DISCUSSION TOPIC:

Could the IVP be organized as a low-profit, limited-liability company?

A initial challenge faced by the Information Valet Project is to construct a form of ownership for the shared-user network which will be stable, fundable and yet not subject to the challenges of either charitable or Wall Street ownership. One option to consider could be incorporation using a new Vermont statute as a "low-profit, limited-liability company."

Potential advantages:

- Profits are subservient to a requirement to achieve a social mission, and investors are explicitly aware of this.
- The social mission makes it possible for foundations to loan or invest in the L3C as a "program-related investment."
- Bylaws and management can be flexibly constructed to allow collaboration, different member classes and other features common to a co-operative.
- Operating profits, after returning initial investment capital and funding R&D and reserves, could be directed to the social mission -- such as providing grants for investigative or other forms of civic journalism.

To explore this concept, Tom Moody, of the law firm of Downs Rachlin Martin PLLC in Burlington, Vt., will join us via a Skype teleconference session to answer our questions about this idea. Moody is a co-author of the Vermont statute. On the back, he provides background.

-- Bill Densmore, Dec. 4, 2008

"The L3C –
Facilitating Socially Beneficial Investing"

*By Tom Moody / Attorney / Downs Rachlin Martin PLLC /
Burlington, Vermont / tmoody@drm.com*

OVERVIEW

In April 2008, Vermont became the first state in the U.S. to enact a law enabling the formation of Low-Profit Limited Liability Companies. Also known by the abbreviation “L3C,” this new kind of business entity is designed to give socially oriented businesses greater access to capital.

The advent of the L3C holds the promise that we will see more investment capital flowing to charitable organizations that are able to offer a “double bottom line” – a social benefit and a financial return. Private foundations and donor-advised funds will be most interested in investing in companies that are well managed, effectively advance their social mission, and have thoughtful financial plans for leveraging foundation capital.

The companies that are able to create this kind of leverage will be giving private foundations the kind of long-term return they want to see – the possibility of some financial return, but, more importantly, long-term social benefits that will result from the organization’s expanded operations and greater financial self-sufficiency.

Vermont's L3C act has national importance because an L3C organized under Vermont law can do business nationally, even internationally, under ordinary foreign entity qualification statutes. An L3C is essentially a for-profit, limited-liability company (LLC) that is organized primarily to pursue a social or charitable purpose.

In a sense, it is a hybrid of a for-profit and non-profit organization, and has characteristics of each . . . it can have equity owners that have a right of distribution of profits and appreciation of the value of the business entity.

More background is contained in Moody's Sept. 2008 article in Trusts & Estates Magazine:
DOWNLOAD PDF FROM: http://newshare.com/pdf/trusts-and-estates-sept-2008.pdf
And on the Blueprint wiki site:
http://newshare.com/wiki/index.php/Blueprint-resources-l3c

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http://www.poynter.org/column.asp?id=131&aid=159320

Mar. 2, 2009 / From the Poynter Online Website

L3Cs a "Low-Profit" Business Model for News

By Bill Mitchell / Of the Poynter Institute

A new and little-known state law is emerging as a potential business model for news organizations seeking alternatives to maximizing profits as a publicly-traded company or avoiding them with non-profit status.

The Low-profit Limited Liability Company, known as an L3C, was signed into law in Vermont last year and similar legislation has passed in Michigan, Wyoming and the Crow Tribe.

L3C supporters have drafted proposed federal legislation that includes newspapers among the industries it targets. The coalition includes Marcus Owens, a Washington attorney who headed the Exempt Organizations Division of the IRS for 10 years before entering private practice in 2000. Owens works for the D.C. law firm of Caplin & Drysdale, which serves as outside tax counsel for the *St. Petersburg Times* and its owner, The Poynter Institute.

