DELBERT HOSEMANN
Secretary of State

Policy and Research Division

L^{3}C Study Group

L^{3}C - Low-profit Limited Liability Company - a “for profit with a non-profit soul.”

Potential Positives:

- L^{3}Cs must have a social benefit as the primary function/focus of the business
- Proponents claim L^{3}C’s will increase funding in areas of social need
  - Possible funding from Foundations through PRIs (Program-Related Investments)
  - Could raise more capital than traditional non-profit donations because investors would receive a small return
    - Under the L^{3}C model Foundations would hold most of the risk while investors receive most of the reward
- The L^{3}C designation indicates to consumers and investors that the company’s focus in on community improvement/social benefit, not profits
- Easy to enact – L^{3}Cs are variations of the LLC, generally requiring only slight modification to the current statute
- Jurisdictions that have adopted:
  - Illinois (805 ILCS 180)
  - Louisiana (HB1421 / Act 417)
  - Maine (H-819)
  - Michigan (Sec. 450.4101 et seq.)
  - North Carolina (H 769 / SB 308)
  - Rhode Island (H5279)
  - Utah (Tit. 48, Ch. 02c)
  - Vermont (Tit. 11, Ch. 21)
  - Wyoming (Tit. 17, Ch. 15)
  - The Oglala Sioux Tribe
  - The Crow Indian Nation of Montana

(Links available at http://www.americansforcommunitydevelopment.org/Legislation/legislation.htm)

See Americans for Community Development for more information (www.americansforcommunitydevelopment.org)

Potential Negatives:

- PRIs (Program-Related Investments) are already made by Foundations to for-profit companies, including traditional LLCs
- PRIs relate to the purpose of the foundation and the project, not the beneficial purpose of the business as a whole
- Basic requirements of a PRI:
    1. The primary purpose is to accomplish one or more of the foundation's exempt purposes
    2. Production of income or appreciation of property is not a significant purpose, and
    3. Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose

    See http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html
- If a PRI does not qualify it can have harmful tax consequences for the Foundation
    - Foundations can get pre-approval letters from the IRS before making a PRI
- The L^3C model does not, at this time, automatically qualify under PRI rules and regulations
- Who conducts oversight to insure L^3Cs maintain a socially beneficial purpose?
- Possible fiduciary issues as some investors, Foundations, may focus primarily on social benefit while other investors, private, may focus on profit
- ABA Business Law Section opposed L^3Cs - http://open.wmitchell.edu/cgi/viewcontent.cgi?article=1228&context=facsch&sei-redir=1&referer=http%3A%2F%2Fwww.google.com%2Furl%3Fsa%3Dt%26rct%3Dj%26q%3Dapril%25202012%2520aba%2520business%2520section%2520l3c%26source%3Dweb%26cd%3D1%26ved%3D0CEYQFjAA%26url%3Dhttp%253A%252F%252Fopen.wmitchell.edu%252Fcgi%252Fviewcontent.cgi%253Farticle%253D1228%2526context%253Dfacsch%26ei%3Dqx8pUK-YO6X10gG8xYHgDA%26usg%3DAFQjCNHO8sLAMNXvuEFghrk2wYbu-zNrcQ#search=%22april%202012%20aba%20business%20section%20l3c%22

Potential Alternative to L^3Cs:

B Corp (Benefit Corporation)

- A designation available through B Lab if company meets certain qualifications
- http://www.bcorporation.net/
    - Puts private corporation, not state, in role of insuring company does not abandon its beneficial purpose
- Legislation passed in some states creating B Corporations
    - Laws provide protection for officers and board members when pursuing beneficial actions that do not necessarily increase income
    - Creates board position for benefits director (on board of directors) who must report annually to shareholders on the actions taken by the company to further its socially or environmentally beneficial purpose
    - Provides for shareholder action against Board if corporation not pursuing a beneficial purpose
    - See Louisiana statute http://www.legis.state.la.us/billdata/streamdocument.asp?did=809858

Proposal for Mississippi L³C Act

The following is our bill proposal to be used to create a law for L³Cs in Missisippi. Most of the bill should be self-explanatory. Because we are trying to have conformity among the states we have kept the bill simple and have tried as much as possible to conform the law with the L³C statutes in all the other states that have passed the law. The intention is to make the L³C a variant form of LLC with all the other conditions and benefits of the LLC remaining intact.We ask that any drafters who wish to alter the language in any way please discuss it with us.

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Proposed Amendments to
the Mississippi Code,
Revised Mississippi Limited Liability Company Act,
to Implement the Low-Profit Limited Liability Company

MISS. CODE §79-29-105 is hereby amended by revising Subsection (o), as follows:

(o) “Limited liability company” or “domestic limited liability company” means an entity having one or more members that is an unincorporated company or unincorporated association formed and existing under this chapter and is not subject to Section 97-13-15, <u>including without limitation a low-profit limited liability company.</u>

MISS. CODE §79-29-105 is hereby further amended by inserting a new Subsection (p), as follows:

<u>(p) “Low-profit limited liability company” means a limited liability company that is organized for a business purpose that satisfies, and is at all times operated to satisfy, each of the requirements set forth in Section 79-29-117.</u>

MISS. CODE §79-29-105 is hereby further amended by renumbering current Subsections (p) through (bb) as Subsections (q) through (cc), respectively.

MISS. CODE §79-29-109 is hereby amended by revising Subsection (1)(a), as follows:

(a) Must contain the following words:

(i) for a limited liability company other than a low-profit limited liability company, must contain the words “limited liability company” or the abbreviation “L.L.C.” or “LLC”; and

(ii) for a low-profit limited liability company, must contain the words “low-profit limited liability company” or the abbreviation “L.3.C.” or “L3C”;

MISS. CODE §79-29-117 is hereby amended by revising Subsection (1), as follows:

(1) Subject to the provisions of its certificate of formation or the operating agreement and subject to any other laws of this state which govern or limit the conduct of a particular business or activity, a limited liability company may carry on any lawful business, purpose or activity. Notwithstanding the immediately preceding sentence, a low-profit limited liability company must at all times be operated for a business purpose that satisfies the requirements of subsection (3).

MISS. CODE §79-29-117 is hereby amended by inserting a new Subsection (3), as follows:

(3) If a limited liability company is a low-profit limited liability company, it must at all times be operated for a business purpose that satisfies each of the following requirements:

(a) The limited liability company (i) significantly furthers the accomplishment of one or more purposes set forth in Section 170(c)(2)(B) of the Internal Revenue Code, and (ii) would not have been formed but for the entity’s relationship to the accomplishment of such one or more purposes;

(b) No significant purpose of the limited liability company is the production of income or the appreciation of property; provided, however, that the fact that the entity 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; and

(c) No purpose of the limited liability company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code.

If a limited liability company that met the requirements of (a) through (c) of this Section at its formation at any time ceases to satisfy any one or more of those requirements, then the company shall cease to be a low-profit limited liability company; provided, however, that if the company otherwise complies with this title, the company shall continue to exist as a limited liability company and its name shall be changed to satisfy the requirements for a limited liability company other than a low-profit limited liability company under Section 79-29-109.

MISS. CODE §79-29-801 is hereby amended by revising Subsection (1), as follows:

(1) A limited liability company is dissolved and its affairs must be wound up upon the first of the following to occur:

(a) At the time specified in the certificate of formation;

(b) Upon the occurrence of the event specified in the certificate of formation or the written operating agreement;

(c) Upon the consent of all members, or such lesser number as may be provided in the certificate of formation or operating agreement;

(d) At any time there are no members; provided, that the limited liability company is not dissolved and is not required to be wound up if:

(i) Within one hundred eighty (180) days or such other period as is provided for in the certificate of formation or operating agreement after the occurrence of the event that terminated the continued membership of the last remaining member, the personal representative of the last remaining member agrees in writing to continue the limited liability company and to the admission of the personal representative of the member or its nominee or designee to the limited liability company as member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member; however, an operating agreement may provide that the personal representative of the last remaining member shall be obligated to agree in writing to continue the limited liability company and to the admission of the personal representative of such member or its nominee or designee to the limited liability company as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member; or

(ii) A member is admitted to the limited liability company in the manner provided in the operating agreement, effective as of the occurrence of the event that terminated the continued membership of the last remaining member, within one hundred eighty (180) days or such other period as is provided in the operating agreement after the occurrence of the event that terminated the continued membership of the last remaining member, pursuant to a provision of the operating agreement that specifically provides for the admission of a member to the limited liability company after there is no longer a remaining member of the limited liability company.

(e) if a low-profit limited liability company fails to meet any of the requirements in Section 79-29-117 and does not file a certificate of amendment pursuant to Section 79-29-203 amending its name to conform with the requirements governing limited liability company names other than a low-profit limited liability company under Section 79-29-109 within sixty (60) days after; or

~~(e)~~ (f) Upon the entry of a decree of judicial dissolution under Section 79-29-803.

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What is the L^{3}C?

The creator of the L^{3}C, Robert Lang, calls it the “for profit with the nonprofit soul.” It operates in the space between the nonprofit and the pure for profit organization to perform a social mission. A type of LLC, the L^{3}C (Low-Profit Limited Liability Company), is able to bring together a mix of foundations, trusts, Donor Advised Funds, endowments, pension plans, individuals, corporations, nonprofits & governmental entities and others in order to achieve social objectives while operating according to for-profit metrics. Just like any LLC, an L^{3}C has the liability protection of a corporation and the flexibility of a partnership.

Americans for Community Development

. . . . the organization for the L^{3}C

The L³C (Low-profit Limited Liability Company) is not a nonprofit. It is a for profit venture that under its state charter must have a primary goal of performing a socially beneficial purpose not maximizing income. The legislation was specifically written to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations. The L³C facilitates PRI investment without the need for IRS private letter rulings. It also facilitates layered investing with the PRI usually taking first risk position thereby taking much of the risk out of the venture for other investors in more secure positions. In some cases various government grants or investment by nonprofits other than foundations can assume the first risk position. The rest of the investment levels become more attractive to commercial investment by improving the credit rating and thereby lowering the cost of capital. It is particularly favorable to equity investment. Because the foundations take the highest risk at little or no return, it essentially turns the venture capital model on its head and gives many social enterprises a low enough cost of capital that they are able to be self sustainable.

It is the perfect vehicle for economic development, medical research, operation of social service agencies, museums, concert venues, housing and any other activity with both a charitable purpose and a revenue stream. It can be used to consolidate a group of activities some which will earn significant revenue with some that will earn very little and or even loose significant amounts of money and use the total revenue to keep the overall L³C revenue positive and achieve the social benefits.

The L³C is now legal in all 50 states as a result of legislation signed into law in Vermont in April 2008, Michigan in Jan. 2009, the Crow Indian Nation in January 2009, Wyoming in February 2009, Utah in March 2009, the Oglala Sioux in July 2009, Illinois in August 2009, Maine in April 2010, Louisiana in June 2010, North Carolina in August 2010, and Rhode Island in June 2011. An L³C from any of these states, like a Delaware corporation, can be used anywhere. The L³C bill is now active in the legislatures of many states.

About half of all L³Cs that have been formed were formed with no intention of asking foundations for PRIs, at least not in the initial stages. Probably more importantly than anything else, the L³C is a brand which signifies to the world that it is a for profit that puts mission before profit yet is self sustaining. As a brand it makes these concepts easy to grasp and thereby will be frequently used.

The L³C laws also create a template for the structure and are a protection against possible misuse by owners or management of the L³C.

The L³C was built on the llc structure in order to provide the flexibility of membership and organization needed to cover a wide variety of social enterprise situations while including the liability protection of a corporation. It is very easy for lawyers and laymen alike to grasp since it does not create a totally new structure but merely amends the definition section of the llc acts in most states. That leaves 15+ years of legislation and litigation that is behind the llc intact behind the L³C.

071711-01
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What is the L^{3}C? The creator of the L^{3}C, Robert Lang, calls it the "for profit with the nonprofit soul." It operates in the space between the nonprofit and the pure for profit organization to perform a social mission. A type of LLC, the L^{3}C (Low-Profit Limited Liability Company), is able to bring together a mix of foundations, trusts, Donor Advised Funds, endowments, pension plans, individuals, corporations, nonprofits, governmental entities and others in order to achieve social objectives while operating according to for-profit metrics. Just like any LLC, an L^{3}C has the liability protection of a corporation and the flexibility of a partnership.

The L^{3}C & Economic Development

by Robert Lang

The L3C (Low-profit Limited Liability Company) is not a nonprofit. It is a for profit venture that under its state charter must have a primary goal of performing a socially beneficial purpose not earning money. The legislation was specifically written to dovetail with the federal IRS regulations relevant to Program Related Investments (PRIs) by foundations. This makes it a perfect vessel for PRI investment. It also facilitates layered investing with the PRI usually taking first loss position thereby taking much of the risk out of the venture for other investors in more secure levels. The rest of the investment levels become more attractive to commercial investment by improving the credit rating and thereby lowering the cost of capital. It is particularly favorable to equity investment. Because the foundations take the highest risk at little or no return, it essentially turns the venture capital model on its head and gives L3Cs a low enough cost of capital that they are able to be self sustainable.

This makes the L3C the perfect engine for low cost, highly effective, socially beneficial directed economic development and job creation.

The L3C can help without government investment. Since profit is not its primary goal, a structure can be created to maximize the social benefit and attract investment dollars heretofore not available to the public sector.

An L3C might buy a run down industrial building in a depressed area, rehab it, make it green, reequip it and lease it out at low rates to a business willing to locate in the area and create new jobs from within the community.

It is the ideal vehicle to incubate new technology or enhanced technology for struggling industries and provide significant employment. It could save vital but dying industries such as newspapers which need investment for new technology.

An L3C could be formed to rehab an old theatre building complete with complementary businesses such as a restaurant and a parking garage and use some of the revenues to subsidize theatre productions.

An L³C might be organized to build and run a charter school. In that case, the mezzanine financing of the school would be sold to parents who would, by virtue of their membership in the L³C, have a vote in how the school is run.

The Montana Food Bank Network is using an L³C to build and operate a new food company, Endless Sky L³C. Endless Sky L³C will produce and sell a retail product line, while using the revenues to cover the costs of processing food for the Food Bank Network. It will buy food from local farmers who do not have a current local outlet for higher value crops. So in addition to reducing the cost of feeding the hungry and providing more nutritious food to the hungry, it will create jobs and provide improved opportunities for farmers.

The L³C is the future of BioTech. As Chris Larson pointed out in his American Chemical Society blog: *The structure of an L³C is designed to create a microenvironment conducive to the simultaneous investment of private and not-for-profit capital.*

Ownership is layered, and risk and reward is unevenly spread over a number of investors.... If adopted more widely in the U.S., the L³C structure could be a win-win for both sides of the biotech entrepreneurial struggle, as investors/donors would then have the possibility of sustainability and return through ownership versus pure charity, and scientists and other start-up founders could then have access to a fresh new pool of money willing to invest in deals of a scale, and with a time horizon and expected rate of return, that traditional investors of the last several years have forgone.

Another point is that the L³C as a for profit vehicle would pay taxes not drain money from the public coffers. As an llc it can either "grow up" and turn into a viable commercial enterprise or remain a quasi non profit but be self sustaining.

The L³C is now legal in all 50 states as a result of legislation signed into law in Vermont in April 2008, Michigan in January 2009, the Crow Indian Nation in January 2009, Wyoming in February 2009, Utah in March 2009, the Oglala Sioux in July 2009, Illinois in August 2009, Maine in April 2010, Louisiana in June 2010, North Carolina in August 2010 and Rhode Island in June 2011.

A Vermont, Wyoming, Utah, Illinois, North Carolina, Maine, Rhode Island, Louisiana, or Michigan L³C, like a Delaware corporation, can be used anywhere. The L³C bill is now active or about to become active in many other state legislatures.

The L³C was built on the LLC structure in order to provide the flexibility of membership and organization needed to cover a wide variety of social enterprise situations. It also makes it very easy for anyone familiar with business structures to grasp since it does not create a new structure but merely amends the definition section of the llc act in most states. That leaves 15+ years of legislation and litigation that is behind the LLC intact behind the L³C.

Probably more importantly than anything else, the L³C is a brand which stands for all this and more. Hopefully, as a brand it will make the concepts easy to grasp and thereby frequently used. We believe that social enterprise is the "next big thing." The middle class American is tired of investment bubbles, convoluted financial schemes, and giant corporate entities that treat employees like inventory to be revalued and dumped as the "market" dictates. They want to work in kinder, gentler places that have high social values and treat workers as the most important resources. They want to invest their money where they know it will not disappear when another bubble bursts and most of all they want stability in their lives.

Everyone also knows that government at all levels is effectively broke. It needs to shrink not spend more money it does not have. The L³C has the opportunity to fulfill those desires while operating under the efficiency of a for profit structure. A significant benefit of the creation of jobs through a partnership of foundation investment and private dollars is that all the jobs created will lead to increased tax revenues at no expense to the government!

For More Information Regarding the L³C Visit Our Website:
americansforcommunitydevelopment.org

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080711-01

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The Future of Philanthropy

Hybrid Social Ventures

Roxanne Phen

An Americans for Community Development Publication

In Association with Mission Throttle L3C

The Future of Philanthropy

Hybrid Social Ventures

Roxanne Phen

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Publication 1501
Publication Date - May 31, 2011

"While business advertises, charity is taught to beg. While business motivates with a dollar, charity is told to motivate with guilt. While business takes chances, charity is expected to be cautious. We measure the success of businesses over the long term, but we want our gratification in charity immediately. We are taught that a return on investment should be offered for making consumer goods, but not for making a better world."

-Dan Pallotta, Uncharitable

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Chapter One

The Problem

In June of 2009, the North Shore Music Theatre, a Massachusetts nonprofit created in 1955, was forced to close its doors. Once the largest regional theatre group in New England, North Shore attempted a last ditch fund raising effort that was insufficient to save the organization. The theatre, which brought high quality productions to the community for decades, once had 10,000 subscribers. At its closing, the theatre had 4,400 subscribers for the recently renovated 1,580 seat theatre (Leighton 2009). When the North Shore Community Arts Foundation went bankrupt, the residents of Beverly, Massachusetts were left without a major arts institution and community landmark (Edgers 2009). Late 2009 brought some hope for the return of musical theatre to Beverly, although the new owner of the North Shore Music Theatre planned to run a "leaner organization" (Leighton 2009).

As a result of $14 million in losses in 2008, the Seattle Post-Intelligencer, the city's oldest business, was put up for sale. However, when 60 days passed without a buyer, the Hearst Corporation decided to stop publishing its newspaper print edition and switch to an online format. (Richman and James 2009). The 146-year-old Post-Intelligencer was not the first or only newspaper that faced such a fate. It joined the Denver Rocky Mountain News and other major publications across the country in ceasing to produce a daily newspaper because of a number of funding difficulties, including a decrease in advertising revenue and increasingly fewer readers (The Guardian 2009).

Every day, socially beneficial nonprofit organizations and for-profit businesses such as these are being forced to cease operations. Our current system of financing social good is insufficient to fund many worthy causes that straddle the nonprofit and private sectors, so these unique organizations often fall through the gaps. Arthur Wood, the former Global Head of Social Financial Services of Ashoka and current Chairman of the World Sanitation Financing Facility (WSFF), explains the current situation in the following way: "The current funding structure of philanthropy…has really only two positions to invest: namely a 'for-profit' with social impact (say, 6 percent plus); or a grant model where the money is given away (at a return of negative 100 percent)" (Wood, A New Social Contract for Philanthropy 2010). As Mr. Wood explains, "there is a range of positions between -100 and +6. But there are no structures that actually allow you to operate within that framework" (Wood, A New Social Contract for Philanthropy? 2010).

The nonprofit landscape is not adequately equipped to accommodate these organizations with potential revenue streams, and the market often will not sustain these efforts as for-profit businesses. Little in the current economic environment leaves room for the possibility that financing social good does not always necessitate a market return or an act of charity. The existing structure is insufficient to fund consistently diverse social goods like the North Shore Music Theatre, the Seattle Post-Intelligencer and countless other endeavors. If we determine that such endeavors are indeed worth sustaining, then we must turn to new solutions to maintain these goods and create others that will advance social good.

Today, even social causes that fall directly into the nonprofit world face the problem of under capitalization, and the issue appears to be getting even more serious. In times of economic prosperity, nonprofits spend time and resources pursuing grants and donations from charitable foundations and individuals. The very process of seeking funding squanders funds. Money that could be used for programs or organizational improvement is instead dedicated to researching grants and foundations, writing letters of inquiry that often go unanswered and submitting grants to foundations that receive thousands of similar requests. It has been estimated that, in the nonprofit sector, the cost of acquiring capital is between 22 and 43 cents on the dollar, ten times the cost of the same action in the private sector (Wood, A New Social Contract for Philanthropy? 2010).

In tough economic times, the situation worsens, and as endowments lose value, foundations are forced to scale back their grant making. In 2008, US foundation endowments faced an average 26 percent devaluation (Preston 2009). This steep drop in endowments not only negatively affects current grantees, but other nonprofits looking to make connections with foundations that have not funded them in the past. It becomes almost impossible to connect with new funding sources when the foundations can barely afford to continue funding programs with which they already have a previous affiliation. The drop in foundation endowments has made it significantly more difficult for nonprofit organizations to continue their work. Social service organizations raised 16 percent less in 2008 than in the previous year, while 54 percent of them reported an increase in the need for their services. Moreover, a recent survey found that 60 percent of organizations were subsequently forced to lay off workers or curtail services (Wasley 2009).

Even in 2011, as foundations are gaining back assets, "foundation endowments remain roughly 17 percent lower than before the recession" (López-Rivera and Preston 2011). As organizations suffer and the people they serve struggle, it becomes all too clear that a solution to the under capitalization of traditionally nonprofit causes is necessary.

A Possible Solution: Hybrid Social Ventures

While not all traditionally nonprofit causes can be aided by hybrid social ventures, they do provide one possible solution for socially beneficial endeavors with a revenue stream. These hybrid, low profit companies fall somewhere in between the nonprofit and for-profit spheres, utilizing the flexibility of a for-profit business for a nonprofit cause. For years, creative individuals and organizations have created makeshift hybrids, attempting to combine the best of both worlds for a social cause. Only recently have attempts been made to create a specific legal structure identifying organizations that are eligible to receive funding from the nonprofit, for-profit, and governmental spheres simultaneously because of their socially beneficial activities.

In the United States, one such structure is garnering attention: the low-profit limited liability company (L^3C). This variation of the preexisting limited liability company (LLC) structure was first passed in Vermont in April 2008 and has since been passed in Utah, Michigan, Wyoming, Illinois, Maine, Louisiana, North Carolina, the Oglala Sioux Tribe and the Crow Indian Nation of Montana. By definition, the L^3C is a for-profit business with the "primary goal of performing a socially beneficial purpose" (Americans for Community Development n.d.). The structure allows for funding to come from private, nonprofit or government sources that are often mutually exclusive. Foundations, government entities, nonprofits, private investors and others all may invest in an L^3C.

Before this new structure was introduced, foundations were permitted to make investments in for-profit businesses as program-related investments (PRI), but they had to endure a long and arduous process to ensure that investments in profit making ventures for social good complied with the Internal Revenue Code. Written with that very code in mind, the L^3C legislation encourages foundations to invest in L^3Cs and have the possibility of getting a return on their investment. The tranched investment structure of the L^3C would allow foundations to take the riskiest position in the venture and a smaller rate of return, making it a more attractive investment for private investors, corporations and governmental groups.

The L^3C is not the only type of hybrid social venture imaginable, or even the only type in existence. The United Kingdom also has a similar legal entity called the Community Interest Company, which has been in existence since 2005. In the United States, the B Corporation is another effort at combining the nonprofit and for-profit worlds, although it approaches this task in a different way than the L^3C. Both of these structures will be considered later in this paper.

Considerations

In the coming chapters, this paper will address a number of considerations associated with hybrid social ventures and recommend a course of action for struggling social causes with access to a revenue stream.

The need for hybrid social ventures

As discussed previously, a number of existing nonprofits and for-profit businesses are strong candidates for hybrid social ventures. The newspaper industry is merely one example of the good that hybrid social ventures could do, but this example alone makes a compelling case for this low-profit structure. Between 2007 and 2008, advertising revenue decreased by 23 percent across the newspaper industry and in 2008 alone, almost 16,000 newspaper employees and journalists lost their jobs (Pickard 2009). Proponents of the L^3C structure have indicated that it could be the best solution to save these public goods. While newspapers may no longer thrive as for-profit businesses, they could continue to be profitable, if only marginally. A newspaper financed primarily by a foundation and then by private investors could be the future of this form of media.

L^3Cs and other hybrid social ventures could be applied to theatres, museums, symphonies and any number of other organizations with a revenue stream. The possibilities are endless. One excellent candidate for the L^3C structure is a unique gang prevention nonprofit based in Los Angeles, Homeboy Industries. This nonprofit operates a number of small businesses that employ former gang members who are looking to get their lives back on track. In addition to businesses like Homeboy Bakery and Homegirl Café, Homeboy Industries provides services, such as mental health counseling, legal services and tattoo removal, to individuals seeking to leave their gang participation behind them. The organization has faced financial hardship in the recession, making it difficult to continue operations and provide these services (Bolderson 2009). Converting Homeboy Industries to an L^3C could allow it to meet its funding needs without relying solely on foundation support.

