PROGRAM-RELATED INVESTMENTS AND YOU—PERFECT TOGETHER?

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No private foundation should dismiss the concept of PRIs out of hand—and neither should many public charities.

As a legal concept, program-related investments have been part of the law of charitable giving in the United States since the Tax Reform Act of 1969, which restructured the rules governing the operations of charities and created a distinction between public charities and private foundations. Technically, program-related investments (PRIs) are investments by private foundations in ventures that help to achieve the charitable goals of the foundation, but that also have elements of for-profit investments. Such investments might not be considered appropriate investments for a private foundation under the Code and underlying regulations,[1] but the 1969 Act, the regulations under it, and the hundreds of rulings that followed it were intended to encourage—or at least not preclude—this kind of hybrid activity that straddles the world of investments and charitable grants.[2] By putting rules relating to PRIs in place, Congress and the IRS recognized that grants and investments cannot easily be separated or always kept in their own little boxes.

Overviews of the PRI rules, and descriptions of their creative uses, have appeared in many places.[3] They do not appear below. Rather, the following discussion is designed as a way to encourage foundations, public charities, their employees, boards, and advisors, to examine the pros and cons of PRIs.

Heading into the second decade of the 21st century, over 40 years since the PRI concept was introduced into the Code, it is time for more creative thinking about how tax-exempt organizations can use this tool to help solve the problems facing the world. Such creative thinking should include a thorough evaluation of PRIs by charitable organizations and a determination by such charities of whether or not their effectiveness would be enhanced by engaging in PRIs.

Sticking with a time-honored tradition, from David Letterman to year-end movie reviewers, here is the author's top ten list of why charities—large and small, private and public—should consider making program-related investments.

1—PRIs are not only for private foundations

As a technical matter, the rules relating to PRIs apply only to private foundations. Public charities do not have to worry about the jeopardy investment rules or making sure that an investment counts towards the 5% qualifying distribution requirement. That being said, public charities are concerned about outcomes and the most effective use of their charitable dollars; they want to get the most "bang for their buck." In making a determination about how to use their lim-

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ited dollars, public charities should consider all options—operating programs, partnering with other nonprofits to run programs, use of alternative means of funding—as well as PRIs.

In facing domestic and international problems—climate change, poverty, recidivism, and disease, for example—public charities should consider whether a structured investment would better serve their goals than a more traditional operating program. Whether such investments by public charities should be called PRIs, "impact investments," "mission investments," or something else, they are functionally program-related investments. The PRI rules offer useful guidance on how to structure an investment by a public charity to ensure that the investment qualifies as a charitable activity that will not be subject to UBIT or constitute private benefit that jeopardizes the public charity's tax-exempt status. Specifically, the PRI rules provide a tight focus on the charitable purpose of the investment, ensuring appropriate measurements of progress against such charitable purpose through regular reports and clearly defined withdrawal rights if the PRI fails. Therefore, it is important for public charities to approach PRIs with an open mind when considering their programmatic options and to use the PRI rules developed for private foundations as a guide.

What are the potential benefits to public charities of investing in PRIs? There are many.

- A PRI done right is, in effect, a recoverable grant. The investment, like a grant, is distributed to be used to further the public charity's goals, but the principal (and, potentially, some investment gain) should be returned to the public charity for use in future programs or investments.
- PRIs offer public charities creative options to step outside of their traditional, direct programmatic focus and approach their goals from another angle. For example, an inner-city health clinic that serves a poor area lacking most basic health services may take some funds and invest in and partner with a for-profit pharmacy that opens a small outlet on the clinic's property. Without some cash incentive, reduced rent, or other subsidy, the pharmacy might find that opening a store in the inner city is not financially feasible. With the help of the clinic, though, the pharmacy may be able to open an outlet for a trial period. That makes the clinic better able to serve its patients in a way that supplements and complements its core charitable services.
- A PRI may offer a public charity greater control or oversight over "partner" organizations, by taking a board seat or board observer status, or by being able to exercise its shareholder right to vote. It can vote to change company policies to bring them more in line with its charitable purposes, or to elect members of the board who are more sympathetic to its charitable goals.

2—PRIs do not have to be complex

Traditionally, PRIs are viewed as fancy, exotic, and complex investments that can and should only be considered by the most sophisticated and well-funded private foundations. There are legal requirements that have to be followed when investing in a PRI, just as there are in many aspects of nonprofit and investment law. Nevertheless, PRIs can be less complex than many transactions nonprofits—both private foundations and public charities—engage in on a regular basis, such as buying or renting office space and setting up and calculating a private foundation's required qualifying distribution for a particular year. PRIs do not need to be complex investments that require investment bankers and teams of lawyers; they can be as complex or as simple as the charity investor wants them to be.

