Advanced Equity PRIs: Business Problems & Solutions

Jeffrey Hom – Omidyar Network
Paul McCoy – Morgan, Lewis & Bockius LLP
Matt Topham – Bill & Melinda Gates Foundation
Introduction

• Panelists
• What we mean by “Business Problems”
• Focus is on *equity* PRIs
• Topics will include:
  ▫ Charitable Primary Purpose
  ▫ Investee Perspectives
  ▫ Co-Investor Perspectives
  ▫ Foundation Staff Perspectives
  ▫ Governance (traditional and PRIs)
  ▫ Issues Related to PRI Exits
  ▫ Follow-On Investments
  ▫ Measuring Charitable Impact
  ▫ Repayment Obligations
Establishing the Charitable Primary Purpose

• The primary purpose of the investment must be to accomplish a charitable purpose

• Requires understanding of programmatic strategies, objectives and goals – close partnership with program team

• Determining the charitable objectives requires not only an understanding of the program team’s goals, but also of the business itself (target clients, unit economics, future expansion, etc.)
Establishing the Charitable Primary Purpose (cont.)

• How do you ensure charitable “value” commensurate with the level of amount invested?

• Specifically, how do you ensure that foundation funds will be used solely for charitable purposes?
  • Private investment fund context
  • Private company context
Establishing the Charitable Primary Purpose  (cont’d)

• Examples:
  ▫ Testing and demonstrating new approaches and models to achieve better educational outcomes for students
  ▫ Financing grocery stores in low-income food deserts
  ▫ Helping low-income young adults have affordable access to a high-quality postsecondary education and complete a degree with labor market value in a timely manner
  ▫ Financing the provision of low-cost financial services to “unbanked” populations
  ▫ Researching new technologies for developing vaccines for a number of infectious diseases that disproportionately impact those most in need
  ▫ Establishing sustainable agriculture for “smallholder” farmers in developing countries
Investee Perspective

• Investee’s primary motivation may be profit rather than charitability

• Investees often have limited understanding of:
  ▫ charitable organization’s mission or the charitable objectives of the investment. Charitable objectives should, to a degree, align with the company’s core business and objectives
  ▫ the specific requirements related to a PRI
  ▫ the measurement of achievement of charitable objectives
  ▫ the consequences of failure to meet charitable objectives
Co-Investors’ Perspective(s)

• Many of the same concerns as the Investee Fund or Company
• Concerns that charitability requirements might reduce flexibility for the growth/future of the company in which they are investing or be a distraction
• Concerns that pursuing charitable objectives might result in missing more profitable opportunities
• Concern regarding additional costs related to measuring impact and other aspects of compliance with charitability requirements
• Concerns with unequal treatment: “I only received shares for my investment, but you are getting shares + charitability requirements.”
Internal Foundation Staff Perspective

• Staff might not be experienced in negotiating commercial transactions and may not understand “market” terms for investments in private companies or investment funds
  • see examples on next slide
• Staff may not appreciate differences between PRIs and grants
• Potential reputation risk to the organization (NY Times Test)
• Foundation may want to utilize third-party expertise to supplement in-house capabilities
Examples of investment terms:

- Company investment terms: determining valuation; anti-dilution rights; liquidation preferences; shareholder protections; dividends; redemption rights; traditional information rights

- Private investment fund terms: capital call mechanisms; economic waterfalls (carried interest); management fees; rights to remove the general partner; rights to terminate investment activity; rights to terminate the fund; no fault vs for cause rights; investment period; fund size relative to number of principals and anticipated deal sizes; fund life
Management of PRIs post closing:
- expectations and roles (e.g., understanding role of board member)
- responsiveness
- tracking progress toward achievement of programmatic objectives
- potential conflicts of interest
Charitability Concepts in Private Fund Structures

