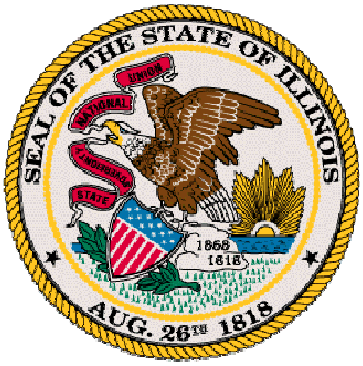
Governor's Task Force on Social Innovation, Entrepreneurship, and Enterprise

Preliminary Report: January 2013



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I. Overview

The Task Force on Social Innovation, Entrepreneurship, and Enterprise was established by Executive Order on November 2, 2011, and officially commenced operations on August 22, 2012 with its first meeting. The purposes of the Task Force are to make recommendations on how to strengthen the capacity of Illinois to work cooperatively to create, scale, and sustain innovative social programs; build the capacity of nonprofit organizations and government to pursue entrepreneurial ventures; and attract funding to Illinois to support these ventures. Central to the Task Force's mandate is to provide a series of reports to the Governor and General Assembly, with recommendations on how to achieve the aforementioned purposes. This is the first of those reports.

II. Landscape and Opportunities for Illinois

Differing significantly from traditional models of charitable entities, a social enterprise is an organization or venture that achieves its primary social or environmental mission using business methods. The social enterprise has serving the common good as its primary purpose, while its commercial activity is a major generator of revenue for itself.[1] A social enterprise can take the form of a corporation, a limited liability company, an L3C (low-profit limited liability company), a benefit corporation, a 501(c)(3) organization, or a 501(c)(4) organization. Because there is no commonly agreed upon legal structure or statutory definition for the term, whether an entity is classified as a "social enterprise" or not often depends on the sources of its supplemental funding.

Social enterprises in Illinois have received funding from multiple sources, including government grants, foundation grants, community development financing, and institutional and private social investors. Capitalization through sources generally used by for-profit commercial enterprises is less common but not unheard of. Despite the diversity of funding sources, there exist significant barriers to investment in social enterprises such as lack of centralized information, restrictions on funding sources, lack of managerial expertise, and investor expectations.

The State of Illinois stands at a unique inflection point to tackle the aforementioned barriers. Special legal forms have emerged in the State that combine sources of capital funding, enhance the branding and understanding of social enterprises, and ease the fear and pressure of the primacy of profit. In addition, there are efforts underway both nationally and internationally to create standard measures of social impact in order to support effective social investment.

In light of deteriorating government budgets and social safety programs, Illinois recognizes that social enterprises offer solutions. The net benefit of leveraging social enterprises is tremendous as it enhances fiscal responsibility, public safety, economic opportunity and social justice. In addition, leveraging social enterprises achieves all of these goals while reducing the draw on taxpayer money and philanthropic funds as many of the income streams produce a dramatically higher return on investment.

The opportunity to further support social entrepreneurial ventures and social innovation in the State of Illinois would deliver multiple levels of benefits: to individuals served through

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[1] *See* Social Enterprise Alliance, *What's a Social Enterprise*?, available at https://www.se-alliance.org/why#whatsasocialenterprise (last visited January 16, 2013).

increased capacity and skills building, to businesses by enabling them to seek a profit while committing to a social mission, and to local communities and the economy through a multiplier effect on jobs, local wages and revenue. Moreover, the potential for sustainability and efficiency could scale the social impact beyond the enterprise and translate into more well-developed and effective policies of government, partners, and other providers.

With the recommendations to the General Assembly that follow, the Task Force hopes to further encourage and assist the State towards becoming a hub for social innovation and to drive a culture of recognizing and celebrating change makers in hopes of greater growth and prosperity in Illinois.

III. Current Recommendations Ahead of Legislative Session

Explore a Social Impact Bond Strategy: Social impact bonds, also known as "pay for success contracts," are a promising new approach to government financing of social service programs. By combining performance-based payments and market discipline, social impact bonds have the potential to improve results, overcome barriers to social innovation, and encourage investments in cost-saving preventive services.

With start-up funding from the Rockefeller Foundation, the Harvard Kennedy School recently established a social impact bond technical assistance lab led by Professor Jeffrey Liebman.[2] The lab provides pro bono technical assistance to state and local governments that are considering the pay for success approach, and this offer has been extended to Illinois. The Task Force hosted Professor Liebman in Chicago in November of 2011 to provide an overview of social impact bonds. Upon this meeting, Professor Liebman extended the offer from the technical assistance lab to aid Illinois in their exploration of this innovative model. In addition, In January 2013 the lab announced a request for proposals for up to four state and local governments to receive assistance.

