pays back its investment. Even if the PRI is made with no expectation of a return (or interest), the foundation still gets back its amount invested, in essence allowing the endowment to be maintained and the funds to be redis-

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tributed, again and again. If the PRI is made with a return expectation, then the endowment may be able to grow as well as redistribute the original PRI amount many times over.

This example is one of many socially responsible businesses that are benefiting from the joint efforts of the for-profit and nonprofit sectors working together to create beneficial social enterprises. L3Cs are being organized all over the nation as food banks, health clinics, museums, affordable housing ventures, renewable energy ventures, and other social enterprises. As their popularity grows and the nonprofit sector begins to work more closely with the for-profit sector, society will reap immeasurable positive benefit while providing a model for a new source of renewable funding.

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Endnote

1 Each year, every private foundation must make eligible charitable expenditures that equal or exceed approximately 5 percent of the value of its endowment. The minimum payout requirement can be met by any expenditure that meets the definition of a “qualifying distribution,” including program-related investments.