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## Regulation of L<sup>3</sup>Cs for Social Entrepreneurship: A Prerequisite to Increased Utilization

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# Regulation of L<sup>3</sup>Cs for Social Entrepreneurship: A Prerequisite to Increased Utilization

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## I. L<sup>3</sup>Cs SERVE NEEDS OF SOCIAL ENTREPRENEURS

Between 2008 and 2012, three new business models were legally activated in the United States to facilitate the creation of hybrid firms.<sup>1</sup> While social enterprises have been part of the U.S. economy for more than a hundred years,<sup>2</sup> organizations in the United States have operated in two very different legal categories: for-profit businesses and nonprofit charitable organizations.<sup>3</sup> Although some companies, such as Goodwill Industries, blend charitable work with revenue-generating services, they are rare exceptions.<sup>4</sup> The advent of the new legal business models, however, has created strong interest in businesses that can pursue a dominant social mission.<sup>5</sup>

One new business model is the low-profit, limited liability company (L<sup>3</sup>C). The L<sup>3</sup>C was first introduced in Vermont in 2008 and has since been adopted by several other states.<sup>6</sup> The L<sup>3</sup>C is designed to serve the for-profit and nonprofit needs of social enterprise within one or

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1. See Stephanie Strom, *A Quest for Hybrid Companies That Profit, but Can Tap Charity*, N.Y. TIMES, Oct. 12, 2011, available at <http://www.nytimes.com/2011/10/13/business/a-quest-for-hybrid-companies-part-money-maker-part-nonprofit.html?pagewanted=all> (describing flexible purpose corporations, L<sup>3</sup>Cs, and CICs); see also Anne Field, *Benefit Corporations, L<sup>3</sup>Cs and All the Rest: Making Sense of Those Confusing Choices*, FORBES (May 25, 2012), <http://www.forbes.com/sites/annefield/2012/05/25/benefit-corporations-l3cs-and-all-the-rest-making-sense-of-those-confusing-choices/> (discussing L<sup>3</sup>Cs and Benefit Corporations (B Corps), as well as the growing impact and spread of social enterprises).
  2. See Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 293 (2010) (noting that although "one of the best known social enterprises" in the country was established in 1902, similar businesses did not become prominent until the late 1970s and 1980s because of "economic downturn" and government budget cuts).
  3. *Id.* at 294 (noting the traditional business forms limited companies at either end of the economic spectrum: nonprofit or for-profit).
  4. *About Us*, GOODWILL INDUSTRIES, <http://www.goodwill.org/about-us/> (last visited June 2, 2013) (explaining that, in addition to its participation in charitable programs, Goodwill Industries also generates revenue through various commercial services such as food preparation, shredding, and document imaging).
  5. See Leonardo Becchetti, Stefania Di Giacomo & Damiano Pinnacchio, *Corporate Social Responsibility and Corporate Performance: Evidence from a Panel of U.S. Listed Companies*, APPLIED ECON., March 2008, at 541, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=871402](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=871402) (finding that dual missions can increase profits for corporations by creating goodwill, attracting socially minded investors, reducing taxes, insuring against bad publicity, and retaining employees).
  6. Anthony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1362 (2011) (stating that, as of 2008, Vermont and seven other states have adopted L<sup>3</sup>C legislation). The two additional business forms are the Benefit Corporation and the Flexible Purpose Corporation. The B Corp establishes the primary mission of a corporation as maximizing stakeholder value, not simply shareholder value, and requires that a diverse set of interested parties are included in its decision-making. *Id.* at 1365–70.

ganization.<sup>7</sup> As such, it has been referred to as a “[f]or-profit with [a] nonprofit soul.”<sup>8</sup> The L<sup>3</sup>C operates like a nonprofit by primarily pursuing a social or charitable mission, but it also functions like a for-profit company because it generates revenues and distributes the profits to its equity owners. The L<sup>3</sup>C model thus enables social entrepreneurs to combine funding that would typically be set aside for either financial investments or charitable donations and allows investors to seek both a financial and social return on their investment. This double bottom line, involving social and financial returns, increases access to funding not ordinarily available to social entrepreneurs.<sup>9</sup>

In an effort to efficiently introduce the L<sup>3</sup>C business model, states have designed L<sup>3</sup>C laws under existing LLC regulations.<sup>10</sup> The flexibility provided by LLC laws allows an L<sup>3</sup>C to claim a primary social mission and avail itself of unique financing tools such as tranche investing.<sup>11</sup> Specifically, the L<sup>3</sup>C statutes are devised to attract the program related investments (PRIs) of charitable foundations.<sup>12</sup>

Foundations give out billions of dollars every year, and PRIs are a valuable financing tool that allows social enterprises access to this money.<sup>13</sup> PRI funds can also be used to reduce the risk for other investors, thereby increasing returns as well as the total funding available to social entrepreneurs.<sup>14</sup> By design, L<sup>3</sup>C qualifications mirror the Internal Revenue Service’s (IRS) definition of a PRI-qualified entity,

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7. See Carter G. Bishop, *The Low-Profit LLC (L<sup>3</sup>C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 244 (2010) (defining the features of the L<sup>3</sup>C business model).
  8. Carol Coren & Robert M. Lang, *The L<sup>3</sup>C: The For-Profit with the Nonprofit Soul*, BRIDGES (Winter 2009), available at <http://stlouisfed.org/publications/br/articles/?id=1848> (suggesting that capitalism offers a market that can solve both the social and economic problems of the world).
  9. See Robert R Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 582 (2009) (stating that an L<sup>3</sup>C is merely a definitional addition to LLC statutes).
  10. See Andrew M. Wolk, *Social Entrepreneurship and Government: A New Breed of Entrepreneurs Developing Solutions to Social Problems*, SMALL BUS. ECON., 2007, at 151, 201, available at [http://archive.sba.gov/advo/research/sbe\\_07\\_ch06.pdf](http://archive.sba.gov/advo/research/sbe_07_ch06.pdf).
  11. See *id.* (arguing that tranche investing could lower the risk of investing in L<sup>3</sup>Cs for certain investors and therefore increase the overall funding available for L<sup>3</sup>Cs).
  12. See Anne Field, *IRS Rule Could Help the Fledgling L<sup>3</sup>C Corporate Form*, FORBES (May 4, 2012), <http://www.forbes.com/sites/annefield/2012/05/04/irs-rules-could-help-the-fledgling-l3c/> (stating that new changes to the PRI IRS guidelines could open up significant funding not previously available to social enterprises).
  13. See *Highlights of Foundation Yearbook*, FOUND. CENTER (Dec. 2011), [http://foundationcenter.org/gainknowledge/research/pdf/fy2011\\_highlights.pdf](http://foundationcenter.org/gainknowledge/research/pdf/fy2011_highlights.pdf) (using pie charts to show that approximately 2,733 corporate foundations in the U.S. awarded \$4.7 billion in grants in 2009).
  14. See Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 622 (2010) (stating that L<sup>3</sup>Cs are designed to make it easier and less costly for for-profit firms to obtain IRS-approved funding from

making this business model an attractive recipient of PRI funds.<sup>15</sup> However, neither the IRS nor the federal government has provided formal notification that L<sup>3</sup>Cs will receive preferential consideration,<sup>16</sup> and L<sup>3</sup>C advocates have thus proposed federal legislation that would enable L<sup>3</sup>Cs to receive preferential designation as presumptively PRI-qualified organizations.<sup>17</sup>

An L<sup>3</sup>C's access to large-scale funding allows it to develop a business that is both long-term and self-sufficient, unlike charities that are often dependent on annual refunding processes to sustain their operations.<sup>18</sup> The L<sup>3</sup>C model's focus on a double bottom line and tranche investing "gives many social enterprises a low enough cost of capital that they are able to be self sustainable," therefore making it "[a] 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."<sup>19</sup>

The creation of the L<sup>3</sup>C form was accompanied by high expectations that it could benefit some struggling businesses.<sup>20</sup> For example, in 2010, the North Carolina Legislature justified the passage of L<sup>3</sup>C legislation by arguing the hybrid model would help reinvigorate a stagnant state economy.<sup>21</sup> By mid-2012, forty-seven companies incor-

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nonprofit foundations); Field, *supra* note 12 (commenting that the Gates Foundation set up a \$100 million PRI fund in late 2010).

15. CHRISTOPHER REINHART, OLR RESEARCH REPORT NO. 2011-R-0344, LOW-PROFIT LIMITED LIABILITY COMPANIES OR L<sup>3</sup>Cs (2011), *available at* <http://www.cga.ct.gov/2011/rpt/2011-R-0344.htm> (describing how L<sup>3</sup>C statutes have been designed to mirror the requirements for an entity to receive a PRI).
16. *See id.* (discussing arguments against L<sup>3</sup>Cs in Connecticut, including the lack of a preferential IRS ruling).
17. *See* Malika Zouhali-Worrall, *For L3C Companies, Profit Isn't the Point*, CNNMONEY (Feb. 9, 2010), [http://money.cnn.com/2010/02/08/smallbusiness/l3c\\_low\\_profit\\_companies/](http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies/) ("L<sup>3</sup>C proponents . . . are courting potential sponsors on Capitol Hill for a federal bill.").
18. Evangeline Gomez, *The Rise of the Charitable For-Profit Entity*, FORBES (Jan. 13, 2012), <http://www.forbes.com/sites/evangelinagomez/2012/01/13/the-rise-of-the-charitable-for-profit-entity/> (stating that L<sup>3</sup>Cs, unlike charities, can turn a profit and distribute these profits to their investors).
19. Ams. for Cmty. Dev., *What Is the L<sup>3</sup>C?*, INTEGRATED CARE MGMT., [http://www.icm3.org/\\_PDFs/L3C.pdf](http://www.icm3.org/_PDFs/L3C.pdf) (last visited June 2, 2013) [hereinafter *What is the L<sup>3</sup>C?*] (describing how enabling socially responsible businesses to turn a profit makes them more self-sustaining in the long term).
20. Robert Lang, *The L<sup>3</sup>C and Economic Development*, AMERICANS FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/downloads/The%20L3C%20&%20Economic%20Development.pdf> (last visited June 2, 2013) [hereinafter Lang, *The L<sup>3</sup>C and Economic Development*] (discussing how the L<sup>3</sup>C could bring much-needed capital investments to the struggling newspaper industry).
21. S.B. 91, Gen. Assemb., Reg. Sess. (N.C. 2007), *available at* <http://www.ncga.state.nc.us/Sessions/2007/Bills/Senate/PDF/S91v5.pdf> (stating that the use of L<sup>3</sup>Cs would help improve the struggling North Carolina manufacturing economy).

porated as L<sup>3</sup>Cs in North Carolina, giving L<sup>3</sup>C supporters hope for even greater business growth in the upcoming years.<sup>22</sup>

