

“THINK DIFFERENT” ABOUT FLOW OF INVESTMENT CAPITAL WHEN PRIORITIZING OUTCOMES

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This article identifies 10 ways in which thinking differently about detailed terms by which capital is provided and put to use in furtherance of targeted social or charitable purposes, outcomes, and results can facilitate a venture. All 10 apply whether investing directly in a company or indirectly through a fund.

“Think Different.” Some will remember this slogan from Apple’s campaign in the late 1990s and early 2000s. This philosophy and approach resonates – or should resonate – more robustly in the context of getting productive capital to entrepreneurs, especially for those entrepreneurs that create and operate enterprises that prioritize social and charitable outcomes, investors interested in funding them, and those who advise each, especially their lawyers.

This approach especially applies among entrepreneurs and investors who provide and facilitate the flow of capital to under-represented, under-served entrepreneurs, including those of color, who are women, and who operate in service to economically disadvantaged areas. It is that explicit context and experiences therein that gave rise to this article.

“Think different” similarly applies to other social and charitable contexts, many of which depend on various entrepreneurs and investors more broadly. They may be working to prove concepts about

and/or bring to market better approaches to clean, renewable energy; environmental remediation or prevention; medical treatments, diagnostics, or preventions; agricultural productivity or efficiency; storage and transportation of medical samples, vaccines, and/or nutrition; tools for advancing education; and more.

This article is also relevant for a broad variety of entrepreneurs who pursue social/charitable ends and investors and others who work through such entrepreneurs for the same objectives. Those dedicated to social/charitable outcomes and effects likely are already thinking differently about the substance of the change they want and means for realizing that change. It is almost inherent in seeking alternatives to a substantive status quo. This article focuses less on those substantive objects than on the pathways used to achieve them. This article asserts that thinking about capitalizing such efforts – their mechanisms and details – should also be different. The absence of such thinking risks getting in the way of those efforts, especially as the flow of

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capital shapes how that capital is used. Thinking different about the flow of capital may be necessary to avoid ultimately reinforcing and entrenching the very status quo being targeted for substantive change.

Whether investing directly in companies or through funds that aggregate money (e.g., private equity, angel, etc.), this article posits that those who desire discrete social/charitable outcomes and results are likely to benefit if they “think different” in at least two additional ways about how they structure how capital is received and provided. First is to think differently – the normally anticipated combination of the words “think” and “different.” That is, use and combine different ways of thinking: how to think. Second, focus thinking on that which is different. That is, the objects of that thinking: what is being thought about.

This article identifies 10 ways in which thinking differently and different about detailed terms by which capital is provided and put to use in furtherance of targeted social/charitable purposes, outcomes, and results can facilitate those ventures. All 10 apply whether investing directly in a company or indirectly through a fund.

They also are meaningful for both the entrepreneur and investor as they fashion better solutions for overcoming operational and administrative challenges that each face and often share given larger goals. For charitable investors, these points can help advance a private foundation or other charitable investor’s compliance efforts in making program-related investments or their priorities of purpose if transacting with endowment dollars. But these points are not exclusively for charitable investors. For financially oriented investors with non-financial priorities, the points below can help inform how they strategically approach their decision making and balance their respective purposes of financial and non-financial returns relative to each other. When financially- and non-financially-oriented enterprises and investors find themselves in the same venture – which may be with increasing frequency – understanding the points below can help each better understand and define where interests converge and likely diverge.

The points presented below have special application for lawyers and others who advise relevant entrepreneurs and investors. For lawyers, many of the below may need to be captured in organizing and/or governing documents, agreements, and/or memoranda. At a minimum, proper understanding facilitates proper docu-

mentation. For lawyers and other advisors, the below can shape their perspectives and advice about risk taking, allocation of resources, and other decisions.

While the below points arise as terms in legal documents,¹ their solutions are generally not legal. They usually require business- or program-based decisions. The exception may be for charitable investors under Section 501(c)(3) whose involvement may require compliance with charityability mandates and protections against impermissible private benefit, including if doing a program-related investment. In those instances, there may be both substantive legal decisions and the need to justify (and document) deviating from what might be considered “normal” approaches to providing capital.

The ten topics cover what might be considered mission critical (i.e., structures, scope and priorities, reporting, remedies), inherently important (i.e., key person provisions, how to deal with debt, and the flow capital reinvestment and return), and deceptively mundane (i.e., thresholds for approvals, clawbacks and guarantees, fees). Each of these have relatively typical approaches and applications in profit-oriented and -prioritized contexts, but they present different challenges for contexts that target social/charitable outcomes. Thus, they also often require different approaches, solutions, and thinking.

