NEGATING THE LEGAL PROBLEM OF HAVING "TWO MASTERS": A FRAMEWORK FOR L3C FIDUCIARY DUTIES AND ACCOUNTABILITY

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INTRODUCTION

The low-profit limited liability company (L3C) is a new business form that unites in one enterprise two principles often considered irreconcilably in competition with each other: pursuing charitable, exempt purposes and generating and distributing profits. The L3C, as a creature of state statute appended to the limited liability company form, adapts standards from the law applied to private foundations called program related investments (PRI), which incorporates both charitable exempt purposes and distributable profits.[1] Such arguably conflicting, dual purposes seem to create ambiguity and exacerbate the problem of appearing to serve "two masters."[2] This conflict and ambiguity has been the nature of purportedly hybrid enterprises, particularly for-profit forms whose operations are considered charitable or that operate with "social" missions,[3] such as Google.org, benefit or B Corporations, Ben & Jerry's, and others.

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1. As of September 2009, five states and two Indian nations have passed laws that make L3C a viable business form, and an additional eight states were considering similar legislation. Elizabeth Carrott Minnigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations*, 34 TAX MGMT. ESTS. GIFTS AND TRS. J. 209, 209 nn.2–3 (Sept. 2009) (citing Vermont, Illinois, Michigan, Utah, Wyoming, Oglala Sioux Tribe, and Crow Indian Nation of Montana as jurisdictions that have passed L3C legislation). In addition, the following states introduced legislation to enact the L3C form as part of their 2009 legislative sessions: Arkansas, Missouri, Montana, North Dakota, Oregon, and Tennessee. *Id.* at 209 n.4. Since then, North Carolina and Maine have enacted L3C legislation and additional states have been considering L3C legislation, including Colorado, Kentucky, Maryland, Massachusetts, New York, and Virginia. *See* AMS. FOR CMTY. DEV., http://www.americansforcommunitydevelopment.org/legislativewatch.php.

2. *See Matthew* 6:24 and *Luke* 16:13.

3. One of the difficulties with hybrids is the lack of clear terminology. For instance, combining "social" with words like "innovation," "enterprise," and "entrepreneurship" neglects or understates the critical "social" contributions that for-profit businesses make such as those that are obvious (*e.g.*, jobs, tax revenues, goods, and services) and those that are less obvious but as critical (*e.g.*,

Unlike more traditional business operations, hybrid pursuits have generally functioned in clouds of confusion and difficulty for investors, managers, creditors, policy makers, and regulators. For instance, investors in hybrid enterprises need to know and understand the relationship between the hybrid purposes and the corresponding risk of loss and opportunities for gain. Managers need to understand the framework within which they are expected to make operational and structural decisions, how to determine priorities to pursue when inevitable conflicts arise among competing interests, and the extent to which they can be held liable for deviating from those expectations. As a related point, managers also need to know who can hold them accountable and by what right. Creditors should understand the fiduciary context within which managers make decisions that affect the credit-worthiness of the enterprise. Of course, regulators need to understand the scope of their responsibility for monitoring manager decisions and hybrid activities, including charitable, exempt purposes.

Properly understood and implemented, one of the innovations of the L3C is how the enabling statutes properly order priorities in a way that imposes fiduciary responsibilities and makes available accompanying enforcement tools. This resolution can help instill sufficient predictability and consistency so that the new form can be a viable strategy to address certain charitable, exempt needs and opportunities that follow from our economic, social, and political systems. Among these could be alternatives to relying on government to scale certain charitable endeavors, capital to help bridge the "valley of death" that frequently stunts advancement of results of federally-funded research, or resources to retool factories and supply chains and retrain talent in ways that revitalize dying areas to begin serving new industries and opportunities.

In an effort to facilitate movement toward that predictability and consistency, this Article proposes a framework for the L3C's fiduciary duties and their enforcement.

Part I of this Article describes the L3C and its most relevant characteristics. It also tries to correct misunderstandings about the L3C and its application that could undermine the form and proper application of its fiduciary duty regiment. Recognizing that the L3C is a hybrid and that its conceptions of fiduciary duty evolve from more traditional forms, Part II presents these underlying fiduciary duty contexts and principles, including whether the duty of for-profit directors and managers is to maximize owner value or to operate the firm as a social entity. This Part features an in-depth

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the dignity of work, opportunity to pursue personal fulfillment, innovation and creativity, and community identity). Such lack of clarity inadvertently, or maybe intentionally in some instances, regards "social" firms as somehow more worthy than other for-profit enterprises.

analysis of constituency statutes, how they affect fiduciary duties, and the extent to which they can inform L3C fiduciary duties and enforcement. Part III more explicitly proposes an approach to defining L3C fiduciary duties, which distinguishes it from existing forms as a legal innovation. Part IV finally discusses approaches to enforcement and ensuring accountability for pursuing those duties, particularly with regard to preserving the priority of charitable purpose.

I. BACKGROUND ABOUT THE L3C AND COMMON MISPERCEPTIONS

This Section provides background about PRIs generally, a summary of relevant characteristics necessary for a transaction or enterprise to be considered a PRI, and certain insights into the evolution of L3Cs from PRIs. This Section also identifies and addresses certain misunderstandings about the L3C.

A. Developing a General Understanding of PRIs and Their Relevance to Private Foundations

Although there are many ways to undertake a PRI, the most common are for a foundation to make an equity investment or provide loans, guarantees, or credit enhancement for an enterprise, whether for-profit or tax-exempt, on terms or conditions that are less restrictive or more favorable to the recipient than ordinarily found in the market. Unlike a grant, a PRI contemplates that the foundation will recover its investment or principal amount, often with expectations of a below-market investment return or interest. Congress first provided for PRIs over forty years ago as a corollary or exception to certain of the then new mandates and prohibitions to which private foundations became subject in 1969. At the risk of gross oversimplification, the PRI strategy facilitates foundation compliance with applicable laws and regulations in five primary ways.

First, private foundations generally may not make payments to for-profit entities without the payments being impermissible "taxable expenditures"[4] or private benefit.[5] Exceptions include investing the underlying endowment or corpus, payments in exchange for fair value received in return, and grants for which the foundation exercises expenditure responsibility.[6] PRIs, in some ways, combine the first and third

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4. I.R.C. § 4945 (2006) and accompanying regulations.

5. I.R.C. § 501(c)(3) (2006).

6. I.R.C. § 4945 (2006). Expenditure responsibility involves conducting due diligence, properly documenting the relationship and charitable purposes for the funds, ongoing monitoring and

of these exceptions because the foundation can realize a return from the PRI and must exercise expenditure responsibility in making the PRI.[7] In essence, PRIs are a strategy by which foundations may use for-profit enterprises as intermediaries for accomplishing charitable purposes under the right circumstances.[8]

Second, foundations must annually satisfy statutorily-imposed minimums for expenditures made in furtherance of their charitable purposes, often referred to as the "payout" or "5%" requirement.[9] Amounts paid as a PRI can count toward that minimum.[10]

Third, foundations annually pay an excise tax of either 2% or 1% of net investment income.[11] Capital gains realized on PRIs are not included in calculating this excise tax,[12] but net investment income, such as dividends, interest, rent, and royalties, are subject to the applicable tax.[13]

Fourth, foundations may not make certain high-risk investments that jeopardize their ability to carry out their charitable purposes.[14] Often, the types of pursuits supported by PRIs are more risky than the market will bear in that full return of the investment may be less likely and earnings are more likely to be below market or even non-existent. Whether the investment affects the foundation's ability to carry out its purposes depends on the size of the foundation and the corresponding investment, as well as other factors. In the Internal Revenue Code (the Code), Congress

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reporting to ensure proper use of the funds, and reporting to the IRS as part of the foundation's annual tax filing. *See* I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006) [hereinafter March 2006 I.R.S. Priv. Ltr. Rul.].

7. Foundations that make a PRI to an L3C must exercise expenditure responsibility if they intend to benefit from the PRI's status. The L3C can facilitate due diligence by ensuring that charitable, exempt purposes are primary.

8. Contrary to some assertions, the L3C form does not excuse foundations from their obligation to conduct expenditure responsibility if the foundations want to treat their involvement as a PRI. The L3C form can facilitate the due diligence aspects of expenditure responsibility because of the inherently charitable, exempt purposes of every L3C venture as mandated by statute, but the foundation must still undertake reasonable efforts to ensure that charitability is not merely a pretense. In addition, as is discussed more below, the L3C helps with expenditure responsibility because of the additional mechanisms for enforcement and accountability afforded by charitable purposes as a fiduciary and not merely contractual duty.

9. I.R.C. § 4942 (2006); 26 C.F.R. § 53.4942(a)-2(c)(3)(ii)(d), (a)-3(a)(2)(i) (2010).

10. If the foundation treats its PRI payments as qualifying distributions toward the 5% requirement, the foundation has a limited time within which it must re-distribute all amounts received by the foundation as return of capital or repayment of loan principal from the PRI. I.R.C. § 4942(d)(1), (f)(2)(C) (2006). This re-distribution requirement will still apply if the PRI is to an L3C.

11. I.R.C. § 4940(a), (e).

12. 26 C.F.R. § 53.4940-1(f)(1).

13. *Id.* § 53.4940-1(d)(1).

14. I.R.C. § 4944 and accompanying regulations (jeopardy investment).

specifically recognizes PRIs as exceptions to these "jeopardy investment" restrictions.[15]

Finally, the law and accompanying regulations generally do not permit foundations and their disqualified persons to collectively hold more than a 20%, or in some cases up to 35%, interest in a "business enterprise."[16] As with jeopardy investments, the Code recognizes exceptions to the "excess business holdings" rules so that PRIs are not subject to these rules, which allow foundations to hold more than the permitted interest in a business enterprise as long as the foundation's investment satisfies the PRI criteria.[17]

Over the decades, the Department of the Treasury and Internal Revenue Service (IRS), through respective regulations, actions, and guidance, have consistently reinforced the legitimacy of PRIs, including affirmation that PRIs may involve limited liability companies.[18]

B. Evolving from PRI to L3C

The L3C as a business form that embraces these elements received its first semi-public airing at a 2006 symposium hosted by the Aspen Institute in Washington, D.C. to explore and begin debate about whether hybrid activities needed or could benefit from a new business form to facilitate their operations and effectiveness. The B Corporation also received significant attention at the same event. Much of the conversation focused on whether hybrid operations could most effectively and legally be conducted using current business forms or if a new form was appropriate. At that time, both the L3C and B Corporation seemed to lack a strategy for successfully addressing potentially competing or conflicting fiduciary responsibilities.