Despite these successes, adoption of the L<sup>3</sup>C form has been slower than proponents expected. Some critics argue that L<sup>3</sup>Cs are nothing more than “specifically branded LLCs” and that the novelty of this new business form leaves its benefits and consequences shrouded in uncertainty.<sup>23</sup> With little state or federal governance, many questions remain regarding investor rights, securities trading, fiduciary duties, and profit distributions. Despite these criticisms and uncertainties, several states have passed L<sup>3</sup>C laws, and an increasing number of businesses are adopting this model.<sup>24</sup>

A similar business initiative has found great success in the United Kingdom (U.K.), where numerous proponents supported legislation designed to create hybrid business models that would promote social entrepreneurship.<sup>25</sup> As a result, the U.K. created the Community Interest Company (CIC) in 2006, allowing more than 4,500 companies to register as CICs that offer a double bottom line (or dual benefit) to investors.<sup>26</sup> Companies adopting the CIC model have ranged from one-person startups to well-established multimillion dollar companies.<sup>27</sup> The CIC model operates in a wide range of economic sectors, including agriculture, fishing, manufacturing, construction, hotels, education, and health services sectors.<sup>28</sup>

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22. See *Corporation Search*, N.C. DEPT. OF SEC'Y OF STATE, <http://www.secretary.state.nc.us/corporations/searchresults.aspx?onlyactive=OFF&Words=ANY&searchstr=L3C> (last visited July 15, 2012); see also *Our Story*, FIBERACTIVE ORGANICS, <http://www.fiberactiveorganics.com/our-story/> (last visited June 2, 2013) (stating that Fiberactive Organics was originally incorporated as an LLC and later converted to an L<sup>3</sup>C that manufactures custom clothes, quilts, linens, and other assorted items while promoting organic farming).
  23. See Bishop, *supra* note 7, at 244 (arguing L<sup>3</sup>Cs are unnecessary because everything an L<sup>3</sup>C can do an LLC can already accomplish).
  24. *Laws*, AMERICANS FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/laws.html> (last visited June 2, 2013) [hereinafter *Laws*] (listing nine states and two federal jurisdictions that have adopted L<sup>3</sup>C legislation).
  25. See Doeringer, *supra* note 2, at 307 (stating there are nearly two million social enterprises operating in Europe).
  26. REGULATOR OF CMTY. INTEREST CO., DEPT FOR BUS. INNOVATION & SKILLS, ANNUAL REPORT, 2010, (U.K.) available at <http://www.cicregulator.gov.uk/news/Annual%20Report/Annual%20Report%202009-10-%20Final.pdf> [hereinafter REGULATOR, ANNUAL REPORT 2010] (stating that between 2009 and 2010, there were roughly 131 applications for CIC classification per month).
  27. REGULATOR OF CMTY. INTEREST CO., THE CIC REGULATOR CASE STUDY SERIES: THE EXPERT PATIENTS PROGRAMME, (U.K.) available at <http://www.cicregulator.gov.uk/The%20Expert%20Patients%20Programme-ver0.1.pdf> [hereinafter REGULATOR, CASE STUDY SERIES] (stating that the Expert Patients Programme employs 1500 staff members and has £7.5 million of income a year).
  28. REGULATOR, ANNUAL REPORT 2010, *supra* note 26, at 12 (discussing the wide range of businesses that CICs currently operate).

While CICs and L<sup>3</sup>Cs were created with the same double bottom line in mind, CICs face strict government regulations that provide investors with additional protections. These regulations have indirectly contributed to the success of many CICs by increasing investor confidence in the success of these businesses.<sup>29</sup> In the United States, the flexibility of LLC statutes may provide L<sup>3</sup>Cs with unique funding options, but the lack of government regulation leaves investor outcomes uncertain and inhibits L<sup>3</sup>Cs from being a better-utilized business model for social entrepreneurship.

## II. SOCIAL VENTURES AND L<sup>3</sup>Cs

While the L<sup>3</sup>C business form is still in its introductory stage, there are examples of social entrepreneurs taking advantage of the business model and the L<sup>3</sup>C brand to attract new investors. In February 2012, Renewable Social Benefit Funds, “an alternative energy company focused exclusively on bringing solar power to hospitals, schools, low-income housing projects and other governmental and tax-exempt entities,” announced a collaboration with Panasonic Enterprise Solutions Company and the Conrad N. Hilton Foundation to provide a solar power installation on the Hilton Foundation’s corporate campus.<sup>30</sup> The Hilton Foundation stated that working with “Renewable Social Benefit Funds’ financing will allow [it] to allocate assets to other charitable purposes, a double win for the Foundation.”<sup>31</sup> This collaboration enables the Hilton Foundation to take advantage of Renewable Social Benefit Funds’ L<sup>3</sup>C business model and “lower [its] carbon footprint.”<sup>32</sup>

Another business that has successfully used the L<sup>3</sup>C’s unique financing model is the Paradigm Project, a company dedicated “to creat[ing] sustainable social, economic and environmental value

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29. See REGULATOR OF CMTY. INTEREST CO., GUIDANCE CHAPTER 1: INTRODUCTION 3, available at <http://www.bis.gov.uk/assets/bispartners/cicregulator/docs/guidance/11-950-community-interest-companies-guidance-chapter-1-introduction> (last updated Dec. 2010) (stating that the government regulation helps protect public confidence in CICs by ensuring that they follow the law).

30. See *Panasonic and Renewable Social Benefit Funds Team to Bring Solar Power Capability to Conrad N. Hilton Foundation’s New Campus*, PRNEWswire (Feb. 28, 2012), <http://www.prnewswire.com/news-releases/panasonic-and-renewable-social-benefit-funds-team-to-bring-solar-power-capability-to-conrad-n-hilton-foundations-new-campus-140721673.html> [hereinafter PRNEWswire, *Hilton Foundation*] (describing the collaboration between the Hilton Foundation and Renewable Social Benefit Funds, a Colorado-based L<sup>3</sup>C).

31. *Id.* (describing how the project will be financed and indicating the use of a PRI by the foundation).

32. *Id.* (setting forth the reasons for the collaboration, including reducing the campus’s carbon footprint and promoting environmentally responsible habits).

within developing world communities.”<sup>33</sup> The Paradigm Project combines grants, low-interest loans, charitable donations, and traditional market investments to fund its various projects, including the marketing of affordable, energy-efficient stoves in Kenya, Guatemala, and Haiti.<sup>34</sup> Through partnerships with nongovernmental organizations (NGOs), charitable organizations, social capital partners, and investors, the Paradigm Project has distributed over 36,000 energy efficient stoves in developing countries across the globe.<sup>35</sup>

### A. The Development of the LLC

Since 1990, market demands for more diverse and flexible business arrangements resulted in dramatic changes in traditional business forms that exceeded the original flexibility allowed under corporate and partnership law.<sup>36</sup> The first LLC statute was passed in Wyoming in 1977; however, widespread adoption of the LLC business form was stagnant until the IRS officially classified the LLC as a partnership for federal income tax purposes in 1988.<sup>37</sup> As a result of this classifi-

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33. *The Paradigm Project Featured at Clinton Global Initiative*, PRNEWswire (September 20, 2010), <http://www.prnewswire.com/news-releases/the-paradigm-project-featured-at-clinton-global-initiative-103269839.html> [hereinafter PRNEWswire, *Clinton Global Initiative*] (“The Paradigm Project is a low-profit, limited liability company (L3C) whose mission is to create sustainable economic, social and environmental value within developing world communities . . . . Their desire to create a lasting, positive impact on these communities was the impetus for the creation of a unique model that combines best practices from market driven and philanthropic sectors to deliver sustainable change . . . .”); see also *About Us, Levering Carbon Offsets on Behalf of the Poor*, PARADIGM PROJECT, <http://www.theparadigmproject.org/about-us/> (last visited June 2, 2013) [hereinafter PARADIGM PROJECT, *Levering Carbon Offsets*] (describing how initial project funding for the Paradigm Project is derived from a “mix of investor and donor capital, which covers costs until the carbon revenue makes the project self-sustainable”).
  34. See PARADIGM PROJECT, *Levering Carbon Offsets*, *supra* note 33; *Current and Future Projects*, PARADIGM PROJECT (Dec. 20, 2011), <http://theparadigmproject.org/our-stoves-in-kenya/> [hereinafter PARADIGM PROJECT, *Current and Future Projects*]; see also PRNEWswire, *Clinton Global Initiative*, *supra* note 33 (describing the current and future business plans for the Paradigm Project as of 2010).
  35. See *Our Commitment*, PARADIGM PROJECT, <http://www.theparadigmproject.org/our-commitment> (last visited June 2, 2013) [hereinafter PARADIGM PROJECT, *Our Commitment*] (describing the organization’s mission to deliver five million energy efficient stoves in developing countries by 2020).
  36. See J. William Callison & Allan W. Vestal, “*They’ve Created a Lamb with Mandibles of Death*”: *Secrecy, Disclosure, and Fiduciary Duties in Limited Liability Firms*, 76 IND. L.J. 271, 272 (2001) (stating that traditional business forms have been reworked to make new forms such as the LLC, Limited Liability Partnership (LLP), and the Limited Liability Limited Partnership (LLLLP)).
  37. Thomas E. Rutledge & Lady E. Booth, *The Limited Liability Company Act: Understanding Kentucky’s New Organizational Option*, 83 KY. L.J. 1, 64 (1995) (describing the proliferation of the LLC business model after the IRS’s 1988 ruling, which classified a Wyoming LLC as a partnership for federal income tax purposes).

cation, the LLC was able to combine limited liability and favorable tax benefits into one business form.<sup>38</sup>

Statutory developments have curtailed the unique limited liability protections of the LLC and have rendered it a less desirable business model.<sup>39</sup> For example, LLC members have been held personally liable for pre-formation transactions, post-dissolution transactions, acts other than as an owner, improper purposes, wrongful distributions, and professional obligation violations.<sup>40</sup> However, the developments in LLC law have also created a flexible and fluid business form that is used for many purposes and serves the needs of businesses ranging from one-person operations to multi-billion dollar international companies.<sup>41</sup>

## B. Legislative History and Passage of the L<sup>3</sup>C

The flexible nature of the LLC has made it amenable to expansions and statutory modifications in order to create hybrid business forms.<sup>42</sup> North Carolina was the first state to propose amending its LLC laws to allow the establishment of L<sup>3</sup>Cs.<sup>43</sup> In 2007, Senator Jim Jacumin sponsored Senate Bill 91, the Endangered Manufacturing and Jobs Act, which included provisions allowing the creation of an L<sup>3</sup>C.<sup>44</sup> Although S.B. 91 did not survive the legislative session, L<sup>3</sup>Cs eventually