There are undercapitalized worthy causes with a revenue stream that would benefit from hybrid structures for social good. This is not to say, however, that all social goods can be sustained, even with the introduction of hybrid social ventures into the picture. In order for a nonprofit or hybrid to survive, it must have a sufficiently high social return to warrant the funding.

What qualifies as a hybrid: A look at existing solutions

Numerous configurations already exist that combine nonprofit and private structures to promote social good. For the purposes of this paper, however, a hybrid social venture is defined as one entity that combines the methods of the nonprofit and for-profit sectors with the possibility of receiving funding from either. There are a number of structures that already exist that combine for-profit businesses with nonprofit goals. Corporate foundations, nonprofits with business subsidiaries and for-profit businesses paired with non-governmental organizations (NGOs) utilize different structures, but it is not useful to consider these structures as hybrids. Each structure will be discussed in more detail, but since these all utilize preexisting structures, they will not tell us more about the effectiveness and efficiency of a structure that, by itself, can receive funding from nonprofit and private sources.

The effect of hybrids on nonprofits

The hybrid structure is not appropriate for all nonprofit causes. If no aspect of the organization lends itself to for-profit activities, then the hybrid structure as it currently stands would not be a viable option. However; this does not mean that hybrid structures could not still be beneficial to those organizations that remain fully nonprofit in structure. Since legal structures for hybrid social ventures are in their nascent stages and their impact still small in comparison to the US nonprofit sector generally, it is difficult to forecast how the introduction and success of hybrid structures such as the L^3C will affect the funding landscape for traditionally nonprofit causes.

The hybrid social venture, through its effect on foundation endowments, could either funnel additional funding toward causes traditionally addressed by nonprofits, or siphon money away from those targeted activities. This paper hypothesizes that the former condition will hold, and that the existence of hybrid social ventures is good not only for the causes they serve, but for nonprofit organizations as well. In so doing, it also examines the effect hybrid social ventures could have on foundations.

The effect of hybrids on foundations

Given the ease of making program-related investments (PRIs) in low-profit limited liability companies (L^3Cs), it is possible that we will see a shift in how foundations allocate the five percent of their endowments that they are required by law to distribute. Currently, most foundations distribute this money in the form of grants rather than perform the due diligence required to make an informed PRI in a for-profit entity. Currently, it is customary for foundations to give away money with no hope of any return on their investment other

than social good being done. If a foundation were to use some of its five percent to invest in an L^3C, there would be at least the possibility of a return on the investment, even if turned out to be small. In theory, this could change the way foundations do business. This paper analyzes whether a shift from grants to PRIs is likely, and advisable..

The effect of hybrids on other investors

Next, this paper will examine the scenario from the perspective of a private investor – a corporation or individual who chooses to become an investor in a low-profit company. We will examine whether the possibility of a small return on the investment is enough for individuals to become partners at the mezzanine level of investment and how socially responsible investing impacts an individual's willingness to accept a smaller return on an investment

The effect of hybrids on the social cause

Finally, this paper will address the impact that introducing a profit will have on traditionally nonprofit causes. This is a concern that some individuals have expressed: that "'market' values may supersede charitable ones, causing organizations to judge their activities by what they are worth, rather than whether they are worthwhile" (Lenkowsky 1999). While many nonprofits are currently run by individuals knowledgeable about the cause or population they are serving, a different class of individuals might be the ones needed to run these converted hybrids in a way that turns a profit. While the primary goal of a low-profit hybrid is the social good, it is unclear if and how much profit will affect the organizational operations and structure.

A look forward

In the past, a response to issues typically addressed by nonprofits has been the introduction of more nonprofits. This paper suggests not only that other options exist for bringing about social good, but that, for some types of organizations, better options exist in terms of structure and financing. Innovation is not limited to the for-profit world. Creative and business savvy solutions are available to organizations with socially conscious purposes, but only if nonprofits and foundations are open to fundamentally changing the way that they do business.

Chapter Two

What is a Hybrid Social Venture?

The hybrid social venture was not an idea that emerged overnight. For many years, innovative individuals and organizations have been experimenting with new business forms that combine aspects of nonprofit and for-profit organizations.

In order to fully understand the implications of the hybrid social venture and its most common form in the United States, the low-profit limited liability company (L^3C), it is important to be aware of the continuum of this marriage of business and philanthropy and where the hybrid social venture falls on that spectrum. While the following list is by no means exhaustive, it gives a good indication of the types of organizations that incorporate nonprofit and business efforts together and better clarifies what a hybrid social venture is by showing what it is not. It is worth noting that there may be some variation as to where these structures lie within the continuum, but nonetheless their relativity to each other remains somewhat constant.

On one end of the spectrum are traditional for-profit companies that make no explicit effort to pursue social causes beyond the profit maximizing advantage and goodwill that motivates this pursuit. Some for-profit businesses will sacrifice a degree of profit to pursue these social causes. **Socially committed private enterprises** are still primarily concerned with profits, but they do address social issues in one way or another, either through education or funding. An example of a social enterprise is Ethos Water, the bottled water company with the social mission of “helping children get clean water” by donating a portion of the revenue to programs that support safe water (Ethos Water 2008).

Ethos Water was founded in 2003 by Jonathan Greenblat and Peter Thum, who were inspired to form the company after working on a consulting job in South Africa. The company donates $0.05 for every $1.80 bottle of water that is sold to support projects around the world in Bangledesh, the Democratic Republic of the Congo, Ethiopia, Honduras, India and Kenya (Dahm 2006). Ethos Water was purchased by Starbucks in 2005, which has led to even greater profits and contributions made from the sale of the water. The classification of Ethos Water as a socially committed private enterprise is still not entirely clear without an extensive analysis of the company. It may be possible that the company’s promise to give helps to brand the company in such a way that it actually has higher revenues than it would without the social cause.

A **corporate foundation** is a charitable organization associated with a corporation. These foundations are usually formed to create positive change in their communities and, in some cases, to illustrate to the public the company's commitment to social good. The closeness of the foundation and company is highly variable and depends on the individual organization. When categorized by "total giving," the largest corporate foundation is The Bank of America Charitable Foundation, which is a separate legal entity from the Bank of America Corporation (Foundation Center 2009). This foundation is loosely connected to the Bank of America Corporation and concentrates its giving in areas where the bank does business through small local grants. Other foundations, like the Ford Foundation, were once connected to a corporation but have since become entirely independent (The Ford Foundation 2009).

Sometimes, a for-profit company partners with a non-governmental organization (NGO) to form a **collaborative effort for social good**. The company's primary goal remains a profit, while the NGO has a primary goal of promoting some element of socially beneficial outcome. One example of such a partnership is the relationship between brewer SAB Miller and CARE International. SAB Miller has produced a new beer that is made from sorghum, a crop common to Uganda. Local farmers are growing the crop for the brewery, which is helping to provide an income to the farmers and also taking over the beer market in the country. Assisting with this effort, CARE International is aiding the farmers with their farming and business skills (Inspiris Limited 2006).

Some nonprofit organizations engage in activities that bring in some amount of revenue into the organization. **Nonprofits with revenue streams** have a primary purpose that is not a profit, but revenue is pumped back into the organization. For example, museums may be nonprofits but generate revenue through ticket sales. The primary source of funding for these types of organizations, however, is often foundation grants. Some **nonprofit organizations** do not have a revenue stream, but provide goods or services to advance some sort of charitable cause. They receive funding through private donations or foundation grants. Currently these are the structures least associated with business, although some nonprofit leaders might run their nonprofits with a businesslike approach.

Even though the above examples illustrate the interaction of business and nonprofit causes in some capacity, only the hybrid social venture, as defined in this paper, allows for the combination of funding from nonprofit and for-profit investors in one legal entity. This will prove to be the distinguishing factor that separates hybrid social ventures from previous attempts to combine these two areas.

In the United States, the most prevalent hybrid social venture is the low-profit limited liability company (L^3C). However, other hybrid structures exist in other countries, such as the Community Interest Company (CIC) in the United Kingdom.

One might ask why a new business form is needed when other alternatives already exist that combine nonprofit and for-profit forces. While the forms previously described have had their successes, they are not appropriate in all circumstances. Let us reexamine these forms and why some valuable ventures fall through the cracks despite their presence.

1. **Socially committed private enterprises** – These organizations are for-profit businesses, and many publicly held organizations have obligations to their shareholders. This eliminates a fair amount of organizations that have a revenue stream but cannot bring in enough money to survive in the market without subsidization.

2. **Corporate foundations** – Corporate foundations provide many nonprofit organizations with grants for programs. Unfortunately, these grants have limitations and cannot provide funding to all causes that activists believe ought to be funded. Even when funding is provided to an organization, it is often for programs rather than operating expenses. Finally, corporate foundations are limited in how they can spend their funds. They often limit their funding to nonprofit organizations and in most cases do not fund for-profit enterprises that promote a social good.

3. **Collaborative efforts for social good** – This term could apply to a variety of different partnerships, so it is difficult to conclude that partnerships between businesses and nonprofits cannot fill the void that the hybrid social venture seeks to occupy. There are, however, some difficulties that suggest that another form might be more effective for new or small efforts for social good. Many partnerships entered into by for-profit businesses are with large and well-established nonprofit organizations. One such example is the partnership between American Express and the Statue of Liberty – Ellis Island Foundation, Inc. The credit card company launched a campaign that increased card usage and raised $1.7 million for the restoration of the statue so that it could be reopened to the public (Sinclair and Galaskiewicz 1996-1997). Since these partnerships are helped by name recognition and a track record of legitimacy, such partnerships are nearly impossible to achieve for small, local organizations, or organizations just forming. This is not to say that these partnerships cannot be used to address a number of funding deficiencies for social causes, however the difficulties for small organizations makes one think that another form might better achieve the task in some cases.

4. **Nonprofits** – Nonprofits with and without revenue streams face the problem of under capitalization. Since these organizations are self-contained, they do not benefit from for-profit funding unless they are engaged in a partnership. As discussed previously, some nonprofit organizations are not getting the funding they believe they need from foundations and individuals donors to serve their communities. According to Arthur Wood, the current nonprofit system pits organizations against each other for the same funding. He notes that "competitive advantage for capital is about coming up with a clever idea, at least in the foundation world, and not collaborating with the very people you should collaborate with" (Wood, A New Social Contract for Philanthropy 2010).

Despite the existence of the above forms, newspapers, local theaters and other organizations are slipping through the funding gap. Since the existing forms do not cater to the needs of such organizations, one foundation CEO, Robert Lang, saw it necessary to create a form that did.

Low-profit Limited Liability Companies

Structure

The structure that exists for hybrid social ventures in the United States is the low-profit limited liability company (L^3C). The L^3C is a form of limited liability company (LLC). The LLC is a hybrid all on its own: a combination of the corporation and partnership. The LLC is a fairly new legal structure in its own right. While the LLC was first introduced in Wyoming in 1977, the structure did not become popular until the Internal Revenue Service (IRS) classified the LLC as a partnership for tax purposes in 1988 (Ribstein 1995, 3). It was not until 1994 that the Uniform Limited Liability Company Act (ULLCA) was passed (Bishop 1995, 51). The L^3C simply amends state law to expand the definition of the LLC. This means that the L^3C is the same legal structure as the LLC with the caveat that it must exist primarily for a socially beneficial purpose that must be included in its state charter (Mannweiler Foundation 1). The Vermont law sets forth three requirements for a company to qualify as an L^3C:

(A) The Company significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.

(B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person 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.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D) (State of Vermont 2010).

Since the LLC is a flexible business form, there are many ways that an L^3C could be structured. An L^3C could be formed, for example, in one of the following ways.

1. Foundation investment: In this scenario, a private foundation becomes the primary investor in the L^3C. When a foundation makes a program-related investment (PRI), they assume a high risk and the possibility of a low financial return on their investment. The next class of investors has a higher return on their investment, and eventually a class of investors makes market returns.

2. Government grant: When a government grant becomes the first investment, the foundation enters in a less risky position and will likely need to lower its interest rate in order to make an allowable PRI. For-profit investors will follow with a higher rate of return. Alternatively, an L^3C might only have government and private members.

3. For-profit investment: In another scenario, a for-profit investor agrees to make an investment that is contingent upon the hybrid obtaining funding from additional sources. This does not mean that the for-profit investor will then receive a lower rate of return because of its status as the first investor. The nonprofit funder, when identified, will still receive the lower rate of return.

The above list is by no means exhaustive. As of May 2011, proponents of the L^3C are exploring a number of other funding structures as alternatives to the ones listed above: the Donor-Advised Fund (DAF) and the New Markets Tax Credit (NMTC).

1. Donor-Advised Fund: A DAF is a “separately identified fund or account that is maintained and operated by a section 501(c)(3) organization, which is called a sponsoring organization” (Internal Revenue Service 2010) and contributed to by private donors. In this scenario, a donor would make a tax-deductible donation to a Donor-Advised Fund, which he would advise to make a PRI in an L^3C.

2. New Markets Tax Credit: The Community Development Financial Institutions (CDFI) Fund awards a tax credit allocation to an organization that qualifies as a "community development entity" (CDE). L³Cs engaged in community development activities would apply to receive a portion of the awarded allocation that it could use to attract investors (Briscoe 2011).

An L³C does not need to have foundation, government or even private members other than the founder in order to exist. Some L³Cs might elect to function much like traditional LLCs for a number of reasons. It's possible that additional funding is not needed, and the branding of being a charitable business is desired.

Program-Related Investments

The program-related investment (PRI) exception was created by the Tax Reform Act of 1969. That piece of legislation made "jeopardizing investments" by foundations fineable offenses. If an investment has the possibility of "imperil[ing] the foundation's ability to carry out its charitable activities," it is not permitted, with one exception: the PRI (Carlson 2006). Before the law took effect, the only action that a foundation could take to satisfy the 5 percent disbursement requirement would be to issue a grant to an organization. The PRI, which would be a jeopardizing investment if a part of the foundation's endowment, became acceptable as another tool to carry out the foundation's charitable purpose. In order for an investment to count as a PRI, it must meet three standards:

1. The investment's primary purpose must be to advance the foundation's charitable objectives.

2. Neither the production of income nor appreciation of property can be a significant purpose.

3. The funds cannot be used directly or indirectly to lobby or for political purposes (Carlson 2006).

PRIs can take a number of forms such as equity investments, below-market loans or loan guarantees. According to Luther Ragin, Vice President for Investments at the F.B. Heron Foundation, there are two schools of thought about what makes a PRI not significantly for the purpose of producing income. The first functions under the assumption that a PRI with a low return (one to two percent) will not be seen by the IRS as an attempt to use an investment for the production of income. Foundations operating under this assumption, like the Ford Foundation, sometimes even cap their returns at two percent. Other foundations, like Ragin's, seek below-market returns on a risk adjusted basis, believing that PRIs should

be compared to what a socially indifferent market-rate investor would expect as a return (Ragin 2010).

Despite the fact that PRIs have been in existence for over 40 years, grants are still the method of choice for meeting the disbursement requirement. Approximately $90 billion of distributions are made by foundations each year, yet only about $1 billion of those distributions are made in the form of PRIs (Ragin 2010).

History

Robert Lang, the CEO of the Mary Elizabeth and Gordon B. Mannweiler Foundation, introduced the concept of the low-profit limited liability company (L^3C) in 2005 (Schwister 2009). Since then, eight states and two sovereign Indian nations have passed L^3C legislation. Vermont was the first, passing the legislation in April of 2008. As of September 24, 2009, 77 L^3Cs were registered in the state of Vermont. As of May, 2011 that number had jumped to almost 150. The first L^3C, L^3C Advisors, L^3C, was created in Vermont by Robert Lang to promote the new structure and to aid others in beginning their own L^3Cs. Many of the L^3Cs incorporated in Vermont do not operate within that state, but operate in states in which the L^3C legislation has not yet passed.

The types of causes that L^3Cs are addressing are varied. Rethink Impact is a website, set to launch in June, which matches nonprofits and L^3Cs with foundations looking to award grants and make PRIs. Nonprofits and L^3Cs may join free of charge, while foundations can subscribe for premier features. Each nonprofit/L^3C makes a short video in the format suggested by Rethink Impact, and foundations search for organizations that match their funding guidelines. After watching the short videos that the organizations make, foundations invite possible matches to apply for a funding (Andrews 2011). Maine's Own Organic Milk Company (MOO Milk) is a Maine-based L^3C that serves a very different purpose. MOO Milk was formed after ten dairy farmers in Maine were dropped by their distributor. The farmers joined together to save dozens of jobs in the community and provide organic milk to their state. Their stated purpose is "to promote farm preservation and economic development in Maine by marketing and distributing 100 percent Maine organic milk." As of March 2010, MOO Milk was being sold in over 150 stores in Maine, New Hampshire and Massachusetts, including Whole Foods and Wal-Mart. One L^3C actually incorporated and based in Vermont is Faithful Travelers, a company that organizes service trips for schools, churches and other groups to locations around the globe. It is evident that the L^3C structure can, and already is, being used in a wide variety of ventures.

In January of 2009, the L^3C legislation was passed in Michigan. As of May, 2011, eighty-six

L^{3}Cs were in existence, or in the process of being approved by the state. As of the same date, Utah had thirty-three and Illinois had fifty-nine L^{3}Cs incorporated in their states, while Wyoming had twenty-three L^{3}Cs incorporated there. The two states which have most recently passed L^{3}C legislation, North Carolina and Louisiana, have twenty and eight L^{3}Cs registered, respectively. One L^{3}C has been incorporated in the Oglala Sioux Tribe. The L^{3}C legislation has been passed in Maine, doesn't take effect until July 1, 2011.

Are the Causes Pursued by Hybrids Worth Pursuing?

If an organization cannot be funded to the necessary degree in either the nonprofit or for-profit sector, then one might question whether it should be funded at all. Many organizations that meet this description are funded via subsidy because they fall into one of two categories: 1) distributions or 2) public goods. In both cases, the market fails to sustain activities which society deems worthy of existing even though individuals often will not pay for these activities on their own.

At first glance, hybrid social ventures do not fall into either category. In all cases, these organizations have a revenue stream and are not purely distributional. While hybrid social ventures are certainly capable of producing public goods, in many cases they provide private goods. However; many organizations that do not traditionally fall under one of the above two categories should be sustained even when they cannot exist as fully for-profit businesses or nonprofit organizations. Some possible hybrid social ventures might have distributional qualities while retaining their status as a business. One example is the aforementioned Homeboy Industries. If that organization, currently organized as a nonprofit, were to become a hybrid social venture, its primary purpose would be a socially beneficial one: lowering the recidivism rate by providing a steady job and income to individuals who have been in gangs. While Homeboy Industries would not be distributing food or money to the individuals directly, it is providing job opportunities to a specific segment of the population that is less likely to be hired by employers. Therefore, this type of organization should be sustained despite its inability to function on its own as a for-profit business because of its pseudo-distributional qualities. Other types of hybrids that do not have any distributional qualities might be more susceptible to criticisms about the need for their existence.

If a hybrid social venture provides a private good and, in the long run, revenue is exceeded by costs, then it should cease operations and shut down. An arts organization that fits these criteria, according to this view, is not sufficiently valued by the market, and its resources

should be put to better use. Weisbrod (1964) suggests that a closure of the business is not always the choice that optimizes utility. He argues that private goods can have qualities of public goods that make them, in some cases, worthy of subsidization because of what he calls “option value.” According to this idea, even if the individuals contributing to the revenue of the business are not consuming enough of the good to sustain the business, there are other consumers who are not currently contributing to revenue but value the option of being able to do so in the future. These people are not accounted for in a traditional economic analysis of a firm, and may not even become users despite their intentions. Even so, Weisbrod argues that these people “will be willing to pay something for the option to consume the commodity in the future” (Weisbrod, 472). He acknowledges that this idea could apply, in theory, to any good or service, but does not mean that every business is necessarily worthy of being sustained via subsidization. He concludes that the idea of the “option value” does provide a reason to question whether an unprofitable organization providing a private good should close.

While Weisbrod applies this theory to national parks, hospitals and public transportation, Cameron classifies local theaters as “option goods,” because their closing would diminish the “value obtained from knowing that one could use something if one wanted to” (Cameron, 244). It could be argued then, that at least some museums, theaters and other hybrid social ventures that derive their revenue streams from private goods are worthy of being sustained despite their inability to succeed with only nonprofit or only for-profit funding.

Chapter Three

Organizational and Financial Feasibility

In a traditional business, success is usually evaluated monetarily. Nonprofits face a more complicated situation in which they must try to measure their impact against their stated social cause, often involving intangible metrics. While this may be difficult, the nonprofits can look to their achievements and say whether or not they have met their goals. Hybrid social ventures present an interesting case. Their success cannot be measured by profits or impact alone. These two factors must be examined together in some way, however. Brooklyn Law School Professor Dana Brakman Reiser has said, "The boundary between charity and business has become a moving target" (Brakman Reiser 2010).

In order to determine whether L^3Cs have the capacity to be successful socially and financially, the organizational structure and financial model must be assessed.

Organizational Structure

Since hybrid social ventures do involve profit-making, what separates them from traditional businesses must be determined. It seems as though the main difference is the existence of an additional requirement on the business, indeed its primary requirement, which is to pursue some type of social good. One factor that must be examined is if and how the interaction of nonprofit and for-profit investors in a hybrid social venture affects the mission and operations of the business.

Given that the hybrid social venture is a relatively new structure, few scholarly critiques have emerged to challenge its effectiveness. There is extensive literature, however, on the blending of nonprofit and for-profit structures generally. While this literature does not specifically address organizations that receive funding from both nonprofit and for-profit sources, it does examine the benefits and costs of pursuing traditionally nonprofit causes with a businesslike strategy.

In the late 1990s, the idea of venture philanthropy was introduced. Two articles published in the Harvard Business Review in 1997 and 1999 prompted a discussion in the philanthropic world about the place of business in nonprofit operations. Letts, Ryan and Grossman (1997), argue that foundations should adopt some of the practices of venture capitalists in order to make a larger impact on their respective causes. They continue to say that

foundations' work often "comes even before a grant is made – in screening applications or seeking new ideas" (Letts, Ryan and Grossman 1997). In approaching the grant making process from the venture capital perspective, foundations would focus more on building relationships with the nonprofit they are funding. This would include ensuring that results are being measured and funding the nonprofit consistently so that they can continue to build strong and effective programs after the first few years. The authors conclude with questions that foundations and nonprofits should ask themselves about the way they were currently doing business.

Letts, Ryan and Grossman's ideas about applying business practices to philanthropy prompted additional examinations of this potentially beneficial relationship between business and nonprofits. In 1999, Porter and Kramer wrote, "Instead of competing in markets, foundations are in the business of contributing to society by using scarce philanthropic resources to their maximum potential. A foundation creates value when it achieves an equivalent social benefit with fewer dollars or creates greater social benefit for comparable cost" (Porter and Kramer 1999). They proposed that foundations adopt a strategy and apply it rigorously to their giving.

Many scholars have been wary of introducing business practices into the social sector. These early treatises on venture philanthropy were followed by critiques of the combination of for-profit and nonprofit methods to promote social good. Eikenberry and Kluver argue, "A corporate model, which stresses the values of strategy development, risk taking, and competitive positioning is incompatible with the nonprofit model, which stresses the values of community participation, due process, and stewardship" (Eikenberry and Kluver 2004). These values, however, can in fact coexist in an organization.

Concerns about competing nonprofit and for-profit interests in an organization are usually of the general sort: that the introduction of profit into the nonprofit cause might de-emphasize justice and fairness and impact the nonprofit's mission. Some scholars, such as Young (2002), have introduced scenarios that reveal possible problem points. Young provides examples of how business and nonprofits have interacted with unfavorable outcomes in the world of higher education. His scenarios, however, only show the potential problems in an ill constructed partnership between a nonprofit and for-profit cause. In the cases he examines, for-profit interests play a major role in the sacrificing of the nonprofit mission at a private university. In all likelihood, the problems he raises could have been avoided if the roles and responsibilities of both the nonprofit and for-profit parties were decided before moving forward. These examples do not show the fundamental incompatibility of business and nonprofits. While the current literature does not address these concerns as they apply

to hybrid social ventures specifically, this paper examines possible concerns about the competing interests that could exist within such an organization and how they could be addressed.

A foundation's primary interest is promoting its mission through the funding of programs, while a traditional business's primary objective is to make a profit. Of course, these goals do not always coincide. If they did, there would be no need for the social sector; what would promote the social good would also be profitable. Since that is not the case, conflicts between these two competing interests could possibly manifest in three areas in a hybrid social venture: content, prices and people.

Content

Conflicting interests concerning content would in many cases be found in arts organizations. While one content set might align better with the organization's mission, another might lead to greater profit. Take the case of a hypothetical nonprofit classic movie theater.