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15. *See id.* § 4944(c); March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6 (explaining that a PRI "shall not be classified as an investment which jeopardizes the carrying out of the exempt purposes of a private foundation").

16. I.R.C. § 4943(c)(2)(A)–(B) and accompanying regulations (describing excess business holdings). There are caveats that apply generally such as the 2% de minimis threshold, the at least 95% passive income exception to the definition of "business enterprise," and for functionally related businesses. *Id.* at § 4943(c)(2)(C), (d)(3).

17. I.R.C. § 4943; 26 C.F.R. § 53-4943-10(b) (stating that program-related investments are exempted from the definition of "business holdings"). *See also* I.R.S. Priv. Ltr. Rul. 2009-47-065 (Nov. 20, 2009) (declaring that funds disbursed pursuant to program-related investment grant agreements "do not create any 'business holdings' within the meaning of section 4943").

18. *See* March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6; I.R.S. Priv. Ltr. Rul. 1995-50-039 (Sept. 21, 1999) (noting that a foundation may receive benefits from participation in an LLC). *See also* Letter from A.B.A., Section of Taxation, to Hon. Douglas Shulman, Commissioner, Internal Revenue Service (Mar. 3, 2010), *available at* http://www.abanet.org/tax/pubpolicy/2010/Comments_Concerning_Proposed_Additional_Examples_on_Program_Related_Investments.pdf ("We believe that, if a particular loan to, or investment in, an ordinary LLC would qualify as a PRI, then, *a fortiori*, a loan to, or investment in, an L3C should also so qualify.").

However, both forms shared an understanding of the potential benefits of branding and marketing to enhance awareness of businesses pursuing "socially" desirable ends in responsible ways.

Part of the impetus for the L3C was the unrealized potential of PRIs, the misperception that only sophisticated foundations could effectively deploy PRIs, and frustration with the time and expense of pursuing pre-approval of PRIs from the IRS—even though such pre-approval is not legally required as a condition of making a PRI.[19] One of the primary initial goals for the L3C was to make PRIs more accessible, simpler, less expensive, and less mysterious by codifying the elements into a new business form and injecting those elements into the form's genetic code, rather than something merely peripheral.[20]

Another initial, and probably more important, goal for the L3C was to pursue opportunities that PRIs and the LLC form together might present for creative approaches to financing appropriate ventures, including varied strategies for using tranches or layers to help satisfy diverse needs and expectations of various investors and using serial financing that is becoming more common in LLCs.[21]

However, none of these goals necessarily required a new business form. For instance, a public relations campaign could have promoted the benefits of PRIs and demystified some of their perceived complexity. An expedited review process at the IRS could have addressed certain concerns related to the complexity and interactions with the IRS.[22] In addition, existing for-profit forms, including the LLC, could be used to pursue opportunities for creative financing and investment.

One of the L3C's innovations is a clearer, more consistent approach to understanding and enforcing fiduciary, not merely contractual, duties in a hybrid context. That innovation arises from the explicit statutory application of the PRI elements and characteristics to create a new business form.

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19. *See* Minnigh, *supra* note 1, at 212–13 (noting that "the cost, time and resources to acquire a legal opinion from counsel or a private letter ruling from the IRS" have inhibited wide use of the PRI mechanism).

20. *See id.* at 209 ("The low-profit limited liability company (L^3C) format was created to bridge the gap between the underutilized capacities of non-profit organizations and for-profit entities.").

21. *Id.* at 214, 216.

22. In fact, as part of the overall L3C strategy, legislation has been proposed in Congress to impose such a process and to afford certain presumptions based on an entity's status as an L3C. *Id.* (discussing the proposed federal Program-Related Investment Promotion Act of 2009).

1. Adapting PRI Elements to an L3C Context and Correcting Accompanying Misperceptions

The two most important of these elements, as incorporated by states into the L3C statutes,[23] are primacy of charitable, exempt purposes and de-emphasis of profit and value.[24] The third element, that the purposes of the enterprise may not influence legislation through lobbying or intervention in political campaigns or elections, is not as crucial to purposes of this Article.[25]

The first critical element of the PRI that is adapted to the L3C form is that the entity's primary purposes must be pursuing charitable, otherwise exempt objectives within the meaning of the Internal Revenue Code, [26] such as reversing the effects of discrimination, assisting in revitalizing an economically disadvantaged area, combating community deterioration, providing specialized training programs, and facilitating scientific research.[27] One way to meet this element is to establish and document that the entity would not have been formed but for its relationship to accomplishing the charitable, exempt purposes.[28] This is a variation of the regulatory requirement that the foundation's PRI must relate to the foundation's charitable mission and that, but for such relationship, the foundation would not make the PRI.[29]

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23. *See* 805 ILL. COMP. STAT. ANN. 180/1-5, 180/1-10, 180/5-5 (West 2004 & Supp. 2010) (Illinois); ME. REV. STAT. tit. 31, §§ 1559 and 1611 (2010) (Maine); MICH. COMP. LAWS § 450.4102 (LexisNexis Supp. 2010) (Michigan); N.C.G.S.A. § 57C-2-01(d) (West 2010) (North Carolina); UTAH CODE ANN. §§ 48-02c-412, 48-02c-1411 (LexisNexis 2009) (Utah); VT. STAT. ANN. tit. 11, Ch. 21, §§ 3001(27), 3005(a) and 3023(a) (West 1997 & Supp. 2009) (Vermont); and WYO. STAT. ANN. § 17-15-102(a)(ix) (2009) (current version at WYO. STAT. ANN. § 17-29-102(a)(ix) (West 2010)) (Wyoming).

24. March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6.

25. *See* 26 C.F.R. § 53.4944-3(a)(1)(iii) (2010); March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6 (detailing the three requirements of a PRI). This Article focuses on the first two elements. However, the third element may be a critical factor in choosing whether to use the L3C form. The ability or inability to lobby or to support or oppose candidate(s) for public office may be essential for successfully operating the enterprise. In some circumstances, the members or managers may be able to undertake these activities using other entities or statuses, but that may not always suffice. It could be a substantial mistake for members, managers, and their advisors not to appropriately consider the effect of this element on the business of the L3C.

26. I.R.C. § 4944(c) (2006); 26 C.F.R. §§ 53.4944-3(a)(1)(i), 53.4944-3(a)(2)(i); Robert R. Keatinge, *LLCs and Nonprofit Organizations – For-Profits, Nonprofits and Hybrids*, 42 SUFFOLK U. L. REV. 553, 581–82 (2009).

27. *See* I.R.C. § 170(c)(2)(B).

28. 26 C.F.R. § 53.4944-3(a)(2)(i); *See* Keatinge, *supra* note 26, at 581–82 (noting that an L3C is a "LLC which is established to advance a charitable or educational goal"; (a) the primary purpose is to "accomplish one or more charitable purposes," (b) "LLC would not have been formed but for its relationship to the accomplishment" of the purpose(s), and (c) "no significant purpose of the LLC" can be "production of income or the appreciation of property") (citations omitted).

29. 26 C.F.R. § 53-4944-3(a)(2)(i).

Note that so-called "social" benefits are not adequate without more. Creating jobs, expanding the tax base, generating wealth, and other contributions of entrepreneurial and for-profit enterprises are socially beneficial, desirable, and even necessary, but they would not satisfy this prong of the PRI and L3C requirements without an overriding charitable, exempt context such as those identified above. Consequently, characterizing L3Cs as pursuing "social" ends is inaccurate and potentially confusing.

Second, no significant purpose of the L3C enterprise can be generating profit or appreciation of value.[30] One of the ways this is assessed in the PRI context is the extent to which the opportunity would attract a full complement of regular, commercial, market investors or lenders on market terms. If it would, then profit is more likely to be considered a significant purpose. If market returns become common, however, the L3C risks losing its status, and it may need to convert to an LLC or terminate.[31] Fortunately and as discussed in greater detail in Part II, Congress and the IRS contemplated such success and provided for it as a legitimately recognized strategy inherent to the PRI experience.

This "no significant purpose" element has given rise to substantial confusion in at least two respects. For instance, this requirement inspired the misleading "low-profit" part of the L3C name and corresponding confusion that mistakenly projects "low-profit" as a goal of the enterprise, rather than as an adjective that describes the likelihood of below market returns. Under the law and accompanying regulations, PRIs, and by extension L3Cs, can generate distributable profit, the profit need not be "low," and it is possible that profit in certain circumstances may achieve market or even above market levels.[32]

Another misunderstanding inspired by the "no significant purpose" element is a perception that private foundations do not want or cannot have profit, interest, or an investment return.[33] The corollary to this belief further re-characterizes the PRI as a grant or gift with some hope of getting the base amount back but no real expectation that it will be returned. While some foundations in certain circumstances may be prepared to have their investment treated as the highest risk and lowest return capital, it is not a safe presumption that all foundations or L3Cs will pursue that course.

30. I.R.C. § 4944(c); 26 C.F.R. §53.4944-3(a)(1)(ii); March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6; Minnigh, *supra* note 1, at 213; Keatinge, *supra* note 26, at 581–82.

31. *See infra* text accompanying note 158.

32. *See* 26 C.F.R. § 53.4944-3(a)(2)(iii); Minnigh, *supra* note 1, at 213 n.33 ("However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.") (quoting 26 C.F.R. § 53.4944-3(a)(2)(iii)).

33. *See* Minnigh, *supra* note 1, at 209.

While this is one possible approach for conceiving of an L3C, it is unduly restrictive to limit opportunities for and applications of the L3C so narrowly.

2. Correcting Misperceptions about Foundation Involvement with the L3C

Although not related to any specific condition for L3C status, there are misconceptions derived from the L3C's origins in a strategy that previously had unique application for private foundations. For instance, there is a mistaken belief that L3Cs must always involve foundations as members or creditors. That is not the case. There are many applications and opportunities for using the L3C form that do not require foundation involvement. Stated differently, there is no application of the L3C that depends on the presence of a foundation.[34] Consequently, the L3C and its justification transcend foundation involvement.[35] As such and without discouraging efforts to make PRIs less mysterious, proper conceptions of the L3C should not be limited to or rely on a foundation presence.[36]

A related misperception is reflected in a belief that any foundation that is involved with an L3C must control the day-to-day operations and governance of the enterprise in order to protect the benefits of its PRI.[37] Although certainly one permissible approach to the L3C, such control is not required, may actually be unwise, and could discourage foundation engagement with L3Cs. Foundations may need to preserve certain rights to

34. For instance, others have talked about the branding benefits of the "L3C" name. As is discussed later in this Article, the additional fiduciary duty implications available through this form can also be important and are independent of foundation engagement.