This assistance to Illinois would include, but is not limited to:

- explaining the social impact bond/pay for success concept and helping state and local decision makers determine 1) whether this tool can help them achieve their policy priorities and 2) which policy domains are the most appropriate places for applying this tool;

[2] Liebman is the Malcolm Wiener Professor of Public Policy and an expert on tax and budget policy, social policy, and program evaluation techniques. During the first two years of the Obama Administration he was the Executive Associate Director and then Acting Deputy Director of the Office of Management and Budget.

- helping states and cities structure a transparent request for information process or other procedure for soliciting ideas from the public of promising areas to apply this approach;
- working with agencies to match data across administrative data systems and evaluate the potential cost savings achievable from a successful initiative;
- developing a strategy for producing credible impact estimates;
- developing a procurement strategy, drafting a request for proposals, and preparing for negotiations with intermediaries and service providers; and
- developing contract terms that provide appropriate incentives for intermediaries and providers and appropriate protection for taxpayers and those being served.

An assistance model has so far been implemented in two other states, New York and Massachusetts. The assistance model offered to Illinois would involve:

- placing a full time "government innovation fellow" funded by the lab in the state agency that is spearheading the state's pay-for-success initiative. The fellow can help the state both in coordinating its policy process and in performing technical analysis. The fellow will report to the state pay-for-success policy lead and also receive supervision from Professor Liebman;
- pro bono consulting from Professor Liebman, including travel to the state for in-person meetings when needed.
- additional dedicated funding and technical support for matching and analysis of state data as necessary; and
- a small flexible pool of funds that can be used to solve other barriers to implementation of the pay-for-success model.

Though these steps are preliminary, the Task Force is excited about the opportunity the model provides for cost-savings and results-based performances. Such a strategy would parallel the goals set forth by the State's Budgeting For Results (BFR) Commission as a comprehensive and cost-effective approach to tackling some of Illinois' most pressing issues in a fiscally responsible manner. Implementation and execution of social impact bonds in challenging areas like corrections and homelessness are not only transformational but have proven necessary given that taxpayer funding for preventive programs is becoming ever more difficult to find. A social impact bond strategy could epitomize the values of efficiency, effectiveness, accountability and transparency in Illinois and restore public faith in state government. In light of these conversations and opportunities, the Task Force recommends that Illinois take a leading role in the nation by fully embracing the offer set forth by Professor Liebman and developing a holistic and comprehensive social impact bond strategy.

Amend the LLC Act to Expand the Purposes of L3Cs: The low-profit limited liability company, or "L3C," is a new hybrid business form that combines aspects of the traditional for-profit LLC and socially beneficial aspects of nonprofit organizations. As of January 11, 2013, the Secretaries of State of the nine states and two Indian tribes that authorize them reported that 711 active L3Cs are in operation, of which 115 are organized in Illinois.[3] Because of the statutorily required social purpose and other features of the form, the L3C is able to facilitate private foundations' program-related investments (PRIs) into for-profit social ventures, including those affiliated with nonprofit, tax-exempt organizations.

By way of background, private foundations are generally required to make "qualifying distributions" equal to approximately 5% of their net assets per year. Qualifying distributions are generally defined to mean "any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(2)(B)."[4] Traditionally, most private foundations have met their minimum qualifying distributions requirement by distributing funds to public charities. However, Treasury regulations specifically include "program-related investments" within the definition of "qualifying distributions."[5] Program-related investments, in turn, are defined as "investments, the primary purpose of which is to accomplish one or more of the purposes described in section 170(c)(2)(B), and no significant purpose of which is the production of income or the appreciation of property."[6]

Hence, L3Cs have been established under the laws of certain states, including Illinois, requiring that a company seeking to qualify as an L3C further the accomplishment of charitable or educational purposes (which are included in Section 170(c)(2)(B)), and not have the production of income or the appreciation of property as one of its significant purposes, which should enable investments in the company to qualify as PRIs.

Currently, the L3C is a subset of the LLC in which the governing documents must specifically identify objectives that are geared toward charitable or educational purposes. The Task Force recommends that legislators embrace a more expansive description of the purposes for which L3Cs can be created. This clause would allow religious, scientific and literary organizations, organizations which foster national or international amateur sports competition, and organizations which seek to prevent cruelty to children or animals to be created as L3Cs (in

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[3] InterSector Partners L3C, *Latest L3C Tally*, *available at* http://www.intersectorl3c.com/l3c_tally.html (last visited January 16, 2013).
[4] I.R.C. § 4942.
[5] Treas. Reg. § 53.4942(a)-3(a)(2)(i).
[6] I.R.C. § 4944(c).

addition to charitable and educational organizations, as the law currently contemplates). All of these additional purposes are also included within Section 170(c)(2)(B) and thus should be suitable for companies which are seeking to receive PRIs.