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38. Thomas E. Rutledge, *Limited Liability (Or Not): Reflections on the Holy Grail*, 51 S.D. L. REV. 417, 422 (2006) (arguing that the LLC combines the best features of corporate law and partnerships to create a powerful tax-planning business form).
  39. See Callison & Vestal, *supra* note 36, at 272–73 (noting that all fifty states have adopted LLC legislation and LLC statutes are being constantly reworked and amended); Rutledge, *supra* note 38, at 430. (setting forth statutory and judicial restraints on the limited liability of LLCs and their individual members).
  40. Rutledge, *supra* note 38, at 430 (stating that individual LLC members can be found personally liable for a multitude of violations and that the principle of “piercing the corporate veil” has been applied in order to hold individual members accountable for egregious conduct).
  41. See Matthew G. Dore, *What, Me Worry? Tort Liability Risks for Participants in LLCs*, 11 U.C. DAVIS. BUS. L.J. 267, 269 (2011) (discussing the widespread use and acceptance of LLCs and indicating they have surpassed traditional corporations as the preferred business entity).
  42. See Heather Sertial, Note, *Hybrid Entities: Distributing Profits with a Purpose*, 17 FORDHAM J. CORP. & FIN. L. 261, 282 (2012) (discussing how the flexibility of the LLC’s governance structure can benefit the L<sup>3</sup>C’s social agenda).
  43. S.B. 308, Gen. Assemb., Reg. Sess. (N.C. 2009), available at <http://www.ncga.state.nc.us/Sessions/2009/Bills/Senate/PDF/S308v5.pdf>.
  44. N.C. S.B. 91, *supra* note 21 (arguing that L<sup>3</sup>Cs would help improve North Carolina’s struggling manufacturing industry). The Endangered Manufacturing and Jobs Act, or S.B. 91, sets forth a list of reasons for the introduction of L<sup>3</sup>Cs. *Id.* Specifically, S.B. 91 states that overseas competition damaged the North Carolina furniture industry and L<sup>3</sup>Cs could help stimulate job creation and attract investors and other funding in order to revitalize the furniture industry. *Id.* S.B. 91 also states that the benefits of L<sup>3</sup>Cs merging with the furniture industry would strengthen the overall economy of North Carolina. *Id.*

became a reality in North Carolina in 2010 with the passage of Senate Bill 308.<sup>45</sup>

Senate Bill 308 defines an L<sup>3</sup>C as an LLC that is formed for both business and charitable purposes.<sup>46</sup> However, an L<sup>3</sup>C is considered a for-profit company for any tax issue.<sup>47</sup> To satisfy the charitable purpose requirements of the statute, an L<sup>3</sup>C must be set up “[t]o accomplish one or more charitable or educational purposes within the meaning of section 170(c)(2)(B) of the Code, as defined in G.S. 105-228.90.”<sup>48</sup> In addition, the L<sup>3</sup>C must operate in such a manner that “no significant purpose of the company is the production of income or the appreciation of property.”<sup>49</sup> However, production of “significant income . . . is not, in the absence of other factors, conclusive evidence of a significant purpose to produce income or accumulate capital.”<sup>50</sup> The L<sup>3</sup>C also must operate in such a way “that no purpose of the company is to accomplish . . . [any] political or legislative purposes within the meaning of section 170(c)(2)(D) of the Code, as defined in G.S. 105-228.90.”<sup>51</sup>

The North Carolina L<sup>3</sup>C statute sets forth the requirements of an L<sup>3</sup>C’s articles of incorporation.<sup>52</sup> The statute also states that the name of any low-profit limited liability company must contain the words “low-profit limited liability company” or the abbreviation “L<sup>3</sup>C.”<sup>53</sup> If at any time the L<sup>3</sup>C fails to meet the requirements of the

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45. See N.C. S.B. 308, *supra* note 43.

46. *Id.* (“[An L<sup>3</sup>C] is formed for both a business purpose and a charitable purpose that requires operation of the company in accordance with the requirements of this subsection.”).

47. *Id.*

48. *Id.*; see also INTERNAL REVENUE SERV., EXEMPT PURPOSES—INTERNAL REVENUE CODE SECTION 501(c)(3), *available at* [\(http://www.irs.gov/Charities-&-Nonprofits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501\(c\)\(3\)\)](http://www.irs.gov/Charities-&-Nonprofits/Charitable-Organizations/Exempt-Purposes-Internal-Revenue-Code-Section-501(c)(3)) (defining the term “charitable” as “used in its generally accepted legal sense and includes relief of the poor, the distressed, or the underprivileged; advancement of religion; advancement of education or science; erecting or maintaining public buildings, monuments, or works; lessening the burdens of government; lessening neighborhood tensions; eliminating prejudice and discrimination; defending human and civil rights secured by law; and combating community deterioration and juvenile delinquency.”).

49. See N.C. S.B. 308, *supra* note 43.

50. *Id.*

51. *Id.*; see also INTERNAL REVENUE SERV., THE RESTRICTION OF POLITICAL CAMPAIGN INTERVENTION BY SECTION 501(c)(3) TAX EXEMPT ORGANIZATIONS, *available at* [\(http://www.irs.gov/Charities-&-Nonprofits/Charitable-Organizations/The-Restriction-of-Political-Campaign-Intervention-by-Section-501\(c\)\(3\)\)](http://www.irs.gov/Charities-&-Nonprofits/Charitable-Organizations/The-Restriction-of-Political-Campaign-Intervention-by-Section-501(c)(3)) (“Under the Internal Revenue Code, all section 501(c)(3) organizations are absolutely prohibited from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office.”).

52. N.C. S.B. 308, *supra* note 43.

53. *Id.*

statute, the L<sup>3</sup>C will no longer be able to use the L<sup>3</sup>C name but will remain a fully functional LLC.<sup>54</sup>

Although North Carolina was the first state to propose an L<sup>3</sup>C statute, Vermont was the first state to actually enact such a statute.<sup>55</sup> Vermont's L<sup>3</sup>C statute is very similar to the original North Carolina legislation, although one significant difference between the two is that the Vermont statute requires that an L<sup>3</sup>C can only be created when it maintains a "relationship to the accomplishment of charitable or educational purposes."<sup>56</sup> The laws are also similar in that the Vermont statute provides that if at any time an L<sup>3</sup>C fails to satisfy any requirement, it shall immediately cease to be a low-profit LLC and will exist only as an LLC.<sup>57</sup>

### C. Current Legal Landscape of L<sup>3</sup>Cs

Since 2008, Illinois, Louisiana, Maine, Michigan, North Carolina, Rhode Island, Utah, Wyoming, and two Indian nations have enacted L<sup>3</sup>C legislation.<sup>58</sup> As of June 2013, L<sup>3</sup>C statutes have been proposed in twenty-seven additional states.<sup>59</sup> Additionally, an increasing number of businesses are utilizing the L<sup>3</sup>C model. For example, Vermont had 185 registered L<sup>3</sup>Cs as of June 2013, less than five years after it

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54. See, e.g., N.C. S.B. 91, *supra* note 21 (stating that "if an entity that met this definition at its formation at any time ceases to satisfy any one of the foregoing requirements, it shall immediately cease to be a low-profit limited liability company but will continue to exist as a limited liability company.")

55. H.B. 775, Gen. Assemb., 2007–08 Leg. Sess. (Vt. 2008) (codified at VT. STAT. ANN. tit. 11, § 3001 (West 2009)).

56. *Id.* (defining an L<sup>3</sup>C as a business that "significantly furthers the accomplishment of one or more charitable or educational purposes" and "would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes").

57. *Id.* (stating that failure to comply with the state's L<sup>3</sup>C statute will result in immediate revocation of the L<sup>3</sup>C designation).

58. See, e.g., 805 ILL. COMP. STAT. 180/1-5 (West 2010); LA. REV. STAT. ANN. § 12:1301 (West 2010); ME. REV. STAT. ANN. tit. 31, § 1502 (West 2009) (effective July 1, 2011); MICH. COMP. LAWS ANN. § 450.4102(2)(m) (West 2010); UTAH CODE ANN. § 48-2c-102 (West 2010); VT. STAT. ANN. tit. 11, § 3001 (West 2009); WYO. STAT. ANN. § 17-29-102 (West 2010); see also *Laws, supra* note 24 (listing Illinois, Louisiana, Maine, Michigan, North Carolina, Utah, Vermont, Wyoming, the Oglala Sioux Tribe, and the Crow Indian Nation of Montana as jurisdictions that have adopted L<sup>3</sup>C legislation).

59. John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, n.1 (2010) (noting that as of 2009, five states and two Indian nations passed L<sup>3</sup>C laws and eight other states, including Arkansas, Colorado, Kentucky, Maryland, Massachusetts, Missouri, Montana, New York, North Dakota, Oregon, Tennessee, and Virginia, were considering similar legislation); see also *Considering Legislation in Your State?*, AMERICANS FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/considering.html> (last visited July 3, 2013) (listing a total of twenty-seven states where L<sup>3</sup>C legislation has been written).

authorized the use of L<sup>3</sup>Cs.<sup>60</sup> By the summer of 2013, there were 490 L<sup>3</sup>Cs registered in Illinois, Michigan, North Carolina, Utah, and Wyoming and over 850 L<sup>3</sup>Cs registered nationally.<sup>61</sup>

## II. SOURCES OF L<sup>3</sup>C FUNDING

Social business ventures provide goods and services where governments, traditional for-profit companies, and nonprofits have not met market and social demands.<sup>62</sup> However, social business ventures have not always had access to the same financing options enjoyed by for-profit and nonprofit organizations.<sup>63</sup> The L<sup>3</sup>C structure was thus developed to allow companies to gain access to financing and investments not previously available to social business ventures, including venture capitalists, angel investors, foundation grants, and PRIs.<sup>64</sup>

L<sup>3</sup>Cs provide three unique features to increase funding to social entrepreneurs. First, the L<sup>3</sup>C structure was created to accommodate PRIs, which is the main vehicle used by charitable foundations to make high-risk investments.<sup>65</sup> Second, the flexibility of LLC statutes allows L<sup>3</sup>Cs to use tranche investing so that the L<sup>3</sup>C can offer different rates of return for different investors.<sup>66</sup> Third, the branding of the L<sup>3</sup>C as a new and reliable business form is tailored to increase the trust of investors interested in funding dual mission companies.<sup>67</sup>

### A. Program-Related Investments

Grant-making foundations are key players in nonprofit financing, even though the IRS has imposed restrictions on how these private,

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60. R.I. GEN. LAWS. ANN. § 7-16-76 (West 2012) (effective July 1, 2012); *see also Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, [http://www.intersectorl3c.com/l3c\\_tally.html](http://www.intersectorl3c.com/l3c_tally.html) (last updated June 25, 2013) (listing approximately 850 registered L<sup>3</sup>Cs in the United States as of June 2013).

61. *See* INTERSECTOR PARTNERS, *supra* note 60.

62. Mukesh Sud, Craig V. VanSandt & Amanda M. Baugous, *Social Entrepreneurship: The Role of Institutions*, 85 J. BUS. ETHICS 201, 202–09 (2009) (discussing how the current makeup of social entrepreneurship has failed to meet the needs of society).

63. *Id.* at 203 (noting that each type of business venture has historically been limited to specific types of funding).

64. *See* Lang, *The L<sup>3</sup>C and Economic Development*, *supra* note 20 (discussing how tranche investing may make available different types of potential L<sup>3</sup>C investors).

65. *Id.* (noting that L<sup>3</sup>C statutes were specifically designed to open up access to PRIs).

