Program (and Mission) Related Investments

Legal Concepts, Structure & Documentation

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MISSION INVESTORS EXCHANGE

Bringing people together around mission investing

Introduction: Why Are We Here?

- Heightened interest in mission related/impact investing generally
- Shrinking boundaries between sectors
  - Rise of mission/impact as a force in the commercial sector
    1) Increased awareness and notion of corporate responsibility
    2) New corporate forms
- Increased (better) charitable investment opportunities
- More organizations willing/eager to jump in
- Another (effective and complementary) tool to accomplish mission

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The Social Context: MRIs and PRIs

- MRIs: profit and social impact
  - Attention to impact outcomes, social values & externalities (e.g., environmental impact, fair labor standards)
  - MRIs may or may not
    1) advance charitable purposes
       a) "Charitable" is usually a higher threshold than "mission-related"
    2) offer a market-rate expected return
       b) MRIs may be considered "prudent" investments
    3) count towards pay-out requirements (for a private foundation)
       c) PRIs generally do

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The Social Context: MRIs and PRIs

- PRIs are a subset of the larger MRI universe
  - A PRI is an investment made (by a private foundation) to accomplish one or more charitable purposes
    - A grant in investment clothing
    - Technically unique to private foundations
    - PRIs have distinct tax characteristics and a long history
    - Greater interest in PRIs as focus on mission investing has grown
  - Although public charities are not subject to the PRI rules, many now seek to make investments that are PRI-like
    - Look to the private foundation experience as a model
- Private foundations can also make "pudent" mission investments that are not PRIs

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The Social Context: MRIs and PRIs

- PRIs must advance charitable purposes & may not be (purposefully) profit driven
  - Excessive risk/lower financial return: OK if investment achieves a charitable purpose
  - PRIs rarely have market-rate expected return
    - charitable focus and
    - restriction on "profit motive"
    - though ultimately OK if they return a profit
- PRI may be made in/to a for-profit or non-profit entity
- Public charities may (often) follow PRI general guidelines when making MRIs (but with greater flexibility)

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The Legal Context for Private Foundations: Jeopardizing Investments

- Section 4944 of the Internal Revenue Code imposes a tax on the "jeopardizing investments" of private foundations
  - An investment will be considered "jeopardizing" if it was not made with ordinary business care and prudence
    - Look at risk/return ratio
  - Case-by-case analysis taking into account portfolio as a whole
  - IRS will not employ hindsight
  - Determination is a function of facts at time of investment decision
- PRIs are an exception to the jeopardizing investment rules

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The Legal Context for Private Foundations: Jeopardizing Investments

- Under the (antiquated) Treasury Regulations, certain investments will be more closely scrutinized
  - Margin trades, futures, short selling, puts, calls, and straddles
- Excise tax penalties on foundation and potentially organization managers
  - Excise tax imposed on foundation managers who knowingly make a jeopardizing investment, unless the making was not willful and was due to reasonable cause
    - Written advice from investment counsel can eliminate foundation manager's liability
    - Legal opinion that investment is not a jeopardizing investment (e.g. is a PRI) can also eliminate manager liability

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The Legal Context for Public Charities: Analogous Investment Concerns

- State law prudent investing concerns: UPMIFA
  - UPMIFA provides guidance for investment decision making
    - Prudent investor standard
  - Carve out for program–related assets:
    - "[A]n asset held by an institution primarily to accomplish a charitable purpose of the institution and not primarily for investment" (e.g., buildings, classrooms, micro-finance loan fund)
  - But … question of degree and approach in context of MRIs
    - May end up with a hybrid approach to stewarding MRIs for state law purposes
      1) Not necessarily a prudent "investor" standard
      2) However, "prudence" required nonetheless
- Contrast to PRI rules

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The PRI Requirements

- Three basic PRI requirements:
  1) primary purpose to accomplish one or more charitable purposes
  2) not have as a significant purpose the production of income or appreciation of property
  3) not have as a purpose influencing legislation or intervening in any political campaign of any candidate for public office

