NEW LEGAL STRUCTURES TO ADDRESS THE SOCIAL CAPITAL FAMINE

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A projected increase in the percentage of people over the age of 65 in the G-7 countries in 2030 and 2050 is described in the U.S. by the Congressional Budget Office as unsustainable.[1] It is unsustainable in terms of the very provision of social capital and social services in our society. And the situation is going to get worse because effectively what you have is a declining tax base at the very same time as pension costs increase. This matters for the reason that the people we serve are at the bottom of this food chain. These figures, profiled in the Financial Times back two or three years ago, said the U.S. was in danger of losing its AAA rating within about ten years.[2]

Now, that was my presentation two years ago. What has happened since? The whole financial crisis has blossomed upon us. There has been a total meltdown in governmental expenditure. Foundations have seen their funds shrink by 30–35%, take another 5–10% out if you factor in the tax code.[3] Corporates are pulling back. There is clearly not enough money in the system. Yet, to solve these huge problems of pension, healthcare, climate, sanitation, and water, we must work within the financial structure that we have in place to address them.

We allocate money in only two ways: we either give money away at -100%, or alternatively, we seek a full profit with social impact [earning 6% plus in return]. Well, I'm not a mathematician, but even I know that there is a range of positions between -100% and +6%. But there are no [legal financial] structures that actually allow you to operate within the range of

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† Please note that the speaker reviewed and edited this transcript. New language appears in brackets, and ellipses indicate omissions of language.

1. *The Long-Term Budget Outlook: Hearing Before the H. Comm. on the Budget*, 110th Cong. 2 (2007) (statement of Peter R. Orszag, Dir. Cong. Budget Office).

2. Jeremy Grant, *Washington Warned on Health Costs*, FIN. TIMES (London), Jan. 30, 2008, at 2.

3. Bill Myers, *Charitable Endowments Shrink as Economy Falters*, WASH. EXAMINER, Dec. 29, 2008, *available at* http://www.washingtonexaminer.com/local/122908-Charitable_endowments_shrink_as_economy_falters.html.

-100% to +6%. Th[e social sector] is a huge sector, estimated at $1.4 trillion in the United States alone.[4] Yet, let me give you two shocking statistics—less than 0.07% of the entities have secured $50 million of revenue or more.[5] Only 3.8% of the entities have expenses of over $10 million.[6] [Those statistics] tell you it is a huge but incredibly fragmented sector. And that's partly because [in the social sector] competitive advantage for [raising] capital is about coming up with a clever idea, at least within the foundation world, and not collaborating with the very people you should be collaborating with. There is no mechanism that allows you to collaborate between government, corporates, and the not-for-profit sector. We each work within our silos. We each try to find solutions within our own silos. Yet, if we sat around with a decent bottle of wine, we would all realize that it requires a collaboration of for-profits, not-for-profits, and a bunch of other groups to actually find the solution. But that is not the financing structure that we have in place.

If you look at the gap in the middle, there is no mechanism that allows organizations to transit from the not-for-profit world into the for-profit world. There is no legal mechanism or financial mechanism that allows you to do that. If you think of philanthropy as essentially having two functions in our society, one is charity, and there will always be things that require grants—stopping child abuse and human rights [violations, for example]. However, much of what we do is also the [research and development] of society. Yet, the structure locks the not-for-profit world inside that grant world. The academics in the pharmaceutical industry, for example, do not see themselves as part of a consistent business proposition. They see themselves as creating [one] idea and then moving on to the next one.

The sector itself does not create the cash flow to retain its sustainability. It doesn't feed itself in terms of linking itself into the mainstream economy. Additionally, there is no system that allows for-profits and not-for-profits to actually collaborate. The result is this system that has crystallized these two positions.

This is probably where we should be heading: [toward the L3C model and the CIC] that Stephen Lloyd and academics in the U.K. created. Th[ese models] look across the whole framework and say, "there are not just two

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4. KENNARD T. WING, ET. AL., THE NONPROFIT SECTOR IN BRIEF: PUBLIC CHARITIES, GIVING, AND VOLUNTEERING 2 (2009), *available at* http://www.urban.org/uploadedpdf/412085-nonprofit-sector-brief.pdf.

5. William Foster & Gail Fine, *How Nonprofits Get Really Big*, STAN. SOC. INNOVATION REV., Spring 2007, *available at* http://www.ssireview.org/articles/entry/how_nonprofits_get_really_big/.