66. *Id.* (noting that PRIs are the most at risk investment in L<sup>3</sup>Cs, but their contribution makes L<sup>3</sup>C investment more attractive to other investors because it “take[s] much of the risk out of the venture” by “improving the credit rating and lowering the cost of capital”).

67. *Id.* (arguing that hybrid business forms need specific branding in order to increase investor security and trust).

tax-exempt foundations can spend their money.<sup>68</sup> In order for a private foundation to keep its tax-exempt status, it is required to expend a certain percentage of its assets every year for charitable purposes.<sup>69</sup> The percentage a private foundation must expend is determined through a complex formula, but generally a foundation will be required to expend nearly five percent of the fair market value of its assets each year.<sup>70</sup>

If a foundation “invests any amount in such a manner as to jeopardize the carrying out of any of its exempt purposes,” § 4944 of the Internal Revenue Code imposes a 10% tax of the amount invested during each year of the taxable period.<sup>71</sup> Jeopardizing investments are investments that are “unduly risky”<sup>72</sup> or investments in which managers “have failed to exercise ordinary business care and prudence . . . in providing for the long- and short-term financial needs of the foundation . . . .”<sup>73</sup> If the questionable investment is not removed from jeopardy within the tax year, an additional 25% tax is imposed on the foundation.<sup>74</sup> Congress, by exempting PRIs from the set of jeopardizing investments, clearly created an exception to the general rule that foundations can only invest in nonprofits.<sup>75</sup> PRIs thus count as part of the required distribution percentage that private foundations must expend for charitable purposes annually, and they do not subject the private foundation to the costly excise taxes that are placed on jeopardizing investments.<sup>76</sup>

To qualify as a PRI, a foundation’s investment must satisfy three requirements.<sup>77</sup> The first is the charitable-purpose test, which man-

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68. See Michael D. Gottesman, Comment, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 *YALE L. & POL’Y REV.* 345, 348–49 (2007) (noting the funding problems that face nonprofits and arguing that a hybrid business form could help these social enterprises tap into the large financial support of foundations).

69. See Reiser, *supra* note 14, at 622 (noting that PRIs qualify toward the required annual distribution).

70. *Id.* (“[The] percentage private foundations must expend for charitable purposes . . . is determined using a relatively complex formula.”).

71. I.R.C. § 4944(a)(2) (West 2006) (imposing a 10% tax on managers who knowingly and willfully participate in making an investment that jeopardizes a charitable purpose).

72. See Richard Schmalbeck, *Reconsidering Private Foundation Investment Limitations*, 58 *TAX L. REV.* 59, 66 (2004) (discussing the statutory history of I.R.C. § 4944 and jeopardizing investments, including Congress’s legislative intent, the penalties the statute imposes, any exceptions to the penalties, and the surprisingly small number of disputes arising under this provision).

73. Treas. Reg. § 53.4944-1(a)(2) (1973).

74. I.R.C. § 4944(b)(1).

75. See Gottesman, *supra* note 68, at 349–50 (noting that Congress enabled PRIs in 1972 to add flexibility to foundation investments and distributions).

76. See Reiser, *supra* note 14, at 622 (noting that a foundation must distribute a certain amount of its assets each year).

77. I.R.C. § 4944(c).

dates that the investment “significantly furthers the accomplishment of the private foundation’s exempt activities and [that] the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation’s exempt activities.”<sup>78</sup> The second requirement, the income-production test, specifies that the production of income or appreciation of property may not be a significant purpose of the investment.<sup>79</sup> The third requirement, the political- and lobbying-expense test, specifies that a primary purpose may not be influencing legislation or taking part in political campaigns on behalf of candidates.<sup>80</sup>

“Program-related investments” is a term applied uniquely to those investments made by nonprofit, tax-exempt private foundations<sup>81</sup> to for-profit companies whose activities help accomplish the foundations’ social missions.<sup>82</sup> For example, “a foundation that aims to expand affordable housing might lend money to a housing development company” and, if the housing development company succeeds financially, then the foundation could receive some financial return on its investment.<sup>83</sup> While no federal law or IRS rule requires a foundation to get IRS approval before making a program-related investment,<sup>84</sup> it could be costly for the foundation to not seek early IRS approval if the investment is later determined to be a jeopardizing investment that subjects the foundation to excise taxes.<sup>85</sup> As alternatives, a foundation has two primary options available to aid in determining whether a specific investment qualifies as a PRI. First, the foundation can consult published IRS letter rulings on PRIs; however, IRS rulings about PRIs are extremely rare.<sup>86</sup> The foundation can also ask the IRS for a private letter ruling (PLR) on whether an investment in a specific L<sup>3</sup>C qualifies as a PRI.<sup>87</sup> This may, however, be an impractical alternative

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78. 26 C.F.R. § 53.4944-3(a)(2)(i) (2013).

79. I.R.C. § 4944(c).

80. See 26 C.F.R. § 53.4944-3(a)(1)(iii) (2013).

81. See Reiser, *supra* note 14, at 622 (describing the development and use of PRIs).

82. See Gottesman, *supra* note 68, at 349–50 (stating PRIs are used to help a foundation accomplish its social mission by providing funding to third parties).

83. *Id.* at 350 (describing how a foundation may use a PRI and still receive a return on its investment).

84. See Robert Lang, *PRIs and Private Letter Rulings*, AMERICANS FOR COMMUNITY DEV., <http://www.americansforcommunitydevelopment.org/downloads/PRIsAndPrivateLetterRulings.pdf> (last visited July 14, 2013) [hereinafter Lang, *Private Letter Rulings*] (stating foundations can currently make PRIs to L<sup>3</sup>Cs without the IRS’s approval).

85. See I.R.C. § 4944 (West 2010) (setting forth the excise taxes on jeopardizing investments).

86. See Bishop, *supra* note 7, at 260.

87. See UNDERSTANDING IRS GUIDANCE — A BRIEF PRIMER, INTERNAL REVENUE SERVICE (Mar. 14, 2013), <http://www.irs.gov/uac/Understanding-IRS-Guidance-A-Brief-Primer> (“A private letter ruling, or PLR, is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer’s specific set of

for many foundations because PLRs are typically expensive and often take substantial time to obtain.<sup>88</sup> PLRs thus appear to be an option that few foundations are willing or able to utilize in determining whether an investment qualifies as a PRI.<sup>89</sup>

While the L<sup>3</sup>C was created to be a viable vehicle to receive the PRIs of foundations,<sup>90</sup> senior IRS agent, Ron Schultz recently expressed concern over foundations making PRIs to L<sup>3</sup>Cs.<sup>91</sup> Schultz warned that the IRS is still undergoing a process to determine the tax consequences of L<sup>3</sup>Cs.<sup>92</sup> He noted that “at the federal level, no one has really signed off” on whether a private foundation’s investment in an L<sup>3</sup>C qualifies as a PRI.<sup>93</sup> He further urged caution by foundations looking to make PRIs in L<sup>3</sup>Cs, stating that if “you think the jeopardy investment issue is a slam dunk and you don’t need to concern yourself with it, that would be premature.”<sup>94</sup>

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facts. A PLR is issued to establish with certainty the federal tax consequences of a particular transaction before the transaction is consummated or before the taxpayer’s return is filed. A PLR is issued in response to a written request submitted by a taxpayer and is binding on the IRS if the taxpayer fully and accurately described the proposed transaction in the request and carries out the transaction as described. A PLR may not be relied on as precedent by other taxpayers or IRS personnel. PLRs are generally made public after all information has been removed that could identify the taxpayer to whom it was issued.”)

88. See Lang, *Private Letter Rulings*, *supra* note 84 (describing the high legal costs associated with PLRs).
89. In 2006, a survey of more than 72,000 foundations was conducted to determine how often they use PRIs. The results showed the foundations made aggregate qualifying distributions of \$43 billion but that PRIs only accounted for 1% of these distributions. *Aggregate Data by Private Foundation Type, 2006*, FOUND. CENTER, (2008), available at [http://foundationcenter.org/findfunders/statistics/pdf/01\\_found\\_fin\\_data/2006/02\\_06.pdf](http://foundationcenter.org/findfunders/statistics/pdf/01_found_fin_data/2006/02_06.pdf). Traditionally, private foundations limit their use of PRIs because of the risk of the IRS ruling that the PRIs were jeopardizing investments. *Id.* See also Michael D. Martin, *Donor Advised Funds and the L<sup>3</sup>C*; “*Shall We Dance?*”, AMERICANS FOR COMMUNITY DEV., available at [http://www.americansforcommunitydevelopment.org/TDE\\_CMS/database/userfiles/Donor%20Advised%20Funds%20and%20The%20L3C.pdf](http://www.americansforcommunitydevelopment.org/TDE_CMS/database/userfiles/Donor%20Advised%20Funds%20and%20The%20L3C.pdf) (stating PRIs typically comprise 1–5% of a foundation’s annual distributions); Robert Lang, *Philanthropic Facilitation Act of 2010*, (2010), available at <http://www.americansforcommunitydevelopment.org/downloads/PhilanthropicFacilitationAct2010.pdf> [hereinafter Lang, *Philanthropic Facilitation Act*] (proposing federal legislation to ease the potential burden of making a PRI to an L<sup>3</sup>C).
90. See Lang, *Philanthropic Facilitation Act*, *supra* note 89, at 1 (stating that only 5% of private foundations make PRIs of any kind).
91. See Diane Freda, *IRS Tax-Exempt Official Urges Caution for Groups Eyeing Low-Profit LLC Investment*, BNA DAILY TAX REP., No. 126, at G-3 (July 6, 2009) (setting forth potential problems with foundations relying on L<sup>3</sup>Cs to make PRIs).
92. See *id.* (noting there is no federal regulation giving special treatment to L<sup>3</sup>Cs, and they are treated as any other LLC).
93. See *id.* (discussing the dangers of ignoring jeopardizing investment issues with L<sup>3</sup>Cs).
94. *Id.*

When a foundation makes an investment in an L<sup>3</sup>C, there is no guarantee that the investment will qualify as a PRI.<sup>95</sup> A foundation needs to make sure that any specific PRI made to an L<sup>3</sup>C furthers the foundation's charitable purposes because an investment in an L<sup>3</sup>C might qualify as a PRI for one foundation but as a jeopardizing investment for another.<sup>96</sup> Therefore, unless this uncertainty is reduced by changes to state and federal law, it is unlikely that L<sup>3</sup>Cs will receive significant funding from foundations in the form of PRIs due to the risks associated with such investments.

## B. Proposed Federal PRI Legislation

Proponents of the L<sup>3</sup>C have pushed for changes in federal law that would resolve the issues faced by foundations that wish to invest PRIs in L<sup>3</sup>Cs.<sup>97</sup> The Philanthropic Facilitation Act (PFA) of 2010 proposes amendments to the IRS Code and the Treasury regulations in order to increase the use of PRIs by allowing private foundations to invest in L<sup>3</sup>Cs more efficiently and effectively.<sup>98</sup> However, the proposed legislation has not received federal support and may not be passed by Congress.<sup>99</sup> While the PFA is not essential for the survival of L<sup>3</sup>Cs, the legislation would enable the L<sup>3</sup>C to become a more viable business model for social entrepreneurs.