No news organizations are among the several dozen companies that have established themselves as L3Cs in Vermont (search "L3C" here), but the L3C model has bubbled up in discussions about saving newspapers in Chicago, Peoria and Seattle. Owens said he has heard from representatives of newspaper owners and unions as well as community organizations "interested in saving their newspapers."

As an L3C, a news organization could rely on a wider range of financial backers than is currently possible, as long as the company and its investors share a common commitment to serving an educational or charitable public purpose beyond financial return.

Other states are working on their own L3Cs, but eligibility is not determined by geography. Just as many companies around the country incorporate in Delaware, you can register a Vermont L3C almost as easily from Burlington, Iowa as Burlington, Vt.

The new hybrid model makes it easier for companies to attract investors with different objectives and expectations. It also addresses a fundamental conflict of publicly traded news companies: the obligation to increase shareholder value while spending what it takes to provide communities with the journalism needed to inform civic life.

"The L3C sanctions a low-profit model -- it makes it explicit that you don't have to maximize profit," said Brian Murphy, a Vermont attorney and one of the state's leading experts on L3Cs. "You can have a tiering of interests -- for-profit investors who need, say, 10 percent return; people looking to support socially-beneficial enterprises willing to settle for 3 percent; and charitable investors willing to take 1 percent."

In order to qualify as an L3C, a news organization would need to be primarily focused on educational or charitable objectives, with making money only a secondary goal.

"When most people think about charity, they think about something like a soup kitchen," Owens said in a telephone interview Sunday afternoon. "But it also includes educational purposes."

He said he believes it's "doable" for a news organization to meet the educational requirement but said it would require a focus on "publishing stories and reports based on a perceived value to the community and the public, as opposed to their ability to sell newspapers."

The L3C structure enables foundations to make so-called "program-related investments" to companies with the prospect of recovering some or all of the investment.

Owens and others say such investments by foundations could help companies shore up their footing sufficiently to boost their chances of raising money in the capital markets.

A news company structured as an L3C -- as opposed to a non-profit -- would avoid some of the limitations of non-profit status, including the prohibition against political endorsements.

Although the L3C lessens the profit pressure faced by publicly-traded companies, it's no panacea for broken business models.

Unless an investor or a foundation is willing to watch its money simply disappear, as Murphy put it in a telephone conversation Saturday, "There needs to be a model that can be self-sustaining."

L3Cs could be especially relevant to foundations committed to helping create and maintain journalism. The structure requires an "alignment of mission" between the foundation and the recipient of any investment it might make. And that mission must reflect a clear benefit to the public.

Robert Lang, a business executive and CEO of a family foundation, the Mary Elizabeth and Gordon B. Mannweiler Foundation, developed the L3C idea in 2005 and retained Owens to draft legislation the next year. He said Vermont seemed like a good first home for the concept because of the popularity of both free enterprise and commitment to social good in the state.

Lang organized the nation's first L3C, L3C Advisors, which produces the Americans for Community Development Web site as a resource for such initiatives. In an e-mail exchange Sunday, he said he is working with the Newspaper Guild and legal experts on "a master plan for recreating a newspaper as an L3C."

Although companies can use existing state legislation to set themselves up as an L3C, Owens said a federally-approved L3C would streamline the process. He expressed optimism for its chances, arguing that "it's not a revenue loser" and that it could generate new tax revenue by enabling low-return, but taxable investments by foundations.

The L3C – Facilitating Socially Beneficial Investing

By Tom Moody
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In April 2008, Vermont became the first state in the U.S. to enact a law enabling the formation of Low-Profit Limited Liability Companies. Also known by the abbreviation "L3C," this new kind of business entity is designed to give socially oriented businesses greater access to capital.

An L3C is a for-profit limited liability company that is organized primarily to pursue some social or charitable purpose. It is taxed like any other for-profit entity, but it has an important advantage over other for-profit entities: It can accept program-related investments from private foundations. Accordingly, the principal purpose of the L3C is to combine foundation capital and private investor capital in enterprises that are significantly focused on charitable or educational mission, but which have equity owners who will receive a return on the investment should the enterprise become profitable.