35. This reality also then limits the effectiveness of criticisms of the L3C premised on foundation engagement. Without commenting on the underlying merit or substance of such critiques, they are generally not assessments of the L3C form itself, but more properly are assessments of limited, very specific variations of the L3C form. Treating such criticisms more broadly than their properly restrictive application reflect a misunderstanding of the L3C form.

36. *See* Daniel Kleinberger, The Snare and Delusion of the L3C, William Mitchell College of Law, Legal Studies Research Paper Series, Paper No. 2010-03 25, 36 (Feb. 16, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1554045 (discussing the potential extent of foundation control over L3Cs). With this presumption in hand, some critics attack L3C flexibility to permit tranching of investments with foundations presumably in the lowest tier, and they also criticize a governance structure that places foundations in control of operations—almost as if these are the only approaches to the L3C. If these presumptions were valid, the criticisms would be more attractive. However, among the LLC-derived benefits of the L3C form is the flexibility in financing and governance structures that are permitted, which contemplate a variety of approaches. There no doubt are circumstances in which the tranche approach to investments and/or foundation control of all operations will be strategically appropriate, but such approaches are not likely to characterize all (or even most) L3Cs. Consequently, and despite being positioned as criticisms of the L3C form generally, these types of critiques only address specific possibilities for the form.

37. *Id.* at 25.

protect PRI status and benefits, but that need does not necessarily extend to daily operations or all aspects of governance.[38] Moreover, the talent of foundation personnel is not likely to encompass daily operations of a business enterprise. Generally expecting such control in foundations could inhibit the L3C's ability to achieve its charitable objectives or earn adequate operating or distributable revenues and, as such, would be unwise. Finally, foundations are not likely to want the additional complexity, distractions, and administrative burden of operating the L3C business. Applications that inhibit foundation involvement may undermine a goal of the L3C to make PRIs more—not less—accessible to foundations.

Correcting these misperceptions in the context of understanding the L3C's elements is important to help ensure an accurate and appropriate framework for applying the L3C and pursuing its potential. With that grounding, we can better explore how the L3C form, particularly through its dual core components, approaches the "two masters" problem plaguing hybrids that combine profit and social purposes. The next steps in that exploration involve analyzing the difficulties other forms, particularly the for-profit, have in addressing hybrid situations and how the L3C, properly grounded in its core elements, innovates solutions to that problem.

II. THE PROBLEM OF HYBRID PURPOSES AND FOR-PROFIT ENTERPRISES

The ultimate legal purposes and roles of the for-profit firm—whether to maximize distributable profits and shareholder value or serve non-shareholder interests[39]—provide the basis for defining, implementing, and evaluating fiduciary duties within the context of a larger economic system.

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38. *See* March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6. For instance, foundations should ensure that organizing documents, private placement memoranda, credit vehicles, and other documents allow for the following if the enterprise's use of the foundation's PRI no longer meets the requirements of a PRI: Ability to terminate its participation by forcing liquidation or requiring the enterprise to buyout the foundation's interest and refrain from making future payments that might be due. Depending on the extent of the foundation's engagement in the enterprise, the foundation may want to preserve certain veto rights regarding operational or structural changes. *See id.* at 12 (discussing a foundation's need to use control mechanisms to ensure that its own tax status is not affected by the L3C's actions).

39. For a thorough discussion of this dilemma, see generally, Barnali Choudhury, *Serving Two Masters: Incorporating Social Responsibility into the Corporate Paradigm*, 11 U. PA. J. BUS. L. 631 (2009). Although the legal and economic theories of the for-profit firm have similarities, this Article attempts to address certain legal issues relating to the L3C form and does not consider, and should not be construed as considering, important economic matters applied to the form. For instance, economic theory and practical applications are better positioned to address whether L3Cs that pursue certain purposes actually subvert the market and economic forces by preserving jobs and businesses that the market might suggest should not be preserved. Although the L3C and PRIs generally can be used to facilitate market transitions, it can be dangerous and counterproductive for them to be used to interfere with our economic system, including its uncomfortably disruptive elements.

Such purposes and roles helped give rise to fiduciary duties as a means of ensuring that decision-makers properly prioritize the interests they are to serve, particularly when those interests conflict or compete with each other,[40] which they invariably do. As components of meta-political and economic systems, fiduciary duties and the priorities they advocate also reflect a public policy barometer for how to appropriately allocate profits and wealth.[41]

Debate has waged for decades about which of the competing theories dominates, or if either has actually won. Some contend that the debate has been resolved firmly in favor of maximizing shareholder value.[42] Others have concluded that shareholder value no longer dominates,[43] with

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40. Edward D. Rogers, *Striking the Wrong Balance: Constituency Statutes and Corporate Governance*, 21 PEPP. L. REV. 777, 779 (1994).

41. *See* Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 ANN. SURV. AM. L. 85, 105, 118–19 (1999) (noting that in a hostile takeover of a bank with a white knight, the extent to which price can be sacrificed for social issues is not a "proper determination for the court") (citation omitted); Antony Page, *Has Corporate Law Failed? Addressing Proposals for Reform*, 107 MICH. L. REV. 979, 979 (Apr. 2009) (reviewing KENT GREENFIELD, THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES (2006)); Choudhury, *supra* note 39, at 648–50. *Cf.* Stephen M. Bainbridge, *Interpreting Nonshareholder Constituency Statutes*, 19 PEPP. L. REV. 971, 1024 (1992); Kathleen Hale, *Corporate Law and Stakeholders: Moving Beyond Stakeholder Statutes*, 45 ARIZ. L. REV. 823, 825 (2003). Contrary to some popular misconceptions, shareholder interests are residual and not primary. Shareholders receive distributions only after expenses have been met, including payments to non-shareholders who are frequently considered "stakeholders" or "constituents," such as employees. It is in part because of their residual position that fiduciary duties are necessary to protect shareholders from misallocation of funds to other purposes that would otherwise be to the detriment of shareholders.

42. Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORDHAM L. REV. 2437, 2448 (2009) (highlighting that corporate contributors and corporate social responsibility "[have] drawn consistent, and often withering, criticism"); Bainbridge, *supra* note 41, at 976–77, 1005; Choudhury, *supra* note 39, at 648–50; Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 WASH. & LEE L. REV. 409, 412–13, 435–37 (2002); Michael D. Gottesman, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL'Y REV. 345, 356–57 (2007); Hale, *supra* note 41, at 837; Alissa Mickels, *Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe*, 32 HASTINGS INT'L & COMP. L. REV. 271, 282, 286–87, 297 (2009); Page, *supra* note 41, at 979; Springer, *supra* note 41, at 87–88, 93 (illustrating shareholder primacy in the takeover context) (citing Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)); Rogers, *supra* note 40, at 779–81. *See* eBay Domestic Holdings, Inc. v. Craigslist, Inc., No. 3705-CC, 2010 WL 3516473, at *23 (Del. Ct. Chan. Sept. 9, 2010) (rejecting argument that for-profit corporate directors may seek not to maximize stockholder value when there are shareholders who want that value) "The corporate form . . . is not an appropriate vehicle for purely philanthropic ends, at least not when there are other stockholders interested in realizing a return on their investment." *Id.*

43. Bainbridge, *supra* note 41, at 973–74, 978; Fairfax, *supra* note 42, at 414, 458, 474; Mickels, *supra* note 42, at 272; Page, *supra* note 41, at 980; Springer, *supra* note 41, at 98, 117. Although not trumpeting a declaration of the outright defeat of shareholder primacy, there are those who believe that profit maximization has been considerably weakened or overstated. Fairfax, supra note 42, at 411 n.9 ("For profit directors and officers are principally concerned about long-term profit

constituency statutes helping resolve the debate in favor of the for-profit firm as a social entity. A centrist approach, which seems most prevalent, suggests that the debate continues to evolve with shareholder value still primary but consideration of other interests being acceptable as long as connected to shareholder value in some way.[44]

These debates do not apply to charitable, exempt organizations whose underlying theory, roles, purposes, and corresponding fiduciary duties are well-established in being organized and operated for charitable, exempt purposes and not for distributable profits or value. Similarly, these debates do not apply to limited liability companies because of the substantial freedom and flexibility that the various state laws allow for the members to determine their duties and purposes, including those that are charitable and exempt, by virtue of contract. Consequently, neither form's approaches to hybrid purposes and fiduciary duties is particularly relevant or useful for the L3C, except for the broad ability to waive fiduciary duties provided for in most LLC structures that this Article considers in Part IV below.

As noted above, the L3C can and presumably does pursue and distribute profits. The challenge arises because of the statutory mandate to operate primarily in furtherance of charitable, exempt purposes. Legitimacy and broader acceptance of the L3C will be facilitated as it becomes clearer how the L3C, as a for-profit enterprise, fits within these larger, established theoretical constructs, which also sheds light on whether the L3C innovates or reiterates as a legal matter. Toward that end, this section summarizes the primary competing theories for the purposes and roles of the for-profit firm in our economic system: maximizing profits and the firm as a social entity, including discussion of "constituency" statutes.

A. Purposes of the For-Profit Firm Generally: The Dichotomy of Maximizing Shareholder Value Versus the Firm as a Social Entity

1. Primacy of Shareholder Value

Some variation of maximizing shareholder value as the ultimate objective of the for-profit firm still seems to predominate. These theories

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maximization. While nonprofit directors and officers keep economic matters in mind, they are principally concerned about the effective performance of the nonprofits' mission.") (quoting Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 641 (1998)). *See also* Choudhury, *supra* note 39, at 635, 666–67. *But see* eBay, 2010 WL 3516473, at *23 ("Directors of a for-profit Delaware corporation cannot deploy a rights plan to defend a business strategy that openly eschews stockholder wealth maximization—at least not consistently with the directors' fiduciary duties under Delaware law.").

44. Choudhury, *supra* note 39, at 631, 633.

have traditionally combined legal principles of agency,[45] property rights,[46] and contract,[47] all of which are intertwined in the corporate form, whether for-profit or exempt. Borrowed in part from duties that partners owe one another,[48] the agency theory states that directors are agents of the shareholders and therefore owe duties of care and loyalty as any agent owes his or her principal.[49] The property rights theory begins with shareholders as the owners of the business, which then is their property, and the directors are the stewards of the property for the shareholders.[50] In either instance, there is an implied, if not overt, contract between shareholders and directors by which directors commit to maximizing shareholder value, and this contract incorporates default fiduciary duties that the law presumes the parties would have arrived at if they had incurred the time and expense (and corresponding lost opportunity costs) of negotiating them.[51] Whether derived from agency, property, or contract law or some combination of all three, under this theory, directors are responsible for maximizing the value of the corporation for the ultimate benefit of its shareholders, and their decisions and behavior must prioritize this objective as a fiduciary matter.