The PFA proposes to amend § 4944(c) of the IRS Code to provide for a voluntary procedure through which an L<sup>3</sup>C or foundation could ask the IRS for a ruling on whether or not an investment qualifies as a PRI.<sup>100</sup> This voluntary pre-approval process would be similar to the process for recognizing a § 501(c)(3) tax exempt organization, and the time and cost of the determination would likely be equivalent to the time and cost for a § 501(c)(3) tax exempt status determination.<sup>101</sup> If the IRS ruled that an investment qualified as a PRI, then all private foundations with common purposes could rely on this determination

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95. *See id.*

96. *See* C.F.R. § 53.4944-3(a)(2)(i) (2013).

97. *See* Lang, *Philanthropic Facilitation Act*, *supra* note 89. The Americans for Community Development, an organization founded by Robert Lang to help support the continued growth and creation of L<sup>3</sup>Cs, designed, drafted, and proposed three pieces of legislation: 1) The Program-Related Promotion Act of 2008; 2) The Program-Related Promotion Act of 2009; and 3) the Philanthropic Facilitation Act of 2010. *Id.*

98. *See id.*

99. *See* Matt Doeringer, *Reevaluating the L<sup>3</sup>C: Mistaken Assumptions and Potential Solutions*, PHILANTHROPY, VOLUNTARISM, AND NOT-FOR-PROFIT MANAGEMENT PAPER SERIES, DUKE UNIVERSITY, May 3, 2010, at 17, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1696267](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1696267).

100. *See* Lang, *Philanthropic Facilitation Act*, *supra* note 89, at 8–10.

101. *See* Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 Vt. L. Rev. 163, 170 (2010) (arguing a pre-approval process would facilitate more PRIs).

when making investments to that specific entity until the IRS published a notice of revocation.<sup>102</sup> In addition to the voluntary pre-approval process, the PFA also seeks amendments to § 4944(c) that would clarify that PRIs are not jeopardizing investments.<sup>103</sup>

The PFA also proposes that the Treasury regulations be amended to clarify that a PRI is a qualified distribution and that PRIs are excluded from the Code's definition of a business holding.<sup>104</sup> In addition, the PFA seeks to have the Treasury regulations include examples of investments in an L<sup>3</sup>C that would qualify as PRIs, investments that would not qualify, and investments that initially would qualify but, due to a change in circumstances, would later not qualify.<sup>105</sup> The PFA also seeks guidance from the Treasury regulations on how a private foundation could divest itself of a PRI that no longer qualifies.<sup>106</sup> Finally, the PFA proposes requiring L<sup>3</sup>Cs to disclose a significant amount of financial information to the public.<sup>107</sup> The PFA's creators state that requiring financial disclosures, increasing federal regulation, and providing further clarification on PRIs, will give investors more confidence in L<sup>3</sup>Cs.<sup>108</sup>

The PFA supports its requests for these amendments with a variety of arguments. The PFA first contends that more entities may take advantage of the L<sup>3</sup>C format if PRI rules are clarified.<sup>109</sup> It also argues that L<sup>3</sup>Cs are an excellent alternative business vehicle for non-profit ventures in a variety of struggling industries such as newspapers, magazines, radio stations, broadcast news, and auto manufacturers because the L<sup>3</sup>C model could allow these companies to make use of private foundation money without abandoning for-profit funding.<sup>110</sup> In addition, the PFA states that L<sup>3</sup>Cs are more stable economic business entities than are nonprofits because L<sup>3</sup>Cs can utilize both for-profit and private foundation investors.<sup>111</sup>

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102. *See id.* (stating that "private foundations could then rely on this determination unless and until the Secretary of the Treasury published a notice of revocation").

103. *See Lang, Philanthropic Facilitation Act, supra* note 89, at 8–10 (setting forth proposed amendments to federal legislation in an attempt to make L<sup>3</sup>Cs more attractive for PRIs).

104. *See id.* at 10.

105. *See id.*

106. *See id.*

107. *See Schmidt, supra* note 101, at 170 (noting L<sup>3</sup>Cs might benefit from disclosing their financial statements to the general public and interested investors).

108. *See id.* at 171 (admitting investors are currently distraught by the uncertainty surrounding L<sup>3</sup>Cs and PRIs).

109. *See Lang, Philanthropic Facilitation Act, supra* note 89, at 8 (setting forth proposed amendments to federal legislation in an attempt to make L<sup>3</sup>Cs more attractive for PRIs).

110. *See id.* at 3–8 (stating PRIs and other for-profit funding can successfully be combined in L<sup>3</sup>Cs).

111. *See id.* (arguing a mix of for-profit and charitable funding will make L<sup>3</sup>Cs more economically stable and sustainable).

### C. Proposed IRS Guidelines for PRIs

On April 19, 2012, the IRS released a proposed rule (Proposed Guidelines) that lists examples of qualified PRIs as an aid to private foundations considering the use of PRIs.<sup>112</sup> The Proposed Guidelines would supplement § 53.4944-3(b) of the IRS Code and would add additional examples of qualified PRIs that would not run afoul of the jeopardizing investment excise tax in § 4944(a) of the IRS Code.<sup>113</sup> IRS Code § 53.4944-3(b) currently sets forth nine examples of qualified PRIs, and the Proposed Guidelines offer an additional nine examples of qualified PRIs.<sup>114</sup> Although the Proposed Guidelines could raise concerns among foundations regarding the use of PRIs, the Proposed Guidelines only provide examples of PRI-qualified investments and in no way modify the existing regulations that control PRIs.<sup>115</sup>

Several examples in the Proposed Guidelines are likely quite pertinent to the issue of when foundations can make PRIs in L<sup>3</sup>Cs. The first example describes a qualified PRI for a foundation that provides funding to a drug manufacturer for the development of a vaccine that otherwise would not be developed because of its low expected return on investment.<sup>116</sup> Another example indicates that a foundation may make a qualified PRI by providing a low-interest loan to a business in an area affected by a natural disaster.<sup>117</sup> Similarly, the Proposed Guidelines state that a foundation may provide capital to a limited liability company that purchases coffee from poor farmers in a developing country.<sup>118</sup> This example states that the LLC can use the loan to train the coffee farmers, an activity it cannot do without the foundation's loan.<sup>119</sup>

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112. See Examples of Program-Related Investments, 77 Fed. Reg. 23429 (proposed Apr. 19, 2012) (to be codified at 28 C.F.R. pt. 53).

113. See *id.* (noting the concerns and dangers foundations face when entertaining PRI investments).

114. See *id.* (discussing the wide range of PRI-qualified investments available to foundations).

115. See *id.* (stating the Proposed Guidelines are based on current published letter rulings and PRI regulations).

116. See *id.* (describing how a foundation can buy specialized stock in a for-profit company if its investment capital is used to satisfy the PRI requirements for a qualified investment).

117. See Suzanne Perry, *White House Seeks to Spur Innovative Spending by Foundations*, CHRON. PHILANTHROPY (May 10, 2012), [http://philanthropy.com/article/White-House-Seeks-to-Spur/131840/?sid=pt&utm\\_source=pt&utm\\_medium=en](http://philanthropy.com/article/White-House-Seeks-to-Spur/131840/?sid=pt&utm_source=pt&utm_medium=en) (describing the Proposed Guidelines and their potential to increase the use of PRIs).

118. See Examples of Program-Related Investments, *supra* note 112, at 9.

119. See *id.* (stating a foundation can make a qualified PRI to an LLC in the form of a below-market-rate loan if it advances the education of poor farmers or another qualified activity).

The Proposed Guidelines are the first update to the PRI regulation since its initial development in 1972; they are expected to increase dialogue in the social community about the use of PRIs and to simplify the process by which foundations may utilize PRIs.<sup>120</sup> While the Proposed Guidelines do not specifically mention L<sup>3</sup>Cs, they do discuss for-profit LLCs that operate for charitable purposes and use PRIs to further social goals. The Proposed Guidelines thus provide specific guidance to charitable foundations and L<sup>3</sup>Cs regarding contexts in which PRIs can likely be made to L<sup>3</sup>Cs.

#### D. Flexibility of Tranche Investing

While L<sup>3</sup>Cs are structured to accommodate PRIs, they offer additional investment features that can allow companies to access funds not previously available to both for-profit and nonprofit companies. The ownership flexibility available under LLC statutes enables L<sup>3</sup>Cs to take advantage of a multi-tiered investment strategy known as tranche investing.<sup>121</sup> Under normal equity-investing principles, all investments in the L<sup>3</sup>C share the same risks and returns.<sup>122</sup> However, a tranche system seeks to spread the levels of risk and return to different investors.<sup>123</sup> “The central premise of an L<sup>3</sup>C’s operation is its use of low-cost capital in high risk ventures and its ability to allocate risk and reward unevenly over a number of investors, thus ensuring some a very safe investment with market return.”<sup>124</sup>

The unique structure of LLC statutes makes tranche investing available since membership and ownership rules are almost entirely subject to change through an operating agreement by the members.<sup>125</sup> The operating agreement is the “cornerstone” of each LLC because it

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120. See Jonathan Greenblatt, *Opening the Door for Program Related Investments*, WHITE HOUSE (May 4, 2012), available at <http://www.whitehouse.gov/blog/2012/05/04/opening-door-program-related-investments> (describing how the Proposed Guidelines will help ease the concerns of foundations and may increase the use of PRIs in social ventures).

121. See *id.*; see also REV. UNIF. LIMITED LIABILITY CO. ACT § 301(a) cmt. a, (2006) (stating that “flexibility of management structure is a hallmark of the limited liability company”).

122. See Bishop, *supra* note 7, at 245 (noting that most investors get the same rates of return on their investments in traditional corporations).

123. See Cody Vitello, *Introducing the Low-Profit Limited Liability Company (L<sup>3</sup>C): The New Kid on the Block*, 23 LOY. CONSUMER L. REV. 565, 571 (2011) (stating L<sup>3</sup>Cs can attract for-profit investors through layered or tranching member ownership interests).

124. See Bishop, *supra* note 7, at 251 (noting that tranche investing can spread risks and provide better rates of return for investors more concerned about financial returns and less concerned about the social benefits created).

125. See Daniel Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 910 (2010) (recognizing that L<sup>3</sup>Cs may have substantial flexibility but also noting this flexibility could create dangerous, misunderstood, and complex agreements).

serves as the foundational contract between the entity's owners.<sup>126</sup> The flexibility of LLC membership statutes thus makes the L<sup>3</sup>C an ideal vessel for tranche investing.<sup>127</sup>

Depending on the needs of the L<sup>3</sup>C, different tranche levels may provide different levels of return for investments.<sup>128</sup> A first tranche, the equity tranche, contains PRIs or other investments whose investors are willing to accept a low financial return with a high risk to fund a specific social cause.<sup>129</sup> Investors in the equity tranche look for a "venture with modest financial prospects, but the possibility of major social impact."<sup>130</sup> This tranche of investors wants to support the L<sup>3</sup>C's social mission and is thus willing to sacrifice on its financial returns.<sup>131</sup>

Investments in the equity tranche eliminate much of the financial risk for the investors in other tranches.<sup>132</sup> The equity tranche provides startup capital that the L<sup>3</sup>C can leverage to attract additional investments.<sup>133</sup> While some L<sup>3</sup>C proponents focus on obtaining foundation PRIs as the basis of the equity tranche,<sup>134</sup> PRIs might not be the focus of many L<sup>3</sup>Cs.<sup>135</sup> Instead, L<sup>3</sup>C businesses can focus on obtaining equity financing from investors looking for social returns and some very modest financial returns when compared to those offered in competitive markets.