Program-Related Investing

At the core of the L3C lies the concept of program-related investment ("PRI") by private foundations. Generally speaking, private foundations are required under tax law to make grants to charitable programs of at least 5 percent of the foundation's net assets. These grants are typically charitable contributions with "no strings attached" and offer little in the way of oversight by the foundation. As an alternative to a pure grant, tax regulations allow private foundations to satisfy the 5 percent requirement by making program-related investments.

Stated briefly, a program-related investment is one in which: (a) the company receiving the investment significantly furthers one or more charitable or educational purposes, (b) no significant purpose of the company is the production of income or the appreciation of property, and (c) no significant purpose of the company is to accomplish one or more political or legislative purposes.

Historically, program-related investments have been primarily in the form of low interest loans to non-profit corporations – typically in the range of 1 to 3 percent per annum. While the IRS has issued private letter rulings stating that equity investments in socially beneficial for-profit corporations can qualify as PRIs, there is an inherent inconsistency between the duties of officers and directors of a for-profit entity to maximize shareholder value and the IRS regulations providing that recipients of program-related investment must not have as a "significant purpose" the production of income or the appreciation of property.

The L3C Act

The concept of the L3C was developed, in part, as a solution to the clash between the duties and responsibilities of officers and directors of a for-profit entity and the PRI regulations, and, in part, to bring greater visibility to the benefits of program-related investment.

An L3C is a limited liability company organized under the laws of the State of Vermont that meets the following criteria (upon formation and continuously during the life of the organization):

> (A) The company significantly furthers the accomplishment of one or more charitable or educational purposes, and would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

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

(C) The company is not organized to accomplish one or more political or legislative purposes.

The language of the L3C Act comes directly out of the U.S. Treasury regulations defining the principal characteristics of a program-related investments. An L3C, therefore, is simply an limited liability company organized for a purpose that is aligned with the PRI regulations. In all other respects, its is governed by the Vermont Limited Liability Company Act.

There is no special tax status associated with the L3C. An L3C is a taxable entity which can elect pass-through or corporate tax treatment. And, while the L3C does not have any special tax status, it signals to prospective charitable investors that the purposes for which the L3C were formed are consistent with the PRI regulations.

Because the L3C Act is simply a modification to the Vermont Limited Liability Company Act, the tremendous flexibility that is available to a limited liability company is available when forming an L3C.

<u>Attraction to Private Foundations</u>

Private foundations are constantly looking for ways to maximize the value of their contributions. They are less concerned about return on investment than with the accomplishment of the social and charitable programs they are funding. The L3C is a compelling model because the foundation's contribution is likely to be part of a broader financing strategy designed to build and expand the L3C's social mission. Recipients of program-related investments will be operating with a secondary purpose of generating income to repay debt and/or a return for investors. This is likely to lead to more business-minded management, and, ultimately, an organization that is financially self-sustaining.

Another significant difference between a charitable gift and an investment in an L3C (in the form of a low interest loan or equity investment), is that, in the latter case, the foundation's loan or equity investment creates an on-going relationship with the charitable organization. A foundation seeking some measure of influence over the activities of the charitable organization would be able to exercise such influence in a variety of ways, including having a representative on the board, providing periodic input on the organization's operating plan, and/or retaining approval rights with respect to certain activities that are outside the normal course of the organization's operations.

<u>Strategies for Using L3Cs</u>

While there are a wide variety of ways in which the L3C structure could be used. At a very high level, I anticipate that we will see L3Cs used in the following ways: (i) newly created L3Cs, (ii) existing taxable non-profits and for-profit entities converting to L3Cs by merger, (iii) L3Cs being created as spin-offs of a portion of the operations of existing tax exempt non-profits, and (iv) the formation of social or charitable-focused investment funds.