• Might be more challenging because multiple indirect investments rather than one investment
  ▫ Pure PRI fund vs PRI as part of a fund
  ▫ Consider controls over future investments
    • Investment Committee
    • Charitability Committee
    • Consent or Veto Rights
    • Investment parameters vs tying the general partner’s hands
  ▫ Consider linking waterfall economics of the fund to charitable impact or PRI qualified investments
Governance

• PRI investors must consider both governance related to the PRI requirements as well as traditional aspects of company or private fund governance

• Traditional company governance items include:
  ▫ Rights to appoint board members and/or non-voting board observer
  ▫ Shareholder meetings
  ▫ Protective voting provisions (e.g., limitations on dividends, redemption, change of control)
  ▫ Information rights
Governance (cont.)

• Traditional private fund governance items include:
  ▫ LP Advisory Committee
  ▫ LP protections => right to remove the general partner (cause vs. no cause); right to terminate the investment period (cause vs. no cause); right to terminate the fund (cause vs. no cause)
  ▫ Reporting, transparency and access to information and auditors
PRI Governance

• In addition to traditional issues related to governance, PRIs require special governance measures, such as:
  ▫ Reporting related to charitable impact
  ▫ Charitability committees
  ▫ Whether board seats are appropriate for PRI investors
    • Conflicts of interest
    • Liability concerns
    • In-house designee vs independent appointment
Issues Related to PRI Exits

• Consider Likely Exit Scenarios and Consequences of Being a Shareholder
  ▫ Shares will likely be illiquid
  ▫ Administrative costs
  ▫ Ongoing portfolio management burden (shareholder consents, etc.)
• Exit timing is often outside foundation’s control
  ▫ Sale of company or IPO
• Mechanisms for ensuring charitable rights survive exit
  ▫ Contractual rights unrelated to share ownership
  ▫ Assumption of company’s obligations by acquiring entity
  ▫ Automatic license trigger in the event of bankruptcy/insolvency
• Considerations when charitable objective is complete or impossible, but no exit on the horizon
  ▫ Sale of shares or fund interests on secondary market
  ▫ Redemption rights
When to Make Follow-on Investments

• What analysis is required to support making additional PRIs in companies that have utilized all of the original PRI amount properly but more charitable impact possible with increased PRI?
  ▫ May be able to achieve additional charitable objectives or rationale for initial investment may still stand, but more funds are necessary than originally thought

• PRI investees may be more likely than others to run out of capital (by definition they have more difficulty attracting commercial capital)

• Bridge loans (bridges to nowhere?)
Measuring Charitable Impact

- Must have strong engagement from program team at the outset to define desired charitable impact and appropriate metrics.
- How to measure charitable impact?
  - How to measure impact is a problem best solved with investee input
  - What data is currently captured by investee?
  - Are there good proxies for data that is otherwise difficult to obtain?
Measuring Charitable Impact (cont.)

• Who pays for the expense of measuring/monitoring?
  ▪ Foundation could spend its own funds to engage independent consultants to conduct randomized control trials
  ▪ Consider covenants for investee to cooperate with foundation on measurement and evaluation issues
Measuring Charitable Impact (cont.)

- Payment for the expense of measurement may vary depending on the nature of the investment
  - A private investment fund being established as a pure PRI Fund is likely to require that the management fee cover charitable impact measuring, monitoring and reporting
  - A private company may not view an equity PRI as appropriately tied up in charitable impact measuring, monitoring and reporting
    - Additional money may need to be provided through grant support or facilities
Obligation to Repay Upon PRI Breach

- Breaches of promises to measure charitable impact are material breaches of the PRI requirements:
  - Triggers an obligation to repay the PRI under the Code
- Other triggers for PRI repayment include
  - Use of funds for non-charitable purposes or purposes prohibited by the Code
  - Failure to perform the required charitable work
  - Failure to satisfy reporting requirements under the Code
Obligation to Repay Upon PRI Breach (cont.)