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126. REV. UNIF. LIMITED LIABILITY CO. ACT § 110(a).

127. See *What Is the L<sup>3</sup>C?*, *supra* note 19, at 2. The first and most risky level of funding will be supplied by the PRI. The PRI investment will improve the L<sup>3</sup>C's credit rating, which will enable it to attract more commercial investors in the next tranche level by offering less risk and a higher return. *Id.*

128. See Robert Lang, *Community Foundations and the L<sup>3</sup>C*, AMERICANS FOR COMMUNITY DEV. (2010), <http://www.americansforcommunitydevelopment.org/downloads/CommunityFoundationsAndL3C.pdf>.

129. See *What Is the L<sup>3</sup>C?*, *supra* note 19, at 2 (describing a tranche of investors made up of foundations and other "social" investors).

130. Marc J. Lane, *L<sup>3</sup>Cs Hold Key to Solving State's Social Woes*, CRAIN'S CHI. BUS., <http://www.marclane.com/index.php?src=news&refno=288&category=2008%20Lane%20Reports> (stating there are investors who want a return on their investment but are still primarily concerned with the social impact of their investment).

131. *What Is the L<sup>3</sup>C?*, *supra* note 19, at 2 (arguing the investments made by the "social" investors will be used to help give higher returns for investors in other tranches seeking closer to market-rate returns).

132. See Vitello, *supra* note 123, at 572 (stating each tranche could offer different levels of return and this would allow market-driven investors to receive a safer and more market-comparable level of return on their investments).

133. See Schmidt, *supra* note 101, at 169 (arguing that the "social" investors will help attract other market rate investors).

134. See Bishop, *supra* note 7, at 244 (noting the equity-tranche level could be comprised of PRIs because, by definition, these should not have a return on investment at a market-level rate).

135. See Schmidt, *supra* note 101, at 193 (noting that PRIs will not be an appropriate or feasible investment tools for all L<sup>3</sup>Cs).

A second level of funding, the mezzanine tranche, is provided by socially conscious investors who are looking for both a modest financial return, as well as some achievement of social good.<sup>136</sup> The mezzanine tranche typically offers a modest rate of return because the equity tranche lowers the level of risk by taking little to no financial return.<sup>137</sup> A third tranche, the senior tranche, attracts regular investors seeking a market rate of return on their investment.<sup>138</sup> This market rate return is made possible through the subsidization and risk allocation of the equity and mezzanine tranches.<sup>139</sup>

Because of the flexibility offered via its reliance on the LLC model, L<sup>3</sup>Cs attract different types of investors and different types of investments together under the same company banner.<sup>140</sup> The L<sup>3</sup>C taps into new sources of capital, such as PRIs, socially responsible investors, and normal market-rate investors, and it leverages equity tranche capital that allows the company to provide more manageable and predictable returns to investors in the mezzanine and senior tranches. "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."<sup>141</sup>

Tranche investing enables L<sup>3</sup>Cs to bring for-profit and nonprofit investors into the same company principally by offering for-profit investors a market-level return and nonprofit investors a social return. Ultimately, the tranche system's flexibility allows an L<sup>3</sup>C to supplement PRIs and permits the L<sup>3</sup>C to creatively structure its tranche system to raise capital through a variety of sources.<sup>142</sup> The first tranche allows the L<sup>3</sup>C to attract investors in the next two tranches who might otherwise find the social venture too risky.<sup>143</sup>

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136. See Kleinberger, *supra* note 125, at 910 (noting that typical L<sup>3</sup>C activities cannot generate enough return to draw in market-level investors).

137. *What Is the L<sup>3</sup>C?*, *supra* note 19, at 2 (noting the benefit of tranche investing for L<sup>3</sup>Cs is the ability to spread out financial risk between investors seeking social returns and those seeking financial gains).

138. See *id.* (describing a market rate of return tranche for traditional financial investors).

139. See Kleinberger, *supra* note 125, at 910 (noting that typical L<sup>3</sup>C activities cannot generate enough return to draw in market-level investors).

140. See Lang, *The L<sup>3</sup>C and Economic Development*, *supra* note 20 (discussing the flexibility of LLC operating agreements).

141. See *What Is the L<sup>3</sup>C?*, *supra* note 19, at 2 (describing how tranche investing helps L<sup>3</sup>Cs become more sustainable enterprises).

142. See Schmidt, *supra* note 101, at 169 (noting that L<sup>3</sup>Cs are not dependent on receiving PRIs).

143. See *id.* (stating the L<sup>3</sup>Cs double bottom line structure makes it a good candidate for tranche investing).

IV. LLC FIDUCIARY DUTIES: L<sup>3</sup>C ACCOUNTABILITY ISSUES

Similar to LLCs, the L<sup>3</sup>C model is both enhanced and hindered by established laws, doctrines, and elements. One key feature of LLC statutes is the requirement that LLC members adhere to fiduciary duty requirements.<sup>144</sup> While L<sup>3</sup>C proponents have applauded the LLC model's flexibility and deference to membership agreements in structuring and determining investor rights, the ability to waive fiduciary duties may be a significant concern for L<sup>3</sup>C investor protection.<sup>145</sup>

With each state passing its own LLC statute, there are a variety of approaches to defining an LLC member's fiduciary duty requirements.<sup>146</sup> However, Delaware law, often considered the benchmark for LLC laws, states "[a] fiduciary relationship is a situation where one person reposes special trust in and reliance on the judgment of another or where a special duty exists on the part of one person to protect the interest of another."<sup>147</sup> Furthermore, managers of an LLC owe fiduciary duties to its members because they have discretionary power to manage the business.<sup>148</sup>

The Supreme Court noted that identifying "that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as a fiduciary? In what respect has he failed to discharge these obligations? And what are the consequences of his deviation from duty?"<sup>149</sup> While the managers of LLCs and L<sup>3</sup>Cs owe some fiduciary duties to their members, it is unclear what duties apply.

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144. J. William Callison & Allan W. Vestal, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship: The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 286–87 (2010).
145. See John Tyler, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship: Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 144 (2010) (noting fiduciary duties apply to L<sup>3</sup>Cs but the contractual agreement may waive certain fiduciary duties).
146. *Id.* (stating the statutory sources and approaches to LLC fiduciary duties come from a wide range of sources and that the variety of approaches can be daunting to grasp).
147. *McMahon v. New Castle Assocs.*, 532 A.2d 601, 604 (Del. Ch. 1987) (quoting *Cheese Shop Int'l, Inc. v. Steele*, 303 A.2d 689 (Del. Ch. 1973)).
148. See DEL. CODE ANN. tit. 6, § 18-1101 (2010) ("A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement . . .").
149. *SEC v. Chenery Corp.*, 318 U.S. 80, 85–86 (1943).

Delaware law allows an LLC agreement to limit or eliminate any fiduciary duty of a member or manager to anyone also bound by the LLC agreement.<sup>150</sup> However, the LLC agreement cannot eliminate the fiduciary duties of the covenant of good faith or fair dealing.<sup>151</sup> In January 2012, the Delaware Court of Chancery's decision in *Auriga Capital Corp. v. Gatz Properties, LLC* clarified the role of LLC fiduciary duties.<sup>152</sup> The *Auriga* court held that default fiduciary duties apply to LLCs unless they are contractually altered, and that LLC managers thus owe LLC members a duty of loyalty, care, and good faith and fair dealing.<sup>153</sup>

These fiduciary duties are designed and understood to protect the LLC's members from nefarious dealings by the LLC's controlling members or managers. However, in the context of the L<sup>3</sup>C, these fiduciary duties may create conflicts of interest when the financial interests of the L<sup>3</sup>C's members are in conflict with the business's social mission.<sup>154</sup> One way to handle the fiduciary duty issue is to address it in the L<sup>3</sup>C operating agreement.<sup>155</sup> However, if the operating agreement releases the L<sup>3</sup>C from too many fiduciary duties it also reduces the protections available to investors.<sup>156</sup> In addition, if the L<sup>3</sup>C involves too many special fiduciary duties that favor its social mission, profit-motivated investors may feel marginalized.<sup>157</sup> Operating agreements should thus be designed in a manner that carefully balances the potential conflict between an L<sup>3</sup>C's mission and the needs of its investors.

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150. DEL. CODE ANN. tit. 6, § 18-1101 (2010) (“[A] limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”).

151. *Id.*

152. 40 A.3d 839 (2012) (holding that a controlling member of an LLC breached his fiduciary duties to minority members when he misled the board as to the value of the company, discouraged potential buyers from purchasing the company, set up a sham auction, and purchased the LLC at an amount that was far below fair market value).

153. *Id.* at 851–53 (holding that managing members of an LLC had affirmative fiduciary duties to all minority members unless these duties were specifically altered in the operating agreement).

154. See Callison & Vestal, *supra* note 144, at 287–88 (explaining potential conflicts resulting from the implied fiduciary duties inherent in L<sup>3</sup>Cs).

155. *Id.* (discussing the use of operating agreements to vary the fiduciary duties owed to L<sup>3</sup>C members).

156. *Id.* (describing how an L<sup>3</sup>C operating agreement can change the managing members' fiduciary duties in favor of the L<sup>3</sup>C's social mission and social investors).

157. *Id.* (stating that the pro-social mission fiduciary duties set forth in the operating agreement “increase[d] the difficulty, and the risk, of attracting profit-motivated L<sup>3</sup>C investment[s]”).

V. THE L<sup>3</sup>C BRAND

In a 2007 study, social entrepreneurs listed raising capital and promoting their business as the two primary challenges to their companies' success.<sup>158</sup> These entrepreneurs further indicated that they must create a recognizable brand for hybrid social ventures to increase both financial support from funders and investors and general awareness from consumers and other relevant stakeholders.<sup>159</sup> Proponents of the L<sup>3</sup>C envision creating a brand for the L<sup>3</sup>C that signifies "to the world that it puts mission before profit yet is self-sustaining."<sup>160</sup> The L<sup>3</sup>C offers a chance to brand the business so that it is known for a dual mission.<sup>161</sup>

For the L<sup>3</sup>C brand to be effective, the market must perceive substantial value in what the L<sup>3</sup>C offers.<sup>162</sup> Proponents argue that much of the L<sup>3</sup>C's value is derived from its use as a brand that signals that the business embraces a social-responsibility model.<sup>163</sup> The brand thus helps increase funding to L<sup>3</sup>Cs by encouraging the frequent use of PRIs and tranche investing to raise capital.<sup>164</sup> Yet by designing the L<sup>3</sup>C under existing LLC laws, the L<sup>3</sup>C is able to take advantage of decades of court opinions and legislation enacted around LLCs.<sup>165</sup> The L<sup>3</sup>C is thus able to use the legal reliability of an LLC while simultaneously creating its own brand.

