PROGRAM-RELATED INVESTMENTS IN PRACTICE

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I have been asked to talk for a few moments on the issue of program-related investments (PRIs) from a foundation perspective and particularly PRIs as a rationale for new forms of legal organization. One of the leading rationales for the L3C movement has been the belief that the creation of L3Cs will provide access to a larger pool of below-market PRI capital from foundations.

One of the questions I'll attempt to answer is: Is that indeed the case? Are foundations reluctant to make PRIs today because of the constraints of the existing legal forms of organization? I think it is an empirical question that we can tackle directly.

A second question, following from the first, is: If, in fact, it is not the case that legal forms of organization are the barrier to PRIs by foundations, then what is?

As a basis for addressing these questions, I have the privilege of managing the investments for the F.B. Heron Foundation. We are a New York foundation, which works nationally to promote asset building and wealth creation for low-income people, families, and communities in the U.S. So, our strategies tend to include: affordable homeownership, enterprise development, job creation in low-income communities, and capital-access strategies broadly, among others. We began in 1992 as a foundation and since 1997 have been an active PRI-maker. In more recent years, we were co-founders of both the PRI Makers Network, which is an organization of approximately 173 foundations committed to best and emerging practices in making PRIs,[1] and of the More for Mission Campaign, which is a grouping of approximately 75 foundations—with assets under management of approximately $30 billion—that are committed to using a larger share of their endowments for mission purposes.[2] These have been very significant recent developments in the field of philanthropy.

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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. STEVEN LAWRENCE, THE FOUNDATION CENTER, THE PRI DIRECTORY: PROGRAM-RELATED INVESTMENTS AND LOANS BY FOUNDATIONS, DOING GOOD WITH FOUNDATION ASSETS: AN UPDATED LOOK AT PROGRAM-RELATED INVESTMENTS xiii (Jeffrey A. Falkenstein & David G. Jacobs eds., 3d ed. 2010).

2. Press Release, CSRwire, More for Mission Initiative Now Includes 75 Foundation Members (Aug. 26, 2010), http://www.csrwire.com/press_releases/30378-More-for-Mission-Initiative-Now-Includes-75-Foundation-Members#.

Let me for a moment just talk about our own PRI-making experience. We, at F.B. Heron, have been at it for 12 years now, making 77 separate PRIs totaling $38 million. At the end of 2009, we had just under $21 million in outstanding PRIs in 38 separate transactions. PRIs constitute approximately 8% of the assets of our foundation, which makes us one of the very few foundations with such a large commitment to below-market social capital. Thus far in practice, our default rate has been just under 1%, roughly $343 thousand versus $38 million in cumulative PRIs made. Our income from PRIs, derived from interest, dividends, and capital gains, totals $4 million over that period. So, it represents a portfolio rate of return of about 3.8%, although the returns of individual transactions may vary from 1% to 9%. And that variation will depend on the type of PRI, the purpose of the PRI, and the asset class in which the PRI resides. Is it, for example, a loan? Subordinated or senior? Is it equity? All of these factors affect the terms that would be available. That 3.8% portfolio return represents less than 40% of the yield the foundation's endowment would normally have. So, it is a very substantially discounted yield, or return, for this pool of below-market capital. We would normally expect nearly a 9% total return for endowment assets of the foundation, however difficult it is to achieve under current circumstances. I will point out that 3.8% is below market for sure; it is intentionally so, but, as Robert Lang[3] knew very well, in 2001, 2002, and 2008, PRIs were among the best-performing assets in foundations' portfolios because 3.8%, though below market, is a lot better than the minus 20% that some asset classes returned. But on a general basis, there *is* an opportunity cost to a foundation making PRIs over the longer term.

As I have mentioned, the F.B. Heron Foundation had 38 transactions outstanding at year end, valued at over $21 million. Who do we make them to, and how important is the form of legal organization? Seven of those 38 are limited partnership interests or member interests in for-profit institutions: typically, new-market venture capital companies, rural-business investment companies, and other forms of community-development venture capital that align with our mission. So, 7 of the 38 are for-profit entities created in conventional LP or LLC structures. In addition, two are PRIs that represent preferred stock in for-profit, community-development banks of which one is a registered B-corp. So, of the 38 PRIs we made, nine represent 30% of our PRI dollars in the form of equity to for-profit entities. Another six PRIs are subordinated debt, and those are

3. Robert Lang is currently the CEO of L^{3}C Advisors, L3C, which is the first-ever L3C, organized to help others organize and finance L3Cs.

interesting because the recipients vary. Two of them are low-income, designated credit unions, which are nonprofit financial cooperatives made up of poor and working people. Three are classic nonprofits: Calvert Foundations, Boston Community Loan Fund, and Community Reinvestment Fund. And, one is an LLC, a for-profit, in which the foundation sub-debt provides credit enhancement of $250 million in senior bank debt to promote affordable housing and assisted-living facilities in New York City.

So, if you look at the for-profit equity and the quasi-equity subordinated debt that we make available, they constitute 15 transactions and 40% of our PRIs by dollar value. And, they are mostly to for-profits, although nonprofits and cooperatives are in the mix. The remaining 23 transactions, representing 60% of our PRIs by dollar value, are senior loans almost exclusively to nonprofit organizations. These are most often to community-development financial institutions, community-development corporations, and some social-enterprise ventures. Although, I would say that much of what I described as equity and subordinated debt went to organizations that consider themselves social enterprises.

So, the issue for us is not whether the legal form of the organization seeking the capital is a critical driver. That is not the case because we find that under the existing rules—which for other reasons merit revision—you can apply them and reach positive decisions on making PRIs to a for-profit, nonprofit, cooperative, or other form of legal organization.