Play it Again is a hybrid social venture that educates the public about classic film through frequent movie screenings at its theater. The individuals who started the venture are concerned with showing more obscure films that many people unfamiliar with classic film have not likely come across. These films, however, may not bring in as many viewers as better known classic films such as Casablanca and Psycho. While these films will likely bring in more revenue for the theater, they may not align as closely with the mission of the organization. Should content be decided by the mission, or by what films will result in the highest returns for the private investors?

Prices

The second instance in which the nonprofit and for-profit interests might conflict is in regard to prices. Problems could arise from the pricing of goods, but also from wages paid to individuals. Consider Fresh Start, another hypothetical hybrid social venture.

Fresh Start is a laundering and dry cleaning service that employs women just released from prison. The main purpose of the organization is to provide these women with marketable skills that would help them keep a steady job and stay out of prison. The venture is organized as an L^3C and has nonprofit and private investors. Since the mission of the organization is to provide women with the means to support themselves without turning back to crime, it would follow that the organization would strive to provide women with a wage that would enable them to do so. From a profit perspective, this may not be the optimal choice. The women of Fresh Start would benefit from a higher wage, but the

investors would not receive as high of a return on their investment. Who decides the proper wage?

People

Another point of contention between the nonprofit and for-profit interests could be in the individuals hired to carry out the day-to-day business of the hybrid social venture. In many nonprofit organizations, the individuals running daily operations are often connected to the cause in one way or another. Sometimes these people are more likely to know about the client and their needs than up and coming business practices. On the other hand, for-profit investors might prefer that the business in which they invest is being run by professionals with the proper training to run a business successfully.

Solutions

The problems presented are real. Each of these issues and countless variations on them could arise in hybrid social ventures. What is important to acknowledge, however, is that the perpetuation of these problems is avoidable. The predetermination of roles and responsibilities is vitally important in the success of the hybrid social venture. Failure to effectively plan prior to the formation of the venture could result in conflicts such as those previously discussed. The operating agreement made at the time of formation should hold the answers to a number of questions:

1. What will be the method for determining content?
2. How will wages and the prices of products and services be determined?
3. Who make decisions about personnel?

If these questions were addressed in the situations previously presented, the conflict could have been avoided in one of two ways. If the interests of the for-profit and non-profit investors were irreconcilable, the two parties would simply agree to not enter into a hybrid social venture together. Alternatively, the two parties could anticipate possible problems and arrive at solutions before they actually arose.

Take, for example, Play it Again, the hypothetical classic movie theater. The question of who determines which movies will play should have been examined prior to an agreement being finalized. Given that the theater intends to keep showing films for an indefinite period of time, it would be overly burdensome for the two groups of investors to agree on a list of specific movies. Some classification system could be created, however, based on current popularity as measured by DVD sales or some other means. The funders could agree that a certain

number of films from each category be played every week, or every month. An agreement could be made that certain classes of films are played at certain times or on certain days. The specific structure that is chosen is of secondary importance to simply having a system to adjudicate such disputes. The price scenario could be similarly approached. The for-profit and nonprofit funders of Fresh Start, the hypothetical dry cleaning service, would have to agree not only on a wage for employees, but also how those wages will change over time to adjust to inflation and the cost of living. As long as this agreed to from the inception of the business, this type of conflict could be avoided.

The most complicated situation is the last – conflicting interests concerning personnel. If the individuals who will be running the hybrid social venture on a day-to-day basis are determined prior to complete capitalization of the organizations, funders may simply not enter into an agreement if they feel that those running the business are not qualified to do so. If this is not the case, both sides could work together to choose mutually acceptable individuals to run the business.

It is not realistic nor possible to foresee every problem that could arise within an organization. For example, in the personnel situation, it may be the case that an employee agreed upon by both sides at the beginning of a partnership leaves the organization. Finding a replacement might be problematic if the non-profit funders would prefer an individual with field related experience while the for-profit funders prefer someone with more extensive business experience even at the cost of experience working with the cause the organization is addressing.

It could very well be argued that, since every scenario cannot be accounted for in preliminary discussions between the different funders of a hybrid social venture, the problem of conflicts between the two parties will always be a problem. While it is true that conflicts may remain, the major points of contention will have been worked out at the formation of the organization, or upon the entrance of an additional funding source. Any problems that arise unexpectedly will be dealt with in the context of the previous agreements, leaving the situation to look like one that may be present in any sort of for-profit business. In any organization there are differing opinions about business decisions, for instance, who should be hired. The fact that a hybrid social venture still faces problems such as these does not indicate the incompatibility of business and nonprofit causes, especially when the magnitude of these problems is lessened by extensive planning and contracting.

Despite the expectation that adopters of the L^3C structure will construct appropriate operating agreements that attempt to balance the goals of social benefit and profitability, some, like Brooklyn Law School Professor Dana Brakman Reiser, are concerned that this

will not always be the case. She notes, "First, none of this is mandatory. The hallmark of the L^{3}C is its flexibility. An L^{3}C form allows its adopters to adopt this technique in the operating agreement but they need not undertake any mechanism to enforce their dual mission in order to adopt the form" (Brakman Reiser 2010). Brakman Reiser also suggests that since the IRS will enforce the social mission and foundation investors and will err on the side of caution so as to not incur fines, the blended enterprises will fall more on the side of being charitable than profitable. Some of Brakman Reiser's thoughts are made under the assumption that foundations' "interest in profits is either remote or nonexistent" (Brakman Reiser 2010). She notes that this might not always be the case, but sees it as the prevailing position of foundations.

While foundations should not, and cannot, under the law, have profit as their primary motive in making an investment in a hybrid social venture, it is reasonable to assume that foundations would like to see a return on their investment. Program-related investments (PRIs) in most cases would necessitate more care and attention than the distribution of a grant. If a foundation goes through this extra effort to make a PRI, then either the foundation recognizes that substantially more good can be done by making an investment or that in exchange for the extra effort, they could get a return on their investment. While the incentives of foundations to enforce the dual mission of a hybrid social venture might not be of the sort to perfectly balance profitability and social good, they could be better enforcers of the dual mission than Brakman Reiser suggests.

Brakman Reiser instead proposes that the hybrids like the L^{3}C will need to be refined over time: "Establishing some method for enforcing a dual mission either by fiat through enforcement of specialized fiduciary obligations or structurally by requiring governance rights to be cited by some appropriately incentivized group, I believe would improve the L^{3}C's claim to be a home for blended enterprise" (Brakman Reiser 2010). While, in time, regulations might be established that make the L^{3}C look more like the British hybrid social venture, the Community Interest Company, for now it seems as though L^{3}Cs have a motive to stay true to a blended mission. Err too far on the side of charity, and market-rate investors may not have an interest in the L^{3}C; err too far on the side of profit maximization and L^{3}Cs might not garner the foundation support that they need. Brakman Reiser says, "this may ultimately be a choice between enforcement and capital access," but up to this point, there has been no evidence that the two are mutually exclusive.

Financial Model

Even if business and charity can, theoretically, coexist to pursue missions that include profit and social benefit, whether these entities will be funded is another question entirely. Since the low-profit limited liability company (L^{3}C), in its ideal form, receives capital from private foundations and for-profit investors, the incentives to invest for each group becomes vitally important. If, for some reason, the structure of the L^{3}C is not conducive to investment by foundations and private investors, it will not be able to meet its intended potential and may not be a solution to the undercapitalization of traditionally nonprofit causes.

Do foundations have an incentive to invest in L^{3}Cs?

While much of the talk around the low-profit limited liability company (L^{3}C) involves foundations taking an equity stake in the entity, there are a number of ways in which a program-related investment (PRI) can be made. GrantCraft, a project of the Ford Foundation intended to provide knowledge and resources to grant writers, lists six ways in which foundations can make a PRI: common loans, certificates of deposit, linked deposits, common stock, preferred stock and loan guarantees (Carlson 2006). Using any of these methods, the best outcome for a foundation, given IRS Code restrictions, is a below market-rate return on their investment and a maximization of the social good that is accomplished by the investment. Of course, the optimal scenario may not always be the one that comes to be. Foundations must examine the opportunity costs of these PRIs to determine whether they are the best uses of the foundation's resources. A PRI could unfold in a number of ways, most of which are variations of the two scenarios outlined below.

1. **L^{3}C becomes insolvent** – This scenario assumes that an L3C that becomes insolvent has also not succeeded in carrying out its social purpose. Even if the organization produced more of social benefit than financial benefit while it was in existence, the inability to continue this social benefit in most cases means that the organization has fallen short of achieving its social purpose. The opportunity cost in this case is a grant that could have been made, or perhaps a more appropriate PRI. While it is possible that a grant might have been more successful in furthering the foundation's mission, most grants can only sustain a social benefit for a fixed amount of time before another influx of capital is needed. While a foundation should take into account the trade-off between making a PRI and awarding a grant, a situation in which a foundation, in practice, makes a grant by losing 100 percent of its investment is one that would, in all likelihood, not happen to a conscientious foundation. Foundations should plan for this scenario by securing collateral and only making PRIs in organizations that they trust. While not every PRI will be a successful one for the foundation, a properly formulated PRI will still not result in a 100 percent loss as compared to a grant.

2. **L³C produces below market-rate return** – In this case, the foundation, through a disbursement, is actually expanding its grant making capability. Since returns on PRIs must be re-distributed, more money will be cycled into socially beneficial causes either through new PRIs or grants to nonprofit organizations. Again, the investment must be examined from a programming perspective to determine if the social mission of the organization is best served by a PRI. This, however, has little to do with the financial model of the L³C. Some PRIs will have a larger impact than grants and vice versa. From a purely financial position, a well-thought-out PRI is beneficial to the private foundation.

At the inception of a PRI making program at a private foundation, there may be costs associated with training the existing foundation staff or hiring outside individuals to manage these investments. However, after the foundation has the human capital to approach PRIs confidently, the making of PRIs has the potential to expand the pool of money that foundations can disburse. For a foundation with the motivation of looking to maximize its social benefit, there is substantial incentive to make PRIs in L³Cs.

Do private investors have an incentive to invest in L³Cs?

Even if an L³C receives a program-related investment (PRI) from a private foundation, the L³C model assumes private investment from individuals or companies looking for a market-rate return. While the alternative for foundations to a below market-rate return from an L³C is a 100 percent loss, market-rate investors are choosing between investing in an L³C and a traditional business in which they can expect a market-rate return. Brakman Reiser asks the question "If I am a market-rate investor and I can invest in anything that's providing market-rate returns, why do I invest in something that's being run by a charity?" (Brakman Reiser 2010).

The first answer may be that this is an oversimplification of how most L³Cs would be run. While, in many cases, a foundation might have substantial decision making ability on the L³C's board of directors, this is not a requirement of the structure. Additionally, the foundation will not be running the company on a day-to-day basis. A team of executives will, at larger and more established L³Cs, run the company, with members of the L³C voting on major decisions. A market-rate investor likely will not invest in a company in which the management is not qualified to successfully run a business. Simply because a company is an L³C does not mean, however, that the executives lack the requisite business skills to provide the investors with a market-rate return.

Even if one concedes that an L³C is a business "run by a charity," one must not confuse a private foundation with the typical nonprofit organization. Private foundations are, in

essence, private investment funds that use some of their endowment to promote the public good. Private foundations employ individuals who are knowledgeable about investing, and, despite their charitable purpose, would also prefer to see a return on their investment. Their interest is in seeing the company succeed in its charitable and business purposes.

Another answer to why individuals and companies may choose to invest in an L³C as opposed to a traditional company with a comparable return can be found in the investor's expression of his or her preferences. Dunn (2006) proposes a model that is a variation on Markowitz's Modern Portfolio Theory and includes three factors that investors take into account: risk, return and impact. Dunn suggests that the assumption of rationality might sometimes lead to conclusions that are not supported by our actual actions which may be impacted by emotions. Taking these emotions into account, "optimization is a function of risk and return, plus a function of impact" (Dunn 2006) [Emphasis in the original].

Impact, however, is not always as easy to measure as risk and return. Each individual's preferences are distinct, so one person's optimal portfolio might not be the same as someone else's, even if they are both concerned with advancing the public good with their investments. Despite the fact that impact is difficult to express generally, it is reasonable to assume that each individual investor might take his or her preferences into account when deciding between two investments which will provide market-rate returns. If an investor with an interest in eradicating lung cancer is deciding between investing in a tobacco company with a six percent return and a company that is producing drugs for cancer patients with a comparable return, it makes sense that an investor would choose to invest in the drug company.

While it can be argued that not all investors take into account personal feelings about the companies they are investing in, human nature suggests that enough individuals will hold opinions so that there will be incentives for individuals to invest in hybrid social ventures like L³Cs. According to Dunn, "Assuming the risk and return characteristics of two portfolios are equivalent, the portfolio that is better aligned with its owner's desire for impact is a better portfolio" (Dunn 2006). Some L³Cs will undoubtedly align with the preferences of investors, attracting them to a hybrid social venture over a traditional company.

The organizational and financial structure of the L³C does not preclude it from being successful. As with all forms of business, there will be L³Cs that fail. This does not mean that the structure is unsound. The L³C is a useful tool within an arsenal of business solutions and holds the promise of success.

Chapter Four

Evaluating the L³C

The low-profit limited liability company is still in its infancy. New L³Cs are emerging every day, and with every day make possible new and innovative solutions to serious social problems. As with any new idea, there are complications that will undoubtedly arise in the course of the L³C's growth. When seeking to assess and understand the L³C structure, there is perhaps no better place to start than with the L³Cs themselves; what they are doing, how they are doing it, and with what results. These early L³Cs could set the tone for the L³C structure and predict how the form will evolve in the coming decade.

L³C Experiences

Despite the fact that the L³C legislation has only been passed in a handful of states, these companies are emerging all across the United States. The reasons for incorporating as an L³C are just as varied as their charitable purposes. While some initiators of L³Cs intended to incorporate as either an LLC or nonprofit, when they saw the L³C option on the website for their Secretary of State, they decided to choose the L³C structure (Schmidt 2010). Some of these individuals did so without full knowledge of the possibilities of program-related investments and foundation support. Many even did so without consulting an attorney (Schmidt 2010). Some incorporated with the intent of attracting capital from the private and nonprofit sectors while other L³C founders noted that simply being designated a for-profit business with a charitable purpose was all they expected to derive from the L³C structure. These companies intend to use the designation to differentiate themselves as businesses that are doing social good in their communities.

No two L³Cs are completely alike. From Vermont all the way to California, L³Cs are using the structure to further different causes in unique ways. The four profiles below examine three L³Cs that have incorporated and one nonprofit considering the structure. While all have, or expect to, benefit from the L³C structure, they have also faced real challenges as the leaders in an emerging business structure.

Radiant Hen, L^{3}C

Radiant Hen is a Vermont-based publishing company formed by a group of educators and artists. Its mission is "to publish books for children and adults that encourage good citizenship, kindness to all living things, environmental awareness and debate and raise awareness of where food comes from and sustainable agriculture." In addition to these goals, the company seeks to "incubate new, promising authors and artists, offer reasonable compensation and support to all who work for or partner with Radiant Hen and provide community service via donations of books, workshops and other services" (Radiant Hen Publishing 2009).

In 2010, Tanya Sousa, an author and one of the founders of the company, shared that, if given the chance to reincorporate, she would again choose the L^{3}C structure despite the difficulties she has faced in operating the business. Sousa has been the only person to contribute capital to Radiant Hen, although the company has been generating some revenue from the sale of its books. In fact, as of February 2010, all employees other than the authors and illustrators were working on a volunteer basis. While the company has partnered with a number of nonprofits, these relationships have been merely for the purpose of promoting the company's mission and not for bringing more capital into the organization.

Radiant Hen has sought PRIs from foundations, but as of May 2011, had not received any. Ms. Sousa laments that "foundations just do not recognize [L^{3}Cs] at this point." Still, she thinks that the L^{3}C structure has potential once foundations become aware of it. Even without foundation funding, Radiant Hen has recognized that there are benefits that come with the L^{3}C structure. According to Sousa, when she talks to people about the new business form, "their eyes kind of light up." It signals to those with whom she interacts that she is running a socially responsible company (Sousa 2010).

Univicity, L^{3}C

Univicity, L^{3}C, created by Mark Smith and Steeve Kay, was founded with the purpose of "developing and supporting software for the Humanitarian marketplace. [Its] mission [was] to develop enterprise class software as a service (SaaS) to help increase the effectiveness, efficiency and transparency of [its] client's missions." In 2010, Mr. Kay emphasized that Univicity addressed human needs, like food, shelter, medicine, clothing and literacy, rather than mere wants. In fact, Univicity had been approached to support World Vision in setting up a disaster command center for the relief efforts and transition to development in Haiti.

Steeve Kay, who is also the chairman of the Kay Family Foundation, first remembered hearing about the L^{3}C from his partner, Mark Smith, and a law firm specializing in nonprofits.

Univicity soon became the first L³C to incorporate in Wyoming, despite the fact that the company operates out of Orange County, California. At the outset, the company was associated with two nonprofit entities: it received a PRI from a private foundation (the Kay Family Foundation) and additional funding from a public charity (World Vision). There were two types of shares. The nonprofit members, which contributed capital, had A shares, and decision making authority on the board. The executives of the company received a salary and held a membership interest in the company in the form of B shares in lieu of a higher salary.

Since there was very little in the way of precedent as to how profits should be dispersed, Kay and Univicity did the best they could to interpret the low-profit nature of the structure. World Vision and the Kay Family Foundation, under the original operating agreement, received 10 percent less than the for-profit members.

Soon after the company was formed, Univicity did make an inquiry to the IRS about the status of L³Cs as Program Related Investments. When the IRS refused to rule, they decided to continue forward, confident that their charitable purpose was strong enough to qualify as a PRI. As the chair of the Kay Family Foundation, Mr. Kay recognized the benefits of making a PRI from the foundation perspective as well, saying that the arrangement would "leverage the grant making capability."

At the time, Kay acknowledged that many questions remained due to the lack precedence in the L³C structure. For example, what does "low-profit" mean? How do you strike a balance between being a business and a charity? And how is charitable purpose defined? At the product level? At the profit level? He said, "The L³Cs here, we are blazing the trail that's here and at times might push the envelope to what the IRS might see, but we don't know. We just do it. We do have the L³C and the PRI and it's not entirely in a vacuum. Some organizations will try to push the envelope. That's always there" (Kay 2010).

In early 2011, a Univicity project, Project Bonfire, spun off into a separate L³C, led by Steeve Kay. Mark Smith continues to run Univicity, L³C, albeit with a greater focus toward venture capitalism. Univicity is focusing its efforts on its investment in Transversal, a Haitian IT company working in the mobile money space. Transversal teamed with Haitian carrier Digicel to implement a mobile money platform in the Haiti Mobile Money Initiative, a contest funded by the Bill and Melinda Gates Foundation. Digicel won first prize in the competition, and Transversal and Univicity will continue to play a role in the mobile money initiative throughout 2011.

.Green Omega, L^3C

Some L^3Cs, like Jon Kidde's Green Omega, L^3C found out about the structure when starting the incorporation process on the Vermont Secretary of State website. Mr. Kidde was looking to start a nonprofit or LLC focusing on restorative justice. While Mr. Kidde does not plan on taking advantage of the possibility of program-related investments in the near future, he thinks it might be a nice option.

Even though he has not enjoyed the benefits that a program-related investment could provide, he has encountered some obstacles that are unique to the L^3C structure, at least at the current time. When Mr. Kidde was seeking insurance for his new business, he listed his company as an L^3C. The insurance companies, however, had never heard of the structure, and even when he tried to explain, failed to provide him with insurance for his business. He was instead forced to purchase personal insurance.

To solve this problem, Mr. Kidde thinks that, since the L^3C is so new, what needs to happen is for more people to start L^3Cs and for them to be successful. He believes that it will "take time for it to really be accepted." As for Green Omega's plans, Mr. Kidde has enough contract work coming into his company to keep him busy for now. In the future, he foresees opening up a community justice center that addresses alternatives to the traditional handling of crime issues (Kidde 2010).

Uncommon Good

Uncommon Good is a nonprofit organization local to Claremont, California. The organization, which was founded in 2003 by Executive Director Nancy Mintie, seeks to "break the cycle of poverty" through three innovative programs. The first two are loan repayment programs for doctors and lawyers working in low-income areas, mainly in the City of Los Angeles. The third program is the Clinic to College mentoring program, which matches disadvantaged youth ages 9-15 with members of the community who become both friends and windows to the outside world. The program also provides extracurricular and leadership opportunities to the youth to help make them more attractive college applicants.

Since the goal of the program is to provide the youth with all the resources they need to successfully graduate high school and continue on to a four-year university, Uncommon Good also provides social services to needy families in the program. This sometimes includes food, clothing, and even help in situations in which families are facing eviction.

The current economic recession has taken a toll on the families whose children are in the Clinic to College program. Many parents have lost their jobs and are struggling to make

ends meet. Even though Uncommon Good was facing the same challenges as other nonprofits in raising funds for its programs, Nancy Mintie stayed true to her goal of providing these families with the resources they needed. She decided to try another method of directing funds towards the families that so desperately needed them.

Mintie envisioned an urban agriculture project that would provide fresh local produce to the Pomona Valley, help reduce carbon emissions and provide well-paying, steady, full-time employment to Clinic to College parents. Nancy Mintie immediately started forging partnerships with local organizations to create the Pomona Valley Urban Agriculture Initiative. Despite having a solid proposal and established partnerships with organizations like the US Green Building Council and the Draper Center for Community Partnerships at Pomona College, the project was not attracting the foundation support it needed to get the project off the ground. Looking for another solution, Mintie approached the Peter F. Drucker and Masatoshi Ito Graduate School of Management at Claremont Graduate University (part of the Claremont Colleges Consortium) to provide recommendations on how they should proceed with the project. When the class at the Drucker School recommended the L^3C as a possibility for the urban agriculture project, something clicked for Mintie, who has been working in the nonprofit world for over 30 years.

She started researching the L^3C herself, and enlisted those around her, including Uncommon Good's Development Director Michael Peel and Stanford University intern Jay De La Torre to learn as much as they could about the structure to determine whether it was a feasible option for the farm. In talking to board members and other connections in the Los Angeles nonprofit scene, Mintie and Uncommon Good have found that most people are not familiar with the L^3C. Unlike some L^3Cs, which may have the ability to incorporate and operate as a small business before receiving foundation support, Uncommon Good will need an infusion of capital before beginning their project. Instead of spending the time and money now to begin an L^3C, the organization plans to wait until they can identify and partner with a foundation willing to make a program-related investment. It may take more marketing of the idea, or even the L^3C legislation being passed in California. Either way, Mintie thinks the acceptance of the L^3C structure in California is on the horizon. She plans to watch these developments closely so that she and the Uncommon Good team will be prepared as an early adopter of the L^3C structure.

These cases illustrate the flexibility of the L^3C and the interesting ideas already being put into action. Even these L^3C pioneers have questions about the structure as it stands and how it will change in the future. The answers to these questions and how this knowledge is disseminated has potential to influence and augment adoption and sustainability of L^3Cs.

Will the L^{3}C succeed in bringing additional capital to traditionally nonprofit causes?

The success of the L^{3}C will be determined by its ability to attract investment from both the private and nonprofit sectors. During these formative times when L^{3}C legislation has only been passed in a handful of states and foundation awareness is low, it is difficult to predict the long-term response and ultimate acceptance from foundations. There are signs, however, that foundations may come to embrace the L^{3}C. In October 2009, The Bill and Melinda Gates Foundation awarded a grant to SEEDR, L^{3}C, an Atlanta-based company, "to redesign and reengineer cold-chain containers used in global and domestic vaccine and disease-monitoring programs" (SEEDR, L^{3}C 2009). More recently, the Ford Foundation awarded a grant to Disruptive Innovations for Social Change, L^{3}C to "document & replicate an innovative model providing a continuum of services, including access to benefits, skills training, asset development & career development, to low-wage employees in Michigan" (Foundation n.d.).

The acceptance of the L^{3}C by foundations will be affected by three important factors during this formative time: 1) federal legislation creating the low-profit limited liability company in all fifty states, 2) the IRS's decision to extend the definition of PRIs to include L^{3}Cs, and 3) the willingness of foundations to stray from their traditional grant making practices to make program-related investments.

Federal Legislation

In 2008, Americans for Community Development drafted the "PRI Promotion Act of 2008" with the intention of passing a bill that would make program-related investments easier to make for foundations. This bill did not specifically mention the low-profit limited liability company (L^{3}C), but would have been conducive to that newly created legal structure. When the bill did not make any headway in Washington, Americans for Community Development drafted a new piece of federal legislation that they believed was more appropriate to what they were trying to accomplish. Robert Lang and Americans for Community Development believe that this piece of legislation, written by tax attorney Elizabeth Carrott Minnigh, better reflects the changes needed in the Internal Revenue Code to more easily accommodate PRIs and L^{3}Cs. The Philanthropic Facilitation Bill proposes the following amendments, among others, to the Internal Revenue code and Treasury Regulations:

1. That the qualification of low-profit limited liability companies as Program-Related Investments is presumed.

2. The inclusion of a procedure by which organizations can apply for an IRS designation that the organization qualifies as a PRI for any foundation with a shared purpose.