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158. See ALLIANZ ET AL., GROWING OPPORTUNITY: ENTREPRENEURIAL SOLUTIONS TO INSOLUBLE PROBLEMS 5 (2007), available at [https://www.allianz.com/media/current/en/press/news/studies/downloads/skoll\\_study\\_social\\_entrepreneurs.pdf?search.query=Insoluble](https://www.allianz.com/media/current/en/press/news/studies/downloads/skoll_study_social_entrepreneurs.pdf?search.query=Insoluble) (noting that social entrepreneurs often struggle raising the capital they need to be successful and self-sustaining).
159. *Id.* at 19–20 (arguing a well-branded hybrid business form could increase funding for social enterprises).
160. See Daniel Kleinberger, *When the Law Is Understood—L3C No* (William Mitchell Coll. of Law Legal Studies Research Paper Series, Paper No. 07, 2010), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1568373](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1568373) (arguing the L<sup>3</sup>C model is unnecessary because LLCs already provide all of the advantages of an L<sup>3</sup>C).
161. See Schmidt, *supra* note 101, at 183 (stating one major benefit of the L<sup>3</sup>C is the ability to brand the business form as a socially driven for-profit enterprise).
162. See Kleinberger, *supra* note 125, at 908–09 (noting the market needs to see value in L<sup>3</sup>Cs for them to be successful).
163. See Elizabeth Carrott Minnigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations*, TAX MGMT., EST., GIFTS & TR. J., Aug. 2009, at 1.
164. See *What Is the L<sup>3</sup>C?*, *supra* note 19, at 2 (pushing the use of L<sup>3</sup>Cs to encourage more PRIs).
165. See Lang, *The L<sup>3</sup>C and Economic Development*, *supra* note 20, at 4 (articulating the benefits associated with branding the L<sup>3</sup>C under the flexible LLC statutes).

VI. LEGAL PROTECTION FOR L<sup>3</sup>C INVESTORS

Although an L<sup>3</sup>C investor has the same legal rights as an LLC investor, there are no additional protections in place to specifically protect L<sup>3</sup>C investors. However, LLC “exit right” statutes and L<sup>3</sup>C membership agreements can provide added protection for L<sup>3</sup>C members. For example, L<sup>3</sup>Cs created in Vermont are subject to Title 11, Chapter 21 of the Vermont Code, which states that LLC members may dissociate from an LLC at will.<sup>166</sup> In addition, a member’s distributional interest must be purchased by the LLC at fair market value at the time of the dissociation.<sup>167</sup> Many states, however, have foreclosed these protections by amending their LLC statutes to restrict LLC members from invoking dissociation and buy-out rights.<sup>168</sup>

In addition to exit rights, L<sup>3</sup>C investors, like private foundations, may need ownership controls to safeguard their PRIs and the L<sup>3</sup>C’s charitable mission, such as super-voting, veto power, or other negotiated approval rights.<sup>169</sup> However, in order to protect their financial investments, for-profit investors may require a “first money out” provision, which specifies that for-profit investors are to be paid before private foundations and lower-return social investors.<sup>170</sup> Without a properly negotiated membership agreement, L<sup>3</sup>C investors may be “locked”<sup>171</sup> into an L<sup>3</sup>C with no way to liquidate their investment.<sup>172</sup>

Because L<sup>3</sup>Cs do not have the liquidity of publicly traded companies or partnerships, L<sup>3</sup>C investors will need to protect their investments through precisely worded membership operating agreements. However, some states statutorily forbid the use of dissociation and buy-out rights,<sup>173</sup> meaning that even a well-prepared L<sup>3</sup>C investor

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166. VT. STAT. ANN. tit. 11, § 3082 (West 2010) (permitting dissolution and member withdrawal from an LLC to occur quickly).

167. VT. STAT. ANN. tit. 11, § 3091 (West 2010).

168. See Douglas K. Moll, *Minority Oppression The Limited Liability Company: Learning (Or Not) From Close Corporation History*, 40 WAKE FOREST L. REV. 883, 937–39 (2005) (articulating different state laws addressing LLC exit rights).

169. See Susan A. Maslow & Timothy White, *Enlightened Capitalism and L<sup>3</sup>Cs*, N.J. LAW., Apr. 2010, at 63, 64, available at [www.njsba.com](http://www.njsba.com) (describing ways to protect LLC members and social investments).

170. See *id.* (noting that L<sup>3</sup>C financial investors need to have their own types of protections because their interests could be opposed to the best interests of social investors).

171. See Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 417 (noting that some LLC agreements may not allow for easy dissolution of membership rights).

172. See Tanya Simpson, *Have Estate Planners Hijacked the LLC? How Restrictions on Dissolution Have Crippled the LLC As a Viable Small Business Entity*, 34 FLA. ST. U. L. REV. 573, 577 (stating many LLC members have no way out of the agreement and cannot sell their ownership shares).

173. See *id.* (noting that state statutes vary with regards to LLC exit and dissolution rights).

will not be able to negotiate for buy-out rights in a membership agreement in all circumstances. Ultimately, this could lead the investor to reject an otherwise suitable L<sup>3</sup>C investment opportunity because the membership agreement or the state's LLC statutes cannot adequately protect the investor.

## VII. NEED FOR INCREASED GOVERNMENT REGULATION AND OVERSIGHT

While state laws generally require L<sup>3</sup>Cs to incorporate and adhere to the three requirements for a PRI,<sup>174</sup> rarely does government monitoring exist to ensure the L<sup>3</sup>C follows these requirements. Indeed, only Vermont and Illinois provide oversight that could plausibly be considered L<sup>3</sup>C monitoring. Any L<sup>3</sup>C operating in the state of Illinois is required to register with the state attorney general's Charitable Trust Bureau and is subject to the regulatory authority of the attorney general.<sup>175</sup> When an L<sup>3</sup>C registers, its potential investors are given free access to information about the L<sup>3</sup>C's income, assets, expenditures, programs, and administration.<sup>176</sup> Similarly, in March of 2010, the Vermont assistant attorney general sent a letter to all Vermont L<sup>3</sup>Cs requesting the voluntary disclosure of information about the L<sup>3</sup>C's activities and finances.<sup>177</sup> While Vermont does not require L<sup>3</sup>Cs to disclose financial information, voluntary disclosure can help the government better monitor the L<sup>3</sup>Cs.

The remaining state governments provide very little monitoring of L<sup>3</sup>Cs, thus exposing investors to needless uncertainty and potentially inhibiting federal lawmakers from granting L<sup>3</sup>Cs preferential treatment as PRI recipients.<sup>178</sup> States could, however, easily monitor L<sup>3</sup>Cs by requiring them to register and provide annual financial reports to the state's attorney general and the public.<sup>179</sup> In addition, states could limit the manner in which L<sup>3</sup>Cs use their charitable assets,<sup>180</sup> especially in instances where an attorney general requires that the

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174. See, e.g., VT. STAT. ANN. tit. 11, § 3001(27) (West 2010).

175. See Norah Jones & Krupa Shah, *L<sup>3</sup>Cs: What Are They and What Should Private Foundations Know About Them?*, QUARLES & BRADY LLP (Jan. 2010), <http://www.quarles.com/publications/Detail.aspx?publication=610> (stating L<sup>3</sup>Cs in Illinois must report to the attorney general).

176. See Doeringer, *supra* note 99, at 15.

177. See Letter from Elliot Berg, Vermont Assistant Attorney General, to L<sup>3</sup>C Advisors (March 25, 2010), available at <http://americansforcommunitydevelopment.org/downloads/VermontAttyGeneralLtr.pdf>.

178. See Doeringer, *supra* note 99, at 14 (arguing the lack of state oversight will limit the ability of federal lawmakers to back L<sup>3</sup>Cs as preferential PRI recipients).

179. See Marc J. Lane, *L<sup>3</sup>C and Charitable Trust*, NONPROFIT L. BLOG (Apr. 22, 2010), <http://www.nonprofitlawblog.com/home/2010/04/13c-and-charitable-trust.html> (noting that public disclosure of financial statements could be a possible registration oversight tool used by states to regulate L<sup>3</sup>Cs).

180. See *id.*

L<sup>3</sup>C give notice or seek approval for any major corporate changes, such as “a merger, sale of substantially all of its assets, or dissolution.”<sup>181</sup> Such regulation can help to ensure that L<sup>3</sup>Cs use their assets only for their stated primary social purposes.

### VIII. DOUBLE BOTTOM LINE SUCCESS—COMMUNITY INTEREST COMPANIES

The CIC and the L<sup>3</sup>C are both hybrid business models designed to serve a primary social function with profit-making as a secondary function. The CIC has existed for a few more years than the L<sup>3</sup>C and has had significantly more success. The biggest difference between CICs and L<sup>3</sup>Cs is that CICs are far more regulated by government. Under the British system of government regulation and oversight, CICs have expanded and flourished into multimillion pound industries serving thousands of people across a broad range of social and charitable missions.

The British government, in an attempt to make more capital available to nonprofits, relaxed the nondistribution restraints on nonprofits to create the Community Interest Company (CIC).<sup>182</sup> CICs are “first and foremost a limited company carrying on a social activity and must be viable as such.”<sup>183</sup> The CIC form was passed into law under the Audit, Investigations and Community Enterprise Act of 2004.<sup>184</sup> The CIC was created with the idea that such companies would be self-sustaining businesses that would both make contributions to the community and provide limited returns to their investors.<sup>185</sup> CICs are intended to be profit-making companies.<sup>186</sup> However, they may rely on grants and donations to provide returns to investors and the com-

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181. *See id.* (referring to the Illinois Charitable Trust Act, which imposes restrictions on L<sup>3</sup>Cs by declaring the L<sup>3</sup>C chief operating officer as a “trustee” and thereby requiring L<sup>3</sup>Cs to meet multiple obligations imposed by the Charitable Trust Act).

182. *See* Anup Malani & Eric A. Posner, *The Case for For-Profit Charities*, 93 VA. L. REV. 2017, 2041 (2007) (noting the U.K. created the CIC to open up capital to social enterprises).

183. *See* REGULATOR OF CMTY. INTEREST CO., INFORMATION PACK: COMMUNITY INTEREST COMPANY, 2010, *available at* <http://www.cicregulator.gov.uk/CICleaflets/CIC%20INFORMATION%20PACK%20V00.04%20Final.pdf> [hereinafter REGULATOR, INFORMATION PACK].

184. *See* COMPANIES (AUDIT, INVESTIGATIONS, AND COMMUNITY ENTERPRISE) ACT, 2004, c. 27 (U.K.), *available at* <http://www.legislation.gov.uk/ukpga/2004/27/part/2> (setting forth the statute enabling the use of CICs).