6. WING, *supra* note 4, at 3 ("At the other end of the scale, nonprofits reporting annual expenses of over $10 million account for just 3.8 percent of charities but 84.2 percent of all reported public charity spending.").

positions." [Our global financial system] is not a system invented in 1888 by Carnegie and crystallized in the tax status in 1921 and 1931. They say that we should be looking at a whole range of financing opportunities all the way from grant to recoverable grant to program-related investment (PRI), investment-plus, and mainstream. This range will allow collaboration to occur and ensure that there is not a fundamental contradiction between for-profit and not-for-profit business models.

To achieve that collaboration you have to have a number of things in place. One is a legal structure that allows for that collaboration to occur, because effectively, what we are talking about is taking the subsidies that society has, which are unleveraged, and using those to leverage the corporate sector and the banking sector into this environment. And if you have any doubt as to the necessity of that, I would take you back to those first original slides [showing the large percentage of the population of the G-7 countries over 65 years of age, and growing larger, illustrating the lack of sustainability of our current financial systems to respond to social needs]. There is quite simply not enough money in the for-profit/not-for-profit paradigm for us to actually solve [social] problems.

From a governmental perspective there is an additional irony and cost: the current tax and legal policy creating this fragmentation, and ensuring that the social organizations raise capital that is unleveraged and which has no annuity structure, causes social mission organizations to spend 50% or more of their time and resources raising capital. Thus, they fail to reach scale. Further, in this structure, the U.S. Government, driven by budget constraints, then outsources $600 billion annually.

A partnership structure between the corporate, government, and social sectors within a legal framework that ensures social mission would drive scale, expertise, and, in the view of some, actually be revenue-neutral to revenue-positive to government. There is a desperate need for good econometric analysis in this regard.

The fundamental question is: how do we bring additional capital and additional corporate expertise into this marketplace? The L3C and the CIC are clearly mechanisms that allow that to occur. The second thing we need to achieve collaboration across sectors is an increase in the credit quality of the capital markets, leveraging micro-finance, risk management, [etc.]. Those are techniques that are common throughout history, but again, are things we need to do in [the social] sector. Why do we need to do these things in our sector? [We need to do them] for the simple reason that the vast majority of things that we invest in are small and undercapitalized. They are junk, to use the technical phrase. If we can actually increase their credit quality, again, we can bring different investors into the marketplace, incentivizing collaboration [through] the growth of social entrepreneurship, and social finance, over the course of the next few years.

There has been a massive growth in new financial systems that are being applied to this sector. There has been a massive growth in social entrepreneurship as people realize that the current system of government is not working, there is not even enough capital, and that we need to bring into the framework additional innovation from the community and mechanisms to incentivize engagement into the framework. The whole growth of carbon models, ventures, taxes, mobiles, all these are beginning to see tremendous growth, and it will have huge impacts in terms of the ability to incentivize and empower communities directly.

Finally, [there is] the concept called the creation of synthetic profit. I'd refer to a deal called Gavi, that some of you may or may not know. Gavi is a $4 billion structure put together by Deutsche Bank and Goldman Sachs.[7] Gavi effectively takes a series of government cash-flows, brings them to the present day, empowers the citizen sector to negotiate with the corporate sector—which can now see a business in scale—and drives in economies of scale, thereby dropping the cost of vaccinations down from $50 to $3.50 [for a] huge social impact.[8] Now, the contingent return models that are beginning to be used in the United Kingdom, just on the drawing board at the moment—something called a social impact bond that the Prime Minister got behind recently—[are] exactly taking those future cash-flows that would go to corporates or promises from individuals and monetizing that and bringing that to the present day, a way of totally changing the economics of the whole market. And it is with these types of mechanisms coming together that you can actually begin to change the view of the for-profit/not-for-profit dichotomy—to change the paradigm into how to leverage additional capital and solutions into the marketplace. You can create effective outcome-based models that incentivize collaboration and scale.

I'll use the example of sanitation. The reason I'm using this as an example is because it exemplifies the type of environment you have to have to begin thinking about systemic solutions. One of the things that the L3C does is it begins to allow you to create these collaborations between differing players along the same issue. It enables you to define that legal

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7. *Immunization Bond Gives Investors a Chance to Save Lives*, THE WORLD BANK (Nov. 7, 2006), http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21118784~pagePK:64257043~piPK:437376~theSitePK:4607,00.html.

8. Joe Cerrell, *The Great Debate: Extending Vaccines to the Worlds* [sic] *Poorest*, REUTERS BLOG (Oct. 31, 2009, 12:00 PM), http://blogs.reuters.com/great-debate/2009/10/31/extending-vaccines-to-the-worlds-poorest/.

relationship between the corporate and banking sector, with a definable social aim. And to achieve that you have to have a very clear indication that there is social–economic impact. You need a single data set that is very clear. You need to be able to identify the community. It needs to be a non-zero political sum game. You need to think about two very specific things, because once you come to the conclusion that there just is not enough money, and you change the legal environment, the next stage is ensuring you have an intermediary in the marketplace that can fight [in] the corner of the social entrepreneur vis-à-vis the business sector. This will ensure that within a large and more efficient sector, those resources will go equitably to the community.