A. <u>Newly Created L3Cs</u>

It is likely that many organizations will form L3Cs as new projects are developed or operations of an existing charitable organization are expanded. An example of this might be the creation of an L3C by an affordable housing development company for a new affordable housing project. In this industry, project companies are already a common means of holding and funding a discrete project. Another example might be a tax-exempt charitable organization that wants to expand by adding a new operation that is wishes to fund with program-related investment.

B. Conversion to L3C

While probably less common, we may see taxable non-profits and for-profit entities converting to L3Cs because (i) they are only marginally profitable and (ii) they believe they can attract more capital through the L3C model than a for-profit model. Such a conversion would be accomplished by merging the existing entity into a Vermont L3C.

C. Spin Offs

The third model – the spin off – is likely to be used widely by existing tax-exempt organizations that do not want to lose the stream of contributions from their existing donors, but have identified a revenue-generating part of their operations that could be expanded, and potentially become profitable, with additional investment capital. An example of this might be a recycling company that believes that it could generate substantial revenue from the sale of recycled metals – copper, bronze – if it had the resources to expand its collection and sales efforts. The non-profit entity would transfer the assets relating to the recycled metals part of the operation into an L3C that is formed as a subsidiary of the non-profit. This structure would enable the L3C to explore a variety of capital structures to attract capital from private foundations in order to expand the mission of the non-profit with PRI funding.

D. Socially Oriented Investment Fund

We will also see L3Cs organized as investment funds created for the purpose of making program-related investments. Such funds would be managed in a way that satisfies the mission objectives of its fund participants and satisfies the criteria for program-related investment. These funds would be created as L3Cs. Fund investors would be members of the L3C with membership interests similar to any other limited liability company. As such, they would have limited liability and pass-through tax treatment. Such funds would take the members' pooled investment capital and make below-market interest rate loans and/or equity investments in companies falling within the mission of the fund participants. The L3C would, in all other respects, function like an ordinary private equity fund. It would add a measure of convenience to managers of foundations who do not want to evaluate and monitor individual PRI alternatives on a company-by-company basis. A socially-oriented L3C venture investment fund would serve the very useful function of creating a pool of PRI capital to be deployed for the benefit of important social and charitable causes.

Leveraging Foundation Investment

Perhaps the most compelling case for the use of L3Cs lies in the prospect that private foundation funding will help attract angel and venture capital investment, and even bank loans, on market terms. Used in this way, foundation investment is not simply applied to operating expenses. Instead, foundation investment helps create an equity cushion enabling the L3C to bring in additional capital from more conventional lending and equity sources. In such instances, the foundation investment could be in the form of a subordinated loan or junior equity investment. Commercial lenders or venture investors would then come in on market terms. There are many possible capital structures that could be devised to accommodate differing levels of risk and differing levels of expected financial return.

The kind of outside capital that would be attracted to a low-profit company would in part be a function of the industry and possible exit scenarios. For example, a company doing R&D on a groundbreaking drug would be a candidate for venture investment – by virtue of the possibility of a significant liquidity event in the future. By contrast, a low-profit company in the recycling industry would more likely be a candidate for a below-market-rate loan from a foundation which is used to leverage commercial bank debt – because its revenue stream is likely to be from operations, not from a future sale of the entity.

Conclusion

The advent of the L3C holds the promise that we will see more investment capital flowing to charitable organizations that are able to offer a "double bottom line" – a social benefit and a financial return. Private foundations and donor-advised funds will be most interested in investing in companies that are well managed, effectively advance their social mission, and have thoughtful financial plans for leveraging foundation capital. The companies that are able to create this kind of leverage will be giving private foundations the kind of long-term return they want to see – the possibility of some financial return, but, more importantly, long-term social benefits that will result from the organization's expanded operations and greater financial self-sufficiency.

2483214.2

Date: Mon, 24 Nov 2008 15:13:54 -0600
From: Tom Moody <tmoody@drm.com>
To: densmorew1@densmore.newshare.com
Subject: L3C materials

Bill -
Here are the materials you requested.