PRIs should be calibrated to reflect a charity's level of sophistication and should build off the charity's existing expertise. Charities should start simply—"walk before you run"—by doing a series of small PRIs to gain experience, test theories, assess risks, and confirm economic assumptions. Charities that are just starting out in the world of PRIs can also avoid inefficient duplication by seeking input from charities that have done PRIs before—for example, obtaining sample loan documents or guarantee agreements from a local private foundation that has done PRIs previously.

Example. Consider a private foundation that funds, or a public charity that operates, an education program that works to keep at-risk teens in school or at least off the streets and out of jail. Such an organization could provide grants or run programs in the

1 See Section 4944 (imposing an excise tax on a private foundation and its managers if the foundation invests in high-risk investments that jeopardize the foundation's ability to carry out its exempt purposes).

2 Reg. 53.4944-3 provides that a PRI will not be treated as one that jeopardizes the carrying out of a private foundation's exempt purposes. It defines a PRI as an investment which possesses the following characteristics: (1) the primary purpose of the investment is to accomplish one or more of the purposes described in Section 170(c)(2)(B) (charitable purposes), (2) the significant purposes of the investment do not include either the production of income or the appreciation of property, and (3) the purposes of the investment, important or otherwise, do not include lobbying or advocacy or supporting or opposing a candidate for public office—i.e., activities that private foundations are forbidden from pursuing.

3 E.g., Joseph and Kosaras "New Strategies for Leveraging Foundation Assets," 20 Exempts 22 (Jul/Aug 2008); Chernoff, "Program-Related Investments: A User-Friendly Guide," 5 Family Foundation Advisor 1, page 3 (Nov/Dec 2005).

schools about how to engage these youth in the education process, run a mentoring program, increase vocational training, or make after-school academic and sports programs more accessible. All of these are laudatory charitable goals that can be achieved by funding or operating charitable programs.

Alternatively, though, a foundation or public charity, either alone or in partnership, could also approach local, start-up businesses—anything from restaurants to retail—and offer them below-market rate financing to start or expand their businesses, provided they hire local at-risk teens for entry-level jobs.[4] A more complex PRI might include setting up an investment fund or revolving line of credit that can be accessed at low or no fees by local businesses that hire at-risk teens. Finally, a charity could make equity investments in local entities, with such financing being tied to the entities participating in the charity's mentoring or training program.

Public charities should consider whether a structured investment would serve their goals.

The key is that PRIs do not need to be complex to be effective, but, like any investment, the variations on how to structure a PRI are practically endless.

3—When considering PRIs, do not lose track of the fundamentals.

Regardless of how simple or complex a PRI may be, a private foundation or public charity should follow a few basic rules when considering if it should start or continue a PRI program or invest in a particular PRI.

- Review the charity's mission and its existing programs. Before engaging in any new activity, charity managers should determine whether or not that activity is permitted by and consistent with the organization's organizing documents and charitable mission. Even if PRIs or other activities are not clearly permitted in the organiztion's articles and bylaws, as drafted and presented to the IRS, a charity can always amend its governing documents (consistent with donor intent and restrictions). In addition, whenever a charity expands its activities, whether into PRIs or a new programmatic area, it should determine whether or not it needs to notify the IRS and describe these new activities.[5]
- Understand the charity's limitations and capacity. Private foundations and public charities should invest in PRIs that are appropriate in size, scope, and complexity. This means that a charity may need to avoid certain investments or that it may need to bring on additional expertise at the board or staff level, or both, to help manage its PRIs.
- Make sure people with the proper expertise are involved. Because the charity's mission and objectives lie at the center of PRIs, but investment concepts and principles are important elements, PRIs should be designed, implemented, and monitored by teams that include both program and investment staff, or staff with expertise in both areas. Program staff understand the nexus between the investments and the charity's mission, while investment staff can provide proper due diligence to ensure that the investments are prudent.
- Set aside a small dedicated pool of funds. As discussed further below, diversification is a watchword not only in the investment realm. Unless a charity is established with the express intent to run a charity investment fund and has the expertise to support that mission, most charities engaging in PRIs need to balance that activity, both financially and programmatically, with their other grant making or operational activities.
- Adopt a written PRI policy—and follow it. A written PRI policy is an effective tool to help charity managers make prudent program investment decisions and help focus decision-makers on how each PRI fits into the organization's overall giving strategy. The policy should lay out the organization's programmatic and investment goals, set long-term performance objectives, provide target asset allocations, and set criteria by which managers are evaluated. Does the organization require some investment return? Is the organization willing to risk loss of principal? If yes, will an additional upside return be necessary? A charity that is considering program-related investments should set forth its programmatic goals, how this transaction helps to achieve those goals, and the investment risks and potential benefits of the transaction. The organization also must be able to articulate why it is engaging in this type of investment activity, and it should document the decision-making process for each investment. These steps will help the charity's managers show that their decisions were prudent, especially if an investment turns sour.
- Perform due diligence on each PRI. So much of the over-exuberant investing of the last decade was caused by a failure to focus on fundamentals. A strong balance sheet, a well-defined business plan, and experienced management were replaced by "funny money" and a mystical search for the next "big thing." Because of the relatively rigorous review of