What are the three tests for PRI-making? I'll just mention them because they are integral to my point here. One, is there a charitable purpose served by the PRI and is making the PRI consistent with a foundation's exempt purpose?[4] Two, is the income, or return, from the PRI not a significant purpose in making it?[5] And three, is no lobbying involved?[6] So, typically, the first and third tests are not the biggest problems. In practice, foundations tend to easily recognize charitable purposes, although some seek legal opinions to be absolutely safe. Additionally, we pretty much have a handle on the lobbying rules. But the thing that really becomes problematic for us is the second test: whether the return is a significant purpose in making the PRI.

Within the second test, foundations divide into two broad schools. One is the group of foundations that believe "significant purpose" means taking

4. Treas. Reg. § 534944-3(a)(1)(i) (2010). *See also* I.R.C. § 170(c)(2)(B) (2006) (outlining acceptable uses of "charitable contributions").

5. Treas. Reg. § 534944-3(a)(1)(ii) (2010).

6. *Id.* § 534944-3(a)(1)(iii). *See also* I.R.C. § 170 (c)(2)(D) (prohibiting "charitable contributions" from use for political purposes and lobbying).

a nominal return, which means a fixed coupon, typically 1 or 2% on any PRI made for any purpose. Whether it's senior debt, subordinated debt, or equity doesn't matter; it's still 1 or 2%. The belief is: that is a form of safe harbor that will not attract scrutiny or attention from the IRS, because who would believe that an entity would make an investment for 1 or 2% if its intention was to make money? That has not prevented, though, the foundations that follow that line of thinking from investing in for-profit entities that have a social purpose. Typically, the PRI is made with a cap on the return and the understanding that any return above that cap then inures to the benefit of an affiliated nonprofit organization. So, it typically is a way for a foundation to receive a nominal return, consistent with its comfort level, and some nonprofit receives any upside from the production of income on the investment.

The other approach, and one which we favor, seeks to make PRIs on terms that are materially different from the terms that a market-rate investor would accept, essentially making PRIs that are below market on a risk-adjusted basis. That, we believe, satisfies the IRS's second test. So, again we would argue that the form of legal organization is and should not be a driver of the availability of PRI dollars, and that current rules allow a foundation that is willing to make a PRI to consider making PRIs to cooperatives, nonprofits, limited-equity corporations, for-profit C-corps, and B-corps, etc.

If that is so, and our experience in 12 years indicates that this is a defensible way to make PRIs, why don't more foundations make them? I would argue that there are three principal reasons, and lot of small ones. But I'll focus on the three principal ones. First, there is a lack of awareness, even today, on the part of many foundations, of PRIs, what they are, how they benefit the foundation and its work, and how PRIs can, in fact, leverage change in line with the foundation's mission.

We are frequently invited to conferences and meetings with foundation groups around the country to describe the opportunity for making PRIs and mission investing broadly. The thing that is most interesting to us is that, whether it is CEOs, board members, or others, they all generally have a very low level of awareness of the tool. PRI Makers and other institutions that we support have really been making an effort to address this lack of awareness.

The second reason is that foundations, frankly, have a profound discomfort with the underwriting credit risk associated with PRIs. The program officers who typically have responsibility for PRIs—because it is considered part of the charitable distribution budget of the foundation—are generally not trained in credit or investment analysis. One of my foundation

colleagues offered a good example of this point. She met with 30 of the program offices within her foundation and asked: "How many of you receive copies of the audited financial statements for the groups that you support?" Twenty nine hands arose. Then she asked, "How many of you have read them?" I believe only six hands arose. So, the discomfort level with underwriting cannot be overestimated as a factor in stifling the appetite of foundations to make PRIs.

You might then say: What about the financial and investment staff which most foundations have? The practice has essentially been that those staff members concentrate entirely on market-rate opportunities. So, the wall that separates program and finance often, in foundations, operates to assure that there really is no internal champion for PRIs. What has recently occurred is that there have been committees formed in foundations, of program officers and investment officers, with the idea of getting them to share their expertise. Where that has happened, some really significant movement has occurred.

The third material barrier, I believe, is that there is a bias on the part of grant makers that, frankly, only grant making achieves high social impact. Once you insist on return of principal or return on capital—even if it's a below-market return—then essentially there is a diminution of the social benefit or impact. This is something that is a deeply-felt value on the part of many people, particularly on the program side of the foundation.

So, those, I think, are some of the reasons that there tends to be resistance. The good news, I believe, is that the resistance is lessening and the number of practitioners is increasing. The Foundation Center will put out, in two months, a PRI Directory, which is the first time in seven years it will do so. The PRI Directory will show that PRIs have literally doubled during the period 2006–07 versus seven years ago.[7]

That's the good news. To provide context, from 2006 to 2007, foundations made charitable distributions of $90 billion.[8] So, basically, PRIs of $1 billion are a part of a $90 billion charitable distribution stream in that two-year period. Essentially, PRIs are a very small player in foundation activity today.

That means there is a lot of opportunity, and I think social enterprises and social entrepreneurs knocking on the doors of foundations will loosen the reins. I will point out, however, that one of the things that social enterprises and social entrepreneurs should be aware of is that, increasingly,

7. LAWRENCE, *supra* note 1, at xiii.

8. *Id.*

foundations making PRIs are doing so through intermediaries as opposed to making direct PRIs to individual enterprises.

This method has two benefits to the foundation. One is diversification. The other is that professional management will decide who should be funded or not. So, an access point for social enterprise may not be the foundation as the direct underwriter, but one of the many intermediaries that the foundations underwrite in the course of their business.