3. Additional reporting requirements for organizations receiving PRIs.

The bill also proposes a number of amendments to treasury regulations, including an amendment that proposes:

1. Examples of L^{3}Cs qualifying and not qualifying as Program-Related Investments (Americans for Community Development 2010).

Robert Lang is confident that Congress will address the legislation, although they may not do so until a comprehensive tax reform bill is introduced.

IRS Decision on L^{3}Cs as PRIs

In addition to the federal legislation that would facilitate the program-related investment process, there are a few other mechanisms to encourage the making of PRIs. Richard Schmalbeck, former Dean of the University of Illinois College of Law and Professor of Law at Duke University, sees three ways in which this might be accomplished. The first method is through the federal legislation. While currently foundations feel that they need to obtain private letter ruling from the IRS to approve their investments as PRIs, legislation could invert the process so that individual L^{3}Cs receive determination letters that could be used to indicate to foundations that investments in their L^{3}Cs would count as PRIs.

Alternatively, the IRS could simply change the way they handle PRIs by fast-tracking the process. If the IRS were operating under the presumption that investments in L^{3}Cs generally qualified as PRIs, then the IRS could review the requests very quickly, while still having the ability to deny requests that were not appropriate. Lastly, the IRS could decide that an L^{3}C would automatically qualify as an acceptable recipient of a PRI, although Schmalbeck characterizes this option as an unlikely scenario. Even these changes to the way the IRS operates would require some form of legislative process, which means that the assurances that foundations seek about investing in PRIs might not come quickly (Schmalbeck 2010).

Indications such as a letter from the American Bar Association Section of Taxation hold promise that when the Internal Revenue Code is examined, there will be little opposition from taxation lawyers. That letter, written in March, 2010, issued comments to Douglas Shulman, the Commissioner of the Internal Revenue Service regarding additional examples of PRIs. While the American Bar Association Section of Taxation does not endorse replacing the existing examples provided for in the code, they do believe that the additional proposed examples "reflect current grant-making philosophy and practices, international social and

economic realities, and forms of doing business that have emerged since 1972" (Lewis 2010). While these comments do not explicitly support the L^3C, they do reiterate that LLCs have become more common vehicles for PRIs in recent years and that they "believe that, if a particular loan to, or investment in, an ordinary LLC would qualify as a PRI, then, a fortiori, a loan to, or investment in, an L^3C should also qualify" (Lewis 2010). If a foundation were confident that its program-related investment fit the IRS requirements, then there is no reason to think that its structure as an L^3C would in any way violate the Internal Revenue Code.

Are foundations willing to make PRIs?

Although program-related investments (PRIs) have been in existence since 1969, they are not a widely used method of meeting the IRS's disbursement requirement for foundations. While PRIs have doubled over the last eight years, many foundations are not familiar with the concept, or are hesitant to start making PRIs. Luther Ragin of the H.B. Heron Foundation thinks that the shortage of PRIs is the product of three factors:

1. Lack of awareness among foundations about PRIs,

2. Discomfort with the underwriting of credit risk associated with PRI making, and

3. Bias that only grant making achieves high social impact (Ragin 2010).

Both Ragin and Niel Carlson agree that one problem is a lack of training of program officers at foundations and a general lack of awareness among this populace about PRIs. While these individuals are familiar with the grant making process, many are not trained to make and handle investments. While that knowledge does exist within the organization at the foundation endowment management level, that knowledge often does not filter down to those working with disbursements. If PRIs are to become more common, then these individuals will have to be trained to become capable of handling investments (Carlson 2006, Ragin 2010). Some foundations, like the H.B. Heron Foundation have been making PRIs despite these general trends.

The New York based H.B. Heron Foundation was formed in 1992 and has been an active PRI maker since 1997. The foundation's mission is "dedicated to supporting organizations with a track record of building wealth within low-income communities" which they accomplish by providing "grants and investments in organizations that promote three wealth creation strategies [home ownership, enterprise development and access to capital] for low-income families in urban and rural communities in the U.S." (H.B. Heron Foundation 2009).

Over the past 12 years, the H.B. Heron Foundation has made 77 PRIs totaling $38 million. They have accumulated approximately $4 million in income from these investments with a rate of return of 3.8 percent and a default rate just under one percent. In 2010, 30 percent of the foundation's PRI dollars were invested in an equity form with for-profit companies. While this means that the majority of the foundation's PRIs were made in the form of senior loans to mostly nonprofit organizations through intermediaries, PRIs are being made in for-profit businesses including Limited Liability Partnerships (LLPs), LLCs, cooperatives and community development banks.

Ragin contends that the structure of an entity receiving the PRI is not especially important. Even with the current laws governing PRIs, his foundation and some others have been able to use PRIs to help them advance their mission. While the current laws allow for this type of investment, the complexities of program-related investing coupled with a lack of knowledge about its benefits have limited the number that are using this tool. The H.B. Heron Foundation has made an effort to disseminate information about PRIs by founding the PRI Makers network, a group of 120 foundations "committed to best and emerging practices" (Ragin 2010). Robert Lang agrees that a new legal structure would not be necessary if all foundations had the level of understanding of the H.B. Heron Foundation. So while the current structure does not prohibit program-related investing, the L^{3}C could serve the purpose of making the option known to both foundations and nonprofit and for-profit organizations looking to produce a social good. The L^{3}C legislation could be the first step toward more widely promoting the use of PRIs and simplifying the ways that these partnerships could be accomplished. Luther Ragin recognizes that "resistance [to the use of PRIs] is lessening" (Ragin 2010).

Even if foundations are slow to adopt, alternative funding methods like Donor-Advised Funds and New Markets Tax Credits may prove successful in bringing funding to L^{3}Cs and illustrate their promise to foundations.

Will L^{3}Cs attract private investors?

The ability of low-profit limited liability companies to attract market-rate investors may depend on whether they are able to attract foundations, or other investors willing to accept a below market-rate return. As discussed previously, there is no substantial reason to think that foundations or other below market-rate investors would not invest in L^{3}Cs. Foundations or other below market-rate investors would not invest in L^{3}Cs.

[1]One of these community development banks is a B Corporation.

Additional Hybrid Alternatives

The low-profit limited liability company (L^3C) is not the only hybrid social venture in existence. Other forms do exist, although the degree to which they can be considered truly a mixture between being nonprofit and for-profit is debatable. The alternatives to the L^3C are also based on existing laws for for-profit entities: the company in the U.K. and the corporation in U.S. law. While each has it merits and also potential limitations the existence of other structures to combine social good and business will likely help, rather than hurt the cause of the hybrid social venture. With each structure, we can witness what is successful and what bears correction. Additionally, the forms below have distinct functions that have surprisingly little overlap with each other. While the L^3C might be the ideal legal entity for some organizations, these other hybrids can serve useful purposes in their own rights.

Community Interest Companies

The Community Interest Company (CIC) is a hybrid business structure in the U.K. designed to provide a social good to the public. In order for a company to register as a CIC, it must meet certain requirements. A reasonable person test is used to consider whether the activities that are being carried out are for the benefit of the community. It must complete a community interest statement detailing how it will carry out its purpose before being issued a certificate of incorporation.

The CIC was the product of the collaboration of Stephen Lloyd and Roger Warren Evans. The two men recognized that there was “no safe place for a public purpose organization that was not a charity.” This problem, paired with the rise of social entrepreneurs gave rise to idea of the CIC. According to Lloyd, it was “difficult to imbed social purposes in a legal form because there was not an off the shelf, simple to use, legal entity ready for social enterprise unless you used these Industrial and Providence Societies,” which are cooperatives. Since those laws had not been updated since the 1960s, Lloyd, then working on his own, decided to “take company law and use it in a special way,” because laws pertaining to companies have been well-maintained in the United Kingdom.

Lloyd and Evans originally planned on calling their idea the Public Interest Company, but an initiative with a similar title forced the adoption of the term Community Interest Company for their creation. After running workshops in the House of Lords and at the London School of Economics and gaining the support of then Prime Minister Tony Blair, Lloyd’s idea was turned into law in July of 2005.

Since the CIC is modeled on traditional company law, it is possible for an existing company to transition from being a company to a CIC. Unlike in a traditional company, directors of a CIC have a duty to a number of different groups: the community, the shareholders, and the creditors. The CICs are controlled by a regulator, who sets the dividend caps that are hallmarks of the CIC structure. As of April, 2010, the maximum dividend that a shareholder can collect is 20 percent of the value of their shares at the time they were purchased. The CIC also has a cap for how much it can distribute: 35 percent of the distributable profits. In this structure, capital growth stays within the business, so when a shareholder decides to sell his or her shares, he or she receives only the original investment, not adjusted for inflation. Lloyd describes the shareholders as being more like bond holders. The CIC's asset lock protects against owners taking advantage of the structure by turning it onto a traditional company to collect higher profits.

The CIC regulator, hired by the Secretary of State, has a wide range of powers and does "what is necessary to maintain public confidence in the CIC brand." This includes initiating audits, starting civil proceedings, appointing and removing directors, taking control of the property and aiding in the dissolution of CICs. Every year, CICs must submit a report detailing how it has contributed to the public benefit.

As of February, 2010 there were 3,832 CICs operating in a variety of sectors such as Education, Agriculture, and Manufacturing. CICs grew at double the rate that the British government originally expected. Even with the number of CICs that have been formed and the structure's high rate of growth over the past few years, there are still unanswered questions. For example, some, like Lloyd, think that there should be more incentives for individuals to invest in CICs, including adjusting for inflation when considering the amount of money a shareholder can get when he sells his interest in the company. Others think that the 35 percent cap on dividends is too low. More general questions may still arise about what is in the public interest. Lloyd presents a hypothetical situation in which a company producing life-saving drugs is also a major polluter. Is that company providing a public benefit in the relevant sense? The CIC has already seen changes in its structure in the five years it has been in existence, and these questions and more will likely provoke the need for further clarification or regulation in the future (Lloyd 2010).

B Corporations

The Benefit Corporation, or B Corporation, is a new certification process that indicates that a business is socially responsible. Despite what the name indicates, B Corporations do not have to be legally incorporated as corporations, although legislation has been passed in two states. Many B Corporations are LLCs and partnerships as well. According to B Lab, the

501(c)3 organization that created the certification, B Corporations are different because they "meet comprehensive and transparent social and environmental performance standards, institutionalize stakeholder interests and build collective voice through the power of a unifying brand" (B Lab 2010).

In order to become a B Corporation, a business must take the B Survey, which asks questions about "social and environmental performance" (B Lab 2010). A score of 80 out of 200 points is necessary for a business to become certified. Next, the business must update their governing documents to take into account stakeholder interests. For states in which the law does not explicitly allow companies to consider interests other than those of the shareholder, B Lab suggests that a company reincorporate in a state more amenable to stakeholder interests.

B corporations must pay an annual fee based on sales. Companies that have annual sales under $2 million are subjected to a $500 fee, while the largest fee is $25,000 for companies with annual sales over $100 million.

There are four ways in which B Lab verifies that the companies it has certified are living up to the standards proposed by the organization:

1) To become a B Corp, each company must complete a Survey Review with a B Lab staff member to make sure that all answers accurately reflect the intention of the B Ratings System.

2) When a company becomes certified, they must submit documentation for approximately 20 percent of their answers to the B Survey.

3) 10 percent of B Corporations are audited every year - So in their two-year term, all B Corporations have a one in five chance of being audited. In an audit, B Corporations are asked to validate and prove each of their answers on the B Ratings System and their compliance with the B Corp Legal Framework. Typically, the audit results in a score adjustment. If the score falls below the passing grade of 80, B Lab auditors provide a 90 day cure period to cure as well as improvement recommendations. If the audit reveals that a company has filled out the B Survey has intentionally misrepresented aspects of their business, the company's B Corporation Certification is publicly revoked.

4) Lastly, all B Corporations are required to submit a copy of their company's governing documents amended with the B Corp Legal Framework. We provide a one year period for B Corps to obtain approval from the company's board of directors and re file the amended articles with the secretary of state. (B Lab 2010).

So far, there are 255 B Corporations in 54 industries. Some well-known B Corporations include Seventh Generation and Better World Books.

How do these hybrids measure up?

One might ask whether there is a need for the B Corporation and the low-profit limited liability company (L^{3}C), or if the L^{3}C should resemble the UK's structure, the Community Interest Company (CIC). The truth is, these structures are operating within different spaces. While the proponents of each structure might be able to learn something from the others, it is not necessary for one of these solutions to prevail.

The CIC is necessarily different from the L^{3}C because it arose out of a different legal structure, the UK's Company Act. The CIC, after five years of existence, is much more regulated than the L^{3}C is now. Even at its inception, the CIC was regulated by the CIC Regulator. There are caps on the CIC that do not exist in the L^{3}C legislation. While some, like Professor Brakman Reiser, believe that the L^{3}C needs to become more regulated, the man behind the L^{3}C thinks that the beauty in this new form is the flexibility and lack of stifling regulation that is so prevalent in the nonprofit world. However, even some L^{3}C owners see some type of regulation of the L^{3}C in the near future. Some, like Univicity founder Steeve Kay think that even if some L^{3}Cs step out of line, "if you solve the problem by legislation, a policy maker will create a few more [problems] down the line" (Kay 2010). The extent to which L^{3}Cs are regulated will be discovered as time passes and more companies incorporate with the structure.

In the United States, the L^{3}C and B Corporation are being presented together as structures that are seeking to do the same thing. While each sounds like ways in which a business can structure itself legally, the B Corporation is, at its heart, a certification, while the L^{3}C is a structure centered on attracting capital. The B Corporation does not necessitate that a business have a charitable purpose as defined by the Internal Revenue Code. While some B corporations might qualify as having charitable purposes, even regular companies that meet the standards of corporate responsibility set by B Lab can attain that certification. So, the conversation in the United States need not be about which form will eventually prevail. In fact, there is no reason that an L^{3}C cannot also be a certified B Corporation. The B Lab is focused on building its brand, and the B Corporation designation might, in the next few years, be a recognized sign that a company is doing good. At this point, however, there still seems to be some confusion about what a B Corporation is in relation to the L^{3}C and traditional business structures. Only when sufficient information is made available about both the L^{3}C and B Corporation can each be recognized for the value it brings, despite the presence of the other form.

Chapter Five

Conclusion

The rules governing program-related investments (PRIs) are complex. The interaction of charity and business is new, and to many, frightening. There is a feeling of uncertainty as companies embark on this journey toward a new kind of solution to social problems.

The hybrid social venture and, more specifically, the low-profit limited liability company (L^3C), raise new challenges and force us to reexamine our beliefs about the best ways to produce social good, but when deciding whether this is a good thing, we can ask three simple questions: Is it useful? Who should use it? And will they succeed?

To the first question, the answer is yes, although not for the reason one might think. The L^3C is not useful because it allows foundations to do something they have never been able to before. It does not bring anything new to capabilities of traditional LLCs, either. What the L^3C is doing, however, is taking an under utilized capability, the PRI, and bringing it out into the open. There has been more activity and discourse around the PRI since the creation of the L^3C than ever before. In its current form, the L^3C is encouraging individuals and groups to bring private sector expertise and theory to traditionally nonprofit causes. It is encouraging innovation and, slowly but surely, showing foundations how they can evolve and have greater impact.

All of these benefits can be seen today, before changes to the Internal Revenue Code have been made, before federal legislation has been passed, and after the L^3C legislation has been passed in only a number of states. It is only a matter of time before some of these changes take place to make program-related investing a more efficient process, and when they do take place, the full usefulness of the L^3C will become clear.

Currently, many individuals and organizations are incorporating as L^3Cs in their respective states. It is not clear that all of these new L^3Cs are necessarily perfect matches for the structure. The decision to incorporate as an L^3C is a serious one, and one that should be given considerable thought. If someone is considering starting an L^3C in its current state, they should, ideally, have a foundation or private investors willing to contribute capital, or have the financial resources to successfully run a small business. Without the support of a below market-rate investor, there is no difference in the operation of the company from an LLC. When making the decision to incorporate as an L^3C, the company should make use of

an attorney specializing in nonprofit tax law when drawing up the operating agreement. L^{3}Cs should also take care to remember that they will not be receiving constant support from the foundations that make PRIs in the L^{3}C. While a foundation can infuse capital into the company so that it can begin operations, the company still must be able to make a profit without subsidization from the foundation.

The L^{3}C is not a one-size-fits-all solution to every social problem. It is not even the solution for every organization that does not fit wholly in either sector. The L^{3}C is a company, and some organizations are not prepared to run such a business. Those that should are nonprofits with revenue streams that could, after an infusion of capital, sustain the business. They are for-profit entities that cannot provide market-rate return to their investors, but provide a social benefit and a small profit. Mainly, they are organizations willing to do their research, collaborate with others, and critically examine their own ability to run a successful hybrid business.

Even if the L^{3}C is a good idea, and a number of organizations would fit into the space that the legal entity creates, it will only be a success in the long run if foundations, nonprofits, private investors and individuals with ideas about ways to do good accept the structure. Although there is more and more talk about the L^{3}C every day, not all of it is accurate, and not all of it is positive. It would be strange if such an idea combining business strategies with nonprofit causes did not arouse some suspicion, but these criticisms could affect how the L^{3}C is accepted by the general public once the form gains popularity. Recently, Rush Limbaugh lambasted the L^{3}C on his radio show, misidentifying it as the low-profit limited liability corporation. He criticized the Maine farmers who run MOO Milk as socialists for accepting a government grant as capital for their L^{3}C (Limbaugh 2010). In some states in which the L^{3}C legislation is in consideration, vocal opponents have come out against the form.

The best way for the L^{3}C to respond to these attacks is to spread awareness about the structure and what it does and does not do. Americans for Community Development is a lean organization with limited resources which makes it difficult to promote the structure, advise L^{3}Cs, and respond to questions and criticisms. There is, however, a team of dedicated individuals working to educate the public about the L^{3}C and suggest new and creative ways to use the structure to do good. In February of 2010, some of these individuals were brought together at the Vermont Law Review Symposium, hosted by Vermont Law School in South Royalton, Vermont, which focused largely on the low-profit limited liability company. As the L^{3}C gains more supporters in cities across the country, it will be easier to educate the relevant groups that might be interested in the L^{3}C.

In the mean time, the best way for the word to spread about the L^{3}C would be for existing L^{3}Cs to be successful. If the pioneering L^{3}Cs are accomplishing great social good and operating as profitable businesses, people will take notice. Even in the first few years of the structure, L^{3}Cs are engaging in interesting projects that have the possibility of setting the tone for others to come. As Robert Lang realizes and we have often heard, it is only a matter of time.

Acknowledgements

I owe many people great thanks for making this paper possible. First, I would like to thank Phillip William Fisher of Mission Throttle, L3C. If not for his generosity, this paper would only be known to a few individuals. I greatly appreciate his passion for this topic, and his support in bringing this paper to a wider audience.

Next, I'd like to thank Robert Lang, for introducing me to the L3C and a network of incredible individuals working together to solve important problems with this exciting new structure. I appreciate not only his vision and creativity, but his willingness to take the time to share his knowledge with others.

I owe my gratitude to Professor William Ascher, who first oversaw the writing of the original version of this paper at Claremont McKenna College. In August of 2009, I walked into his office asking him to advise the thesis of a student he did not know on a topic no one else wanted to read. I am incredibly grateful that he said yes, allowing me to spend a year writing on a topic I care deeply about. This paper would not have been possible without his guidance and support.

I would also like to thank the following people for sharing their knowledge and experiences: John Andrews, Ed Briscoe, Sue Feldman, Michael Hurley, Steeve Kay, John Kidde, Mark Smith, Tanya Sousa and the organizers of the 2010 Vermont Law Review Symposium. Thank you to Nancy Mintie, Michael Peel, Shelley Randles, Carlos Carrillo and Nancy Dufford of Uncommon Good for showing me firsthand why structures like the L3C are important.

I would like to thank my friends and family for their love and support. They have always encouraged me to follow my passions and to try to help others. Anything I do, I owe to them. Lastly, I would like to thank my grandparents, Clayton and Judy Anderson, for making my time at Claremont McKenna possible. They were two of the most wonderful people I have ever had the pleasure of knowing, and they are forever in my heart.

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Americans for Community Development Position Papers

The L3C creates a new paradigm for the execution of solutions to social problems. Almost everyone agrees that the present solutions leave something to be desired but many are reluctant to embrace new concepts like the L3C because of lack of information, fear of the unknown, or unwillingness to take the risk. We hope that this and other papers to follow will provide the information needed, for those contemplating the structure, to become more informed. We are grateful to Roxanne Phen for taking on the assignment of writing the first paper in this series and trying to cover the entire spectrum of the issues.

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Americans fo Comunity Development was created ifor the purpose of fostering the passage of L3C legisation and the organizition of the support services needed to help individuals and organizations incorporate and manage L3Cs. Membership is available to anyone who wishes to support the L^3C. Our founder and creator of the L3C Robert Lang said the L3C is *The for profit with the nonprofit soul.* It is our mission to try to make sure that all L^3Cs that are organized operate in that spirit.

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THE MISSISSIPPI BAR

Spring 2010

Volume 1, Issue 1

The Mississippi

Business Law

Reporter

A Publication of Business Law Section of The Mississippi Bar Association

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Alphabet Soup: Low-Profit Limited Liability Company (L^3C)

By David M. Allen, Esq.

INTRODUCTION

Over the past several years, an entity known as the low-profit limited liability company, or "L3C", has entered the business realm. This new hybrid non-profit/for-profit form of limited liability company first saw light of day in Vermont following the enactment of House Bill 0775 on April 30, 2008. Legislation authorizing the L3C was conceptualized by Robert M. Lang, Jr., CEO of Mary Elizabeth & Gordon Mannweiler Foundation. It was Lang's idea to streamline the process of obtaining approval for grants and donations made by non-profit, charitable foundations for what are known as Program Related Investments ("PRI"). With the help of Marcus Owens of the Caplin & Drysdale law firm, legislation was drafted and then submitted to the Vermont legislature. Since that time, several states have passed, or have considered, legislation designed to authorize the use of this unique funding vehicle. *See* "Status of L3C Legislation" below. This article will address some of the unique elements of the L3C, briefly review the federal response, suggest possible uses for the L3C, and reasons why L3C legislation should be considered in the State of Mississippi.

ATTRIBUTES OF L3C'S

The L3C is a hybrid of for-profit and non-profit entities, blending the attributes of both organizations in a limited liability company format. The Vermont L3C model differs from the standard limited liability company in several ways. First, an L3C's operating agreement must set forth the primary business objectives as one or more charitable or educational purposes, as defined by Section 170 of the Internal Revenue Code ("I.R.C."). Additionally, the term "low-profit" (the third "L") must appear in the title to serve as notice that the entity is motivated first and primarily by a social mission, but not necessarily to the exclusion of making money.

L3C's are designed to address funding-related challenges of non-profit, eleemosynary entities, providing a vehicle to support charitable missions with market-oriented methods. One of the major benefits would be qualification of the new entity to receive PRI treatment under Section 4944 of the I.R.C. The Vermont legislation was specifically designed such that it would mesh with existing Internal Revenue Service ("IRS") regulations relevant to foundations making program-related investments.

L3C'S IN VERMONT

Deborah Markowitz, Vermont's Secretary of State, describes the L3C on Vermont's corporate division website as a cross between a non-profit organization and a for-profit organization but with charitable or educational goals. In order to qualify as an L3C in Vermont, Vermont Stat. Ann. Title 11, § 3001(27) requires that:

> 1. The company significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170(c)(2)(B), and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable and educational purposes.
>
> 2. No significant purpose of the company is the production of income or appreciation of property; provided, however, that the fact that a person 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.
>
> 3. No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS Code of 1986, 26 U.S.C. Section 170(c)(2)(D).

According to Gene Takagi ("Takagi"), a California non-profit attorney and contributing editor and publisher of the Nonprofit Law Blog, the initial L3C was L3C Advisors, L3C, which

was organized for the purpose of helping others to set up and obtain funding for L3C's. Takagi has noted that there are slight differences in the enabling legislation in several states. For example, Illinois and Utah amended their individual limited liability company acts to allow for the creation of L3C's as hybrids of standard non-profit and for-profit entities. North Dakota, on the other hand, amended its code relating to limited liability companies to expressly allow for the creation of non-profit limited liability companies.

FEDERAL APPROACH

It is estimated that private letter rulings from the IRS concerning a PRI can cost as much as $50,000 or more. The fees, together with the amount of time necessary to receive a private letter ruling, make this an extremely inefficient way to deal with and obtain PRI approval. It was the intent that the L3C would become a structure for easy-to-make PRI's, in that they would be built on the limited liability structures currently in place in all fifty states and by providing a flexibility of membership in organizations needed to cover a wide variety of social enterprise situations that has arisen in America.