The PRI Requirements: Charitable Purposes

- An investment will be considered to be made primarily to accomplish one or more charitable purposes if…
  - it significantly furthers the foundation's exempt activities and
  - it would not have been made **but for** the relationship between the investment and the accomplishment of the foundation's exempt activities

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The PRI Requirements: Charitable Purposes

- Typical PRI charitable purposes include:
  - Providing relief to the poor and distressed
  - Revitalization of distressed communities (combatting community deterioration)
  - Lessening the burdens of (the U.S.) government
  - Conducting educational activities/promoting education
  - Protecting and preserving the natural environment
  - Supporting scientific research
  - Education
  - Promotion of health

The PRI Requirements: Financial Returns

- In determining if a significant purpose is the production of income or appreciation of property, relevant factors include
  - Would investors engaged in the investment solely for profit be likely to make the investment on the same terms
  - Foundation's typical risk/return profile for investments of this type
- But note how the world has changed/become more nuanced as the lines between pure for-profit investors, mission investors, charitable investors, etc. have blurred
- The fact that an investment ultimately produces significant income or appreciation should not alter this determination

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For-Profit Recipients

- A PRI recipient may be a for-profit entity
  - Charitable benefits should outweigh private benefit
    - Note inherent tension of traditional private benefit concerns in the investing context
    - Calibrate deal terms in order to induce the desired result without giving rise to excessive private benefit
    - Determination of PRI-acceptable deal terms is heavily dependent on specific facts and circumstances

Applicability of Other Private Foundation Rules

- "Taxable expenditure" rules apply
  - Expenditure responsibility is not required for a PRI to a U.S. public charity (or the foreign equivalent thereof)
  - Must exercise expenditure responsibility over a PRI to a non-public charity
- Income from PRIs included in gross investment income for purposes of section 4940 tax
- Self-dealing rules (section 4941)
- Amounts disbursed as PRIs are qualifying distributions for purposes of the 5% payout requirement (section 4942)
- Excess business holdings under section 4943 do not include PRIs

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MRIs in Context

- Decision points:
  - MRI v. Grant
    - Can we do both?
- Why and how to choose:
  1) Goals & desired outcomes (organizational, programmatic, etc.)
  2) What behavior are we trying to encourage
  3) Catalyze other funders
  4) Sustainability v. subsidy
- How to think of MRIs in the context of larger mission and other Foundation activities

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Public Charities as PRI Makers

- PRI (and other private foundation) rules do not apply to public charities
- Many public charities make PRI-like investments
  - E.g., mission or impact investing
- Basic considerations:
  - Structural
  - Fiduciary
  - Practical

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PRI Types

- PRIs may take any "investment" form
  - Loans (below market)
  - Equity Investments
    - Direct investments
    - Fund vehicles (LLCs, Limited Partnerships)
  - Guarantees/Letter of Credit
  - Linked Deposits

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Choosing the Right Vehicle

- What is the right structure (e.g., loan v. equity v. guanranty) and why
  - Characteristics
  - Differences
  - Benefits
- New corporate structures
  - L3Cs
  - Benefit Corporations

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Loan Documents

- Basic
  - Due Diligence
  - Commitment Letter
  - Loan Agreement
  - Promissory Note
  - Officer's Certificates
  - Legal opinion(s)
- Other
  - Security Agreement / UCC Filings
  - Inter-creditor Agreement

Anatomy of a Loan Agreement

- Preamble
  - Identity of the parties
  - Effective Date
- Recitals
  - Purpose for entering into the agreement
  - Background and key assumptions
  - Address issues important for analysis (i.e. how investment fulfills a charitable purpose)

Anatomy of a Loan Agreement

- Loan Terms
  - Principal, Interest Rate, Maturity Date, etc.
  - Purpose of the Loan / Use of Funds
  - Prepayment provisions
- Representations and Warranties
  - What is it important to know?
  - Standard representations
    - duly formed, duly authorized, duly executed and delivered, no conflicts, no litigation, etc.

