

# Unfreezing the Foundation Asset Landscape to Create a Liquid Social Capital Market

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*"It is not because things are difficult that we do not dare; it is because we do not dare that things are difficult"*

Seneca (54 BC - 39 AD)

## Introduction

How can foundation assets be invested for greater social impact without sacrificing financial return objectives – for example, by investing in social enterprises? And why is this relevant? In organizing the socioeconomic activity outside the public sector two options are generally available. At one end of the spectrum, businesses usually incorporate as privately held, profit-maximizing entities. At the other end, organizations that have a charitable purpose incorporate as non-profit entities. By giving up the profit motive and adopting a social purpose these non-profits are endowed with special privileges such as exemption from taxation in many jurisdictions. This fundamental differentiation has remained in place for several decades, during which the social sector has grown immensely in scale and ambition. Today it functions not only in niche areas, but with support from private philanthropists and individuals is pushing the barriers of social service provision. Social enterprise has emerged as the new frontier and typically relies on market mechanisms to work toward goals that are not purely or even primarily financial.

## The Challenge

Social enterprises face multiple challenges in becoming main stream but access to capital is currently the binding constraint. This was the conclusion of a meeting at the Aspen Institute in September 2006 that examined social enterprises' difficulty under present laws to attract investment capital, whether from bank loans, venture capital, or in some other form.<sup>1</sup>

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<sup>1</sup> Thomas Billitteri, "Mixing Mission and Business: Does Social Enterprise Need a New Legal Approach?" The Aspen Institute, January 2007.

Two primary sources of capital are conceivable: commercial and philanthropic. However, commercial capital often avoids social enterprises, partly because of lower target returns and the greater difficulty of conceptualizing business models that generate both social and financial returns in the language of the capital markets.

Thus, charitable foundations emerge as a potentially major source of capital. Foundation endowments have grown substantially in past decades. The Foundation Center estimates that in the United States alone, the combined assets of grant-making foundations grew from US\$ 30 billion in 1975 to US\$ 227 billion in 1995 and about US\$ 510 billion in 2004 (in 1975 dollars)<sup>2</sup> – a compound annual growth rate of nearly 10%.

Currently, charitable foundations seeking to invest in social enterprises with such “hybrid” returns face a specific set of challenges, which are largely regulatory. For example, under US tax laws non-profit foundations can make “program related investments” (PRI) into such profitable organizations that further the charitable cause of the foundation. PRI investments are beneficial to a foundation as they count as part of the required 5% payout and are not booked as part of the endowment. This means they do not count towards calculation of the next year’s 5% payout requirement and any capital gain is not included in the excise tax. So PRI investments, unlike regular endowment investments, are a kind of “off the books” investment – to be dealt with only when they earn income or are sold. Even then, rules are simple – any income or gains must be given away or reinvested in another PRI within the same year in addition to the 5% already allocated for that year.

Despite these many benefits, PRIs have not been widely adopted in the US, partially because the perceived transaction costs are too high.

### **The Solution: Developing PRI-friendly Legal Vehicles**

How can the transaction costs of investing foundation assets in social enterprise be reduced? Several initiatives are under way to address this challenge. Here are two examples from the US and the United Kingdom.

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<sup>2</sup> [http://foundationcenter.org/findfunders/statistics/pdf/02\\_found\\_growth/06\\_04.pdf](http://foundationcenter.org/findfunders/statistics/pdf/02_found_growth/06_04.pdf)

- *The Low-Profit Limited Liability Company (L3C):*<sup>3</sup> Recent moves, initiated in North Carolina, USA by the Mannweiler Foundation, and supported by Ashoka, GAVI, and others, aim to create an institutional context for PRIs – the low-profit limited liability company (L3C). The L3C would be a specific type of LLC, a privately held corporation owned by members with limited liability, that would operate a profit-making business, but one with a charitable goal. The requirements for an L3C would match exactly the conditions placed on PRIs in IRS tax law. However, as a company, the L3C would also be able to access capital markets.
- *Community Interest Companies (CIC):*<sup>4</sup> In 2006, the UK established a new limited company type called the Community Interest Company. CICs have special features, created for the use of people who want to conduct a business or other activity for community benefit, and not purely for private advantage. Through certain qualification tests (community interest test) and an “asset lock,” regulations ensure that the CIC is established for community purposes and the assets and profits are deployed accordingly. However, a CIC can have both non-profit and for-profit member ownership, allowing it to work across the spectrum.

## Conclusion

The initiatives under way take into consideration that there are organizations that create both a strong social benefit and an economic return. However, in so doing, these initiatives also provide the additional benefit of creating opportunities to unfreeze the foundation asset landscape. One of the likely by-products of the L3C in particular would be to significantly expand PRIs into a viable social capital market for two reasons:

- *Layered investing:* As an LLC an L3C can distinguish between its members. This allows different entities to buy memberships with different levels of return and risk. For instance, philanthropists could buy the highest-risk membership of an L3C from the grant component of their portfolios, while a small foundation may buy the lowest-risk membership of the same vehicle from its bond component. This layering would allow a variety of investors to participate in L3Cs, depending on their risk preference, expanding capital available.

<sup>3</sup> “The L3C: The For-profit with a Nonprofit Soul,” Mannweiler Foundation Inc., 2007.

<sup>4</sup> <http://www.cicregulator.gov.uk/index.shtml>

- *Transparency and tradability*: Initiatives such as the CIC increase the transparency of social enterprises by requiring annual reporting, a major precondition for the development of a viable secondary market for such investments. Once tradable, such securities would make the social capital market more liquid, again encouraging greater participation. This would apply even for foundations that do not have matching mission investments, since they could provide backing to investments of smaller foundations.

The two initiatives discussed above address the immediate lack of regulation and definition for social enterprises as for-profit charitable entities. However, they are important for a more fundamental reason. By institutionalizing the concept of a “for-profit social enterprise,” they recognize that organizations can reconcile the twin goals of social impact and financial return. The acceptance that this is possible expands the possibility frontier for funding social enterprise, both from commercial and philanthropic sources. Just envision a campaign where one year of annual payouts or 5% of the overall US foundation assets would be invested in social enterprise – and over US\$ 30 billion in additional funding for social enterprise would come on stream!<sup>5</sup>

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<sup>5</sup> Europe has a sizeable foundation sector as well. The largest 50 European foundations have cumulative assets of US\$ 147 billion – roughly comparable to the assets of the top 50 American foundations, with assets of 133 billion. *European Foundations: Report on Top 50*, Watson Wyatt. February 2007.