2. The For-Profit Firm as a Social Entity

Advocates of non-shareholder, stakeholder, constituency, or otherwise "social" theories frequently rely on the presence of interests other than

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45. Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 814 n.116 (2008); Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 678–79 (2009) (noting that equitable fiduciary duties trace back to the 1742 decision from *In Charitable Corporation v. Sutton*, 2 Atk. 400, 406, 26 Eng. Rep. 642, 645 (ch. 1742), in which the Lord Chancellor explained that directors are both agents and trustees required to act with "fidelity and reasonable diligence," which have been translated into duties of loyalty and care) (citations omitted); Fairfax, *supra* note 42, at 431; Timothy L. Fort, *The Corporation as Mediating Institution: An Efficacious Synthesis of Stakeholder Theory and Corporate Constituency Statutes*, 73 NOTRE DAME L. REV. 173, 187–88 (1997); Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager after More than a Decade of Experimentation?*, 32 J.CORP. L. 565, 570 (2007); Mary Szto, *Limited Liability Company Morality: Fiduciary Duties in Historical Context*, 23 QUINNIPIAC U. L. REV. 61, 98–101, 111 (2004).

46. Choudhury, *supra* note 39, at 635–36; Fairfax, *supra* note 42, at 430. *See also* Bainbridge, *supra* note 41, at 1005.

47. Choudhury, *supra* note 39, at 635–37; Conaway, *supra* note 45, at 805; Fairfax, *supra* note 42, at 431; Page, *supra* note 41, at 984.

48. Szto, *supra* note 45, at 101.

49. Fort, *supra* note 45, at 187–88.

50. Choudhury, *supra* note 39, at 635–36; Fairfax, *supra* note 42, at 430; Szto, *supra* note 45, at 99.

51. Choudhury, *supra* note 39, at 635, 637; Conaway, *supra* note 45, at 805; Page, *supra* note 41, at 984.

shareholders who are affected by or vital to the corporate operations.[52] They also cite to the broad purposes that corporations fulfill in the lives of people and communities to assert that directors must consider the interests of all groups or interests affected by the corporation,[53] including some combination of employees, customers, suppliers, creditors, community, the environment, and others.[54] Some reach this result by arguing that corporations exercise their power pursuant to a delegation from the state which, in turn, imposes obligations to the state and broader society.[55]

There are variations and extremes within the ambit of corporation as "social" entity. The spectrum includes those who seek to place all interests on par with those of shareholders;[56] those who choose to consider certain "stakeholder" interests but not others;[57] those who encourage a balancing of interests provided shareholder interests are not jeopardized;[58] and those who elevate non-shareholder interests at the expense of shareholders.[59] As a sort of catchall approach, others contend that directors owe duties to the corporation itself and must serve the best interests of the corporation, which impose a duty to consider non-shareholder interests, particularly employees, in this larger corporate context.[60]

There are at least three problems with these theories. First, the general lack of coherence among the theories of for-profit firm as "social" entity inhibits the ability of these theories to be implemented effectively. For instance, the absence of clear priorities and objectives allows directors either unfettered and unassailable discretion or subjects them to liability for every meaningful decision they make because these decisions inevitably offend some interest(s). Second, because interests collide, the implicit

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52. Bainbridge, *supra* note 41, at 973, 975–76; Fairfax, *supra* note 42, at 412, 432; Hale, *supra* note 41, at 825, 830; Mickels, *supra* note 42, at 272; Springer, *supra* note 41, at 87–88, 93.

53. Conaway, *supra* note 45, at 805; Fairfax, *supra* note 42, at 411–12, 432; Mickels, *supra* note 42, at 275, 277 (describing the definition of corporate social responsibility as vague, but it generally embodies a conviction that corporate purposes are not solely about making money, but also about providing social benefits for the broader community); Miller, *supra* note 45, at 582–83 (defining the team approach to fiduciary duties, where corporate directors mediate among various stakeholders with economic efficiency best served in maximizing interests of all groups with the social context providing "critical cues on expectations of trustworthy behavior," and opining that reduced standards of "acceptable legal conduct" would "signal a lower expectation of trustworthy behavior and . . . business entity accountability"); Page, *supra* note 41, at 980; Springer, *supra* note 41, at 102.

54. Mickels, *supra* note 42, at 274.

55. Springer, *supra* note 41, at 102–03.

56. Choudhury, *supra* note 39, at 634.

57. *See* Fort, *supra* note 45, at 189 (arguing that at least employees should have a voice).

58. Choudhury, *supra* note 39, at 647; Fairfax, *supra* note 42, at 437, 439; Mickels, *supra* note 42, at 289; Springer, *supra* note 41, at 117–18.

59. Mickels, *supra* note 42, at 290, 298.

60. Page, *supra* note 41, at 995.

pursuit of "fairness" of outcome for everyone or even for prioritized groups may not be achievable in theory or practice,[61] although "fairness" in the decision-making process may be achievable or even expected as part of the duty of care. Third, there is a question about whether directors of for-profit corporations should be charged with practical responsibility for developing broad-based public policy, which is a byproduct of expecting directors to pursue conceptions of fairness or justice as a matter of law and holding them accountable for results that favor particular non-shareholder interests, including the broadest definitions of society.[62]

In some ways, advocates of more aggressive variations of fairness and corporation as "social" entity are pursuing a form of informal hybrid entity, but the informality adds to, rather than resolves, complexities and ambiguities for directors, investors, creditors, employees, and ultimately for commerce and the marketplace. Many in the social entity camp rely on liberal application of constituency statutes to bring greater clarity and certainty to their theory and its hybrid applications. However, as is demonstrated below, the actual language and application of nearly all of these statutes do not support this contention, nor do they subvert theories that favor shareholder value.

B. Constituency Statutes and Theories of the For-Profit Firm

Some exploration of constituency statutes is relevant to our inquiry for at least three reasons, the first two of which affect assessments of the L3C's originality. First, the statutes and their application can influence whether fiduciary duties must ultimately be in furtherance of maximizing shareholder value, corporations as social entities, or some combination. Second, these statutes can influence how directors of for-profit corporations fulfill, and are held accountable, for their duty of care in the thirty-one states with such statutes. Both of these points are critical for understanding the B Corporation and its hybrid approach, which require incorporating in a state with a constituency statute and implementing its procedural steps.[63]

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61. *See* Choudhury, *supra* note 39, at 652–55 (discussing the potential for inequitable, or unfair, distribution of social benefits from well-intentioned corporations).

62. *See* Rogers, *supra* note 40, at 780 ("[B]road corporate goals will result in poor social policy decisions," thereby undermining intent of constituency statutes, because boards and managers are "ill-suited to make the inherently political decisions of balancing constituencies, which requires judgment about the proper allocation of wealth in society.") (citations omitted); *id.* at 808 ("In general, government should make policy and corporations should make money."); Fort, *supra* note 45, at 181–82. Note, too, that directors may voluntarily undertake to pursue perceived fairness and justice in an effort to increase revenues, attract customers, retain employees, or otherwise serve goals that add value.

63. *See* Mickels, *supra* note 42, at 278–79, 282 (discussing the prerequisites for achieving B Corporation status).

Finally, because the L3C has for-profit characteristics as a hybrid enterprise, understanding constituency statutes helps the L3C exegesis by allowing a comparison of its approaches to fiduciary duty with those of constituency statutes, which as a practical matter do not alter fiduciary duties at all.

1. Constituency Statutes Generally

In essence, constituency statutes formally allow corporate directors to consider the interests of some combination of non-shareholders—such as employees, suppliers, customers, creditors, communities, localities, economies, short- and long-term interests, and others—when fulfilling their fiduciary duties.[64] In many ways, these statutes clarify the business judgment rule and adopt existing case law to explicitly protect directors from lawsuits for decisions they make in which they consider such non-shareholder interests, even if the decisions may seem counter to the priority of shareholder value.[65]

Thirty-one states have enacted some variation of these statutes,[66] but there are material differences among them. For instance, and as is discussed more thoroughly below, most states merely permit consideration of non-

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64. *See* Bainbridge, *supra* note 41, at 973–74; Fairfax, *supra* note 42, at 459; Gardner Davis & Danielle Whitley, *Directors' Fiduciary Duties: Increasing Focus on Good Faith and Independence.* 83 FLA. B. J. 38, 38 (Aug. 2009); Hale, *supra* note 41, at 832, 834; Rogers, *supra* note 40, at 777; Springer, *supra* note 41, at 97.

65. Bainbridge, *supra* note 41, at 989; Fairfax, *supra* note 42, at 462–63, 473; Springer, *supra* note 41, at 107.

66. Mickels, *supra* note 42, at 290 n.113 (citing ARIZ. REV. STAT. ANN. § 10-2702 (West 2008); CONN. GEN. STAT. § 33-756 (2008); FLA. STAT. ANN. § 607.0830(3) (West 2007); GA. CODE ANN. § 14-2-202(b)(5) (2003); HAW. REV. STAT. § 414-221 (2004); IDAHO CODE ANN. § 30-1602–1702 (2008); 805 ILL. COMP. STAT. ANN. 5/8.85 (West 2004); IND. CODE ANN. § 23-1-35-1 (West 2008); IOWA CODE ANN. § 491.101B (West 1999); KY. REV. STAT. ANN. § 271B.12-210(4) (LexisNexis 2003); LA. REV. STAT. ANN. § 12:92(G)(2) (2008); ME. REV. STAT. ANN. tit. 13-C, § 831 (2009); MD. CODE. ANN., CORPS. & ASS'NS. § 2-104(b)(9) (LexisNexis 2007); MINN. STAT. ANN. § 302A.251(5) (West 2004); MISS. CODE ANN. § 79-4-8.30(d) (2000); MO. ANN. STAT. § 351.347 (West 2001); N.J. STAT. ANN. §§ 14A:6-1(2), 6-14(4) (West 2003); N.M. STAT. ANN. § 53-11-35(D) (LexisNexis 2004); N.Y. BUS. CORP. LAW § 717(b) (McKinney 2003); N.D. CENT. CODE § 10-19.1-50(6) (2007); OHIO REV. CODE ANN. § 1701.59(E) (LexisNexis 2009); OR. REV. STAT. § 60.357(5) (2009); 15 PA. CONS. STAT. § 1715 (West 1995); R.I. GEN. LAWS § 7-5.2-8(a) (West 2009); S.D. CODIFIED LAWS § 47-33-4(1) (2007); TENN. CODE ANN. § 48-103-202–204 (2008); VT. STAT. ANN. tit. 11A, § 8.30(a)(3) (West 2007); WIS. STAT. ANN. § 180.0827 (West 2002); WYO. STAT. ANN. § 17-16-830(e) (2009)). Some authorities list thirty-two states with constituency statutes. However, Nebraska repealed its statute in 1995. NEB. REV. STAT. § 21-2035(1)(c) (repealed 1995). Also, it may be that some include the Texas statute which permits directors to consider the long-term and short-term interests of the corporation and its shareholders without recognizing non-shareholder interests. TEX. BUS. CORP. ACT ANN. art 13.06 (West 2009).