Tom Moody
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By Thomas H. Moody

The Promise of the L3C

This new entity, recently born in Vermont, could facilitate socially beneficial investing

In April 2008, Vermont became the first state in the United States to enact a law allowing for the formation of low-profit limited liability companies. Also known as L3C, this new business entity is designed to give socially oriented businesses greater access to capital.

Similar legislation has been pushed in Georgia, Michigan, Montana and South Carolina. But only South Carolina actually had a bill introduced; it did not pass.

Vermont's L3C act has national importance because an L3C organized under Vermont law can do business nationally, even internationally, under ordinary foreign entity qualification statutes.

Applicability

An L3C is essentially a for-profit limited liability company (LLC) that is organized primarily to pursue a social or charitable purpose. In a sense, it is a hybrid of a for-profit and non-profit organization, and has characteristics of each. Like a non-profit, it must be formed to pursue some charitable purpose. But, unlike a non-profit (and like a for-profit entity), it can have equity owners that have a right to distribution of profits and appreciation of the value of the business entity.

Accordingly, the L3C is an entity that allows for side-by-side investment by private foundations seeking to maximize a charitable outcome and ordinary financial investors seeking both a charitable outcome and a return on investment.

The rules governing the L3C's management structure and the capital structure are found in Vermont's LLC act that, like most states' LLC statutes, allows for a great deal of flexibility.

The L3C is taxed like any other for-profit entity, and would not qualify as a tax-exempt entity under Internal Revenue Code Section 501(c)(iii).

Consequently, it's suitable for a fairly narrow segment of socially responsible organizations that:

(1) have a social or charitable mission as their primary purpose,

(2) believe they can attract program-related investment, and

(3) expect to have sufficient revenue or capital appreciation to generate a positive after-tax return for its equity holders.

An organization that has the first two characteristics but is not confident that it can be profitable on an after-tax basis should probably be a non-profit corporation. An organization that has a social or charitable mission as its primary purpose and could make a profit but is not able to attract program-related investment, should be an ordinary for-profit entity.

In the few months since Vermont made these new entities possible, about fifteen L3Cs have been formed. They

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cover a wide range of industries, including health care, education and land conservation. My firm has assisted clients in forming many of the L3Cs organized to date. The social entrepreneurs who created these entities have come to us with creative plans to carry out noble social and charitable missions while generating some financial return for their owners. Most have charitable/business concepts they've been working on for years. They see the L3C structure as a way to bring together foundation funding and financial investors to finance their projects.

Program-Related Investment

At the core of the L3C lies the program-related investment (PRI). Briefly stated, a PRI is an investment by a private foundation in which:

(1) the company receiving the investment significantly furthers one or more charitable purposes;

(2) no significant purpose of the recipient is the production of income or the appreciation of property; and

(3) no significant purpose of the recipient is to accomplish one or more political or legislative purposes.

Generally speaking, private foundations are required to make grants to charitable causes of at least 5 percent of the foundation's net assets. These grants are typically charitable contributions with no strings attached and little in the way of oversight by the foundation.

As an alternative to a pure grant, tax regulations allow private foundations to satisfy the 5 percent requirement by making PRIs. PRIs necessarily involve a continuing financial relationship between the foundation and the charitable organization. The PRI regulations require a degree of continuing oversight by the foundation.

A PRI can be made in the form of a low-interest loan or an equity investment. Historically, most PRIs have been made in the form of loans to non-profit corporations. While the IRS regulations describing PRIs include examples of PRIs being made in the form of equity investments, any such equity PRI would necessarily have to be made in a for-profit entity, because non-profit corporations cannot, as a matter of corporate law, have equity owners.

Conflicting Duties

At least part of the reason foundations have shied away from making PRIs in for-profit entities is an inherent conflict between:

(1) the duties of officers and directors of for-profit entities to maximize shareholder value and

(2) IRS regulations that provide that PRI recipients must not have as a "significant purpose" the production of income or the appreciation of property.