I'll give you an example. In the carbon market, which is a big-growth market, if we just leave it to the vagaries of government and the banking sector, what will happen is that the banking sector, well-resourced, will come in and prime pick each of these individual players, and the margin, I will guarantee you, will go to the banks. What we need to create are intermediaries—and there are a couple of examples growing up—at the margin of a much larger, aggregated market. These intermediaries will ensure that it is actually in the interest of both players and that margin goes back to that community to incentivize that community to pursue better forestry or sanitation practices, [etc.]. Unless you create that essential link with the community, you will not fundamentally succeed at the end of the day. It will become a bilateral relationship between multilaterals and corporates. So, that fundamental engagement and ownership of the community is absolutely the key in all of these issues, both to capture their innovation and ensure that as stakeholders they are remunerated for their participation.

To summarize, there is simply not enough money in the current not-for-profit paradigm. We need to move, across the political spectrum, from silos to collaboration. [There have been] calls by the Secretary General [of the United Nations, Ban Ki-moon],[9] [the former Prime Minister of the United Kingdom], Gordon Brown,[10] and the former Prime Minister of Canada, Paul Martin.[11] And the reality is that markets only grow through transparency. And what I have listed here is a series of examples where you

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9. U.N. DEV. PROGRAM, BUSINESS CALL TO ACTION 4, *available at* http://www.un.org/millenniumgoals/2008highlevel/pdf/background/business-call-action-booklet.pdf (last visited Oct. 12, 2010).

10. *Id.*

11. Paul Martin, P.C., M.P., Unleashing the Power of Social Enterprise, Address Before the Monk Center for International Studies in Toronto, (Nov. 8, 2007), transcript *available at* http://www.paulmartin.ca/en/speeches-20071108-1.

can see these strands beginning to come together. Look at the work that Rockefeller is doing around GIIN [the Global Impact Investing Network].[12] The Institute Monitor report recently [has brought] transparency to the market, indicating this market could grow to $500 billion in ten years.[13]

The second fundamental point [here is that], in our marketplace, most people in the social sector assume that return is unitary—a dollar in, a dollar out, a dollar in, social benefit out. That is not the case. If you look at any other sector, you will see that different players can take different social–economic return out of the same structure. You can create cross-subsidization structures, which is exactly again what the L3C does. And you can see examples of that: (1) the Deutsche Bank Eye Fund[14] that we, Ashoka, with Deutsche Bank, worked on; and (2) the U.S. affordable housing market,[15] to which some people say, "well this is totally new, you can't do this funny sort of stuff." But if you look at the limited liability partnership structures in U.S. affordable housing, they are exactly the same structures. There are foundations using LLC structures to leverage billions of U.S. dollars into the affordable housing market.

In essence, what the L3C has done is simply make [leveraging capability] broadly more accessible to the philanthropic sector. DFID [Department for International Development] in the United Kingdom, again, [uses] layered financial structures.[16] The creation of these new layered financial structures, described by Fast Company as one of the top fifty ideas,[17] is a way of drawing additional private capital, but it requires you to realize that return is not unitary in this market. Everybody thinks it is

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12. "The Global Impact Investing Network is a not-for-profit organization dedicated to increasing the effectiveness of impact investing. Impact investments aim to solve social or environmental challenges while generating financial profit." GLOBAL IMPACT INVESTING NETWORK, http://www.globalimpactinvestingnetwork.org (last visited Oct. 12, 2010); *see* Tom Stabile, *Architects of a 'Social Investment Data Engine'*, FIN. TIMES (London), April 12, 2010, at 12 (explaining that the Rockefeller Foundation is propelling the effort to combat poverty through socially-beneficial investing).

13. MONITOR INST., INVESTING FOR SOCIAL AND ENVIRONMENTAL IMPACT 5 (2009), *available at* http://www.monitorinstitute.com/impactinvesting/documents/InvestingforSocialandEnvImpact_FullReport_004.pdf.

14. *See* Press Release, Deutsche Bank, Deutsche Bank to Launch Investment Fund Supporting Eye Care Hospitals in Developing Countries (Sept. 22, 2006), *available at* http://www.deutsche-bank.de/presse/en/content/press_releases_2006_3194.htm?month=4 (explaining Deutsche Bank's efforts to finance eye care hospitals).