shareholder interests.[67] Only Connecticut mandates consideration of non-shareholder interests, and that mandate is imposed only upon publicly traded corporations and only when there is a change of control.[68] Four of the other thirty states mandate consideration of shareholder interests, while only permitting consideration of the non-shareholder interests.[69]

Some of the statutes apply exclusively to the takeover or structural context.[70] Some specifically list, and therefore limit, the non-shareholder interests covered by the statutes, but the interests included are neither uniform nor consistent, although all at least mention employees.[71] There are other differences as well, including whether the statutes expressly provide for long- versus short-term considerations,[72] whether they apply solely to directors or also cover officers,[73] whether corporations may opt out or must affirmatively opt in by including language in their charter documents,[74] and even whether the statutes only cover directors of publicly traded corporations.[75]

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67. *See supra* note 66 for citations to the statutes of Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nevada, New Jersey, New Mexico, New York, North Dakota, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Vermont, Wisconsin, and Wyoming. The Tennessee statute declares a public policy that favors Tennessee business, emphasizes the importance of stable, long-term growth, and bemoans the disruptive nature of mergers. TENN. CODE ANN. § 48-103-202 (LexisNexis 2009).

68. Bainbridge, *supra* note 41, at 973–74, 987; Choudhury, *supra* note 39, at 644–45; Fairfax, *supra* note 42, at 461 n.290, 464; Hale, *supra* note 41, at 832, 834; Springer, *supra* note 41, at 101, 107–08, 121. *See also* Rogers, *supra* note 40, at 778 (noting that broad construction is possible since the consideration of interests is not mandatory).

Connecticut requires directors of corporations with classes of voting stock registered pursuant to § 12 of the Securities Exchange Act of 1934 to consider interests of shareholders, employees, customers, creditors, suppliers, and other factors, but only in the context of mergers and sales of assets. CONN. GEN. STAT. § 33-756(d) (2008). Some might also characterize Arizona's statute as mandatory, but it requires consideration of the long- and short-term interests of the corporation and its shareholders without otherwise identifying any non-shareholder interests. ARIZ. REV. STATE. ANN. § 10-2702 (LexisNexis 2009). Therefore, although technically "mandatory," the Arizona statute's mandate does not favor non-shareholder interests and, arguably, specifically subjugates them.

69. *See supra* note 66 for citations to the statutes in Mississippi, New Mexico, Ohio, and Wyoming.

70. Fairfax, *supra* note 42, at 463, 474 (noting that about one third of the states limit the statute to the takeover context); Bainbridge, *supra* note 41, at 986; Hale, *supra* note 41, at 836; Springer, *supra* note 41, at 100, 110–11. Connecticut is among these states, which necessarily restricts the effectiveness of its "mandate." Others include Idaho, Iowa, Louisiana, Maryland, Missouri, Oregon, and South Dakota. *See supra* note 66 for specific citations.

71. Fairfax, *supra* note 42, at 460–61, 461 n.290, 462 n.294; Springer, *supra* note 41, at 97.

72. Fairfax, *supra* note 42, at 462 n.292; Hale, *supra* note 41, at 836; Springer, *supra* note 41, at 97.

73. Hale, *supra* note 41, at 834–35 (noting that most state statutes only cover directors, but Illinois also includes officers).

74. Springer, *supra* note 41, at 101–02, 121.

75. Connecticut, Idaho, South Dakota, and Vermont have such statutes. *See supra* note 66 for

Despite the material differences and frequently limited application, there are those who argue that these statutes broadly "swing" balance "back in favor of . . . socially responsible director[s]" to prefer "stakeholder interests over shareholder interests."[76] At best, however, these statutes merely create the potential for "socially responsible directors" to afford some degree of consideration to the effects of decisions on non-shareholder interests, which is a far cry from being able to prefer non-shareholder interests over shareholder interests. Concluding that these statutes actually upset the priority of shareholder value substantially misreads the statutes, including both what is written and what is not provided for.[77]

2. Effect of Constituency Statutes on Directors

As noted above, the clear language of the statutes in all states except Connecticut is permissive—not mandatory—regarding non-shareholder interests, and even Connecticut's mandate is very limited. Therefore, whether to consider non-shareholder interests, and to what degree, is generally up to the directors,[78] and there appears to be no legal requirement to justify not considering such interests or for giving them only minimal consideration. Therefore, directors may choose to consider non-shareholder interests seriously, only cursorily, or not at all as they deem appropriate under the circumstances. Such a grant of permission does not and should not replace maximizing shareholder value as the ultimate purpose and theory of the for-profit corporation. Permission may protect directors, but it properly does not and should not vest rights, benefits, or even expectations in non-shareholders.

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specific citations.

76. Mickels, *supra* note 42, at 290. *See also* Bainbridge, *supra* note 41, at 987 ("[T]he statutes should not be interpreted as creating new director fiduciary duties running to nonshareholder constituencies and the latter should not have standing under these statutes to seek judicial review of a director's decision."); Springer, *supra* note 41, at 101, 111, 120–21 (stating that, with the exception of Connecticut, corporations have discretion to consider constituents). There are those who disagree and believe that maximizing shareholder value remains primary. *See* Davis & Whitley, *supra* note 64, at 38 ("[T]he board is primarily responsible for the economic performance of the corporation . . . ."). *See also* Fairfax, *supra* note 42, at 463 (noting that directors can consider interests broader than those of the immediate beneficiaries).

77. New York leaves no ambiguity about this conclusion by specifically disclaiming that the statute creates any duties to consider any non-shareholder interests or afford any particular weight to non-shareholder interests. The New York statute concludes by affirming that it does not abrogate any duties owed by directors under statutes, common law, or court decisions. *See* N.Y. BUS. CORP. LAW § 717(b) (McKinney 2003).

78. *See supra* text accompanying note 68. *See also supra* note 66 for a list of the state statutes. Arizona also has mandatory language, but it requires consideration of shareholder interests without any mention of non-shareholder interest. *See supra* text accompanying note 68.

This conclusion is reinforced by what the statutes do not contain. The constituency statutes lack enforcement mechanisms or standing provisions to hold directors accountable for inadequately considering non-shareholder interests.[79] This absence appropriately positions these statutes as defensive mechanisms benefiting directors rather than as rights vested in non-shareholders.[80] Also absent from the statutes are requirements that directors favor or prioritize non-shareholder interests over those of shareholders.[81] Even Connecticut requires only consideration of non-shareholder interests and does not dictate a particular priority in which directors of publicly traded companies must consider the interests or the weight to afford such interests.[82]

Consequently, there is no legal duty, obligation, or responsibility that directors have to maximize or even ensure benefits to non-shareholders,[83] and, to the extent directors decide in one instance to protect non-shareholder interests, they are legally free to change their mind with impunity. At best, these statutes permit consideration of the interests of and effects on non-shareholders, which does not by itself authorize subjugating shareholder interests. In all but three states, there are strong legal and practical arguments that decisions to benefit non-shareholder interests or minimize effects on non-shareholders must still be justified relative to shareholder value, and those three states do not require favoring non-shareholder over shareholder interests.[84] Assertions to the contrary are unsupported by the plainly permissive and/or otherwise limited language of the statutes, the lack of non-shareholder enforcement mechanisms, and the general absence of priorities to undermine shareholder value.

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79. Pennsylvania even expressly disclaims any right of non-shareholders to enforce any duty, which the statute clearly directs toward the corporation. 15 PA. CONS. STAT. § 1717 (West 1995).

80. Hale, *supra* note 41, at 840 (citation omitted); Springer, *supra* note 41, at 100, 106–09, 117. *But see id.* at 121 (recognizing that although four states specifically deny standing, Pennsylvania permits enforcement using derivative suits but not direct suits).

81. Bainbridge, *supra* note 41, at 987 n.86, Fairfax, *supra* note 42, at 464; 989–90; Springer, *supra* note 41, at 108.

82. CONN. GEN. STAT. § 33-756 (2008).

83. Georgia leaves no ambiguity about this conclusion by specifically providing that its constituency statute "shall not be deemed to provide to any constituency any right to be considered." GA. CODE ANN. § 14-2-202(b)(5) (LexisNexis 2003). Pennsylvania reaches the same result by specifically vesting authority to enforce the duties owed by directors, the board, or its committees, including any that may be construed as existing under the constituency statute, only by a shareholder "action in the right of the corporation." 15 PA. CONS. STAT. § 1717 (West 1995). The statute continues by rejecting the ability of "any other person or group" to enforce such duties. *Id.*

84. *See* Fairfax, *supra* note 42, at 459 (statutes enacted to allow directors to "consider the concerns" of non-shareholders); *id.* at 464; Bainbridge, *supra* note 41, at 987 n.86, 989; Springer, *supra* note 41, at 117, 121.

3. Correcting Perceptions that Three State Statutes Impose Equanimity of Interests

One commentator has suggested that three states—Indiana, Iowa, and Pennsylvania—specify a policy that "no single interest may dominate over other interests."[85] Such a conclusion is no longer accurate. For instance, the Indiana and Pennsylvania statutes provide that directors are not required to consider the interests of any group as "dominant or controlling," which may allow—but does not require—directors in these states to subjugate shareholder interests to those of non-shareholders.[86] The Iowa statute produces a similar result by acknowledging that the discretion vested in directors may allow them to decide that "community interest[s] . . . outweigh the financial or other benefits to the corporation or a shareholder or group of shareholders."[87] These three states go further than any other to permit directors to avoid, or even undermine or ignore, maximizing shareholder value as a fiduciary principle. However, this result differs substantially from a claim that directors must consider all interests equally.[88]

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85. *See* Springer, *supra* note 41, at 98. Five states expressly prevent removal of shareholder interests by specifically requiring that directors consider shareholder interests. Bainbridge, *supra* note 41, at 989. *See supra* note 66 for citations to the statutes of Arizona, Mississippi, New Mexico, Ohio, and Wyoming.