- Investee Companies and Co-Investors alike balk at the notion of a repayment obligation
  - Private investment funds will have deployed their capital into illiquid investments
  - Private companies might have little excess capital to repay a PRI
  - How should the PRI be valued upon a repayment?
  - “No other investors get these special rights”
    - Actually, in private funds ERISA investors, BHCA investors, public pensions and private foundations often get limited withdrawal rights
Obligation to Repay Upon PRI Breach (cont.)

- Repayment mechanisms can be structured to be acceptable to private investment funds and investee companies
  - Need to clearly define triggering events and provide for a reasonable cure period
  - Redemptions
    - In kind from a fund
    - Priority rights to distributions from a fund
    - Short term note
    - Cash repayment
    - Mandatory vs foundation’s election
  - Sale to third parties
  - Damages
Solutions: Alignment & Communication

• Alignment: Avoid material misunderstanding and conserve time/resources by coming to agreement on charitable objectives and an understanding of PRI requirements early in discussions with company and investors.

• Recommend that company engage legal counsel that understands PRI rules. Consider the need for legal advice regarding PRI rules and legal advice for the commercial transaction – ideally in one firm solution

• Communication:
  ▫ Use of well-developed term sheets may help educate all parties and identify terms and issues early in the process
  ▫ When available, use precedent PRI materials to accelerate learning and demonstrate what is “market” for PRIs
Solution: Clear Transaction Documents

• Term sheets only go so far
• Clear transaction documents provide an opportunity to ensure all parties understand their roles and responsibilities
• Most of the problems discussed in the slides above find solutions drafted into the transaction documents
PRI - Background

- To avoid certain excise taxes under chapter 42 of the IRC, private foundations must make a minimum level of qualifying distributions (as defined in IRC section 4942 of the IRC) each year and must avoid making taxable expenditures (as defined in IRC section 4945)

- Under IRC section 4945(d)(4), a taxable expenditure includes any grant to an organization unless: (1) the grantee is a public charity (other than a disqualified supporting organization) or an exempt operating foundation; or (2) the private foundation exercises expenditure responsibility with respect to the grant in accordance with IRC section 4945(h)

- PRIs are treated as qualifying distributions and count towards meeting the 5% minimum distribution requirement

- New IRS regulations provide updated examples of permissible PRI investments
Program Related Investments

• Summary of IRC Section 4944 and PRI Requirements
  ▫ Jeopardizing Investments
  ▫ PRI Exception
  ▫ Primary Exempt Purpose
  ▫ No Significant Purpose Is Income or Appreciation
  ▫ No Political Purpose
  ▫ Key Terms of the PRI Documentation
Jeopardizing Investments

Investments by a private foundation that “jeopardize the carrying out of any of its exempt purposes” may subject the foundation and its managers to punitive excise taxes. IRC Section 4944.

- **Example of Jeopardizing Investments.** “The investment of [10% of the foundation assets] in the common stock of [seriously undercapitalized] Y and the investment of [8% of the foundation assets] in the common stock of [high-risk] Z may be classified as jeopardizing investments.” Treas. Reg. § 53.4944-1(c), Ex. 1.
PRI Exception

A safe harbor exception from the jeopardizing investment excise taxes are investments:

1) “the **primary purpose** of which is to accomplish one or more of the purposes described in section **170(c)(2)(B)** (e.g., the charitable purpose of a foundation), and

2) “**no significant purpose** of which is the production of **income** or the appreciation of property and

3) “**no purpose** of the investment is to accomplish one or more of the purposes described in section **170(c)(2)(D)**” relating to legislative or political activities

IRC Section 4944(c); Treas. Reg. § 53.4944-3(a)
Primary Exempt Purpose

• “The **primary purpose** of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B).” Treas. Reg. § 53.4944-3(a)(1)(i)

• “An investment **shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B)** if it:
  
  • **significantly furthers** the accomplishment of the **private foundation’s exempt activities** and
  
  • if the investment **would not have been made but for such relationship** between the investment and the accomplishment of the foundation’s exempt activities.” Treas. Reg. § 53.4944-3(a)(2)(i)