On the federal level, Takagi reports that following the passage by Vermont of its L3C enabling legislation, Robert M. Lang, Jr., together with Robert Collier, President and CEO of the Council of Michigan Foundations, and Steve Gunderson, President and CEO of the Council on Foundations, worked with congressional leaders to introduce a federal L3C bill. This bill, originally entitled The Program-Related Investment Promotion Act of 2008, was intended to facilitate PRI's by private foundations through an amendment of Section 4944(c) of the I.R.C. Basically, the legislation would provide a safe-harbor process which would expedite and streamline the approval process. In addition, it would establish a rebuttable presumption that below-market rate investments in L3C's by private foundations would be deemed PRI's.

To accomplish this, the proposed act included:

1. A Determination Process, establishing a process whereby an entity seeking to receive PRI's could receive a determination by the IRS that below-market foundation investments would qualify as PRI's. Foundations would continue to rely on this IRS determination until revoked.

2. A Rebuttable Presumption, establishing that below-market foundation investments would qualify as PRI's. The L3C would have a stated purpose to achieve a charitable objective, with profit a secondary goal. The L3C must be organized and operated at all times to satisfy the IRS requirements for PRI's and, thus, to qualify as a recipient thereof. The L3C's proposed structure would allow members to make different types of investments with varying levels of risk, with the highest-risk investments being borne by the PRI's and the hope that non-charitable investors would earn market returns at acceptable levels of risk thereby bringing new pools of funds to bear on social issues traditionally addressed by non-profits.

This legislation died in Congress in 2009.

FUNDRAISING CHALLENGES

Those who have served on boards of non-profit foundations and charitable organizations realize that fundraising is a continuous problem for nearly all non-profits. In today's economy, the problems are exacerbated. Many in the non-profit world would say that their hands are tied as a result of federal tax laws that restrict non-profits from accessing traditional forms of equity and, therefore, these entities must rely on grants, governmental support, and, to a limited extent, fees arising from services provided. Some non-profits have turned to separate social enterprise business guidelines as an additional way in which to raise funds. The problems are aggravated in that federal tax laws either restrict or prohibit non-profits from accessing traditional forms of capital, as well as limiting commercial debt.

A for-profit entity with a charitable desire or with social goals faces similar challenges. The IRS restricts private business entities from accessing foundation grants and government assistance. Investors almost always expect market rate returns on investments. Obviously, these expectations do not align well with the non-profit sector. The L3C is an effort to bridge the gap between the profit and non-profit sectors, with the result that it would eliminate the need for investment minded entrepreneurs to either choose between for-profit and non-profit business models or create and manage both.

PRI'S AND L3C'S

Those familiar with Sections 4940 through 4949 of the I.R.C., which deal with private foundations, will recognize that the Vermont L3C requirements closely track the provisions of I.R.C. Section 4944(c) of the I.R.C., which establishes PRI's as a safe-harbor exception to taxes imposed on investments which jeopardize charitable purposes of foundations. If the investment fails to satisfy the requirements necessary to be granted the exception, a tax, equal to 5% of the amount so invested for each year, is imposed. Additionally, the foundation's manager, who normally is responsible for the investment, is liable for an additional 5%. There are additional adverse consequences on both the foundation and its management if, once the foundation investment is determined to be in jeopardy and is not immediately removed, then the tax is levied.

PRI's are at the heart of the L3C structural concept. The Ford Foundation made the initial PRI in 1968. Thereafter PRI's were authorized pursuant to the Tax Reform Act of 1969, which allows a PRI to be an investment that a foundation makes in a non-profit or for-profit venture to support a charitable purpose, but with a potential for return of the foundation's capital over a period of time. PRI's can be any type of investment vehicle such as a loan or loan-guaranteed line of credit, asset purchase, or covers a grant or active investment. Foundations can even use PRI's to meet their federally-mandated 5% minimum payout obligation. Such investments must meet the three–prong test under Section 4944(c) of the I.R.C. in order to qualify. Specifically, they must possess the following characteristics: (a) primary purpose to further tax-exempt objectives; (b) production of income cannot be a significant purpose; (c) cannot be used for political lobbying or campaigning.

POSSIBLE L3C USES

Several uses for the L3C entity have been suggested. Takagi recently reported on a proposal from North Carolina, a state with its furniture manufacturing industry suffering from increased global competition. This proposal would have L3C's buy factories in the state, modernize them, and then lease them to furniture manufacturers at a low rate. Citing Robert Lang of the Mannweiler Foundation, Takagi further suggests a multi-tiered L3C structure, allowing various entities to meet charitable or social goals or internal rate-of-return requirements. Another possibility for L3C use was highlighted by Takagi's report on an article by Sally Duros as reported in Huffington Post issues of February 9 and February 26, 2009. Therein, Duros proposed federal regulations which would make newspapers eligible for PRI's by expanding charitable purpose definitions to include newspapers. Again, according to Takagi's report, the goal would be a newspaper as a self-sufficient entity, not as a high-profit entity. Another use reported by Takagi again concerns Marc Lane's recommendation that L3C investors can offer low-interest loans to needy students, finance low-income housing projects, provide credit to disadvantaged business owners, combat community deterioration, and help alleviate other social strains.

Cassady V. Brewer, a partner in the Tax, Exempt Organizations, and the Wealth Planning Practices section of Morris, Manning & Martin, LLP, in Atlanta, has written and spoken extensively on the L3C. In a presentation entitled "THE L3C: A FOR-PROFIT WITH A NON-PROFIT SOUL", Mr. Brewer suggests recent trends that seem to favor utilizing L3C's. Brewer suggests that L3C's capitalized with PRI's have a tremendous potential to fill the desire to grow social enterprise organizations. He also cites several IRS private letter rulings that suggest that such program related investments would work. *See* PLR 200603031 (I.R.S. 2005) and PLR 200610020 (I.R.S. 2005).

Several commentators, including Brewer, have suggested a multi-layered structure for membership in the L3C, similar to Takagi's approach mentioned above. The initial layer would be the founders of the entity. The middle layer would be tax-exempt charities or private foundations. The final tier would be for-profit organizations with a requirement for a rate of return.

OPPOSING VIEWS

As with most things, there are opposing views as to the need for L3C's. J. William Callison, a partner at Faegre & Benson, LLP, in Denver, addressed L3C's in the American Bar Association's Business Law Section Blog in November and December of 2009. In his article entitled "*Non-Binding Opinion, L3C's: Useless Gadgets?*", Callison opined that L3C's are useless gadgets, adding nothing to the LLC package and which run the risk of giving "unsuspecting users the unfounded belief that difficult tax problems have been solved." His objections are that, with the failure of Congress to pass

the Program Related Promotion Act, no special presumptions concerning PRI treatment have been adopted on a federal level. Says Callison: "Thus, L3C's are in no better position to receive PRI treatment that the LLC's out of which they emerged. LLC's are already flexible entities and nothing prevents an LLC from receiving a PRI when its articles of organization and operating agreement provide for the LLC to significantly further a charitable or educational purpose and for no significant purpose of the LLC to be income production or property appreciation."

Cassady Brewer has also raised concerns. He feels that reliance on the L3C entity alone will not ensure that a foundation has made a valid PRI. He further opines that only compliance with federal law, not a state L3C statute, will ensure that a PRI is valid. Until there is active support by the federal government, uncertainties will remain a factor in decisions. The Program-Related Investment Promotion Act of 2008, as cited above, would have allowed this by creating a safe harbor for PRI's. However, this has not passed.

ARE L3C's WORKABLE IN MISSISSIPPI?

Mississippi would seem ripe for adoption of the L3C entity. Of particular interest would be the utilization of such multi-tiered entities in rebuilding after natural disasters such as hurricanes on the Gulf Coast or floods or tornadoes in all parts of the state. It is interesting to note that several entities which arose or were established after Hurricane Katrina were able to achieve their social objectives through a partnership of non-profit organizations and profit organizations. An additional result has been facilitated by corporate entities wishing to take advantage of New Market Tax Credits, which has resulted in the development of downtown Jackson, i.e., King Edward Hotel. Had Mississippi had enabling legislation for the L3C, this might have been the vehicle for these transactions.

The question that remains for Mississippi legislators, as well as those dealing with LLC's, is whether amending Mississippi's Limited Liability Company Act to provide for L3C's would be beneficial. Although there appears to be ample opportunities to achieve certain social objectives in certain areas of the state, the jury is still out. As Callison stated, it is possible to tailor an existing LLC for social purposes and, through proper compliance with state statutes and federal tax regulations, to qualify the entity for PRI's. However, it is good to know that such a tool exists and, should the need arise, that it could be adopted fairly quickly and put into effect.

STATUS OF L3C LEGISLATION

Arkansas: Introduced as House Bill 2102; subsequently withdrawn and submitted for study by Joint Interim Committee on Insurance & Commerce-House.

Crow Indian Nation: Legislation adopted January 13, 2009.

Illinois: Enacted August 4, 2009 and will take effect January 1, 2010

Michigan: Legislation signed January 16, 2009, as MCL § 450.4102(M).

Missouri: House Bill 817 introduced February 19, 2009; referred to Special Standing Committee on General Laws. Voted do pass (H); no further action reported.

Montana: In 2009, introduced as House Bill 235. Died in standing committee on April 28, 2009.

North Carolina: Senate Bill 308 passed Senate in July 2009 and sent to North Carolina House for consideration.

North Dakota: Legislation adopted in 2009 as Nonprofit Limited Liability Company Act, N.D. Cent. Code, § 10-36-01 et seq.

Oregon: Legislation pending.

Oglala Sioux Tribe: Legislation adopted July 2, 2009.

Tennessee: Legislation pending.

Utah: Legislation signed March 23, 2009. Utah Code Ann. § 48-2c-102 et seq.

Vermont: Legislation signed April 30, 2008. Vermont Stat. Ann. Title 11, § 27 (2009).

Wyoming: Legislation signed February 26, 2009, eff. July 1, 2009. Wyo. Stat. Ann § 17-15-102 et seq.

The following sources were utilized for this article:

1. Gene Takagi, Esq., various posts, The Nonprofit Law Blog, www.nonprofitlawblog.com (Used with permission of Mr. Takagi).

2. J. William Callison, Esq., "NONBINDING OPINION: L3C'S: USELESS GADGEST", American Bar Association, volume 19, number 2, November/December 2009 (Used with permission of Mr. Callison).

3. Cassady Brewer, Esq., presentation entitled "A FOR PROFIT WITH A NON PROFIT SOUL" (Used with permission of Mr. Brewer).

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ABA Business Law Section, on behalf of its committees on LLCs and Nonprofit Organizations, opposes legislation for low profit limited liability companies (L3Cs)

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Publication Information
Professor Kleinberger posts this document as the chair of the L3C Review Subcommittee of the Committee on Limited Liability Companies, Partnerships and Unincorporated Entities. The letter and attachment were principally drafted by that Subcommittee and sent to Minnesota Representative Steve Simon on April 19, 2012.

Repository Citation
Kleinberger, Daniel S., "ABA Business Law Section, on behalf of its committees on LLCs and Nonprofit Organizations, opposes legislation for low profit limited liability companies (L3Cs)" (2012). *Faculty Scholarship.* Paper 228.
http://open.wmitchell.edu/facsch/228

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ABA Business Law Section, on behalf of its committees on LLCs and Nonprofit Organizations, opposes legislation for low profit limited liability companies (L3Cs)

Abstract
This document comprises a letter and attachment "submitted by the ABA Business Law Section on behalf of its Committee on Limited Liability Companies, Partnerships, and Unincorporated Entities and its Committee on Nonprofit Organizations … and states our views on … a bill 'relating to limited liability companies [and] providing for the creation and operation of low-profit limited liability companies.'" The letter and attachment "have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the policy of the ABA."

Supported by detailed analysis of both tax and LLC law, the letter makes the following major points:

- The L3C is no better than any other business form for receiving program related investments from private foundations. L3C legislation implies otherwise and we believe is therefore misleading.
- Using a program related investment as part of the type of tranched financing promoted by L3C advocates portends serious risk of improper "private benefit" – i.e., using charitable assets to the benefit of private interests such as for-profit investors. "Private benefit" transactions are improper for a private foundation and imperil a foundation's tax-exempt status. A private foundation cannot remain qualified as a tax-exempt charitable entity if the foundation has transgressed the private benefit doctrine.
- In addition:
    - enacting L3C legislation inadvertently but dangerously signals that state law can streamline and simplify compliance with federal tax law requirements and that program related investments can be accomplished simply, quickly, and almost "off the rack;"
    - it is inappropriate and unnecessary to use state entity law to provide a new and potentially misleading "brand" to mark private business ventures as socially beneficial;
    - the L3C legislation contains a technical flaw that renders the legislation self-defeating in most instances; and
    - current LLC law already permits the type of ventures contemplated by the L3C legislation.

Keywords
low profit limited liability company, L3C, hybrid, social justice, benefit corporation, business, ABA, American Bar Association, Business Law Section, LLC, limited liability company, tranched, program related investment, PRI, social benefit, jeopardizing investment, moral capitalism, private foundation

Disciplines
Corporation and Enterprise Law | Organizations

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April 19, 2012

The Honorable Steve Simon
Assistant Minority Leader
Minnesota House of Representatives
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100 Rev. Dr. Martin Luther King Jr. Blvd
Minneapolis, MN 55155-1298

Re: House File No. 2702 – Low Profit Limited Liability Companies (L3C)

Dear Representative Simon:

This letter is submitted by the ABA Business Law Section on behalf of its Committee on Limited Liability Companies, Partnerships, and Unincorporated Entities and its Committee on Nonprofit Organizations ("the Committees") and states our views on House File No. 2702, a bill "relating to limited liability companies [and] providing for the creation and operation of low-profit limited liability companies." ("the L3C legislation" or "the legislation"). Attachment A explains our views in detail. This letter and Attachment A have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the policy of the ABA.

We recognize that many people of good will are seeking methods to increase the flow of capital to socially beneficial business enterprises. As part of that effort, the proponents of L3Cs argue that the L3C provides a new vehicle to increase that capital flow:

- by facilitating the leveraging of federal tax benefits,
- through obtaining funds in the form of tax-favored, program related investments ("PRIs"),
- from heavily regulated charitable private foundations whose assets are obtained and maintained under the aegis of federal tax benefits.

We have carefully studied the L3C legislation and relevant federal tax law and have concluded that, under current federal tax law:

> ***The L3C is no better than any other business form for receiving program related investments from private foundations. L3C legislation implies otherwise and we believe is therefore misleading.***

Using a program related investment as part of the type of tranched financing promoted by L3C advocates portends serious risk of improper "private benefit" – i.e., using charitable assets to the benefit of private interests such as for-profit investors. "Private benefit" transactions are improper for a private foundation and imperil a foundation's tax-exempt status. A private foundation cannot remain qualified as a tax-exempt charitable entity if the foundation has transgressed the private benefit doctrine.

L3C legislation is completely ineffective in providing advantages over any other legal form of business organization in obtaining PRIs, and is, moreover, at odds with precisely those aspects of the federal tax law which the L3C legislation seeks to invoke.

L3C advocates heavily promote a particular type of "tranched investment" structure as a core benefit of the L3Cs,[1] but this structure is dangerous for any private foundation. In the tranched investment structure promoted by L3C advocates, a private foundation makes a high-risk/low-return investment, which enables the recipient organization to offer attractive terms to one or more other "tranches" of for-profit investors. Although the recipient organization may itself have socially beneficial purposes, by definition one of its purposes is to provide profit for the for-profit investors (including above market rates for the top "tranche" of investors).

Thus, the tranched investment structure commingles assets from private foundations with capital investments from private profit seekers and inevitably uses charitable assets to confer "private benefit" on the for-profit investors in the recipient organization. If, qualitatively and quantitatively, those benefits are not merely incidental to furthering exempt (i.e., charitable) purposes, the risk to the investing private foundation is extreme – i.e., loss of its tax exempt status.

The same concerns would exist if an ordinary limited liability company ("LLC") or a for-profit corporation were to deploy private foundation funds in a tranched investment structure. The special danger of L3C legislation is that enactment gives a misleading state-government imprimatur to a structure that: (i) does nothing distinctively beneficial to accomplish its purported goals; and (ii) to the contrary, may mislead unsophisticated people of good will into significant federal tax problems. The tranched investment structure is apt to be promoted as having been approved by any state legislature that adopts L3C legislation.

In addition, we note that: (i) enacting L3C legislation inadvertently but dangerously signals that state law can streamline and simplify compliance with federal tax law

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[1] See, e.g., Americans for Community Development, "What is an L3C?" at http://www.americansforcommunitydevelopment.org/downloads/What%20is%20the%20L3C-101010.pdf (last visited June 27, 2011) ("The L3C facilitates PRI investment without the need for IRS private letter rulings. It also facilitates tranched investing with the PRI usually taking first risk position thereby taking much of the risk out of the venture for other investors in lower tranches. The rest of the investment levels or tranches become more attractive to commercial investment by improving the credit rating and thereby lowering the cost of capital. It is particularly favorable to equity investment. Because the foundations take the highest risk at little or no return, it essentially turns the venture capital model on its head and gives many social enterprises a low enough cost of capital that they are able to be self sustainable.")

requirements and that program related investments can be accomplished simply, quickly, and almost "off the rack;" (ii) it is inappropriate and unnecessary to use state entity law to provide a new and potentially misleading "brand" to mark private business ventures as socially beneficial; (iii) the L3C legislation contains a technical flaw that renders the legislation self defeating in most instances; and (iv) current LLC law already permits the type of ventures contemplated by the L3C legislation.

For all these reasons, we respectfully urge you to oppose House File No. 2702.

On behalf of the Section and our Committees, thank you for considering our views on these important issues. If we can provide any further information (including testimony), please contact Scott Ludwig, Chair of our Committee on Limited Liability Companies, Partnerships and Unincorporated Entities at sludwig@babc.com or (256) 517-5149 or Michael Malamut, Chair of our Committee on Nonprofit Organizations at michael@michaelmalamut.com or (781) 329-9096.

Respectfully submitted,

Linda J. Rusch
Chair, ABA Business Law Section

cc: Scott Ludwig, Esq.
Michael Malamut, Esq.
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Appendix A
In re: Minnesota House File No. 2702

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I. General Background – LLCs and L3Cs

Over the past 25 years, the LLC has become the dominant form of legal entity for business organizations whose ownership interests are not publicly traded. For example, last year in Minnesota, 5965 new corporations were incorporated, while 24,923 new LLCs were organized.[2]

L3C legislation seeks to establish a special form of LLC, known as the *low profit limited liability company* ("L3C"). Typical L3C legislation provides that an LLC designated as an L3C must: (1) significantly further a charitable purpose; (2) have no significant purpose of producing income or the appreciation of property; and (3) not engage in lobbying.[3]

L3C advocates assert that the L3C will further socially constructive goals by facilitating cooperation between non-profit and for-profit enterprises – in particular by encouraging private foundations to invest charitable funds in L3Cs which will leverage those funds to attract for-profit capital investments or otherwise provide financial support to a business enterprise with for profit owners. The fulcrum of the L3C concept is a component of federal tax law – the program related investment (PRI).

The leverage advocated for the L3C is a particular type of tranched investing – an arrangement in which a private foundation makes a high-risk/low-return investment, which enables the recipient organization to offer attractive terms or otherwise provide investment enhancement to one or more other "tranches" of for-profit investors. L3C advocates assert that this combination of capital enables the socially beneficial enterprise to pursue both self-sufficiency and the enterprise's social goals.

II. Tax-Based Strictures on Private Foundations – In General

Private foundations enjoy tax-exempt status.[4] In return, they face comprehensive and complex tax requirements designed to: (i) preclude diversion of charitable assets to non-charitable purposes or private persons;[5] (ii) deter investment of charitable assets that might jeopardize a foundation's charitable purpose;[6] (iii) require each foundation annually to make a specified minimum distribution in furtherance of the foundation's charitable purpose;[7] and (iv) permit the required minimum amount to be met, in part or in

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[2] Source: spreadsheet provided April 2, 2012 by the Office of the Secretary of State of Minnesota.inser

[3] L3C statutes also typically provide that the production of significant income or appreciation is not itself conclusive of a purpose to do so. In other words, if the LLC makes a great profit, disqualification under the state definition does not result automatically.

[4] IRC § 501(a).

[5] See the authorities cited in note 8.

[6] Treas. Reg § 53.4944-1.

[7] IRC § 4942.

whole, through tightly controlled and carefully considered investments in for-profit enterprises when the investment is designed to further the investing foundation's charitable purpose.[8]

For the purposes of making a tax-based analysis of L3Cs and tranched investing, the following concepts are the most important: (i) private benefit; (ii) jeopardizing investments; (iii) PRIs; and (iv) expenditure responsibility.

With regard to each of these concepts, the L3C provides no special benefit whatsoever. With regard to several of these concepts, tranched investing can be dangerous or fatal to a private foundation's tax exempt status. In all events, PRIs always require careful of planning and design plan specially tailored to the charitable purpose of the investing foundation.

III. The Prohibition of Private Benefit

A. In General

A prohibition on non-incidental "private benefit" overarches every aspect of a private foundation's operations and programs.

> After extensive hearings in 1969, Congress singled out "private foundations" from the tax-exempt population and subjected them to a series of intricate restrictions of unprecedented severity, which are buttressed by extensive reporting requirements…. [T]he underlying policy apparently is that additional regulation of foundations is required to ensure that their income and assets are not used inconsistently with the basic premise of the charitable deductions and exemption--that the deducted and exempted amounts should be used for public rather than private benefit.[9]

Private benefit is prohibited unless merely incidental to furthering the foundation's exempt purposes.[10] A private foundation that breaks the rule against private benefit risks a draconian penalty - loss of the foundation's tax-exempt status.[11]

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[8] §53.4942(a)-3(a)(2)(i).

[9] Boris I. Bittker and Lawrence Lokken , Federal Taxation of Income, Estates and Gifts, § 101.1 (available at 1997 WL 440016 (W.G.&.L.) (current through 2011

[10] Better Business Bureau v. United States, 326 US 279, 283 (1945) ("[T]he presence of a single non-[exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes.'). Universal Church of Jesus Christ, Inc. v. C.I.R. T.C. Memo. 1988-65, 1988 WL 12612 (1988) ("The regulations under section 501(c)(3) not only require an organization to be operated for one or more exempt purposes, but require that organization to be 'operated exclusively' for such purposes. Sec. 1.501(c)(3)-1(c)(1), Income Tax Regs. However, 'An organization which engages in nonexempt activities can obtain and maintain exempt status so long as such activities are only incidental and less than substantial.' Church in Boston v. Commissioner, 71 T.C. 102, 107 (1978)."). See also United Cancer Council, Inc. v. Comm'r, 165 F3d 1173, 1179-1180 (1999) (Posner, J.) ("The usual 'private benefit' case is one in

B. Private Benefit and the L3C

Any comingling of for-profit goals and charitable assets inevitably raises the specter of improper private benefit. Despite claims to the contrary, the L3C structure contains no "magic bullet" for this problem. To the contrary, nothing in the L3C structure prevents private benefit. An L3C is a low profit limited liability company, not a "no profit" limited liability company. Moreover, the L3C legislation does not prevent an L3C from shucking its L3C status and becoming a "profit above all" LLC.

An L3C operating agreement can be structured to avoid that transformation, but the operating agreement of an ordinary LLC can do likewise – even to the extent of granting a non-member a veto right over any change in the socially beneficial mission of the LLC.[12]

In any event, the mixing of for-profit (even low profit) motives with charitable purposes requires nuanced thinking, thoughtful planning, and expert professional advice. When private benefit is possible, the stakes are very high. A private foundation that transgresses the prohibition on private benefit risks its very existence as an exempt organization.

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which the charity has dual public and private goals … and … the board of a charity has a duty of care, just like the board of an ordinary business corporation and a violation of that duty which involved the dissipation of the charity's assets might support a finding that the charity was conferring a private benefit, even if the contracting party did not control, or exercise undue influence over, the charity."). See also Boris I. Bittker and Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 100.4 INUREMENT OF EARNINGS TO PRIVATE INDIVIDUALS, 1997 WL 440011 (footnotes omitted) ("The IRS has, in recent years, given increased attention to compensation arrangements between exempt hospitals and physicians. For example, in 1992, it noted that some hospitals claiming exemption under § 501(c)(3) 'have formed joint ventures with members of their medical staff and sold to the joint venture the gross or net revenue stream derived from the operation of an existing hospital department or service for a defined period of time.' Such an arrangement jeopardizes the exemption, according to the IRS, because it 'causes the hospital's net earnings to inure to the benefit of private individuals (the physician investors),' the "private benefit flowing from the transaction 'cannot be considered incidental to the public benefits received,' and the arrangement may violate federal law.").

[11] IRC §§ 4941-4945.