86. IND. CODE ANN. § 23-1-35-1 (West 2008); 15 PA. CONS. STAT. § 1715 (West 1995).

87. IOWA CODE ANN. § 491.101B (West 1999).

88. In April 2010, the Governor of Maryland signed a bill that created the first "benefit corporation" or "B Corporation." *See* MD. CODE. ANN., CORPS. & ASS'NS. §§ 5-6C-01 to 5-6C-08. This legislation does not modify Maryland's constituency statute, but instead creates a wholly distinct enterprise that pursues general public benefit. *Id.* § 5-6C-06. "General public benefit" is defined as having "a material, positive impact on society and the environment, as measured by a third-party standard, through activities that promote a combination of specific public benefits." *Id.* § 5-6C-01(c). "Specific public benefit" includes providing beneficial products or services; promoting economic opportunity beyond creating jobs in the ordinary course of business; protecting the environment; improving human health; promoting the arts, sciences or advancement of knowledge; or accomplishing "any other particular benefit for society or the environment." *Id.* § 5-6C-01(d). These definitions would permit many different types of businesses and operations to qualify—well beyond the more limited number that would qualify as serving charitable, exempt purposes.

The most significant difference between the benefit corporation and other corporate forms and their constituency statutes is that, in a benefit corporation, directors "shall consider" the following interests when determining the "best interests" of the enterprise: stockholders, employees and workforce, customers, "community and societal considerations," and the environment. *Id.* § 5-6C-07(a). The law does not establish the priority or weight for such considerations, nor does it appear to vest enforcement rights should directors fail to appropriately consider one or more of the vested constituents. Even so, in some ways, the Maryland benefit corporation statute may be tainted by some of the same legal problems and benefits discussed below with the Indiana, Iowa, and Pennsylvania constituency statutes.

Such equanimity would be unreasonable and unworkable for at least two reasons. First, interests inevitably will collide irreconcilably, and some interest(s) will need to predominate and subjugate others.[89] Such an application puts directors in the untenable position of being forced to choose between making no decision and potentially violating the law. Second, this positioning could negatively affect the pace of decision-making, possibly interfering with timeliness and efficiency, as well as leading to unnecessary uncertainty and ambiguity—all of which can undermine director accountability and negatively affect the market and investor behavior.[90] Untimely and inefficient decisions can result in lost or delayed market opportunities that, ironically, can mean lost or decreased revenue, jobs, taxes, and other contributions to society.[91] Moreover, even if the equanimity reading were accurate, the absence of enforcement rights renders the applicable portions of the three states' statutes irrelevant except as a policy suggestion.

4. The Trumping Effect of Practical Shareholder Considerations

In nearly all states with constituency statutes, the right and ability to enforce duties of for-profit directors remains with shareholders. By permitting directors to consider non-shareholder interests, these statutes generally protect directors from actions by shareholders when the directors choose to consider other interests and decide to minimize the negative effect of decisions and actions on those interests, particularly when there is a connection that can be made to shareholder interests.

However, because maximizing shareholder value appears to be the dominant applicable theory for purposes of the for-profit corporation, except possibly in the three states identified above (at least theoretically),[92] constituency statutes may not generally protect directors motivated by a desire to maximize benefits to non-shareholder interests when doing so has no legitimate benefit to shareholders. In addition to potential legal ramifications for breaching fiduciary duty, directors are still subject to

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89. *See* Fort, *supra* note 45, at 180. By making a decision in such a context, are directors violating the statute? Are they breaching fiduciary duties? Can they be held liable, and if so by whom and to what degree? After all, "corporations are not designed to determine justice or fairness. They maximize preferences within the context of normative rules established by others." *Id.* at 182.

90. *See*, *e.g.*, Rogers, *supra* note 40, at 795, 796 n.92, 808 (discussing constituency statutes undermining director accountability); Springer, *supra* note 41, at 107. Many of these same arguments can be made to criticize constituency statutes generally, not just those that purport to equalize all interests.

91. *See* Fort, *supra* note 45, at 180; Page, *supra* note 41, at 997; Rogers, *supra* note 40, at 801.

92. *See supra* text accompanying notes 86–87.

practical accountability. For instance, shareholders still have the authority to either remove or decline to renew directors who subjugate their interests; director and manager compensation is often tied to share price, which is connected to profitability; and directors must be wary of competitors who may take market share or pursue takeover strategies that could detrimentally affect the company, its shareholders, and constituents when the new owners and directors re-assert shareholder value as their objective.[93]

III. THEORY, PURPOSES, AND FIDUCIARY DUTIES OF THE L3C

This Section applies the above framework to the L3C as a hybrid, profit-distributing enterprise primarily pursuing charitable, exempt purposes. The L3C is an amalgamation of for-profit and charitable, exempt purposes, so theories in both contexts are relevant. Contrary to the assertions of some, however, the L3C's permissible dual purposes do not necessarily impose the problem of serving two masters. The L3C operates pursuant to properly-ordered fiduciary priorities that promote a clarity and consistency unlike any other form.

As noted in the for-profit enterprise discussion above, the ultimate test of purpose and corresponding duty for for-profit entities and their directors arises when decisions that favor one or some interest(s) over others (and may even be detrimental to certain interests) must be made. That is when clarity for directors, investors, creditors, and society about the objectives to which fiduciary duties are in service becomes most critical. In that context, the debate about theories and purposes of the for-profit firm becomes most relevant to determine whether to maximize shareholder value or serve non-shareholder interests.[94]

Understanding the need for clarity, the dominant theory in the courts (as evidenced by case law defining the duty of care and applying the business judgment rule) and state legislative policy (as evidenced by the

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93. Bainbridge, *supra* note 41, at 1001; Rogers, *supra* note 40, at 795, 802.

94. *See* eBay Domestic Holdings, Inc. v. Craigslist, Inc., No. 3705-CC, 2010 WL 3516473, at *22 (Del. Ct. Chan. Sept. 9, 2010) (finding that directors failed to prove that the culture of rejecting attempts to further monetize services results in profitability for stockholders). Regarding the inability to serve two masters and the need to separate profit and charity, see Bainbridge, *supra* note 41, at 1005 ("Because no one can serve two masters at the same time, if shareholder and stakeholder interests conflict, directors cannot be loyal to both constituencies. The board of directors' role as stewards requires it to prefer the interests of its shareholder masters."); Fairfax, *supra* note 42, at 411, 433; Mickels, *supra* note 42, at 289 (describing the current U.S. legal system with a wall between profit and public interest requiring that a company choose one or the other, with charities being the public interest extreme but precluding private inurement and denying capital). For a discussion regarding the ability to reconcile profit and broader purposes, see Choudhury, *supra* note 39, at 634, 665; Fairfax, *supra* note 42, at 413, 474. *See also* eBay, 2010 WL 3516473 at *19–20, *25.

substantial deference afforded directors in most constituency statutes) recognizes that directors and managers are in the best position to assess and pursue maximum shareholder value, and their operational decisions and monitoring activities are afforded substantial deference.[95] This deference acknowledges that directors, as a fiduciary matter, are charged with having the requisite knowledge and information to assess and oversee how decisions and activities advance shareholder value, including whether non-shareholder interests might be affected and whether those consequences affect shareholder value.[96] Over the decades, courts and scholars appear to have recognized that, particularly in contexts not involving takeovers or structure changes, directors should not function with a tunnel vision that only sees today's stock price or that neglects the influence decisions have on perceptions and the valuable goodwill of the enterprise, all of which connect to shareholder value.[97] Rather than changing that dynamic as some have posited, constituency statutes generally reinforce it.

For the L3C, however, that is not the end of the inquiry because profit and value as ultimate purpose give way to charitable, exempt purposes, which requires some understanding of the theory, purposes, and fiduciary duties of exempt organizations.

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95. Courts are less deferential when assessing structural decisions involving takeovers or changes in control in that they focus more narrowly (but not necessarily exclusively) on maximizing shareholder value. As is discussed more thoroughly below, courts are similarly less deferential when evaluating issues that involve the duty of loyalty or covenant of good faith. *See infra* text accompanying notes 96–97.

96. For instance, short-term losses may result in long-term gains that benefit shareholders. Decisions that appear to favor employees at shareholder expense can generate favorable publicity that enhances the corporation's reputation among consumers. Such decisions also might increase employee morale and lead to productivity gains. Bainbridge, *supra* note 41, at 999–1000 (discussing charitable giving and benefits to the corporation); Springer, *supra* note 41, at 88.

97. *See* Fairfax, *supra* note 42, at 437. (Courts have not formally rejected the shareholder primacy model, but fashioned a doctrine that seemed to accommodate both "corporate paradigms," which allow directors to make decisions that appear antithetical to shareholder interests "as long as directors could provide a plausible connection between the decision and the long-term interests of the shareholders"). *Id*. at 439 (noting that courts have also given directors wide latitude "to address the concerns of other groups as long as they could muster some plausible relationship between the shareholders' interests and such concerns") (citations omitted). *See also id.* at 442–44, 463; Mickels, *supra* note 42, at 284; Rogers, *supra* note 40, at 779; Bainbridge, *supra* note 41, at 972, 977–78, 1024 (citing Shlensky v. Wrigley, 237 N.E.2d 776 (Ill. App. Ct. 1968)); Springer, *supra* note 41, at 88, 117; Choudhury, *supra* note 39, at 650 ("[W]here private and social costs and benefits are not aligned, competitive markets do not produce efficient outcomes and these 'market failures' result in discrepancies between the best interests of the corporation and the best interests of society.") (citations omitted). *See also id.* at 656, 670–71. *But see* Bainbridge, *supra* note 41, at 976–77 ("[I]t is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefitting others.") (quoting Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919)).

The Code requires that charitable, exempt enterprises be both organized and operated in furtherance of permissible charitable, exempt purposes.[98] In addition, and as part of operating charitably, the law prohibits unlawful private benefit, including enjoining private distribution of profits.[99] Both of these characteristics negate profit maximization as the recognized theory or purpose of such enterprises, which is why they are often (and sometimes confusingly) called "non-profit" or "not-for-profit."[100] This does not mean that these organizations cannot operate profitably;[101] in fact, fealty to charitable, exempt purposes may require profitability as a means of sustaining and/or scaling their charitable endeavor, but profits generally may not be distributed.

The clarity and certainty of purpose for exempt organizations focuses not on shareholder value but on faithfulness to the charitable exempt purposes as defined by law and declared by the organization, which helps distinguish these entities from for-profit operations.[102] Further solidifying such fealty is a corresponding responsibility to the declared intent of those who donate to the enterprise.[103] Consequently, directors of charitable,

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98. I.R.C. § 501(c)(3) (2010).