15. *See Low Income Housing Tax Credit*, HOUSING.COM, http://www.housing.com/categories/low-income-housing-tax-credit.html (last visited Oct. 29, 2010) (explaining the low-income housing tax credit, which creates incentives to use private equity to develop low-income housing).

16. *See generally* U.K. DEP'T FOR INT'L DEV., http://www.dfid.gov.uk/ (last visited Oct. 29, 2010) (explaining that DFID forms partnerships with private enterprises to work towards achieving the Millennium Development Goals).

17. *The 6th Annual Fast 50*, FASTCOMPANY.COM, http://www.fastcompany.com/magazine/113/open_13-deutschebank.html (last visited Oct. 29, 2010).

unitary in this market, because our market doesn't move in enough scale. We are all trying to raise a half million or a million [dollars], so it doesn't actually allow you to bring these larger instruments to bear. The Gavi deal I mentioned before [is another example of this]. The incentives to create economies of scale in a market of $1.4 trillion, where the players don't change, where only 3.8% of the entities have revenues of more than $10 million [is not there]. There are no economies of scale in this sector for the most part.

[Another problem in the social sector is determining how to] capture the value of social externalities. How do you capture the value of what everybody produces? In sanitation, the cost of achieving the MDG [Millennium Development Goal] is estimated at roughly a $137 billion annual market.[18] But, the social externalities that are generated from that [would be] roughly $556 billion [in additional labor, production, etc.].[19] Now if you examine how people look at that, they tend to look at the $137 billion worth, rather than the generation of the outcome. If you can monetize that value to governments, corporates, and people who have conscience and are prepared to pay for that, then you totally change the economics of this marketplace.

As I said, there is a series of examples being pursued by multilaterals, and a series of examples in the social sector, [where we are empowering and connecting] the community [through] social entrepreneurship and social finance. We can happily talk about [these new businesses] as being a massive growth. [It is critical that, going forward, these new businesses] use the skills and resources of for-profit banks and corporates, but with a clear, defined social objective. The critical issue is to ensure that, while motivating and mobilizing these [private sector] resources, there is a social intent and a social purpose in this process. And you have seen a range of organizations, J.P. Morgan, Deutsche, and Nike for example, all playing around in this space. And then fundamentally, [the question becomes] how do you change the legal framework?

The Aspen Institute paper by Thomas Billitteri, [in] 2007, did a survey of a whole range of legal structures.[20] This is an issue that has been bubbling away. It is driven by the fact that government realizes it hasn't got enough money. One of the benefits potentially of the L3C structure is that if

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18. GUY HUTTON & LAURENCE HALLER, EVALUATION OF THE COSTS AND BENEFITS OF WATER AND SANITATION IMPROVEMENTS AT THE GLOBAL LEVEL 26 (World Health Org. ed., 2004).

19. *Id.* at 34.

20. Press Release, The Apsen Inst., New Aspen Institute Report Outlines Potential New Legal Forms for Social Enterprise Organizations (Feb. 26, 2007), *available at* http://www.aspeninstitute.org/news/2007/02/26/new-aspen-institute-report-outlines-potential-new-legal-forms-social-enterprise-orga.

you [can] bring the tax-paying corporate sector to address what is a cost to the government, [then] you can create a process [that is] potentially tax-neutral to tax-positive. In the current environment, where there is not enough money, this situation whereby our sector can simply go out and ask for more tax breaks, is not credible. We need to create an environment where philanthropy can potentially be a source of competitive advantage. It needs to be a mechanism whereby we motivate all stakeholders in our society, both for-profit and not-for-profit, to collaborate together. Finally, to achieve that [collaboration] you have to create new intermediaries that fight in the corner of the social entrepreneurs. And I say this with bloodied experience, because you have effectively got social entrepreneurs [with a range of business expertise]. When you use words like margin, cash-flow, it's a different language [that the social sector is largely unfamiliar with]. We are two communities separated by a different language. If we are actually to solve these problems, social [problems], climate [change issues], water [scarcity and quality issues], [then] we have to motivate and empower all members of our society.

I leave you with one very simple anecdote. In April, when Vermont passed th[e L3C] law, a very major foundation with billions of dollars of resources based out of New York started to do a program-related investment. They completed that PRI four or five months ago, during which time the L3C legislation had [in parallel] empowered about a hundred organizations here in Vermont, and [continues] empowering a range of social entrepreneurs. And I leave you with that anecdote [to illustrate that in the question of] do we stay with the existing status quo, that even when well-resourced can't be mobilized, [or do we move towards] a structure that empowers ordinary Americans to become social entrepreneurs to achieve social purpose. Thank you very much.