[12] See e.g. Revised Uniform Limited Liability Company Act ("Re-ULLCA"), § 112(a) ("An operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition."); Del. Code Ann. tit. 6, § 18-101(7) ("A limited liability company agreement may provide rights to any person, including a person who is not a party to the limited liability company agreement, to the extent set forth therein."). Neither Re-ULLCA nor the Delaware LLC Act require an ordinary LLC to have a for-profit purpose. Re-ULLCA, § 104(b) ("A limited liability company may have any lawful purpose, regardless of whether for profit."); Del. Code Ann., tit. 6, § 18-106(a) (providing that "[a] limited liability company may carry on any lawful business, purpose or activity, whether or not for profit"). Even under an LLC statute that requires a business purpose, that requirement does not prevent LLC owners from agreeing to mix social benefits with their business or from agreeing to operate their business in a socially beneficial way.

Thus, the notion that the L3C is superior to the LLC in dealing with the issue of private benefit is unfounded and misleading. Whatever type of organization is used, there is no quick fix and no simple way out. "Off the rack" solutions are recipes for disaster.

C. Private Benefit, the L3C, and Tranched Investing

As extolled by L3C proponents, the tranched investment mechanism is a multiple-tiered investment strategy under which the foundation makes an investment in an L3C with the highest risk and lowest return. This capital permits an L3C to leverage the foundation's investment to attract other investors for other investment tiers at a lower risk and higher return.[13]

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[13] *E.g.*, The Florida Senate Committee on Commerce, An Overview Of Low-Profit Limited Liability Companies (L3Cs), Issue Brief 2011-210 (Oct. 2010), http://www.flsenate.gov/Committees/InterimReports/2011/2011-210cm.pdf ("Ideally, the structure of an L3C allows for three tranches of investment; the equity tranche, the mezzanine tranche, and the senior tranche. The first level of investment, the equity tranche or junior tranche, consists of investors that seek little or no returns on their contribution. For L3Cs, equity tranche investors are likely to be private foundations making program related investments (PRIs) as they are prohibited by federal regulations from contemplating a financial return as their motive for investment. Once this initial equity investment is made in the L3C, it absorbs most of the financial investment risk, making the L3C a more attractive investment for the mezzanine tranche of investors…. Senior tranche, or third tier, investments are provided by investors that seek market-rate returns. These types of investors are likely to make investments with guaranteed returns or returns that are keyed to the L3C's profits, which is possible given that the equity tranche and mezzanine tranche of investments take on most of the financial risk."); S3011-2011: Relates to establishing the L3C act regarding low-profit limited liability companies, http://m.nysenate.gov/legislation/bill/S3011-2011 ("It is also envisioned to facilitate tranched investing by foundations, with a PRI taking the first risk position and thereby taking much of the risk out of the venture for other investors in lower tranches."). *See also* Antony Page & Robert A. Katz, "Is Social Enterprise the New Corporate Social Responsibility?" 34 SEATTLE U. L. REV. 1351, 1363-64 (2011) ("Proponents of the L3C form envision that its controllers can leverage these program-related investments with private capital to achieve its social aims, which would also serve the investing foundation's purposes. On this model, investments in L3Cs would be structured in tranches: program-related investments would ideally take the riskiest position in the capital structure and receive no or lower returns, thereby lowering risk and increasing returns for other equity investors. The top tranche might be at the risk-adjusted market rate of return. There might also be a "mezzanine" tranche, designed for investors willing to accept a lower return because of their contribution to social welfare."); David Shevlin & Jennifer Maimone-Medwick, "Low-Profit Limited Liability Companies ('L3CS'): A Fact Sheet," SS019 ALI-ABA 179, 181 (2010) ("The ability to tranche the stake of the various investors allows for uneven allocation of risk and reward among investors could open up additional streams of capital, both from private foundations … and from individuals. For example, a private foundation could make an investment in a junior tranche, absorbing excess risk and receiving below market returns, and a more senior tranche could be offered to attract additional capital from non-charitable investors that could generate a market rate of return, while investing in projects that provide tangible social benefits. The market rate of return can be offered due to the lower rate of return obligations on the private foundation's investment."); Elizabeth Schmidt, "Vermont's Social Hybrid Pioneers: Early Observations and Questions To Ponder," 35 VT. L. REV. 163, 169 (2010) ("The L3C creators reasoned that a private foundation would make the initial investment in an L3C through a PRI. That investment would be the investment with the highest risk and the lowest rate of return. It would provide the initial equity capital to the L3C, which would then give the L3C sufficient capital to attract investors who would otherwise have found the investment too risky. Such investors would then become a part of a separate membership class (or tranche) in the L3C, a class that could expect a higher rate of return than the foundation did. This

There is absolutely nothing special about an L3C to make possible a tranched investment arrangement. Indeed, the federal tax ruling closest in concept (although not involving tranched investing) was a private letter ruling involving a private foundation investment in an ordinary LLC.[14]

***As promoted by L3C advocates, tranched investing purposefully uses foundation funds to subsidize (and thereby attract) private, profit-seeking investors. The principal goal may be laudable but the means – using charitable funds to enrich "top tranche" investors – portends serious risk of private benefit*.[15]

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class might become a middle tranche of investors, those who still accept a below market rate of return in order to encourage a social return. Ultimately, a class of investors who expect a market rate of return could emerge. Thus, the PRI would not only provide capital; it would also leverage additional investment."); Americans for Community Development, "The Concept of the L3C," http://www.americansforcommunitydevelopment.org/concept.php, last visited 7/24/11 ("The L3C facilitates tranching or layering. The keys to an L3C's operation is its use of low-cost foundation capital in a high risk tranche of its structure and its ability to allocate risk and reward unevenly over a number of investors, thus ensuring some a very safe investment with market return. As is appropriate under the PRI structure, foundations would normally be expected to assume the highest risk at very low return, making the rest of the investment far more secure."). The same strategy could be pursued with an ordinary LLC or even a for-profit corporation. However, the strategy is promoted in relationship to L3Cs.

[14] I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006).

[15] Compare this type of private benefit with the situation described in I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006). The ruling letter described an arrangement in which: (i) the private foundation and the other LLCs members shared risk and return equally; and (ii) the other members were investing not only to lend their personal, sports-based prestige the project's goal of "investing in businesses in low-income communities owned or controlled by members of a minority or other disadvantaged group" but also to receive mandatory training in how to use their wealth through "angel investing and entrepreneurship." See also the authorities cited in note 8 and Boris I. Bittker and Lawrence Lokken, Federal Taxation of Income, Estates and Gifts, ¶ 100.4 (Inurement of Earnings of Private Individuals), 1997 WL 440011. In ¶ 100.4 of their treatise, Bittker and Lokken discuss the private benefit resulting from a different arrangement for intertwining non-profit and for-profit activity: "The IRS has, in recent years, given increased attention to compensation arrangements between exempt hospitals and physicians. For example, in 1992, it noted that some hospitals claiming exemption under § 501(c)(3) 'have formed joint ventures with members of their medical staff and sold to the joint venture the gross or net revenue stream derived from the operation of an existing hospital department or service for a defined period of time.' Such an arrangement jeopardizes the exemption, according to the IRS, because it 'causes the hospital's net earnings to inure to the benefit of private individuals (the physician investors),' the "private benefit flowing from the transaction 'cannot be considered incidental to the public benefits received,' and the arrangement may violate federal law.'") (footnotes omitted).

IV. Jeopardizing Investments

A. In General

Tax law uses the concept of "jeopardizing investments" to channel private foundations and their managers toward careful, mission-oriented investments.[16] "If a private foundation invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes," both the foundation and its managers face substantial excise taxes.[17]

Program related investments (PRIs), discussed below, are exempt from the jeopardizing investment analysis.[18] For all other investments by private foundations, the following standard applies:

> [A]n investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. [19]

The rule's purpose is to safeguard each foundation's financial ability to purpose its charitable purpose, and the focus is largely financial:

> In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole.[20]

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[16] IRC § 4944(a)(1); Treas. Reg. §§ 53.4944-1 and 53.4944-2

[17] IRC § 4944(a) and (b).

[18] IRC § 4944(c).

[19] Treas. Reg § 53.4944-1(a)(2). Even a mission oriented investment might be jeopardizing if the risks were high and the investment comprised an imprudently large proportion of the foundation's assets.

[20] *Id.*

B. Jeopardizing Investments and the L3C

A private foundation's investment in a L3C is not automatically a jeopardizing investment. As explained below, a valid PRI is not a jeopardizing investment, and "[n]o category of investments shall be treated as a per se violation of section 4944 [the jeopardizing investment rule]."[21]

However, in general, investment in an L3C poses greater risk than investment in a for-profit enterprise and portends lower returns. ***Almost by definition, L3Cs intentionally seek opportunities unattractive to investors driven "merely" by the calculus of profit and loss.***[22] ***Thus, it could hardly be the "exercise [of] ordinary business care and prudence" for a private foundation to commit a substantial portion of its assets to an L3C.***

Moreover, state legislation can do nothing to affect the "investment by investment" determination required of a private foundation and its managers. "[No] … State law [may] exempt or relieve any person from any obligation, duty, responsibility, or other standard of conduct provided in section 4944 and the regulations thereunder."[23]

C. Jeopardizing Investments, the L3C, and Tranched Investing

Tranched investing, in the form advocated by L3C proponents, can significantly increase a private foundation's risk of making a jeopardizing investment, especially for foundations with limited assets. In that particular tranched investing structure, the private foundation is a high risk/low return investor – precisely the opposite of what a careful investor typically seeks.

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[21] *Id.*

[22] Put another way: if careful investors consider a particular venture to be a worthwhile investment, the market will fund the venture. There will be no need for a nonprofit or "low profits" enterprise to step in.

[23] Treas. Reg §53.4944-1(a)(2)(i).

III. Program Related Investments

A. In General

Under IRC, § 4944(c), "investments, the primary purpose of which is to accomplish one or more of the [charitable] purposes described in section 170(c)(2)(B),and no significant purpose of which is the production of income or the appreciation of property, shall not be considered as investments which jeopardize the carrying out of exempt purposes." In addition, a PRI counts toward a foundation's annual distribution requirement. Thus for a private foundation considering an investment in a for-profit entity, PRI status is invaluable.[24]

The PRI regulations are specific in defining a PRI:

> A program-related investment is an investment which possesses the following characteristics:
> (i) The primary purpose of the investment is to accomplish one or more of the purposes described in section 170(c)(2)(B) [charitable purposes];
> (ii) No significant purpose of the investment is the production of income or the appreciation of property; and
> (iii) No purpose of the investment is to accomplish one or more of the purposes described in section170(c)(2)(D) [influence legislation/elections].[25]

According to the regulations, the first PRI requirement is specific to the mission of the particular foundation seeking to make a PRI:

> 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.[26]

The second PRI requirement ("no significant purpose [to produce] income or … appreciation"0 authorizes high risk/low return investments in the proper circumstances. However, PRI status does not exempt a private foundation from the strictures on private benefit and the severe risks to any private foundation that runs afoul of those strictures.

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[24] A PRI is also a "qualifying distribution" as provided in Treas. Reg. § 53.4942(a)-3(a)(2)(i) and therefore counts towards a private corporation's annual required distribution amount under IRC § 4942.

[25] Treas. Reg. § 53.4944-3(a)(1).

[26] *Id.* at § 53.4944-3(a)(2)(i).

In addition, PRI status does not override the requirement that any program related investment be mission specific. The relevant mission is that of the private foundation. Thus, PRI analysis must always focus on the specific charitable purpose of the private foundation. ***No state law designation can make a recipient organization generically qualified to receive PRIs or even categorically superior to other state law entity types.***

B. Expenditure Responsibility

In addition to the requirements just described, a private foundation that makes a PRI must exercise "expenditure responsibility" so as to assure the recipient organization will properly use the invested charitable assets.[27] "Expenditure responsibility" requires the foundation "to exert all reasonable efforts and to establish adequate procedures – (1) to see that the [PRI] is spent solely for the purpose for which made, (2) to obtain full and complete reports from the [recipient organization] on how the funds are spent, and (3) to make full and detailed reports with respect to such expenditures to the Secretary [of the Treasury]."[28] Failure to exercise "expenditure responsibility" subjects the foundation and its managers to substantial excise taxes.[29]

C. Potential Fiduciary Duties of Private Foundation to Recipient Organization and Organization's Other Investors

When a private foundation invests in a for-profit organization (even a low profit version), the foundation may become a part owner of that organization.[30] If so, the foundation must consider what fiduciary or other duties it may have under the state entity law applicable to the recipient organization. In general, fiduciary duty tends to follow power over other people's investment, and under federal tax law a foundation making a PRI must have in place powerful constraints on the activities of the recipient organization. By complying with federal tax law requirements, a foundation and its managers might find themselves exposed to state law claims for breach of fiduciary duty.[31] This problem is not insurmountable, but – like so many matters that arise from co-mingling charitable assets

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[27] IRC § 4945(d)(4)(B). The Code applies this requirement to "grants" but the regulations define "grants" to include "program related investments." Treas.Reg. § 53.4945-4(a)(2) (stating that "[f]or purposes of section 4945, the term 'grants' shall include … 'program related investments'").

[28] IRC § 4945(h).

[29] IRC § 4945(a)-(b). The Code defines "foundation manager" to mean "with respect to any private foundation—(1) an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and (2) with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act)." IRC § 4946(b).

[30] A foundation might also make a PRI in the form of a loan at a below-market interest rate. *See e.g.* Treas. Reg. § 53.4944-3(b)(2) (example).

[31] For example, it requires considerable care to establish the proper balance between duties owed for-profit investors and need to avoid improper private benefit.

with for-profit purposes – the problem requires sophisticated rather than simplistic analysis.

D. General Effect of PRI Requirements, Expenditure Responsibility, Potential Fiduciary Duties, and the Risk of Private Benefit

A private foundation contemplating a PRI must take into account the PRI requirements and expenditure responsibility, take note of potential fiduciary duties under the relevant state entity law, and pay very careful attention to any risk of private benefit. This complex combination of requirements means that whenever a foundation seriously contemplates a PRI, the foundation must make a careful, fact-specific assessment of: (i) the connection between the foundation's charitable purpose and the purposes of the proposed recipient; (ii) the structures in place in the recipient organization to assure the recipient's continued commitment to the foundation's charitable purpose *and not merely to charitable purposes in general*;[32] (iii) how to balance the control mechanisms required by federal tax law against the risk of fiduciary duties under the applicable state entity law; and (iv) the potential of the investment producing private benefits that are not merely incidental to the foundation's charitable purposes.[33]

In short, a prudent PRI analysis cannot be quick, easy, label-driven, or "off the rack."

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[32] This concern can also be addressed by providing that recipient will promptly return the PRI (i.e., buy out the private foundation's ownership interest in the recipient) if the recipient deviates from the agreed-upon, foundation-specific charitable purpose.

[33] Treas. Reg. § 53.4944-3(a)(3)(i) ("Once it has been determined that an investment is "program-related" it shall not cease to qualify as a "program-related investment" *provided that changes, if any, in the form or terms of the investment are made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property*. A change made in the form or terms of a program-related investment for the prudent protection of the foundation's investment shall not ordinarily cause the investment to cease to qualify as program-related. *Under certain conditions, a program-related investment may cease to be program-related because of a critical change in circumstances*, as, for example, where it is serving an illegal purpose or the private purpose of the foundation or its managers.") (emphasis added).

E. PRIs and L3Cs

The L3C structure does nothing to resolve the several serious issues pertaining to PRIs. Even assuming that L3C status were to guarantee that that each L3C would forever keep profit-making in the background,[34] a private foundation contemplating a PRI must focus on its charitable purpose in particular and not benevolence in general. Moreover, L3C status does nothing to address the "expenditure responsibility" issue. With an L3C – just like an ordinary LLC – the operating agreement must be tailored to fit the state law entity into the federal tax law requirements.

Likewise, L3C status does nothing to address the state law fiduciary duty questions and nothing to eliminate the specter of private benefit.

As is often the situation with L3Cs, with regard to PRIs, L3Cs promise what they cannot deliver – simple solutions to inevitably complex problems.

F. PRIs, L3Cs, and Tranched Investment

Tranched investment further complicates the PRI-L3C connection. As discussed above, tranched investment carries substantial risks of private benefit regardless of PRI status. In addition, "top tranche" investors will naturally wish assurance that the L3C will keep their profit-making interests in mind. As a result, establishing "expenditure responsibility" for the private foundation will be more complicated to devise and more difficult to achieve. For the related reasons the potential for fiduciary duty conflicts will increase (because if the L3C encounters financial difficulties the top tranche investors and the foundation will likely be pulling in opposite directions).

Advocates of L3Cs often promote L3Cs as a break-through device that opens a streamlined channel from charitable assets to socially beneficial commercial ventures. To the contrary, the PRI-L3C connection inevitably requires painstaking analysis and planning, which must take into account sometimes contradictory legal requirements and potentially disastrous risk.[35]

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[34] As explained above, L3C status does not guarantee this result. Nothing prevents those who control an L3C from deciding to abandon L3C status and the limitations that go with it. Also as explained above, a properly crafted operating agreement can provide for this problem, but: (i) such provisions require careful thought and drafting – i.e., they complicate matters; and (ii) are no simpler in an L3C than in an ordinary LLC.

[35] As discussed below, the same complexity and risk attend a PRI in any for-profit enterprise. But such PRIs have been aggressively promoted only in connection with L3Cs.

IV. Federal Tax Requirements and the L3C – Summary

In to regard the myriad requirements of federal tax law, ***the L3C has no significant advantage whatsoever over the ordinary LLC.***[36] By itself, L3C legislation is entirely inadequate to satisfy the requirements of tax law. State law cannot control federal tax law, and the L3C structure cannot streamline, simplify, or "green light" the PRI process.

Tranched investing is extremely complex for a private foundation; a simplistic approach to private benefit will put a foundation's tax exempt status in jeopardy. In addition, tranched investing substantial complicated the already complicated analysis and planning necessary to qualify a private foundation as a PRI.

In sum, from the perspective of federal tax law, the L3C is at best a distraction and more likely a simplistic trap for the unwary.

V. Defects in the L3C Legislation

A. The Misleading Implications of L3C Legislation

1. In General

When private foundations put charitable assets in the hands of for-profit entities, federal tax law is acutely, deeply, and inescapably involved. The prohibition against private benefit is long-standing and fundamental public policy of the United States, and there is no reason to expect Congress to overturn that policy. The PRI focus on the private foundation's purpose is similarly fundamental; to make recipient organizations generically qualified would turn the PRI concept "on its head."

State law cannot change the federal tax law, and enacting L3C legislation implicitly but inevitably promises benefits in an area of law over which the state has no control. That promise is the special evil of L3C legislation. Statutes perform a signaling function. They not only regulate; by their terms they suggest what behavior is acceptable.[37]

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[36] One of the country's foremost experts on PRIs has stated: "I've structured, prepared documents for and closed over 250 PRIs (over $350 million total) of all forms, and never felt the need for an L3C." (email, 7/14/11, from David S. Chernoff, Esq.)

[37] James J. Fishman, "Improving Charitable Accountability," 62 MD. L. REV. 218, 248 (2003) ("the law occupies a signaling function of appropriate behavior"); Karen Gross, Kathryn R. Heidt, Lois R. Lupica, "Legislative Messaging and Bankruptcy Law," 67 U. PITT. L. REV. 497, 499 (2006) (noting that "legislation performs a signaling function"); Alan Scott Rau, "Contracting Out of the Arbitration Act," 8 AM. REV. INT'L ARB. 225, 260, n. 147 (1997) (stating that "[a] particular statutory standard may have the signaling function of suggesting a standard that is common and socially approved"); Mark A. Drumbl, "Rights, Culture, and Crime: The Role of Rule of Law for the Women of Afghanistan," 42 COLUM. J. TRANSNAT'L L. 349, 362 (2004) ("[L]aw sends a message, and expressive theories of law tell us that this signaling function is critical to the development of social norms.");

Especially in light of the claims of L3C advocates, statutory recognition of L3Cs suggests that an L3C is somehow a safer, easier, or otherwise superior type of recipient for a PRI. After all, why would the legislature create a specialized type of entity unless that entity type provided special benefits?

More particularly, L3C legislation "hardwires" into a state statute restrictions that are intended to resonate with federal requirements for PRIs; the claimed compatibility between L3Cs and PRIs has been central to the advocacy for L3C legislation. The obvious implication is that L3C legislation facilitates compliance with PRI requirements. Why would the legislature enact the L3C restrictions if those restrictions did not make compliance easier and simpler? Thus, enacting L3C legislation signals that the L3C can increase and simplify access to PRIs through compliance with state rather than federal law.

This implication is incorrect and misleading. As noted above, in determining whether an investment qualifies as a PRI it is essential to ask whether the investment "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."[38] Thus, the PRI analysis must always focus on the specific "exempt activities" of the foundation, which means that the private foundation must analyze each potential investment in terms of its suitability to the foundation's mission.

The PRI analysis must also consider carefully the governance structure of a potential PRI recipient, because a PRI investment always involves "expenditure responsibility." The recipient's structure must therefore accord the private foundation sufficient control or exit rights (or a combination) to insure that foundation funds remain committed to acceptable purposes. Devising such controls and exit rights is no simple matter, because the overall structure must also be acceptable to the profit-seeking investors and, moreover, protect the foundation from liability that might arise if the foundation were to exercise too much control over the recipient organization and trigger breach of fiduciary claims.

A state-sponsored label for potential PRI recipients – L3C – suggests that PRI analysis is not only recipient-focused ("a PRI is safe with us because we're an L3C") and but also generic ("because we're an L3C, we're suitable for PRIs generally"). The L3C label also suggests that the L3C structure "as is" resolves the very complex governance and financial issues inherent in any PRI. The result is dangerous for private foundations, especially those that cannot afford expert legal advice.

2. L3Cs and Tranched Investment

The "signaling error" is even more egregious with regard to the tranched investment structured promoted by L3C advocates. Although in theory any LLC could attempt to use a PRI for that type of tranched investing, in practice the danger is far greater under L3C legislation. Since their first appearance, L3Cs have been associated with the potential of

[38] Treas. Reg. § 53.4944-3(a)(2)(i).

tranched investing. Given that history, a state's enactment of L3C legislation suggests that the state has recognized the L3C mechanism as safe and appropriate not only for PRIs in general but also for tranched investment in particular. From the perspective of federal tax law, quite the opposite may be true – much to the harm of private foundations that may rely upon the apparent legislative endorsement.

C. State Entity Law Not an Appropriate Method to Create a "Brand" to Identify Socially Beneficial Ventures

From the outset, discussion of L3C legislation has included the notion that the L3C can serve as a "brand" to signal the socially beneficial quality of an enterprise to potential investors and customers. Indeed, once federal tax law is understood, "branding" is all that remains in the pro-L3C argument. But branding – as the term itself suggests – is a function for the private sphere. Branding has never been the function of the law of business organizations, and a low profit limited liability company remains a business organization.

Some L3C proponents have claimed that the L3C label is a proper "brand" because the L3C structure makes social benefit the primary purpose of the entity. As previously noted, without appropriate language in the operating agreement, the L3C legislation cannot prevent an entity from abandoning social benefit through the simple mechanism of dropping the L3C label.

Moreover, even in this context the "brand" is a misleading signal of simplicity. Assuming that an L3C has members who expect some return on their investment, the operating agreement must address how the managers will balance the potentially competing interests. According primacy to social benefit does not by itself adequately answer the balancing question. With the tranched investment arrangement, the problem becomes extreme. You cannot promise investors above-market rate returns and then assume that "primacy" resolves conflicts in every instance. You can state in the operating agreement that in every instance the social benefit trumps the pecuniary interest, but: (i) the statutory language alone does not so provide; and (ii) the L3C will have to be very careful with its representations to the for-profit investors.

More fundamentally, when it is important to brand business organizations regarding issues of social concern, advocates of social justice and well-intentioned businesses find powerful private means to create a brand. Consider, for example, the Sullivan Principles, which established rigorous standards (enforced through public opinion) for companies dealing with apartheid South Africa.[39] Consider currently the numerous private

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[39] http://muweb.marshall.edu/revleonsullivan/indexf.htm, last visited 6/9/11 ("When Leon Sullivan joined the Board of Directors at General Motors in 1971, he used his corporate foothold to oppose apartheid, the government policy of segregation in South Africa. Since the passage of a Declaration of Grand Apartheid in 1948, a number of reformers, including Nelson Mandela, had tried unsuccessfully to end apartheid.

General Motors was the largest employer of blacks in South Africa at that time, and Sullivan decided to use his position on the Board of Directors to apply economic pressure to end the unjust system. The

organizations that assess the "green" quality of products and services[40] and the influence on businesses of the Halo Awards, the Gold Standard Certification of the Women in Law Empowerment Forum, and other such devices.[41] State government is not needed to create branding for private enterprises; it is not the function of the law of business organizations to do so.

D. The Technical Error in the L3C Legislation

As noted above, House} File No. 2702 incorporates almost verbatim the wording of the federal PRI regulations. In particular, in section 6, the bill provides that: "A significant purpose of a low-profit limited liability company must not include the production of income or the appreciation of property."[42] Tranched investing cannot possibly work under this constraint. In the L3C context, foundation funds are used to subsidize "top tranche" investors. These investors seek at least a market rate of return; their investment is premised on the expectation of profit. More generally, when "no significant purpose of the company is the production of income or the appreciation of property," the label "low ***profit*** limited liability company" is a misnomer.