PRIs necessitated by the IRS rules, charities should continue to focus on fundamentals when picking PRIs. In addition, most charities do not make a PRI and disappear. They watch and monitor the activities of the investment, in large part to ensure that the charitable goals of the investment are met, but this has the added benefit of allowing the charity, as an investor, to raise the alarm if management is getting off track. When considering PRIs and after making a PRI, a charity should not undervalue this oversight and review function. Unlike investors in the stock market, charities that have invested in a PRI are never, truly, passive investors. They may not be actively engaged in running the business day-to-day, but they also are not unengaged investors who just sit back and wait for the dividend or interest checks to come in. Indeed, in some cases, the charity may be better situated to oversee and influence the activities of the PRI recipient as a shareholder or investor than it would be as a grant-maker providing a grant.

- Have an exit strategy. Anticipate that some PRIs may not work out. How could an organization pull out of a loan or equity investment without causing significant disruption to the business in which it invested? Has the charity imposed tough programmatic goals—in conjunction with an immediate withdrawal rights—that will scare off other investors and impede the company's growth? Are there ways in which an organization can protect its rights and help achieve its charitable goals, while helping to build the financial viability of the business in which it invested? Has it timed its exit strategy to coincide with new rounds of investment for the company, so the withdrawal does not tip the company into bankruptcy or call into question its future?

4—PRIs are attractive investments in turbulent economic times

It is hard to think of much good that has come out of the economic collapse of the last two years, but low interest rates on bank deposits and negative returns on equities should make many charity boards, and even investment managers, take a second look at PRIs.

Charities should not be comparing for-profit investment returns to PRI returns, despite the temptation to do so. The old adage about apples and oranges comes to mind. PRIs instead should be compared to programmatic activities, which is consistent with the Code's treatment of PRIs as simple grants. The question is what form of support—grant or PRI (whether guarantee, loan, or equity investment)—is the better way to achieve particular charitable goals? Can this PRI, in conjunction with programmatic activity, give an organization a greater likelihood of success?

To be realistic, however, charities have to divide up their limited resources and determine what can be spent on charitable activities today and what must be invested and saved for another day. Ten years ago, when a board considered a PRI strategy, directors weighed the option of investing in below-market rate loans to minority-owned businesses—getting at best a low, single-digit return—or investing in technology stocks, potentially getting a 30%+ return and using the proceeds from such investments to make larger grants or expand programs. Now, that is not the case. Charities that invested in the below-market rate loan ten years ago may be in much better financial shape today than other, more aggressive charities that have lost their principal. The bursting of the investment bubble, at least, makes it easier to focus on the programmatic goals of PRIs and grants without comparing the financial return of the PRI to a market-based investment.

PRIs do not need to be complex investments that require investment bankers and teams of lawyer.

In addition to the benefits of PRIs to a private foundation's portfolio during a declining economy, PRIs can provide crucial funding to charities during turbulent and unexpected economic events. For example, the recent financial and credit crunch had an enormous impact on the ability of all entities, including charities, to obtain credit to fund their basic day-to-day operations, such as making payroll and purchasing supplies. PRIs can be structured to provide short-term, emergency loans during unanticipated market conditions. A PRI could also be structured as a guarantee, with a private foundation guaranteeing a letter of credit to purchase equipment or supplies, or as bridge financing to tide the charity over until the next tranche of a multi-year grant, a large receivable or approved government grant, or a contract payment arrives.

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4 As discussed further below, if this kind of project would be difficult to start and manage for an organization that lacks the necessary size or expertise, the organization could join with other charities, including local community foundations, and couple this kind of PRI with other programmatic activities to help give these young workers training about the working world—the importance of showing up on time, how to deal with disagreements with co-workers, and so on.