185. *See* REGULATOR, INFORMATION PACK, *supra* note 183, at 5 (arguing that by opening up funding for social enterprises, the government made these businesses more self-sustaining).

186. *See id.* (noting that while a CIC is developed primarily for a social purpose, it has a secondary goal of making money in order to keep the company self-sustaining).

munity.<sup>187</sup> Thus, while CICs may receive funding in the form of donations, they are expected to be able to generate sufficient income to cover all operating costs.<sup>188</sup>

The CIC Act also created the Regulator of CICs (the Regulator), an independent statutory office holder appointed by the Secretary of State, to encourage CIC branding, development, and execution.<sup>189</sup> The Regulator is charged with determining if a company is eligible to be a CIC and overseeing any major business decisions made by the CIC, including the distribution of dividends and the disposal of assets.<sup>190</sup> The Regulator also ensures that the business maintains conformity to the statutory requirements.<sup>191</sup>

States could provide similar oversight from either an attorney general or from a specifically created L<sup>3</sup>C regulator to ensure that L<sup>3</sup>Cs are properly following their stated social purpose. Government monitoring could also help determine whether or not the L<sup>3</sup>C is properly using its resources in order to achieve its social mission. Such regulation would help build investor security and confidence by requiring L<sup>3</sup>Cs to utilize their resources in pursuit of their stated social mission.

The CIC, like the L<sup>3</sup>C, does not receive the traditional tax breaks awarded to nonprofits.<sup>192</sup> The CIC is set up as a limited liability company, but it has a variety of statutory and legal features that are distinct from for-profit companies.<sup>193</sup> The CIC faces increased transparency, an asset lock, restrictions on dividends, governance by the Regulator, and requirements to provide a community benefit.<sup>194</sup> The CIC is required to be more transparent than a for-profit company by filing its annual report with the Regulator as a public record document open for public scrutiny.<sup>195</sup> It is required to report the aggregate pay of its directors and highest paid director<sup>196</sup> to prevent

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187. *See id.* (noting that reliance on donations can help the CICs to deliver higher rates of return to financial investors).

188. *See id.*

189. *See id.* at 7 (designating a statutory regulator to oversee the success and development of CICs).

190. *See id.* at 7–8 (stating that one of the Regulator’s duties is to ensure the distributions of profits do not violate the CIC investors’ rights).

191. *See id.* (noting the Regulator oversees and enforces the legal requirements of a CIC).

192. *See* Malani & Posner, *supra* note 182, at 2034 (stating for-profit companies do not receive the same tax breaks as do nonprofits but indicating this could change as hybrid companies emerge).

193. *See* CMT’Y INTEREST COS. REGULATOR, THE CIC REGULATOR CASE STUDY SERIES: THE BENEFITS OF A COMMUNITY INTEREST COMPANY (CIC), 2010, (U.K.), <http://www.cicregulator.gov.uk/CICleaflets/benefitsofacicleaflet.pdf> (differentiating a CIC from a for-profit corporation and a nonprofit).

194. *See id.* at 2 (setting forth some of the many CIC investor protection mechanisms).

195. *See id.* at 1 (setting forth the reporting requirements for CICs).

196. Malani & Posner, *supra* note 182, at 2039 (setting forth the disclosure requirements for CICs).

windfall payments.<sup>197</sup> The CIC must also report how it has helped the community and how it has involved its stakeholders in these ventures.<sup>198</sup> In addition, the CIC must declare what dividends it paid and any information on the transfer of its assets.<sup>199</sup> These requirements make the CIC more transparent to investors, thereby increasing investor confidence that the company is acting properly.<sup>200</sup> Similarly, if the L<sup>3</sup>C was required to disclose more information to investors, such as dividends paid and any transfer of assets, an anticipated effect would be to raise investor confidence by increasing the business's operational transparency.

A CIC's assets are further regulated through a system called an "asset lock."<sup>201</sup> The asset lock prevents a CIC from selling its assets to a for-profit firm unless it receives full market value.<sup>202</sup> The asset lock was put in place to ensure that the CIC uses its assets and profits for the community's benefit.<sup>203</sup> It comforts investors who want reassurance that the CIC continues to run both its business and social operations.<sup>204</sup>

Another important aspect of the asset lock system is the restriction on CIC dividend payments.<sup>205</sup> CICs are restricted from giving out large financial dividends, which helps to strike a balance between encouraging investments in the CIC and making sure the CIC reinvests its profits to serve the community.<sup>206</sup> By statute, dividends may only be paid if authorized by the Regulator.<sup>207</sup> Once the Regulator approves a dividend payment, there are still three important restrictions:<sup>208</sup>

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197. See REGULATOR, INFORMATION PACK, *supra* note 183 (stating strict disclosure requirements protect the CIC from being financially drained through unnecessary financial distributions).
  198. See Malani & Posner, *supra* note 182, at 2038 (stating that CICs are required to advertise and disclose their social impact).
  199. See *id.* at 2039 (noting CICs have strict disclosure requirements).
  200. See *id.* (describing the benefits of CIC transparency).
  201. See REGULATOR, INFORMATION PACK, *supra* note 183, at 14 (describing the asset lock system of protecting CIC investments and assets from financial greed).
  202. *Id.* (stating the reasons underlying the asset lock system).
  203. *Id.*
  204. Malcolm Lynch, *For and Against the Community Interest Company*, INVESTMENT MATTERS, Jan. 2004, at 1 (noting the CIC's strict asset protection mechanisms helps ease investor concerns).
  205. See Reiser, *supra* note 14, at 635 (stating that the CICs are limited regarding how much they can distribute through dividends each year).
  206. See REGULATOR, INFORMATION PACK, *supra* note 183, at 14 (describing how the dividend limit forces the CIC to reinvest into its social mission).
  207. See Reiser, *supra* note 14, at 635 (noting the Regulator oversees all dividend payments).
  208. See *id.* (stating the Regulator and CIC are further bound by statutory requirements regulating dividend disbursements).

1. The dividend may not exceed 5% of the Bank of England base lending rate of the paid-up value of a share;<sup>209</sup>
2. The aggregate dividend cap is set at 35% of distributable profits;<sup>210</sup> and
3. Unused dividend capacity can only be carried forward for five years.<sup>211</sup> When the dividend restrictions are viewed together with the asset lock, investors are only given rights to limited dividends and are not given access to the CIC's full profits.<sup>212</sup>

L<sup>3</sup>Cs offer more flexibility than CICs in their self-governance and financing because L<sup>3</sup>Cs are not constantly monitored and guided by a government regulator.<sup>213</sup> However, the CIC regulations and oversight by the Regulator afford more structure and certainty for potential investors than are provided by the relaxed L<sup>3</sup>C regulations.<sup>214</sup> The asset lock, dividend cap, and Regulator protect social investors and better ensure that the company continues to provide a social benefit. An asset lock system could help ensure that L<sup>3</sup>Cs do not gouge companies for financial profit while ignoring their primary stated social purposes. Additionally, an asset lock system could also increase investor confidence by ensuring that any investment in the L<sup>3</sup>C would remain in the L<sup>3</sup>C to help achieve the company's stated social goal. A dividend cap could help ensure that the L<sup>3</sup>C reinvests in itself and thereby extends its social reach, instead of returning substantial profits to investors. Finally, the designation of an L<sup>3</sup>C regulator could help ensure that the L<sup>3</sup>C is following the three PRI statutory requirements. This increased transparency and monitoring would likely give investors greater confidence in the social venture and may provide foundations for determining PRI-qualified recipients.

## IX. STRENGTHENING THE L<sup>3</sup>C FORM

With more than 800 registered L<sup>3</sup>C companies in nine states, the L<sup>3</sup>C is becoming a part of the social entrepreneur landscape. While critics and governance issues remain, the continued adoption of L<sup>3</sup>Cs demonstrates the value that investors and social entrepreneurs see in the hybrid model. The flexibility of tranche investing and the appeal of the L<sup>3</sup>C brand have enabled businesses to utilize for-profit and non-

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209. REGULATOR, INFORMATION PACK, *supra* note 183, at 16. (Any shares given out after April 6, 2010, will be able to receive 20% instead of 5%).

210. *See id.* (setting a cap at 35% of profits).

211. *See id.* (stating unused dividends can only be carried forward for five years, protecting investors against long carried out dividends).

212. *See Reiser, supra* note 14, at 636 (noting investors cannot access all of a CIC's profits).

213. *See id.* at 636 (noting the difference in flexibility between L<sup>3</sup>Cs and CICs).

214. *See id.* (describing the stricter regulation and success of CICs as compared to L<sup>3</sup>Cs).

profit investors by offering varying rates of social and financial returns. This double bottom line model has increased the levels of financing available to social entrepreneurs and has created a new fourth sector outside the traditional three: nonprofit, for-profit, and government.

The lack of government incentives and regulation, however, have inhibited the growth of L<sup>3</sup>Cs. Although the L<sup>3</sup>C model was created in hopes of enticing foundations to invest in socially driven businesses through PRIs, they rarely actually attract PRIs because investors are still wary of the tax consequences of these investments. PRIs are unlikely to become a common source of financing for L<sup>3</sup>Cs unless state and federal laws explicitly grant L<sup>3</sup>Cs preferential treatment as qualified PRI-recipients. Furthermore, with the exception of Illinois, L<sup>3</sup>Cs do not face any special governmental oversight and regulation. The lack of L<sup>3</sup>C-specific regulation leaves uncertainties with respect to PRIs and investor rights. Without further government regulation, investors can be left without remedy when L<sup>3</sup>Cs fail to follow their stated primary social purposes. In the absence of properly formulated membership agreements, these investors can be stuck indefinitely in a bad investment with no way to liquidate their holdings. Without more regulation and oversight of L<sup>3</sup>Cs, investors will probably remain reluctant to invest because they lack adequate protections for their funds.

While the L<sup>3</sup>C has been steadily adopted by hundreds of companies in multiple states, Great Britain's CICs have been more successful. Although CICs and L<sup>3</sup>Cs are both for-profit companies primarily organized for social purposes, Great Britain's CIC model illustrates how government regulation and oversight can enhance investor confidence in hybrid social enterprises. The U.K.'s regulation of CICs through an asset lock, a dividend cap, and a CIC Regulator protects investors, ensures that CICs remain focused on their primary charitable purposes, and provides CIC transparency to potential investors and the government.

Great Britain's regulation of CICs provides an excellent example of how states could more effectively monitor and regulate L<sup>3</sup>Cs as hybrid social ventures. State regulations, such as Illinois's requirement for L<sup>3</sup>Cs to register with the attorney general, are examples of L<sup>3</sup>C governance that could easily be modified to provide the advantageous enhancements of an asset lock, dividend cap, and a regulator. However, such features need to be generally required. L<sup>3</sup>Cs also need greater oversight. Regulations that increase transparency would help protect and facilitate investment and advance the efforts to convince the IRS and Congress to adopt L<sup>3</sup>C-friendly PRI legislation.