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result was the Sullivan Principles, which became the blueprint for ending apartheid."). Congress eventually incorporated the Principles into the Comprehensive Anti-Apartheid Act of 1986, Pub.L. No. 99-440, 100 Stat. 1086 (1986). The Act "required American businesses with more than 25 employees in South Africa to comply with the Sullivan Principles, a code of fair employment practices for companies operating in South Africa." Board of Trustees of Employees' Retirement System of City of Baltimore v. Mayor and City Council of Baltimore City, 562 A.2d 720, 740 (Md. 1989). When apartheid ended, the requirement was repealed. Pub.L. 103-149, § 4(a)(1), (2), Nov. 23, 1993, 107 Stat. 1503. However, the Sullivan Principles are still at work. http://www.thesullivanfoundation.org/about/about_the_organization , last visited 6/9/11. ("We endeavor to bring the corporate and governmental communities together for the economic benefit of all, and invite businesses and individuals to create partnerships with Africa with our ultimate goal being a peaceful, prosperous, and powerful Africa.").

[40] See e.g. "BMW Picks Up Three Honours at the Environmental Transport Association's Green Car Awards 2010," http://www.bmwblog.com/tag/environmental-transport-association%E2%80%99s-green-car-awards-2010/ , last visited 6/12/11.

[41] http://www.causemarketingforum.com/site/c.bkLUKcOTLkK4E/b.6381267/k.BEDB/Home.htm; last visited 6/12/11; http://womenlawyerleaders.blogspot.com/, last visited 7/6/11.

[42] Minn. House File No. 2702, § 6, lines 5.20-5.22.

E. No Need for an L3C Subcategory

Under Minnesota's existing LLC statute, it is already possible to create a low profit limited liability company. Under Minn. Stat. § 322B.37, a member control agreement has complete authority to determine the LLC's purpose, to allocate governance and financial rights differentially among members, and to protect the agreed structure from inappropriate revisions.[43] L3C legislation adds nothing, and, as explained above, will cause the Minnesota to send inaccurate signals about the safety and effectiveness of L3Cs.

[43] Minn. Stat. § 322B.37 (2010). A member control agreement under Minn.Stat. ch. 322B is equivalent to an operating agreement under other state LLC statutes.

THE L3C ILLUSION: WHY LOW-PROFIT LIMITED LIABILITY COMPANIES WILL NOT STIMULATE SOCIALLY OPTIMAL PRIVATE FOUNDATION INVESTMENT IN ENTREPRENEURIAL VENTURES

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INTRODUCTION

If we choose, we can live in a world of comforting illusion.[1]

Vermont enacted the Nation's first "low-profit limited liability company" (L3C) legislation in 2008.[2] Since then several other states have appended L3C provisions to their limited liability company (LLC) statutes.[3] Initially, the promoters of the L3C concept had a bilateral approach. First, they lobbied Congress for a substantive amendment to the Internal Revenue Code's "program-related investment" (PRI) provisions in order to facilitate increased private foundation investment in L3C enterprises. Second, they pushed state legislatures to establish the L3C form in their existing LLC statutes. The result was intended to match substance and form, thereby allowing private foundation money to flow more efficiently and in greater quantity into profit-making ventures.[4] This "social entrepreneurship" would

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1. NOAM CHOMSKY, 9-11 68 (1st ed. 2001).
2. VT. STAT. ANN. tit. 21, § 3001(27) (2009).
3. Other states with L3C legislation include Illinois, Louisiana, Maine, Michigan, North Carolina, Utah, and Wyoming. *See* 805 ILL. COMP. STAT. ANN. 180/1-26 (West Supp. 2010); Act of June 21, 2010 La. Acts 417; ME. REV. STAT. tit. 31, §§ 1599, 1611 (2010); MICH. COMP. LAWS § 450.4102(m) (LexisNexis Supp. 2010); An Act to Provide for the Formation of a Limited Liability Company as a Low-Profit Limited Liability Company, S. 308, 2009 Sess. (N.C. 2009), *available at* http://www.ncga.state.nc.us/enactedlegislation/sessionlaws/pdf2009-2010/sl2010-187.pdf; UTAH CODE ANN. § 48-2c-412 (LexisNexis Supp. 2009); WYO. STAT. ANN. § 17-15-102(a)(ix) (2009).
4. According to The Foundation Center, in 2000 approximately 57,000 private community foundations made charitable distributions totaling over $30 billion. THE FOUNDATION CENTER, THE PRI DIRECTORY (2003 edition). Approximately $27.5 billion took the form of grants. *Id.* Approximately $226 million took the form of loans and other program-related investments. *Id.* In 2001, approximately 61,000 private and community foundations made $30.5 billion in grants and $233 million in PRIs. *Id.* Thus, in 2000 and 2001, PRIs constituted approximately 0.45% of the total grant and PRI output, a relatively paltry portion. Further, of the $459 million of PRI outlay in 2000 and 2001, 60% came from 10 private foundations. *Id.* Only 135 of 61,000 private foundations made any PRIs in 2000 and 2001; thus, approximately 60,865 foundations made no PRIs. *Id.* There were 667 PRI transactions in 2000 and 2001. Recent data released by The Foundation Center indicates that, in 2006 or 2007, 173 more private foundations (of more than 75,000 foundations) made at least one PRI of $10,000 or more. THE FOUNDATION CENTER, DOING GOOD WITH FOUNDATION ASSETS: AN UPDATED LOOK AT PROGRAM-RELATED INVESTMENTS (forthcoming, copy available to authors). PRIs in 2006 and 2007 totaled $742 million, out of $91.9 billion in charitable distributions. *Id.* Twenty-five foundations made PRIs totaling $545,778,000, while all remaining foundations' PRIs totaled $196,273,000. *Id.* Thus, depending on

assist in a healthy rebound of the United States economy, with a focus on socially-beneficial businesses. Who could argue with that?

But a funny thing happened on the way to the L3C party. Congress has not enacted L3C tax legislation, and substance and form have not aligned. Notwithstanding this setback, the L3C promoters have continued to lobby for state adoption and additional states have considered L3C legislation in 2010. In our view, without changes to federal PRI rules, the L3C construct has little or no value. Indeed, the existence of the state law form, without matching federal income tax substance, is dangerous since the ill-advised may assume value and use the form. Therefore, unless and until tax law embraces the L3C, the form should be shelved. Further, the L3C concept is flawed as a matter of federal tax law, and it seems unlikely that the substance will be created to match the form. In our view, this is particularly the case with respect to "tranched" investment L3Cs due to the "private benefit" rule. Therefore, we conclude that the L3C is a business entity device before its time, a time which likely will never come.[5]

This Article proceeds as follows: Part I discusses the law and policy of private foundations and PRIs, the background against which the L3C is set. Part II discusses L3Cs from a state law perspective, aligns them with PRI concepts, and discusses attempts to change federal PRI law to synchronize federal tax law with the state law form. Part III provides some thoughts concerning the "evolutionary biology" of LLC law, discusses how L3C legislation came to pass in several states, and considers the results in other states where there has been critical examination and opposition. Part IV discusses the mischief wrought by L3Cs in the current environment. We conclude by restating our belief that the L3C experiment is flawed and should be abandoned unless and until the federal PRI rules change in a way that gives meaning to L3Cs. This abandonment would be accomplished by the elimination of the L3C form in the few states that have enacted legislation and the termination of the L3C adoption process in the many states that have not enacted legislation.

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perspective, PRIs are inconsequential and relatively uninteresting, or an underused and untapped source of significant funding. The authors suspect the answer lies somewhere in the middle.

5. Some argue that, although the L3C had its "origins in a strategy that previously had unique application for private foundations," the "L3C and its justification transcend foundation involvement." John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117 (2010) (published in this book). *See also* text accompanying notes 71–72 for a discussion of the Tyler article. For example, there may be "branding benefits" of the L3C name and "additional fiduciary duty implications available through this form . . . ." *Id.* at 125 n.34. We recognize and will discuss the arguments, but in our view these are rear-guard attempts to justify an organizational structure that cannot be justified on its primary, tax-oriented grounds.

I. PRIVATE FOUNDATIONS AND PROGRAM-RELATED INVESTMENTS

A. *Taxonomy of Charitable Organizations*

Tax exemption under Internal Revenue Code § 501(c)(3) provides certain nonprofit corporations with two significant benefits. First, their income generally is exempt from taxation.[6] Second, donors to charitable corporations are allowed deductions for their charitable contributions, thereby facilitating the funding of such organizations.[7] In order to obtain exemption, the nonprofit corporation must be both organized and operated exclusively for one or more exempt purposes.[8] There is a large body of law concerning exempt purposes.

Tax-exempt 501(c)(3) organizations come in two flavors. "Public charities" are the most common, and all 501(c)(3) organizations that are not "private foundations" constitute public charities. "Private foundations" are 501(c)(3) organizations that normally receive one-third or more of their annual financial support from persons who are not disqualified persons *and* normally receive one-third or less of their annual financial support from investment income.[9] "Disqualified persons" include substantial contributors to the foundation, foundation managers, significant owners of interests in entities that are substantial contributors, family members of such persons, and business entities in which substantial contributors own a significant interest.[10] A "substantial contributor" is a person who contributes or bequeaths more than $5,000 to the organization, if the contribution or bequest constitutes more than 2% of the organization's total contributions and bequests for the year.[11] Simply put, private foundations are 501(c)(3) organizations that receive most of their support from a limited number of significant contributors or from endowments and other investments, while public charities are 501(c)(3) organizations with broader public support. The local zoo is probably a public charity. Ford Foundation, Rockefeller Foundation, MacArthur Foundation, the Pew Charitable Trust, and other well-known institutional charitable organizations are all private

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6. I.R.C. § 501(a) (2009). Unrelated business income is subjected to taxation under I.R.C. § 511 and unrelated debt-financed income is subject to taxation under § 514.

7. *Id.* § 170(a)(1).

8. Treas. Reg. § 1.501(c)(3)-1(a)(1) (2009). To be operated exclusively for exempt purposes, the organization must "engage[] primarily in activities which accomplish one or more of such exempt purposes . . . ." *Id.* § 1.501(c)(3)–1(c)(1). It "will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." *Id.*

9. I.R.C. § 509(a)(2) (2006). Investment income frequently takes the form of income from endowments.

10. *Id.* § 4946(a)(1).

11. *Id.* § 507(d)(2).

foundations, as are many family foundations and less well-known charitable entities.

The principal distinction between public charities and private foundations is grounded in numerous excise and other taxes that can be imposed on private foundations.[12] For example, private foundations are subject to a 2% excise tax on their net investment income[13] and a tax on self-dealing transactions.[14] Importantly for this discussion, private foundations are also subject to tax on investments that jeopardize their charitable purposes;[15] tax on undistributed income where there is a failure to distribute a statutorily-mandated amount of income (generally, 5% of net asset value) for charitable purposes;[16] tax on excess business holdings;[17] and tax on certain expenditures, including grants to private businesses when insufficient expenditure oversight is exercised.[18] Program-related investment treatment is significant with respect to this last group of taxes, and each is briefly discussed below.

B. Private Foundation Excise Taxes

1. Tax on Jeopardizing Investments

I.R.C. § 4944 provides that a private foundation that invests funds in such a manner as to jeopardize the carrying on of its exempt purposes shall pay a 10% tax on the amount invested for each year of the taxable period beginning on the date of the investment and ending on a statutorily defined date.[19] An investment is a jeopardizing investment if, when making the

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12. The private foundation tax rules were originally enacted in the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, which was written in a political environment in which foundations were considered to have too much power, to expend too little resources on charitable activities to merit the tax deductions provided to donors, and to engage in inappropriate behavior, such as employing family members as foundation managers. One can recall that the top marginal tax rates at that time were high by contemporary standards, and foundation donors tend to be high-income individuals. In the intervening years, the perception seems to be that foundations are properly operated, perhaps because of statutory influences.

13. I.R.C. § 4940 (2006).

14. *Id.* § 4941.

15. *Id.* § 4944.

16. *Id.* § 4942.

17. *Id.* § 4943.

18. *Id.* § 4945.

19. *Id.* § 4944(a)(1). There is also a 25% penalty tax if the investment is not removed from jeopardy within the taxable period. *Id.* § 4944(b)(1). Further, there is a 10% tax on foundation managers who participate in making the jeopardizing investment knowing its jeopardizing nature, unless the participation is not willful and is due to reasonable causes, and managers also are subject to a 5% tax for failure to cure. *Id.* § 4944(a)(2), (b)(2).

investment, the foundation's managers failed to exercise ordinary business care and prudence in providing for the foundation's short- and long-term financial needs to carry out its exempt purposes.[20] Thus, the jeopardizing investment risk likely correlates to foundation size; a foundation with $1 billion of assets probably could make a $1 million investment without running afoul of the jeopardizing investment rules, but a $1 million foundation likely could not. PRIs are not jeopardizing investments.[21] The jeopardizing investment rules probably eliminate the willingness of foundations (other than very large foundations) to consider significant social investments in private enterprises, unless the investment is clearly a PRI.

2. Tax on Undistributed Income

I.R.C. § 4942 imposes a 30% tax on private foundation undistributed income.[22] Although the rules are complex, undistributed income is the amount by which distributable income, generally equal to 5% of the foundation's net asset value, exceeds the foundation's qualifying distributions.[23] Thus, a foundation with a $1 million net asset value would be subject to a 30% tax on the difference between $50,000 and the amount of its qualifying distributions. PRIs are treated as qualifying distributions.[24] Thus, a foundation with $1 million of assets could avoid the undistributed income tax by making a $50,000 PRI.

3. Tax on Excess Business Holdings

I.R.C. § 4943 imposes a 10% tax on a private foundation's excess business holdings.[25] Generally speaking, to avoid the tax, a foundation cannot own more than 20% of the voting stock in a corporation (increasing to 35% if it is established that persons other than disqualified persons have

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20. Treas. Reg. § 53.4944-1(a)(2)(ii) (2010). Foundation managers may take into account the expected return, the risks of rising and falling price levels, and the need for diversification of the foundation's portfolio. *Id.* The Regulations state that margin trading, futures trading, investments in oil and gas working interests, the purchase of put and call options and warrants, and short-selling will be closely scrutinized. *Id.*

21. I.R.C. § 4944(c) (2006).

22. *Id.* § 4942(a).

23. *Id.* § 4942(c) (defining undistributed income); § 4942(d) (defining distributable amount); § 4942(e) (defining minimum investment return); § 4942(g) (defining qualified distributions).

24. Treas. Reg. § 53.4942(a)-3(a)(2) (2010).

25. I.R.C. § 4943(a)(1) (2006). In addition, there can be a 200% tax if there is a failure to cure with respect to the excess business holdings. *Id.* § 4943(b).

effective control of the corporation).[26] With respect to partnerships and other unincorporated business enterprises, including LLCs and L3Cs, foundations generally cannot own more than a 20% profits interest (again, increasing to 35% in some circumstances).[27] Particularly in the case of investments in start-up ventures, where the relative amount of the foundation's investment can be high, foundations need to be concerned with the excess business holdings rules. Under Treasury Regulations, PRIs are not business holdings subject to taxation.[28] Therefore, foundations may make PRIs that result in their ownership of more than the ceiling limitation of the stock or profits interests of private business entities.

4. Tax on Taxable Expenditures

I.R.C. § 4945 provides a 20% tax on private foundation taxable expenditures.[29] Taxable expenditures include grants to organizations that are not qualifying tax-exempt organizations, unless the foundation exercises expenditure responsibility with respect to the grant.[30] The term "grants" is defined to include PRIs.[31] Expenditure responsibility, without which the grant is a taxable expenditure, means that the foundation must exert all reasonable efforts to establish adequate procedures to ensure that the grant is spent solely for the purpose for which it is made, to obtain full and complete reports from the grantee on how the funds are spent, and to make full and detailed reports to the IRS with respect to the expenditures.[32] The Regulations contain elaborate expenditure responsibility rules, including pre-grant inquiry requirements,[33] term requirements (including a requirement that the recipient of a PRI enter a written commitment with specified terms),[34] grantee accounting and reporting requirements,[35] and grantor record-keeping and annual reporting requirements.[36] Suffice it to say that although PRI treatment is beneficial with respect to jeopardizing expenditure, undistributed income, and excess business holdings, such

26. *Id.* § 4943(c)(2).
27. *Id.* § 4943(c)(3); Treas. Reg. § 53.4943-3(c) (2010).
28. Treas. Reg. § 53.4943-10(b).
29. I.R.C. § 4945(a)(1) (2006). There is also a 5% tax on foundation managers. *Id.* § 4945(a)(2). Both taxes increase if the expenditure is not corrected within a statutory period. *Id.* § 4945(b).
30. *Id.* § 4945(d)(4).
31. Treas. Reg. § 53.4945-5(a)(2) (2010); *id.* § 53.4945-4(a)(2).
32. I.R.C. § 4945(h).
33. Treas. Reg. § 53.4945-5(b)(2).
34. *Id.* § 53.4945-5(b)(3).
35. *Id.* § 53.4945-5(c).
36. *Id.* § 53.4945-5(d).

treatment brings a large and complex host of expenditure responsibility rules into play.

C. Program-Related Investments

A PRI is defined as foundation investment "the *primary purpose* of which is to accomplish one or more of the purposes described in section 170(c)(2)(B) [i.e., religious, charitable, scientific, literary, or educational purposes], and no significant purpose of which is the production of income or the appreciation of property . . . ."[37] The Regulations add a further component to the PRI definition, whereby no purpose of the investment can be to influence legislation or participate in political campaigns.[38] Generally speaking, PRIs provide a method for private foundations to make equity investments, loans, or credit enhancements to a business enterprise on terms or conditions that are less favorable to the foundation than the market terms or conditions. However, unlike a typical grant, a PRI enables the foundation to recover its investment at some point, thereby enabling a recirculation of charitable funds. The Regulations clarify that the primary purpose test focuses on *the private foundation's* exempt purposes:

> An investment shall be considered as made primarily to accomplish one or more [charitable purposes] 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.[39]

Although foundations may have broad exempt purposes, such as to engage in charitable activities generally, a foundation with narrow purposes (e.g., to provide financial assistance to schools in Denver, Colorado) would not be able to make a PRI involving other purposes (e.g., the development of an aquarium in Des Moines, Iowa). Also, the determination of whether an investment "significantly" furthers its exempt purposes is made at the foundation level. Several examples in the Regulations illustrate this focus on the foundation's activities.[40]

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37. I.R.C. § 4944(c) (2006) (emphasis added).

38. Treas. Reg. § 53.4944-3(a)(1)(iii).

39. *Id.* § 53.4944-3(a)(2)(i).

40. *See id.* § 53.4944-3(b), *Example 4* (loan to business enterprise pursuant to *foundation's program* to assist low-income persons by providing increased economic opportunities); *Example 5* (loan to financially secure business enterprise pursuant to *program run by foundation* to enhance economic development of distressed area); *Example 6* (loan pursuant to *foundation's program* to encourage

With respect to the income production/property appreciation element of a PRI, the Regulations state that it is relevant whether profit-seeking investors would likely make the investment on the same terms as the foundation, but that the fact that a foundation's investment actually produces significant income or property appreciation shall not, in the absence of other factors, be conclusive evidence of a significant income-production/property-appreciation purpose. Stated differently, the foundation's investment must be below-market, but the fact that the investment provides a return to the foundation is not of itself conclusive evidence of an inappropriate purpose.[41] Again, the reference is to the nature of the particular foundation investment. Other investors may profit from their investments in the business activity, but this is not significant in determining whether the foundation's investment is a PRI.[42]

The focus of the inquiry on the foundation's purposes and investment is borne out by the IRS's application of the PRI rules. In Private Letter Ruling 2006-10-020, the IRS considered whether a foundation's investment in a fund, organized as a limited liability company for the purpose of making "angel investments" in businesses in low-income communities owned or controlled by members of minority or other disadvantaged groups that have not been able to obtain reasonable conventional financing and that provide community benefits, constituted a PRI.[43] In a favorable ruling, the IRS considered the foundation's charitable mission, purposes, and programs, which focused on helping individuals obtain economic independence by advancing educational achievement and entrepreneurial success and thereby improving distressed communities, and stated that the investment matched several of the foundation's educational and charitable approaches.[44] The IRS noted that the fund would invest only in businesses where at least 67% of the owners are members of a disadvantaged group and that the business actually must have been denied access to traditional funding sources.[45] In addition, preference would be given to businesses that

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economic redevelopment of depressed areas).

41. *See id.* § 53.4944-3(b), *Example 1* (below-market loan to encourage economic development of minority groups); *Example 3* (stock purchase where conventional sources would not loan money unless recipient increased equity capital, and no purpose involves income production or property appreciation); *Example 4* (below-market loan); *Example 5* (below-market loan); *Example 6* (loan at interest rates below that charged by financial institutions that agree to loan funds if foundation makes loan).

42. *See id.* § 53-4944-3(b), *Example 5* (foundation loan to public company to build plant in deteriorated urban area; no indication that public company is not seeking market return); *Example 6* (below-market loan by foundation to stimulate market-rate loans by financial institutions).

43. I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006).

44. *Id.* at 3.

45. *Id.* at 4.

contribute to the economic revitalization of a disadvantaged area. Finally, before investing, the fund would determine that the business is located in a high poverty census tract or a depressed community based on other factors.[46]

The IRS noted that the return on the LLC members' investment, including the foundation's investment, was expected to be substantially lower than for typical high-risk angel investments, and that the fund expected to achieve a substantially lower rate of return.[47] In this regard, it should be noted that both the foundation and the private investors expected a low rate of return; this was not a situation, touted in much of the L3C literature, in which the foundation expected a below-market return while facilitating at-market or above-market returns for private investors. Further, the operating agreement provided that if an investment in a particular neighborhood business reaches a level of success such that it would no longer have qualified as a PRI if made at such time, the foundation may cause the fund to terminate the foundation's participation in that investment.[48] Although the IRS treated the disengagement language favorably, it noted that it was not essential to PRI treatment.[49] The IRS ruled that the foundation's investment in the fund was a PRI.[50]

This Private Letter Ruling highlights several points. First, the ruling concerns a foundation's investment in an LLC that was not an L3C and demonstrates that foundations can and do make PRIs in "regular" LLCs. Second, the IRS focused on the foundation's charitable and educational purposes and financial return, rather than the LLC's purposes and return, other than to the extent it enabled the foundation to achieve its purposes and limited its upside return. It did not focus on the purposes of or returns to the fund's other members.

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46. *Id.*
47. *Id.* at 5.
48. *Id.*
49. *Id.* at 6.
50. *Id.* at 14.

II. LOW-PROFIT LIMITED LIABILITY COMPANIES, AND WHY THEY DO NOT WORK

[T]he writer must believe that what he is doing is the most important thing in the world. And he must hold to this illusion even when he knows it is not true.[51]

Beginning in 1990, the states reacted to the federal government's pronouncement that LLCs could both provide limited liability protection and be taxed as partnerships, by enacting LLC legislation.[52] By the mid-1990s, all fifty states had enacted such legislation and LLCs had become the "entity of choice" for many forms of business enterprise. One major advantage to LLC statutes is that they are malleable, and many state statutes have been frequently amended so that LLCs can fit particular circumstances and purposes. For example, one significant LLC state has modified its LLC statute to, *inter alia*, allow LLCs to engage in nonprofit businesses and non-business activities,[53] permit single member LLCs,[54] allow LLC continuation upon the dissociation of a single member,[55] and allow members with no economic contributions and no economic rights.[56] Other states permit complex LLC structures including "series" LLCs.[57] The L3C promoters seek to use this highly malleable LLC form to accomplish another goal, namely allowing private foundations to increase their PRIs and thereby to provide social benefit. Although we believe that the goal is laudable and although we applaud the malleability of the LLC form, the significant remaining question is whether L3C amendments to state LLC statutes can or should accomplish federal tax goals. In our view, the tax substance of the PRI rules does not match the modified state law form of the L3C and, unless and until it does, the L3C form fails.

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51. *See* JOHN STEINBECK: THE CONTEMPORARY REVIEWS (Joseph R. McElrath, et al. eds., 1996).

52. *See* Rev. Rul. 88-76, 1988-2 C.B. 360. A tax-oriented discussion of LLC history is contained in J. William Callison, *Federalism, Regulatory Competition, and the Limited Liability Movement: The Coyote Howled and the Herd Stampeded*, 26 J. CORP. L. 951, 954–61 (2001).

53. COLO. REV. STAT. § 7-80-102(3) (2009).

54. *Id.* § 7-80-203.

55. *Id.* § 7-80-801(1)(c).

56. *Id.* § 7-80-501.

57. *See* DEL. CODE ANN. tit. 6, § 18-215 (2005 & Supp. 2008).