5 See Form 990, Part III, line 2.

5—With PRIs, as with other investments, diversification is important

Any investment advisor will say that it is vital to have a diversified investment portfolio—a mix of stocks and bonds, large cap and small cap, different industries and geographic locations, and so on. Charities should consider if it is appropriate to have PRIs as part of their diversified portfolio. As noted above, the rate of return on PRIs should not be compared to that of a for-profit investment, but PRIs are investments, and a charity will want to take into consideration the potential investment upside, along with the risks involved in its overall PRI portfolio. The PRI investment risks should then be analyzed in conjunction with the risks in the charity's for-profit investment portfolio to make sure that the overall financial investment risk to the charity is acceptable.[6]

A classic PRI is the quintessential sustainable program.

In addition, it may be useful to have a mechanism for evaluating investment risks and charitable rewards in PRIs and balancing those two elements. If the charitable benefit is great in one PRI, the charity may be willing to take on a lower investment return or a greater investment risk. Put another way, the manager of a charity's PRI program most likely will not want to enter into a PRI that has a low potential investment return, a high risk of loss, and a low charitable value. Having an investment score card is one simplistic way to look at it—a scale of 1 to 10 for each factor, with 10 being a high possibility of a strong financial return, a very low risk of loss, and a high charitable value. As part of an organization's PRI policy, a qualifying PRI could be any investment that has at least a seven on the charitable scale and an overall score of at least 20.

Along with this analysis, PRIs also can be analyzed based on industry, geographic location, and other factors. Because PRIs are not straight investments, some of these factors might not be relevant. For example, if a Caribbean regional development NGO decides that it is important to its mission to make PRIs in Haiti after the recent earthquake, the organization may be willing to have a high geographic concentration risk in its PRIs even though, from a risk or investment perspective, this is not ideal. One way to look at the diversification and economic risks involved in PRIs is that PRIs are investments with a potential charitable return, but the charitable return trumps the investment risk/reward analysis. Nevertheless, the financial risk and reward analysis should not be eliminated or ignored completely.

6—PRIs are one way to achieve sustainable giving

Sustainability is certainly a buzz word in the world of philanthropy today. No private foundation or public charity has unlimited funds, and no one wants to fund or build a program that, down the road, cannot continue to operate because of a lack of funds. To the extent possible, sustainable programming is the goal. Charities want to establish programs that can maintain funding. Foundations want to maintain their bottom lines, so they keep giving grants at an ever-increasing, or at least a steady, rate.

A classic PRI—a below-market rate loan to a business in a low-income area—is the quintessential sustainable program. If chosen well, the business that receives the loan will use it to stabilize and expand its activities. It will repay the loan—perhaps with some interest. At the end of the loan period, either the business will be able to stand on its own or for-profit lenders will be comfortable enough with the business and the area of the city in which it operates to provide commercial financing at a reasonable price. The foundation that made the original loan is now free to make more loans to other businesses in other at-risk parts of the city, or use the principal to make grants in furtherance of its charitable purpose. PRIs done right are the poster child for sustainable charitable giving. For this reason alone, foundations and many public charities should be considering PRIs as part of their charitable portfolio.

7—PRIs expand the options that charities have to achieve their charitable purposes

In a "black and white" world, private foundations provide grants to public charities, and public charities run programs using grant funds. The economic reality of today, however, is that charities need to be much more creative in obtaining funds to achieve their charitable purposes, and, on the programmatic side, it is very important for charities not to limit their search for collaborators to other charities to be effective.

Following the Copenhagen summit at the end of last year, many donor countries have pledged huge commitments to develop alternative, clean energy sources. Many NGOs, including U.S. private foundations and public charities, will be receiving funds and working side-by side and in collaboration with for-profit companies working to expand "green technology." This is an excellent example—ripped from the headlines, as they say—of how PRIs can expand the options of charities to achieve their goals.

If a charity wants to promote solar power, it can do studies on the benefits of solar power, do public advocacy and education on the need to support and utilize solar power, fund research and development through grants, and undertake many other effective programs that may increase solar power usage. Depending on market conditions and the availability of for-profit seed funding, charities could also make PRIs in for-profit companies that are working to develop affordable, sustainable solar power. A group of charities, even working together, might not be able to market and operate businesses that bring solar power into end-user homes but, through PRIs, charities that have spent years educating the public about the benefits of solar power would be able to invest in companies delivering solar-generated power to homes around the country. This kind of PRI (or, alternatively, an MRI) provides charities with another set of interesting partners to help achieve their charitable ends.