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Anatomy of a Loan Agreement

- Covenants
  - Affirmative
  - Negative
- Conditions to Closing
  - e.g., delivery of all executed documents

Anatomy of a Loan Agreement

- Defaults and Remedies
  - Under what circumstances is borrower liable?
  - Opportunity to cure?
  - What happens if borrower doesn't meet its obligations?
    - Accelerate payments of principal and interest
    - Right to suspend future installments

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Anatomy of a Loan Agreement

- Indemnification
  - who is indemnified?
  - what costs are covered?
  - what is the scope of indemnification?
  - procedures for defending indemnified party?
  - exceptions (gross negligence, willful misconduct)

Anatomy of a Loan Agreement

- Miscellaneous
  - Notice
  - Waiver
  - Amendment/Modification
  - Attorneys' Fees
  - Governing Law
  - Entire Agreement
  - Severability
  - Counterparts

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The Role & Importance of Programatic Covenants

- What are we requiring that they do and show?
- How you are going to measure certain outcomes?
- Reporting

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Equity: Direct Investment

- Stock Purchase Agreement
- Stock Certificate
- Articles of Incorporation/Bylaws
- Shareholder's Agreement
- Side Letter
- Officer's Certificates
- Legal Opinion

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Equity: Intermediary Vehicle

- Private Placement Memorandum
- Subscription Agreement
- Limited Partnership/LLC Agreement
- Side Letter
- Officer’s Certificates
- Legal Opinion

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The Side Letter

- Distinguish investment from for-profit investors
- Clarify PRI/mission terms
  - Use of funds
  - Restrictions
- Reporting requirements
- Role of foundation/other charities, if any
- Private foundation specific terms: ER
- Exit/withdrawal procedures
  - The dreaded buy-back

The Legal Opinion

- Corporate, tax and investment counsel opinions
- PRI/prudence opinion protects foundation managers
  - Joint and several liability for excise taxes
- Must be a "reasoned written legal opinion"
- Which party should deliver?

Special Considerations for Non-U.S. PRIs

- Determining appropriate standards
  - e.g., “low-income” or “below market”
- Currency exchange risk
- Translations
- Compliance with local law
  - Do I need local counsel?
- Legal restrictions on foreign investment, ownership, and/or lending
- Anti-terrorism considerations
- Expenditure responsibility/foreign equivalency issues

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PRI Examples: Treasury Regulations

- Newly issued proposed Treasury Regulations add nine new PRI examples
- Welcome guidance for PRI makers and practitioners
  - Confirmed common practice
  - No real surprises

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Original PRI Examples

- The old examples include
  - Loan to small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group.
  - Equity investment in a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group
    - OK even though the Foundation may realize a profit if the company is successful and the stock appreciates in value.
  - Loan to a business enterprise which is not owned by low-income persons or minority group members, but is important to the economic well-being of a deteriorated urban area because it employs a substantial number of low-income persons from such area.

Original PRI Examples

- Loan to a large publicly traded company in order to induce it to establish a new plant in a deteriorated urban area (the company would be unwilling to establish the plant absent such inducement).
  - The loan is made pursuant to a program run by the foundation to enhance the economic development of the area by, for example, providing employment opportunities for low-income persons at the new plant.
- Loan to a business providing marketing outlet for low-income farmers in depressed rural area.

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New PRI Examples

- The new examples include
  - Equity investment in a financially secure business to induce it to develop a vaccine to prevent a disease that predominantly affects poor individuals in developing countries
  - Equity investment in a new recycling business in a developing country the activities of which will prevent pollution and combat environmental deterioration
  - Loan to a business that employs a large number of poor people in a rural area that suffered significant damage in a natural disaster
  - Loan to poor individuals to start businesses in a developing country that just experienced a natural disaster

New PRI Examples

- Loan to a limited liability company that purchases coffee from poor farmers residing in a developing country, to fund the provision of efficient water management, crop cultivation, pest management, and farm management training to the poor farmers
- Loan to a social welfare organization that conducts community art exhibitions to purchase a large exhibition space
- Deposit as credit support to induce a bank to make a loan to a charitable organization to construct a new child care facility
- Guarantee to induce a bank to make a loan to a charitable organization to construct a new child care facility

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