• Note: If a foundation’s governing documents do not specifically identify the exempt activity, the foundation’s governing body should adopt a resolution that creates a project or initiative to specifically further the exempt activity

• Investments in an **activity described in IRC section 4942(j)(4) relating to functionally related businesses** shall be considered as made primarily to accomplish one or more of the purposes described in IRC section 170(c)(2)(B). Treas. Reg. § 53.4944-3(a)(2)(ii)
Primary Exempt Purpose (cont’d)

Significantly Furthers Foundation’s Exempt Activities

How can financing for-profits further a foundation’s exempt activities?

• “Although some of the individuals receiving financial assistance in their business endeavors under the organization’s program may not themselves qualify for charitable assistance as such, that fact does not detract from the charitable character of the organization’s program. The recipients of loans and working capital in such cases are merely the instruments by which the charitable purposes are sought to be accomplished.” Rev. Rul. 74-587, 1974-2 C.B. 162

• Thus, foundations may invest in for-profit entities that are not themselves in need of charitable assistance when these recipients are the instrumentalities to further the foundations’ exempt activities.
Primary Exempt Purpose (cont’d)

Investment Would Not Have Been Made *But For* the Relationship to the Accomplishment of Exempt Activities

- Note that this prong seems to require that, counterfactually, if the investment had not appeared to accomplish exempt activities, then the foundation managers would not have decided to make the investment
No Significant Purpose Is Income or Appreciation

No significant purpose of a PRI is the production of income or the appreciation of property. IRC Section 4944(c); Treas. Reg. § 53.4944-3(a)(1)(ii)

• “In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.” Treas. Reg. § 53.4944-3(a)(2)(iii)
No Significant Purpose Is Income or Appreciation (cont’d)

- Facts supporting no investment purpose include the following: it is unlikely that any for-profit investor would be willing to make the investment on the same terms as the PRI, and any investment return is very uncertain, and most for-profit investors would demand economic rights well above the PRI economic rights because of the uncertainty of any return, and the chance for profit is very low. PLR 201145027

- An equity investment in a company whose business activities will combat environmental deterioration, even on the same investment terms as “a few commercial investors who are concerned about the environmental impact of solid waste disposal,” may be a PRI. Proposed Treas. Reg. § 53.4944-3(b), Example 12
No Significant Purpose Is Income or Appreciation (cont’d)

• “[D]ealings with a for-profit developer would be structured in a manner to ensure that **any private benefit to the for-profit developer would be incidental** to the public benefit emanating from the development of downtown housing in that all transactions with the developer must be on commercially reasonable terms as determined in the greater City market.... In addition, although loans to for-profit developers will carry interest, the **purpose of the interest is to minimize any private benefit** to the for-profit developers. Therefore, the production of income and the appreciation of property is not a significant purpose of the proposed loans.” PLR 200331005
No Political Purpose

“No purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(D).” Treas. Reg. § 53.4944-3(a)(iii)

• “attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.” IRC Section 170(c)(2)(D)
Key Terms of the PRI Documentation

• Primary Exempt Purpose
  ▫ Statement of the purpose of the investment
  ▫ Restriction on use of proceeds for specified purposes
  ▫ Requirement to repay any funds not used for specified purposes or upon a Charitability Default
    • Obligation to repay loan
    • Special equity rights: withdrawal right, redemption, permitted transfer
Key Terms of the PRI Documentation

(cont’d)

• No Significant Investment Purpose

  ▫ Consider actual economic terms in comparison to market-rate economic terms for similar risk/reward investments

  ▫ Consider facts regarding efforts to find financing from conventional market sources; consider representation in agreement or officer’s certificate stating relevant facts regarding attempts and inability to secure financing on comparable terms through conventional sources
Key Terms of the PRI Documentation (cont’d)

• No Political Purpose
  ▫ Prohibition on use of funds for prohibited purposes