A. The L3C Form

Vermont was the first state to engraft the L3C mutation onto its LLC statute. Although some attempts to modify other state LLC statutes have taken different approaches, the Vermont L3C provisions are simple and we will use them as our model. First, the Vermont statute defines an L3C by reference to the words used in the federal PRI definition. A Vermont L3C is an LLC organized for a business purpose that satisfies and is at all times operated to satisfy three requirements: (a) the LLC significantly furthers the accomplishment of one or more charitable or educational purposes and would not have been formed but for its relationship to the accomplishment of such purposes, (b) no significant purpose of the LLC is income production or capital appreciation, and (c) no purpose of the LLC is to accomplish political or legislative purposes.[58] Second, the L3C status must be indicated when the LLC's articles of organization are filed and the LLC's name must include an "L3C" designation.[59] Third, if the L3C ceases to meet the statutory requirements it continues as an LLC, but its name must be changed to eliminate the L3C designation.[60]

Although the Vermont L3C statute superficially tracks the federal PRI definition, several major incongruities exist.

1. Charitable or Educational Purpose

To qualify as an L3C, a Vermont LLC must "significantly further[] the accomplishment of one or more charitable or educational purposes within the meaning of [I.R.C. § 170(c)(2)(B)]."[61] In addition, the LLC must be an entity that "would not have been formed but for [its] relationship to the accomplishment of charitable or educational purposes."[62] This L3C definition poses several problems. First, the L3C classification focuses on the LLC's purposes rather than the purposes of the PRI-making foundation, and therefore does not fit the established PRI rules. For example, a suburban charter school could be organized as an L3C since it significantly furthers educational purposes, but a foundation organized to improve the condition of distressed urban communities could not make a PRI in that L3C. Similarly, the PRI "but for" test focuses on whether the foundation's

58. VT. STAT. ANN. tit. 11, ch. 21, § 3001(27) (1997 & Supp. 2009).
59. *Id.* §§ 3023(a)(6), 3005(a)(2).
60. *Id.* § 3001(27)(D).
61. *Id.* § 3001(27)(A)(i).
62. *Id.* § 3001(27)(A)(ii).

investment would have been made but for the foundation's charitable purposes, not on whether the recipient would have been formed but for its charitable purposes. Second, there is a linguistic mismatch between the Vermont L3C statute, which requires that the LLC "significantly further[]" a charitable purpose and the PRI requirement that the "primary purpose" of the investment be charitable, and in which the "significantly further[]" language is a regulatory elaboration of the "primary purpose" test. Third, there is no administrative gatekeeper with respect to L3Cs, as there is with 501(c)(3) organizations. In order to attain 501(c)(3) status, the organization must meet numerous formal requirements and file for recognition with the IRS, which then determines whether the organization is organized or operated exclusively for charitable, educational, scientific, literary, or religious purposes. There is a large, and often complex, body of case law and administrative decisions concerning whether particular organizations meet the statutory requirements.[63]

The L3C waters are much murkier and, therefore, more dangerous. There is no requirement that the L3C's articles of organization set forth any charitable or educational purpose. Instead, a Vermont LLC becomes an L3C by its own designation as such in its articles of organization and its use of the L3C appellation. Importantly, there is no process in which an administrative agency determines whether the LLC "significantly furthers" any permitted purpose or would not have been organized but for that purpose. Because the L3C process is self-actualizing, it has no meaning. The optimist would note that this means that foundations still need to rigorously approach the PRI question without any reliance on the L3C label; the pessimist would note that the L3C form creates opportunities for charlatans to establish business entities lacking bona fide charitable or educational purposes, call them L3Cs, and then use the goodwill arising from the form to further bad purposes. In Colorado, both the Attorney General and the Secretary of State testified against L3C adoption for charitable fraud reasons.[64]

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63. Professor Schmalbeck's contribution to this book, *Financing the American Newspaper in the Twenty-First Century*, 35 VT. L. REV. 253 (2010), aptly discusses the difficulty in determining whether newspaper publishing can be a charitable purpose under I.R.C. § 501(c)(3), and concludes that the IRS' position is generally negative. Similar issues will likely arise in other contexts. For example, it is conceptually difficult to conclude that a dairy cooperative established by small farmers to obtain a market for their products would constitute a "charitable or educational" organization for federal tax exemption purposes.

64. *See Bill Summary for HB10-1111*, *Colorado House Committee on State, Veterans', & Military Affairs* (Mar. 4, 2010), *available at* http://www.leg.state.co.us/Clics/clics2010a/commsumm.nsf/91320994cb8e0b6e8725681d005cb995/f7e041198be7f630872576dc00691067?OpenDocument.

2. No Significant Purpose of Income Production or Capital Appreciation

The Vermont L3C statute states that L3Cs cannot have a significant purpose of income production or property appreciation.[65] However, the PRI provisions which the L3C statute attempts to mimic focus only on the private foundation's investment purpose. A PRI can be made in a profit-motivated business entity as long as no significant purpose of the *foundation's* investment is income production or property appreciation. Other owners of, and investors in, the business entity can seek profit and appreciation, and the PRI regulations specifically contemplate this objective. Indeed, by focusing on the LLC's profit motivation, the Vermont statute arguably eviscerates L3Cs as a method for attracting capital and encouraging beneficial economic growth. This runs directly counter to aspirations that L3Cs can be used for "tranched" investments whereby the private foundation's PRI investment can be used to alleviate the risk otherwise taken by *profit-seeking* participants.[66]

3. Attempted Statutory Repairs

L3C promoters have recognized the mismatch between federal PRI rules and state L3C statutes and have attempted to repair it. In 2008, the "Program-Related Investment Promotion Act of 2008" was drafted, but the draft act was not introduced in Congress.[67] The Act would have created a

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65. VT. STAT. ANN. tit. 11, ch. 21, § 3001(27)(B) (1997 & Supp. 2009).

66. In his article on financing newspapers, Professor Schmalbeck writes:

> The ideal financial structure of an L3C can be inferred from the idea of the hybrid entity, with foundations contributing a base layer of capital that would be the most junior in terms of the foundation's rights to distributions on dissolution, and hence most at risk if the enterprise were to fail. However, while junior tiers of capital in most entity financial structures are compensated for accepting greater risk by receiving greater returns if the enterprise is successful, this would not be so in an L3C. While some participation in any upside gains would not be inappropriate, the idea of the foundation investment is to permit otherwise marginal enterprises to improve their balance sheets to a point where other capital can be attracted on more or less market terms and rates. Thus, if the market rate of return generally is 10%, and a socially beneficial enterprise projects that it can only pay a return of 6% on the capital it needs, it can be financially viable if it can attract half of its capital from a private foundation as a PRI, paying a 2% return, and the other half from market sources, paying the usual 10% market rate of return.

Schmalbeck, *supra* note 63, at 270. The tranched L3C structure creates fiduciary duty issues, but it is also hard to see how an overall 6% return on capital can be obtained without an income production or capital appreciation purpose.

67. *See* THE MARY ELIZABETH & GORDON B. MANNWEILER FOUND., THE PROGRAM-RELATED INVESTMENT PROMOTION ACT OF 2008: A PROPOSAL FOR ENCOURAGING CHARITABLE INVESTMENTS § 6033A, *available at* http://www.cof.org/Files/Documents/Conferences/LegislativeandRegulatory06.pdf

process for IRS determinations of PRI status and, importantly, would have created a rebuttable presumption that foundation investments in L3Cs constitute PRIs. The Act also would have required information returns with respect to "for profit-organization investments in which [sic] have been determined to be program-related investments."[68] A 2009 statute also appears to have been drafted, and was discussed with Senate Finance Committee staff and Joint Committee on Taxation staff, but it too was not introduced.[69] Efforts continue, but the federal legislative movement appears to have little traction at this time.[70]

B. Fiduciary Duty Issues

One article in this symposium issue suggests that

> [p]roperly understood and implemented, one of the innovations of the L3C is how the enabling statutes properly order priorities in a way that imposes fiduciary responsibilities and makes available accompanying enforcement tools. This resolution can help instill sufficient predictability and consistency so that the new form can be a viable strategy to address certain charitable, exempt needs and opportunities that follow from our economic, social, and political systems.[71]

Further, the author states that, "[t]he L3C operates pursuant to properly-ordered fiduciary priorities that promote a clarity and consistency unlike any other form."[72] In our view, this is far from correct. Speaking from our experience with LLC fiduciary issues, both in theory and in practice, it is our belief that welding the L3C onto the existing LLC chassis makes a large mess when it comes to applying fiduciary duty rules to L3C managers. In our view, this mess is magnified when securities law disclosure rules are applied to L3Cs.

The Vermont LLC Act provides that members of member-managed LLCs and managers of manager-managed LLCs owe the LLC and its

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(last visited Nov. 4, 2010).

68. *Id.*

69. *See* Robert Lang, *What is the L3C? Basic Explanation*, AMS. FOR CMTY. DEV., http://www.americansforcommunitydevelopment.org/downloads/WhatIsTheL3C.pdf (last visited Nov. 7, 2010).

70. *See Program Related Investments Promotion Act*, COUNCIL ON FOUNDS., https://classic.cof.org/templates/311.cfm?ItemNumber=17371&navitemNumber=16177 (last visited Nov. 7, 2010).

71. Tyler, *supra* note 5, at 118.

72. *Id.* at 138.

members a duty of loyalty and a duty of care.[73] The duty of care is to act in good faith, with the care an ordinary prudent person in a like position would exercise, and in a manner he or she reasonably believes to be in the LLC's best interests.[74] The duty of loyalty is comprised of three parts: (a) to account to the LLC for the use of its property or for any benefit derived from conducting the LLC's business, including usurpation of LLC opportunities; (b) to refrain from dealing with the LLC as or on behalf of a party having an interest adverse to the LLC; and (c) to refrain from competing with the LLC.[75] In addition, such members or managers must discharge their duties and exercise any rights consistently with the obligation of good faith and fair dealing.[76] There are no special rules for L3Cs, and the general statutory provisions apply.

The Vermont LLC Act recognizes the primacy of the members' operating agreement, and the operating agreement can, to at least a limited extent, establish fiduciary rules governing members and managers.[77] However, the Act provides that the operating agreement cannot "eliminate from the duty of care" the obligation stated in the Act as the duty of care; presumably this means that the operating agreement can impose a more stringent, but not a less stringent, duty of care than that set forth as the Act's default rule.[78] The operating agreement may vary the duty of loyalty, within limits, and can establish standards by which the obligation of good faith and fair dealing is to be measured.[79] Again, the L3C provisions do not change the statutory rules under which the operating agreement can establish specific rules by which managerial fiduciary duty compliance is to be measured.

When L3Cs are used in what Professor Reiser calls blended enterprises—"entit[ies] that intend[] to pursue profits and social good both in tandem and by making considered choices to pursue one over the other"[80]—it is imperative that the LLC's operating agreement contain provisions to guide management in making these choices, and to protect management from claims, particularly by those seeking to profit from the enterprise, that they breached their fiduciary duties by acting in a manner that reduced profits (or increased risk of loss) by favoring social good, or

73. VT. STAT. ANN. tit. 11, ch. 21, § 3059(a) (1997 & Supp. 2009).
74. *Id.* § 3059(c).
75. *Id.* § 3059(b).
76. *Id.* § 3059(d).
77. *Id.* § 3003(a).
78. *Id.* § 3003(b)(3).
79. *Id.* § 3003(b)(2), (4).
80. Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 105 (2010).

vice-versa. This drafting needs to be undertaken within the Act's limitations on fiduciary duty modification and will be very difficult and uncertain.[81] In our view, it is imprudent to rest solely on the L3C statute's "significantly furthers the accomplishment of charitable . . . purposes" language, in part because it is vague and imprecise and in part because the L3C provision states that LLCs can continue as LLCs that are not L3Cs if their purposes change, for example into profit-seeking purposes. Again, drafting operating agreement provisions guiding and protecting L3C managers will be individualized and difficult, and the L3C provisions give no assistance. In addition, an investment in an L3C with an expectation of profit frequently is a security for federal and state securities law purposes, and may necessitate disclosure of material aspects of the investment.[82] Limitations on profit-seeking by the L3C and fiduciary duty modifications allowing LLC managers to favor social aspects of the enterprise over profit aspects likely will be disclosure items. This increases the difficulty, and the risk, of attracting profit-motivated L3C investment.

In sum, the Vermont L3C Act, like LLC statutory schemes adopted in several other states, provides little guidance or comfort. Since there is no essential match between L3Cs and PRI law, foundations will still need to undertake the same due diligence that they would before making PRIs in a non-L3C world. To the extent that operating agreement drafting is necessary for making PRIs, the same drafting is necessary in an L3C environment, and the Vermont statute provides no rules to assist in that drafting. Further, despite the claims of some L3C proponents, fiduciary duty rules are muddled and confused in L3Cs and the statute provides no guidance to members and managers who now serve two masters. In our view, the Vermont L3C Act simply does not work in the major areas in which a well-conceived statute needs to work.

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81. One of the reasons for well-drafted LLC statutes is to eliminate the cost and uncertainty of drafting complex provisions. The L3C does not serve this purpose. *See* J. William Callison, *Venture Capital and Corporate Governance: Evolving the Limited Liability Company to Finance the Entrepreneurial Business*, 26 J. CORP. L. 97, 116 (2000) (arguing that "[a]lthough customized terms can be tailored to the firm's precise situation," they are troublesome because "they also can involve high drafting costs, risk of negotiating or drafting error, uncertainty regarding the terms' validity, lack of judicial precedent regarding the terms' meaning or effect, and lack of investor or other third-party familiarity with the terms") (citation omitted).

82. *See* J.W. CALLISON & M.A. SULLIVAN, LIMITED LIABILITY COMPANIES: A STATE-BY-STATE GUIDE TO LAW AND PRACTICE § 13 (2010 ed.) (discussing application of securities laws to limited liability companies).

III. THE L3C LEGISLATIVE ADOPTION PROCESS

It is natural for man to indulge in the illusions of hope. We are apt to shut our eyes against a painful truth, and listen to the song of that siren, till she transforms us into beasts . . . . For my part, whatever anguish of spirit it may cost, I am willing to know the whole truth; to know the worst and to provide for it.[83]

L3C legislation was adopted in several states due to effective, and stealthy, lobbying by several proponents and the absence of informed legislative discussion or any opposition from interested parties.[84] Professor Thomas Geu has developed an evolutionary analysis of LLCs that is particularly appropriate to L3C development.[85] He argues that LLCs, like other organisms, get more complex over time because more complexity means either the continued development and fitness of the main organism or the parasitic addition of more tricks and gadgets to the organism, none of which individually affect its fitness.[86] Geu notes that,

> [e]xtending the idea of parasitic genes to the LLC "code" suggests that the analogue of a parasitic gene would be a *rogue* provision (statutory section) that is added not for purposes of increasing the fitness of the LLC phenotype but simply for the sake of its own replication. Such provisions catch a ride, so to speak, on the LLC vehicle because it is cheaper than building a new vehicle.[87]

L3Cs can be viewed as such parasitic genes embedded in the LLC phenotype. They do not particularly hurt the LLC, the LLC is a cheap ride, and they serve their own distinct purposes. Geu notes that one problem with rogue provisions is that an LLC statute, originally designed to accomplish certain useful business tasks well, becomes so overloaded with rogues that

83. Patrick Henry. *See* DIANE REVITCH, THE AMERICAN READER: WORDS THAT MOVED A NATION 34–35 (Harper Collins Publishers Inc. 2000).

84. *See* Callison, *supra* note 52, at 963–64 (discussing LLC as product of public choice model of legislation).

85. Thomas E. Geu, *A Single Theory of Limited Liability Companies: An Evolutionary Analysis*, 42 SUFFOLK U. L. REV. 507 (2009).

86. *Id.* at 540–42.

87. *Id.* at 542 (emphasis in original).

it is inefficient and can no longer perform its fundamental tasks, and thus dies another dinosaur.[88]

Geu further notes that flexibility is a hallmark of the LLC, and that this "flexibility is achieved . . . through flexible 'optional' provisions coupled with a suite of regulatory genes . . . [that] guard against maladaptation caused by cheater genes and . . . control if and when the other statutory provisions . . . will be expressed."[89] The regulatory genes thereby form part of the LLC's structure and help determine its success. Geu has stated that, in the case of L3Cs "people [i.e., lawyers] who know something" about LLCs are the regulatory genes.[90]

We believe that this explains the ease with which initial L3C legislation was adopted, and the subsequent difficulty of the promoters in obtaining further legislative passage. At first, L3Cs were an unregulated cheater gene, and LLCs were a cheap ride. The promoters could postulate good results, legislators could painlessly pass legislation, there was no clear harm to adoption, and, most importantly, there was no opposition. Then, beginning in late 2010, the regulator genes—primarily business lawyers around the United States who have invested significant time and energy in developing and understanding the LLC vehicle—became aware of the L3C movement and became concerned that the L3C cheater (a) does not work as the promoters indicated, (b) does not fit the LLC model, and (c) reputationally and otherwise could harm the LLC. Articles were written,[91] white papers were prepared,[92] resolutions were passed,[93] bar associations

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88. *Id.* at 542–45. "The take-home lesson is that biological evolution suggests that LLC evolution cannot extend forever by the simple addition of more and more genetic choices because (1) the possibility of the emergence of maladaptive or lethal cheater genes and (2) because the resultant cognitive load will swamp the current regulatory genes and lead to material inefficiencies for the LLC entity." *Id.* at 545.

89. *Id*. at 546.

90. E-mail from Prof. Thomas Geu to author (Feb. 3, 2010) (on file with author).

91. *See, e.g*., Carter G. Bishop, *The Low Profit Limited Liability Company (L3C): Program-Related Investment Proxy or Perversion*, 63 ARK. L. REV. 243, 265–67 (2010) (criticizing L3Cs as uncertain, risky ventures ill-suited to perform their objectives); J. William Callison, *L3Cs: Useless Gadgets?*, 19 BUS. L. TODAY 55, 55–56 (2009) (explaining the failure of L3Cs to allow for better PRI treatment in the absence of federal legislation); Daniel S. Kleinberger, *A Myth Deconstructed: The 'Emperor's New Clothes' on the Low Profit Limited Liability Company* (forthcoming 2010), *2, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1554045, (arguing that the L3C concept is "nonsensical and useless"); David Edward Spenard, *Panacea or Problem: A State Regulator's Perspective on the L3C Model*, 65 EXEMPT ORG. TAX REV. 36 (2010) (discussing concerns state regulators have regarding the possible negative impact of the L3C model on the level of diligence exercised by private foundations).

92. Maine's Secretary of State issued a white paper that was strongly critical of L3Cs. *See* ME. SEC'Y OF STATE, REPORT REGARDING LOW-PROFIT LIMITED LIABILITY COMPANIES 9 (2010), *available at* http://www.iaca.org/downloads/2010Conference/BOS/6a_Resolve_2009_chapter_97_L3C.pdf. Ironically, Maine enacted L3C legislation in 2010. ME. REV. STAT. tit. 31, §§ 1599, 1611 (2010). We understand

lobbied legislatures,[94] and the regulator genes switched off the L3C gene. The trick for L3C proponents is to alter the framework, perhaps through federal PRI legislation or rules, such that the lawyer regulator genes will allow the L3C to switch back on again, perhaps in different and more useful form. As discussed below, in our view that is unlikely to happen.

IV. WHY L3CS ARE HARMFUL

Illusions commend themselves to us because they save us pain and allow us to enjoy pleasure instead. We must therefore accept it without complaint when they sometimes collide with a bit of reality against which they are dashed to pieces.[95]

This Article has discussed why L3Cs do not work from the PRI and LLC governance perspectives. In this Part we will discuss our view that the L3C is positively harmful in the present tax and legal environment.

First, as demonstrated above, L3Cs are not entitled to any special presumption concerning PRI treatment and are in no better position to receive PRIs than well-developed LLCs from which they emerged. Since the L3C gadget does not match the PRI rules, it is likely that non-L3C LLCs can adopt a form that better enhances their ability to receive PRIs. However, the existence of the L3C form gives rise to the delusion that the form actually does something, and ill-advised people may use it believing that the form enables PRI treatment. Much of the promotional material for the L3C encourages this conduct. Further, not all private foundations are large and well-advised, and it is likely that some smaller foundations will give undue credence to the L3C form. This is particularly harmful since

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that this was done as part of a political compromise needed to enact other important changes to modernize Maine's LLC Act.

93. In November 2009, the LLC and Partnerships Committee of the American Bar Association Business Law Section discussed L3Cs and unanimously voted not to recommend inclusion of L3C language in the Uniform LLC Acts. This sentiment was formally adopted in an opinion issued on April 23, 2010. A.B.A. COMM. ON LTD. LIAB. COS. AND UNINC. ENTITIES, L3C RESOLUTION, *available at* http://meetings.abanet.org/webupload/commupload/RP519000/relatedresources/ABA_LLC_Committee-L3C_Resolution_and_explanation-2-17-10.pdf.

94. For example, the Colorado Bar Association's Legislative Policy Committee followed its Business Law Section's lead, and actively opposed the proposed Colorado L3C legislation. *Committee Reports*, COLO. B. ASS'N REAL ESTATE SEC. NEWSLETTER, Spring 2010, *available at* http://www.cobar.org/index.cfm/ID/21532/subID/26088/REALES//#CommReports. The legislation did not pass committee, but rumor has it that similar legislation will be introduced in 2011.

95. SIGMUND FREUD, A.A. HILL & ALFRED B. KUTTNER, REFLECTIONS ON WAR AND DEATH 16–17 (1918).

such foundations may run afoul of various tax provisions and, indeed, may endanger their charitable status. Thus, we believe that there is positive harm to unleashing a business form that does not serve its intended purpose. Someone is going to use the L3C improperly and will get burned, and there is no countervailing benefit to the form.

Second, application of charitable organization law to L3Cs has been simplistic and undeveloped. There are risks to a private foundation's charitable status inherent in investing in L3Cs with private investors that require considerably greater understanding before L3C investments are made. The L3C promoters completely ignore these risks. For example, an organization does not qualify as a tax-exempt charity if it transgresses the "private benefit" doctrine, which inheres in the requirement that a charitable organization operate exclusively for exempt purposes.[96] There have been a series of cases involving the participation of exempt organizations in partnerships, and the IRS's continued activity in this area evidences its concern that these partnerships can constitute a method to confer private benefit on private participants.[97] Although our purpose here is to point out the issue rather than to analyze the private benefit doctrine, in our view application of the doctrine is problematic when a private foundation invests in a venture with profit-seeking participants, particularly when the foundation takes a high-risk, low-return position relative to the investors. L3Cs have been marketed as a device to encourage this tranched-type investment and are therefore suspect. Since the risk is loss of tax-exempt status, foundations should act with caution before investing in what is fundamentally a business enterprise.

Third, focus on L3Cs and the technical aspects of L3C law and structuring takes the eye away from the ultimate, shared goal of encouraging and obtaining PRI investment in socially-beneficial enterprises. In a recent article, an associate general counsel at the MacArthur Foundation states that L3Cs have gotten more attention than they deserve.[98] Our concern is that the L3C distraction is a sideshow and

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96. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2010) (stating that an organization is not operated exclusively for charitable purposes "unless it serves a public rather than a private interest"). *See also* Redlands Surgical Servs. v. Comm'r, 113 T.C. 47, 74 (1999), *aff'd*, 242 F.3d 904 (9th Cir. 2001); B. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS § 20.11 (9th ed. 2007).

97. *See* I.R.S. Priv. Ltr. Rul. 85-41-108 (July 19, 1985) ("To be incidental in a quantitative sense, the private benefit must not be substantial after considering the overall public benefit conferred by the activity.").

98. David S. Chernoff, *L3Cs: Less Than Meets the Eye*, TAXATION OF EXEMPTS, May/June 2010, at 3. Chernoff concludes, "Perhaps instead of referring to a low-*profit* limited liability company, a better name would be low-*income* limited liability company. That name would yield the acronym LILLAC. Such bushes are indeed eye-catching and produce a seductively sweet fragrance—for a while. Then they just fade away." *Id.* at 5 (emphasis in original).

that, since foundations can already make PRIs in LLCs and other entities, time and energy spent on L3Cs dissipates the focus on models for PRIs generally. On the other hand, recent publicity and controversy about L3Cs has brought increased focus on PRIs and that is a good thing. We just think it is time for the rumbling to stop.

In short, L3Cs can produce positive harm and, to date, the promoters have not addressed underlying systemic issues. Until these problems and issues have been resolved, it is appropriate that the lawyers (regulatory genes) have called out the L3C as an illusion and put an end to the mischief.

CONCLUSION

In this Article, we demonstrate that L3Cs do not accomplish their stated tax and state law purposes. We also demonstrate that the L3C, like other sleights of hand, does not sufficiently focus the mind on the real substantive issues involved in encouraging private foundations to make PRIs or in managing LLCs that serve the two masters of profit and charity. We conclude by encouraging both termination of the L3C "movement" and increased focus on legal devices that meet the valid goals that underlie the development of the L3C model. The hope for increased private foundation investment remains alive, but the L3C is a deeply flawed vehicle for realizing those hopes. It is time to move on.