99. *Id.* This feature of non-profit corporations has been referred to as the "nondistribution" constraint. Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835 (1980). *See also Developments in the Law—Nonprofit Corporations*, 105 HARV. L. REV. 1578, 1601 (1992) (fiduciary duties for directors of charitable organization "ensure that a corporation's resources are used to achieve the corporation's purposes and not to enrich the directors").

100. *See* EVELYN BRODY & JOHN TYLER, HOW PUBLIC IS PRIVATE PHILANTHROPY? SEPARATING REALITY FROM MYTH, PHILANTHROPY ROUNDTABLE 13–15, 574–75 (2009).

101. Fairfax, *supra* note 42, at 411 n.9 ("For profit directors and officers are principally concerned about long-term profit maximization. While nonprofit directors and officers keep economic matters in mind, they are principally concerned about the effective performance of the nonprofits' mission.") (quoting Goldschmid, *supra* note 43, at 641).

102. Goldschmid, *supra* note 43, at 641 ("[T]he duty of obedience requires that a director act with fidelity, within the bounds of the law generally, to the organization's 'mission,' as expressed in its charter and by-laws.") (quoting DANIEL L. KURTZ, BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS 21 (1988)). *See also id.* at 649 ("[F]iduciaries have a special duty to advance [the organization's] charitable goals and protect its assets.") (quoting Oberly v. Kirby, 592 A.2d 445, 472–73 (Del. 1991)); CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.09 n.1445 (RIA 2009) (2000 WL 713734 (WG&L)). *See also* Brakman Reiser, *supra* note 42, at 2438 (addressing the varied philanthropic efforts of for-profits and their effect on shareholder primacy); Fairfax, *supra* note 42, at 428 (finding that directors of charitable, exempt organizations have a fiduciary duty to the organization's charitable purpose).

103. There are some who posit that fulfilling the non-profit duties of care and obedience are actually more difficult and complex than focusing on maximizing profits. *See* Goldschmid, *supra* note 43, at 641 (noting that non-profit officer and director obligations to the corporate "mission creates a more difficult and complex decision-making process for them than for their for-profit peers," who are concerned principally with maximizing long-term profit) (citation omitted). Bill Bowen, former president of the Andrew Mellon Foundation, noted the following difficulties inherent in running a nonprofit organization:

> The very mission . . . can be difficult to define with precision and [is] subject to

exempt enterprises have clear direction regarding their ultimate, overall responsibility and how they must reconcile competing interests as they arise.

Seemingly, then, the L3C as a hybrid of both forms can be construed as espousing ultimate theories, purposes, and fiduciary duties of both for-profit and exempt organizations, thereby appearing to engender conflict among irreconcilable interests. Such conflict could paralyze decision-making or be so permissive as to render manager accountability almost meaningless. However, the L3C statutes clearly impose an unambiguous ordering of fiduciary priorities:

- the primary purpose of the L3C operations must prioritize pursuing charitable, exempt purposes, thereby exalting charitable purpose above all other purposes;[104] and

- realizing profit and enhancing value can be purposes of the enterprise as long as they are not significant purposes, thereby subordinating profit motive and placing it not just secondary on the continuum of permissible purposes, but near the extreme end of such continuum.[105]

Consequently, at the highest levels, the theory and purposes of the L3C prioritize charitable, exempt purposes as a fiduciary matter. Moreover, characterizing the L3C as "for-profit" does not refer to the firm's objective, as is the case under normal circumstances for other forms, but instead most properly acknowledges legal permission to earn and distribute profits. In some ways, though, it is a misnomer to refer to the L3C as "for-profit." Given its purposes, it is probably more appropriate to refer to L3Cs as "for-charity," but that has its own problems because of the inappropriate connotations regarding tax exemption and charitable deductions.[106]

> intense debate . . . . [The mission is] often seen differently by various influential participants and supporters. Relevant data and analyses are frequently either unavailable or . . . tricky to interpret. Performance often defies easy assessment . . . . Resources are almost always scarce, and problems often appear intractable. Creative solutions can be elusive and . . . hard to put into effect . . . because of the lack of ready access to . . . "buy-sell" mechanisms provided by markets.

Id. at 632 n.2 (quoting Bill Bowen, *Inside the Boardroom: A Reprise*, *in* NONPROFIT GOVERNANCE AND MANAGEMENT 9 (Victor Futter & George W. Overton eds., 1997)).

104. *See supra* text accompanying notes 23–33.

105. *Id.*

106. This is not to suggest that the L3C cannot pursue exempt status and deductibility of charitable contributions by filing the requisite forms and otherwise meeting the requirements under I.R.C. §§ 501(c)(3), 170. However, no L3C is exempt from taxation and charitable deductions to L3Cs

How that hierarchy gets implemented in practice is beyond the scope of this Article's objective to provide a framework for fiduciary duties and accountability in the L3C context. Clearly, though, the L3C's ordering of priorities likely colors the duties of both care and loyalty.

For instance, the for-profit duty of loyalty generally requires undivided and unselfish loyalty to the enterprise and placing entity and ownership interests above the personal interests of directors and any unique officer or owner interests.[107] The duty of loyalty is most frequently implicated by situations involving conflicts of interest, self-dealing, fraud, misappropriation, usurpation of corporate opportunity, competition, diversion of assets, lack of candor or disclosure, and other situations in which a director or manager may use a position of trust and confidence to further private interests.[108] One of the highly touted features of the LLC form is the ability to waive substantial aspects of the duty of loyalty, a feature discussed in Part IV-A below in a context of waiving primacy of charitable, exempt purposes. To the extent violations of the duty of loyalty significantly further personal purposes and interfere with the L3C's ability to pursue its charitable, exempt purposes, the above situations seem difficult to reconcile, although conflicts of interest should be manageable in much the same way as is generally recognized and accepted in for-profit and tax-exempt laws, decisions, and literature.

The for-profit duty of care generally requires acting in the "best interests" of the firm as would an "ordinarily careful and prudent" person in similar circumstances, including due consideration of all material information that is reasonably available.[109] For an L3C, instead of being defined in relationship to maximizing shareholder value, the duty of care relates primarily to the charitable, exempt purposes—in some ways similar (but not identical) in application to exempt organizations with the exception

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are not permitted unless and until specifically approved by the IRS.

107. Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 407 (2007); Choudhury, *supra* note 39, at 658.

108. William J. Callison, *Blind Men and Elephants: Fiduciary Duties Under the Revised Uniform Partnership Act, Uniform Limited Liability Company Act, and Beyond*, 1. J. SMALL & EMERGING BUS. L. 109, 114 (1997); Choudhury, *supra* note 39, at 658; Goldschmid, *supra* note 43, at 646; Holland, *supra* note 45, at 683; Szto, *supra* note 45, at 76, 112.

109. *Recent Cases, Corporate Law—Fiduciary Duties of Directors—In Re Walt Disney Co. Derivative Litigation*, 119 HARV. L. REV. 923, 926–27 (2006); *Developments in the Law*, *supra* note 99, at 1592; Choudhury, *supra* note 39, at 659–60; Davis & Whitley, *supra* note 64, at 38; Fairfax, *supra* note 42, at 435, 439; Grossman, *supra* note 107, at 402; Holland, *supra* note 45, at 691; William M. Roberts, *Searching for a Paradigm for the Fiduciary Duties of Corporate Directors*, 21 MEM. ST. U. L. REV. 501, 501 (1991); Szto, *supra* note 45, at 112.

that the L3C's duty is "primarily" rather than "exclusively" limited to those purposes. Hence, this gives rise to the L3C's hybrid character.

Of course, convergence of charitable purpose and possible profit causes the L3C to be characterized as "hybrid," but that characterization should not confuse the legal theory and purposes of the L3C and its corresponding fiduciary framework. There is a proper ordering of priorities in the L3C that effectively diminishes the "two masters" problem. There is but one master in the L3C—charitable, exempt purposes. More problematic than articulating priority, however, is the related matter of identifying processes and systems for ensuring accountability for faithfulness to that order.

IV. Accountability for Charitable, Exempt Purposes in the L3C Model

The L3C's hybrid nature and what appear to be its dual purposes has contributed to appropriate concern about possible abuse and wariness about the potential to mislead both the public and foundations. The preceding Section presented possibilities for a clearer framework of priorities, notwithstanding ambiguity associated with the words "primary" and "no significant" in reference to charitable purposes and profit respectively. However, properly ordered priorities are not enough. There must be standards and processes for enforcing the framework and ensuring accountability, which for the L3C means ensuring that charitable purpose remains primary and that profit and value appreciation, although allowed, do not become a significant purpose. The credibility and reliability of the L3C, its place as a legitimate business form, and its ability to contribute to our economic system depend on proper accountability and processes.

This Section presents mechanisms for imposing accountability on the members and managers of the L3C. First, this Section addresses issues relating to the L3C's fundamental character as a limited liability company, including ways in which the L3C differs from the LLC. The next two Parts analyze how well traditional charity and for-profit approaches to enforcement might apply to the L3C context and conclude that the market contexts within which L3Cs must function justify giving for-profit mechanisms an opportunity to work.

A. L3C Accountability and the LLC Form

As a subset of the limited liability company, the L3C benefits from many of the features, characteristics, and benefits of that form. Among these are approaches to taxation, limited liability, innovative approaches to

financing, flexibility in governance and management, and presumed deference to contractual arrangements (including ability to waive certain fiduciary duties that might otherwise apply in other forms or by default).

Among the most attractive features of the LLC form generally is the flexibility and presumptive deference to the parties and the agreements they may make, including limiting fiduciary duty.[110] This principled approach to the LLC allows the parties to structure their duties, responsibilities, rights, and benefits as they believe will be best for their purposes, including an extensive but not necessarily absolute ability to waive otherwise applicable fiduciary duties. Theories behind such a permissive approach include encouraging entrepreneurial activity, permitting parties to pursue any of numerous variations of economically viable deals, and allowing parties to determine in advance the amount of human capital they are willing to invest in the venture.[111] A broad ability to waive fiduciary duties in the L3C form, however, would undermine one of its distinctly innovative features and create more significant problems with accountability and enforcement.