> The L3C concept was created by a foundation executive and a former director of the IRS Exempt Organizations Division.

That's where the L3C comes in. Because Vermont law requires L3Cs to be organized primarily for a charitable purpose, the officers and managers of an L3C are not faced with this conflicting mandate. They can manage the L3C to accomplish the charitable mission as the primary objective of the organization—and thereby remain consistent with both the PRI regulations and their corporate duties. In this way, the L3C structure eliminates an obstacle to foundation funding of socially oriented for-profit organizations.

The concept of the L3C was developed by Robert Lang Jr., chief executive of the Mary Elizabeth & Gordon B. Mannweiler Foundation, and Marcus S. Owens, formerly director of the Internal Revenue Service's Exempt Organizations Division. They conceived of a new type of entity that would be specifically designed to attract PRI and to eliminate the conflicting duties facing officers and directors of for-profit entities seeking PRI funding.

The Vermont legislature was taken with the concept of social entrepreneurship and approved the legislation in the first session following its introduction.

Vermont's L3C Act

The Vermont L3C Act contains language taken directly from the IRS regulations on PRIs. The act provides that an L3C is an LLC organized under the laws of Vermont that meets this criteria (upon formation and continuously during the life of the organization):

(1) The company significantly furthers the accomplishment of one or more charitable or educational purposes, and would not have been formed but for the company's relationship to accomplishing the charitable or educational purposes.

(2) No significant purpose of the company is the production of income or the appreciation of property; however, if the company does produce significant income or capital appreciation this is not, in the absence of other factors, conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

(3) The company is not organized to accomplish one or more political or legislative purposes.

Why Form an L3C?

Private foundations are constantly looking for ways to maximize the value of their contributions. They are less concerned about financial return on their investments and more focused on whether the charitable organizations they fund are achieving the foundation's goals and mission. The L3C is a compelling model because the foundation's contribution is likely to be part of a broader financing strategy designed to build and expand the L3C's social mission.

The L3C will operate with a secondary purpose of generating enough income to repay debt and/or to provide a return for investors. This secondary goal is likely to lead to more business-minded management, and, ultimately, an organization that is financially self-sustaining.

Another significant difference between a charitable gift and an investment in an L3C (be it in the form of a low-interest loan or equity investment) is that the foundation's loan or equity investment creates an ongoing relationship with the charitable organization. A foundation seeking some measure of influence over the activities of the charitable organization would be able to exercise influence in a variety of ways, including having a representative on the board, providing periodic input on the organization's operating plan, and/or retaining approval rights with respect to certain activities that are outside the normal course of the organization's operations.

Perhaps the most compelling case for the use of L3Cs lies in the prospect that private foundation funding will help attract angel and venture capital investment, and even bank loans on market terms. Used in this way, foundation investment is not simply applied to operating expenses. Instead, foundation investment helps create an equity cushion that enables the L3C to get additional capital from more conventional lending and equity sources. In such instances, the foundation investment could be in the form of a subordinated loan or junior equity investment. Commercial lenders or venture investors then would come in on market terms. There are many possible capital structures that could be devised to accommodate differing levels of risk and differing levels of expected financial return.

Great Promise

The advent of the L3C creates the promise that we will see more investment capital flowing to charitable organizations that are able to offer a "double bottom line": a social benefit as well as a financial return. Private foundations and donor-advised funds will be most interested in investing in companies that are well-managed, effectively advance their social mission, and have thoughtful financial plans for leveraging foundation capital. The companies that are able to create this kind of leverage will be giving private foundations the kind of long-term return they want to see: the possibility of some financial return, but, more importantly, long-term social benefits that will result from the organization's expanded operations and greater financial self-sufficiency.

Of course, it will be very interesting to see in the coming years how this promise plays out.