This expanded clause would make Illinois the first state authorizing L3Cs whose purposes, while not charitable or educational, are nonetheless permitted purposes for PRIs. The expanded language would also invite other social-purpose ventures – which see the L3C as an attractive business form for governance, branding or other reasons – to select Illinois as their domicile. Such an amendment would be consistent with the proposed examples of PRIs set forth by the IRS in 2012[7] and would track with state law, passed unanimously in both houses of the General Assembly, that authorized L3Cs in Illinois.[8]

The Task Force strongly recommends that the General Assembly should permit social enterprises in Illinois to use the L3C form to facilitate the whole range of statutorily sanctioned PRIs and to pass the amendment allowing for a more comprehensive definition of the purposes of an L3C.

Allow the Creation of Benefit LLCs: The Task Force encourages the General Assembly to pass a bill that makes available to limited liability companies the same opportunities afforded Illinois corporations under the state's new Benefit Corporation Law (which took effect January 1, 2013).[9] Doing so would establish a new type of entity called the "benefit LLC."[10]

As the statute currently stands in Illinois, a lack of case law leaves lawyers and the LLC managers they counsel with a lack of clarity about how a court would rule if managers make a decision regarding a merger or acquisition of the company based on broader considerations than just the highest offer. Similar impediments could occur in the course of operations. The best interests of the LLC are traditionally equated with the financial interests of members, so that any decision by managers must be tied to serving the financial interests of members. This prevents managers from making decisions that consider both financial and non-financial interests.

Creating a new LLC form would explicitly require businesses organized under that LLC form to take multiple interests into consideration when making decisions. A benefit LLC would

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[7] Examples of Program-Related Investments, 77 Fed. Reg. 23429, 23430 (2012).

[8] S.B. 239, 96th Gen. Assem. (Ill. 2009) (Senate vote 59-0, House vote 116-0).

[9] 805 ILCS 40/1 to 40/5.01.

[10] Maryland is the only state which currently authorizes the creation of benefit LLCs. *See* Md. Corps. & Ass'ns Code §§ 4A-1101 to 4A-1108.

provide more clarity to managers, offer legal protections in considering multiple interests, enable a social enterprise to maintain its mission, and demonstrate leadership.

The objective of benefit LLC legislation is to give LLC members the option to require LLC managers to consider non-financial interests. The legislation would accomplish this by creating a new LLC form and, through that, a new class of LLCs whose purpose requires them to create benefit for society generally as well as members.

Moreover, a low-profit limited company (L3C) could thus become a "benefit L3C," voluntarily assuming the obligation to prepare an annual report, which would be made available to the public, describing the Company's social and environmental performance and assessing its performance in accordance with standards developed by an independent, unrelated third party. In doing so they would gain the governance, funding, branding and positioning advantages of both forms.

If Illinois is to advance its goals in social innovation, the Task Force encourages the State to make its law agnostic as to business form, thus allowing management to design entity structures best suited to their business purposes. Because of the popularity of the LLC form, it should not be disqualified from use for benefit purposes. Firms that seek to make social activism part of their mission should be allowed to organize in a form that affords pass-through treatment for income tax purposes —the LLC— just as profit-focused firms are allowed to do.

Illinois would become the first state to offer the opportunity of establishing benefit L3Cs to social enterprises, thereby leading by example in its goal towards making the State a hub for social innovation.

IV. Outlook

The Task Force on Social Innovation, Entrepreneurship, and Enterprise stands prepared to proceed on these recommendations however the Governor and General Assembly see fit. Further, the Task Force will submit a six-month report in February that will outline the major initiatives it intends to spearhead over the next year. Future reports will continue to identify and recommend promising strategies that the state government, businesses, nonprofit organizations, and citizens can adopt to strengthen social sector impact in Illinois.

V. Task Force Membership

- Marc J. Lane (Chairman), President, The Law Offices of Marc J. Lane, a Professional Corporation
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- Brian Rowland, CEO, A Safe Haven LLC
- Debra D. Schwartz, Director of Program-Related Investments, The John D. and Catherine T. MacArthur Foundation
- Eric Weinheimer, President & CEO, The Cara Program
- Elise Zelechowski, Executive Director, Rebuilding Exchange and Senior Director, Community and Economic Development, Delta Institute

VI. Acknowledgements

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- Brandon Bodor, Executive Director of Serve Illinois
- Mavara Agha, Dunn Fellow at the Office of the Governor

The Task Force has been proud of the strong interest and participation by members of the public, as well as other members of the state government who have devoted much time, skill, and knowledge. Special recognition is given to the following individuals:

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- Professor Jeff Liebman, Malcolm Wiener Professor of Public Policy
- Stephen Konya, Chief of Staff for the Illinois Department of Public Health
- Ryan Maley, Director of the Dunham Fund
- Dr. James Galloway, Assistant U.S. Surgeon General
- Nora Moreno Cargie, Director of Global Corporate Citizenship for The Boeing Company
- Francia Harrington, Senior Vice President of Global Philanthropy of JP Morgan Chase
- Mavara Agha, Dunn Fellow at the Office of the Governor
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