8—PRIs can be a bridge to market-based solutions

PRIs can help bring charitable solutions to fruition. In the for-profit world, "two guys in a garage" may have a great idea, but they need early venture capital funding to move beyond a prototype to testing, production, and marketing. In the same way, a charity may conduct research or studies on workable solutions to many of today's most intractable problems, but those solutions will not be put into widespread use without a bridge between the "idea phase" and implementation. An example of this could be wind power as an energy source.

A charity can conduct research on generating wind power in North Dakota or the Sahara Desert. It can create studies on how the power generated in North Dakota can be used in Chicago, or how the power generated in the Sahara can be used in Europe, and sell those studies to provide sustainable funding for the respective projects. The charity, however, should also consider finding, and investing in, for-profit entities that can further develop these ideas and put them into use. On a broad scale, any charitable organization that promotes alternative energy should consider the big picture and invest some of its charitable dollars in a for-profit that would help increase the use of alternative energies.

9—There is no need to go it alone

For years, funders have encouraged grantees to collaborate—do not reinvent the wheel when the charity next door just invented a perfectly good one. In looking at PRIs, funders should take their own advice. Private foundations that have operated PRIs before could bring in investors from other foundations. If the other foundations have not engaged in PRIs before, this would be useful learning tool. Like investors in a hedge or mutual fund, groups of charities (foundations and public charities) can band together and make PRIs. This allows the charities to share, not only the risk, but also the benefit of the other organizations' expertise.

This kind of collaborative investing can be conducted in any environment. A community foundation could organize a PRI fund into which local foundations and other donors could contribute. The community foundation staff, working with the foundation donors, could help to locate investments that meet certain pre-set criteria (from geographic location to the size of the for-profit business in which the fund is investing). On a larger scale, organizations interested in climate change could pool their funds to invest in green technology. Foundations working in Africa could provide seed money to local businesses and act as a guarantor for commercial loans to businesses that have poor or insufficient credit history. With a pooled PRI fund, charities do not have to have the expertise individually to find and monitor investments and the administrative costs can be shared. So, the African PRI fund would pool investments from private foundations, public charities, and even individuals, then hire employees that have the expertise to administer an investment fund filled with PRIs. Just as mutual funds changed the landscape for individual investors in the stock market, the potential impact of such collaborative PRI funds is huge.

It is very important for charities not to limit their search for collaborators to other charities.

10—PRIs can be used by charities to achieve integrated project planning

Integrated project planning recognizes that a private foundation cannot always achieve a sustainable impact with grants alone.[7] Foundations, and public charities, need to look more holistically at the problems they are trying to solve and what tools are necessary to solve them. This may include grants, PRIs and MRIs—market-based investments that compliment

[6] It is important to note that both private foundations and public charities should have an investment policy that guides the board, or appropriate committee, in investing endowment or other funds not needed immediately for program operations or overhead. If a charity is going to engage in PRIs and mission-related investment (MRIs—market-based investments that compliment the charity's programs, goals, and values), it should consider having a written PRI policy, as well as an MRI policy, or at least a section on MRIs in its general program instructions and policies

[7] For more detailed discussion of integrated project planning, see Joseph and Kosaras, *supra* note 3.

the programs, goals, and values of the charity. Integrated project planning uses financially sound, market-rate investments to the extent that the investments increase the likelihood that a project supported by grants, PRIs, or both will be successful and sustainable in the long-term.

A foundation may tackle one of the direct causes of poverty by providing large multi-year grants to build schools and hire teachers to educate poor children in Africa. But what will these children do upon graduation if there are no parallel and integrated investments in the local community that will develop a sustainable economy, create new businesses that need an educated workforce, and build roads and infrastructure that support the community? Using PRIs and MRIs, the foundation can invest in for-profit businesses in the local community that will provide economic opportunities for the young students graduating from the newly built schools. This kind of integrated grant making and investment strategy goes beyond a PRI program but, when considering the pros and cons of making a particular PRI, charities should explore whether integrated project planning is feasible or beneficial.

Conclusion

PRIs may not be appropriate for every private foundation, but in these times, when the need for creative solutions is so great, no private foundation should dismiss the concept of PRIs out of hand. Similarly, public charities should consider if a portion of their programmatic budget would have a greater charitable impact if it were put in a PRI, rather than into existing programs. Certainly, any public charity with an endowment or investment fund should see if a small portion of those funds should be made available for program-related investments. By systematically reviewing the pros and cons, the risks and rewards, of PRIs, charities can make informed decisions about program-related investments and what, if any, PRIs might be right for them.