Before analyzing those detailed terms, however, there are four themes that pervade discussion of them and in their own right validate usefulness of thinking different.

First, while capital transactions should be approached with intentionally and strategically developed plans as might be done normally, transactions that meaningfully target social/charitable outcomes often involve unusual considerations and circumstances. That may require an openness – even vulnerability – that compromises typical power dynamics or pursuits. It may also require acknowledging that the circumstances might involve that which you do not know and have not planned for but which you are open to identifying and addressing.

¹ This article was inspired by the author’s experiences representing the Kauffman Foundation in a variety of initiatives. Most recently and directly was his involvement with the Capital Access Lab Fund established by the Ewing Marion Kauffman Foundation at ImpactAssets as a vehicle for demonstrating new ways of expanding access to capital by entrepreneurs of color and women entrepreneurs denied such access because of those characteristics. The Fund likewise sought to prove concepts about capital flow to entrepreneurs operating in and in service to economically disadvantaged areas. The Fund invested in five private equity funds that meaningfully targeted investing in those populations. The author negotiated the terms of those investment documents, which negotiations helped inform this article.

While the preceding point is inward looking, the second point outwardly focuses on espousing a collaborative approach to others in the transaction, especially as all involved strive to understand these unique efforts and their respective motivations, aspirations, methodologies, and compliance responsibilities (especially for foundations and charities as investors). When interests are aligned, a collaborative approach pursues mutual understanding, evolution or even elimination of preconceived notions, and identification and resolution of new challenges – especially if the interests of those involved are aligned in prioritizing social/charitable outcomes.

Third, thinking different recognizes that the points below help demonstrate the extent to which social/charitable purposes are a priority rather

paradoxically risks undermining intended social/charitable objectives.

Thinking different does mean challenging presumptive norms based on and because of the applicable context in which social/charitable objectives are a – or perhaps even “the” – priority.

1. Alternative models for providing capital

Typical approaches to investing are generally characterized by early returns and exit strategies that strive to maximize financial returns. Such approaches can be appropriate, even useful, in the social good space, especially if market indicators of adoption are relevant for achieving scale effects, but they may not best advance non-financial priorities.

My programmatic colleagues began to think different very early on by shifting focus to revenue-based investing or lending, profit sharing, and other alternative, non-traditional models. These frequently involve more patient approaches to distributions and repayments and have control retained by those who know the opportunities best. In some instances, this may be akin to preferred shares that have interests in dividends or distributions but not voting rights. Adaptations using convertibility based on various conditions or circumstances might also be involved.

Revenue-based does not necessarily mean concessionary returns in the long run, although it might. Market returns over time may be necessary to demonstrate the viability of the underlying business or model as a means for achieving — and especially sustaining — non-financial priorities. What is different is how and when those returns may be realized, which can implicate distributions and reinvestment, about which there are distinctive considerations of their own.

2. Scope of use and clear priority of purpose

Clarity of priority regarding the respective roles of financial and non-financial purposes is essential. After all, actual priorities are and will be reflected in behaviors and decision making, often including negotiation and execution of deal terms.

Beyond an internal mindset, it may be valuable to express these purposes in writing, at least through a side letter. For a program-related investment (PRI), the written declaration will be required. If the company or fund's other owners and operators know your non-traditional and

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than something merely tolerated along with profits and capital growth. It can evidence whether commitment to social good is a motivating priority or arbitrary, jargon-based hyperbole. How those involved in a transaction approach the below considerations can expose degrees of alignment or the lack thereof, which can be a precursor to later potential problems regarding allocation of financial and other resources, assessment and measurement, and otherwise in furtherance of pursuing differentiated social good.² For instance, how an investor or entrepreneur approaches terms such as those below might reveal whether they prioritize social/charitable purposes in practice, are spouting superficial proclamations whose primary effect is feeling good, or there is some combination somewhere in between.

A final theme is more of a caveat about what thinking different does not mean, especially for compliance obligations of foundation and charitable investors. Care still must be exercised to protect against being taken advantage of, bearing disproportionate risk of loss, or presuming lesser participation in financial upsides when appropriate. Thinking different does not mean being a patsy or sucker, especially when mandated charity and private benefit considerations dictate otherwise. Nor does thinking different mean changing typically expected terms if doing so might discourage involvement by financially oriented investors needed for meaningful scale, which

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