For purposes of suggesting a reliable, consistent regiment of accountability in the L3C form, as demonstrated below, there are at least three features that distinguish the L3C from the LLC. The L3C must ensure primacy of charitable purposes through its proper ordering of priorities as a fiduciary matter and not merely by relying on contract (which has already been discussed); this primacy cannot simply be waived unlike broad waiver rights that characterize the LLC form generally; and the contractual covenant of good faith permeates the L3C form to fill certain other gaps. To better appreciate the L3C's approach, it will help to explore how states approach fiduciary duties in the LLC context generally, particularly with regard to waiving such duties.

1. Statutory Sources for the LLC Regiment

At least four sources provide the primary approaches to LLC's freedom of contract and fiduciary duty. However, even after nearly 30 years, the

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110. Deborah A. Demott, *LLCs, LLPs, and the Evolving Corporate Form Fiduciary Preludes: Likely Issues for LLCs*, 66 U. COLO. L. REV. 1043 (1995). Under certain LLC statutes, specific behaviors and activities that might otherwise breach fiduciary duties can be waived or reduced, but not eliminated, as long as doing so is not "manifestly unreasonable." *Id.* at 1058; Richard A. Booth, *Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies*, 1 J. SMALL & EMERGING BUS. L. 55, 56 (1997); Miller, *supra* note 45, at 599–600; Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future.* 56 BUS. L. 499, 543 (2001) (discussing the Uniform Limited Liability Company Act (ULLCA)); Szto, *supra* note 45, at 68, 106.

111. Booth, *supra* note 110, at 63.

variety of approaches to fiduciary duty in LLCs can be daunting.[112] The approaches include common law,[113] the Revised Uniform Partnership Act (RUPA) (1992),[114] the Uniform Limited Liability Company Act (ULLCA) (1996),[115] and Revised Uniform Limited Liability Company Act (RULLCA) (2006).[116]

Under RUPA, which heavily influenced the ULLCA, partners may waive fiduciary duties as long as doing so is not unreasonable and does not involve intentional waiving of harms.[117] The ULLCA allows members to specify that certain acts and transactions that might otherwise violate the duty of loyalty do not do so,[118] but it less clearly provides that the duty of care may not be eliminated.[119] The RULLCA provides that the parties may not eliminate the duty of care entirely, but may otherwise modify the duty—as long as doing so is not "manifestly unreasonable" and does not authorize intentional misconduct or knowing violations of law.[120] The RULLCA does not make a similar prefatory statement about the duty of loyalty, thereby implying that the duty of loyalty may be eviscerated by contract as long as doing so is not "manifestly unreasonable" and does not

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112. David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?*, 51 OKLA. L. REV. 427, 435 n.21 (1998); Demott, *supra* note 110, at 1043; Miller, *supra* note 45, at 568, 587–88. *See also* Rutherford B. Campbell, Jr., *The "New" Fiduciary Standards Under the Revised Uniform Limited Liability Company Act: More Bottom Bumping From NCCUSL*, 61 ME. L. REV. 27, 30–31 (2009) (arguing that the fiduciary duties within the RULLCA are poorly designed).

113. Miller, *supra* note 45, at 611; Murdock, *supra* note 110, at 520.

114. UNIF. P'SHIP ACT (revised 1992) (RUPA); Szto, *supra* note 45, at 61, 68, 106; Callison, *supra* note 108, at 111, 162. The Revised Uniform Partnership Act, which heavily influenced the ULLCA, specifically lists certain activities under the duty of loyalty that partners owe each other to account and hold assets as a trustee and to refrain from dealing adversely with or competing with the LLC. *Id.* at 109, 115.

115. UNIF. LTD. LIAB. CO. Act (1996) (ULLCA); Murdock, *supra* note 108, at 520. Some statutes define the duty of loyalty as avoiding self-dealing, properly disclosing relevant information upon request, and acting in good faith. Cohen, *supra* note 112, at 459–60.

116. UNIF. LTD. LIAB. CO. ACT (revised 2006) 6B U.L.A. 429 (2008) (RULLCA). The RULLCA addresses the duty of loyalty by expressly using the word "includes" to connote that the details that follow are not necessarily exclusive, even though it then lists duties similar to those contained in RUPA and the ULLCA. Campbell, *supra* note 112, at 46–48; Miller, *supra* note 45, at 579 n.73, 600 (quoting RULLCA § 409(b)); Murdock, *supra* note 110, at 535, 536 (discussing Illinois law, which incorporates "fairness" as the touchstone for conflict of interest transactions). Still other states list elements of loyalty that are not presumed to be all-encompassing. Miller, *supra* note 45, at 586.

117. Booth, *supra* note 110, at 68; Callison, *supra* note 108, at 116; Demott, *supra* note 110, at 1054–55; Miller, *supra* note 45, at 578, 599 n.211. *See also* UNIF. P'SHIP ACT § 103(b)(3) (revised 1997).

118. ULLCA § 103(b)(2)(i).

119. *Id.* § 103(b)(3).

120. Campbell, *supra* note 112, at 43 (citing RULLCA § 110(d)).

purport to permit intentional misconduct or knowing violations of the law.[121]

Even in a form deeply rooted in strong freedom of contract principles, the ability to waive breaches of fiduciary duty is not absolute.[122] An unbounded ability to waive fiduciary duties could encourage parties—particularly if unscrupulous—to divert assets, engage in untoward self-dealing, or otherwise misappropriate funds and opportunities with impunity.[123] Permitting such behavior effectively converts an investment into a gift or donation,[124] and rational investors do not normally knowingly agree to permit a manager to engage in such behavior.[125] Consequently, some limits on waiver are appropriate, and they are particularly important for the L3C and the reliability of its properly-ordered priorities.

2. Distinguishing L3C from LLC, Including Approaches to Charitable, Exempt Purposes

Existing LLC models allow members to agree to pursue charitable purposes as a matter of contract in the articles of organization and operating agreement. However, current LLC models also allow members to freely modify that purpose without any public notice or consequence. The models also allow organizing documents to include broad waivers that allow deviation from such purposes with impunity. Current models, therefore, may not effectively preserve charitable purposes in the presence of the will to avoid it.

There are at least three reasons why the L3C form lacks the same flexibility to waive charitable purpose and, as a result, should be stronger in preserving its character. First, both the express language of the L3C statute and what is not stated limit the ability to waive primacy of charitable purpose. The plain language of the L3C statutes unambiguously establishes charitable purpose as primary—not just as a matter of contract, but as a

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121. RULLCA § 110(d); Miller, *supra* note 45, at 599 n.211.

122. Courts ground these limits on principles of equity and the covenant of good faith. Szto, *supra* note 45, at 68–69 (referencing a "transcendent" selfless standard for LLC fiduciaries); *see also id.* at 76–80, 84 (applying equitable duties in absence of a statutory or contractual provision). For instance, disclosure and candor responsibilities still apply under the duty of loyalty even though parties expressly permit a manager to compete with the LLC. As such, equity requires the competing manager to disclose material information to the members or other managers, and equity prevents the same manager from using superior information to mislead members or other managers. Grossman, *supra* note 107, at 408–09; Miller, *supra* note 45, at 592–95.

123. Booth, *supra* note 110, at 58–59; Miller, *supra* note 45, at 595.

124. Demott, *supra* note 110, at 1061.

125. Campbell, *supra* note 112, at 41; Demott, *supra* note 110, at 1061.

matter of law and fiduciary responsibility. That purpose cannot be waived in the L3C because nothing in the statutes allows waiver of such purposes.

The L3C statutes do permit conversion to a regular LLC, but waiver and conversion are not the same. For instance, processes for legitimate conversion should involve relevant public filings at least with the Secretary of State's Office and notice of the conversion—including the inability to continue taking advantage of the L3C branding. More importantly, as with all other L3C operational and structural decisions, the decision to convert from the L3C form or even to pursue exempt status with the IRS should itself be made in the L3C's innate fiduciary context. As such, the decision to convert must be primarily to further charitable purposes and may not be significantly motivated by profit. Under this rubric, a decision to convert may be legitimate if, as is discussed in more detail in Part IV-C-3 below, the venture has succeeded and the charitable, exempt purpose has been achieved or returns are such that profit will likely be deemed a significant purpose. A decision to convert may be legitimate if the venture is failing and the best reasonable option to achieve the charitable purposes is to convert to an LLC. Therefore, a decision to convert may not be legitimate if the purpose for doing so is to increase distributions to members.

In addition, because the prospect of converting is expressly provided for in the statute and, in part, because of the qualities that should naturally accompany the L3C brand, those who invest in or do business with an L3C will be more likely to know about the possibility of conversion. In the LLC context of waiver, only those who have read or are specifically told about waiver provisions in the LLC organizing documents know about the ability to waive charitable purposes, and there is no consistent mechanism to inform the general public about the demotion of charitable purposes. Consequently, people may be more easily duped in the LLC form than in the L3C form.

A second reason that the L3C lacks the typical LLC flexibility to waive charitable purposes is that doing so would not meet the LLC's general standards for waiver, even if they could be applied to subvert statutorily mandated priorities. The LLC statutes generally permit waiver of fiduciary duties only if it would not be "manifestly unreasonable" and would not purport to release intentional misconduct or violations of law.[126] This is a generous standard that favors waiver, but trying to subvert the L3C's properly-ordered priorities could violate all three of these conditions: undermining a statute without authorization from the statute would be manifestly unreasonable; pursuing profit and neglecting charitable purpose

126. *See supra* text accompanying notes 117–21.

would be intentional misconduct; and neglecting primacy of charitable purposes would actually violate the L3C law. Consequently, the general waiver provisions of the LLC statutes do not permit waiver of L3C fiduciary duties.

Finally, principles of contract reinforce fiduciary duties to respect the primacy of charitable purpose because LLC operating agreements, as matters of contract, incorporate presumptions and obligations of good faith in their interpretation and enforcement.[127] As such, it is at least questionable whether the L3C's primacy of charitable, exempt purpose could be waived in good faith without some reasonable determination that converting best positions the enterprise for pursuing those purposes.

Good faith preserves the ability of parties to a contract to expect performance and helps protect them from blatant disregard of and interference with those expectations. Consequently, even the great deference due freedom to contract that is presumed in the LLC form is tempered by "moral codes" and market standards that interject expectations of good faith and that abhor unconscionable terms and behavior.[128] Such temperance permeates the covenant of good faith and fair dealing at common law in every contract.[129] It is also presumed under the Uniform Commercial Code in every contract for the sale of goods.[130] Finally, it is evidenced by the general inability to waive, exculpate from, or indemnify or insure against breaches of the duty of good faith.[131] The various LLC model acts reiterate the covenant of good faith. RUPA § 404(d), which heavily influenced the ULLCA, proposes an obligation of good faith in the

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127. Demott, *supra* note 110, at 1060. Actions of parties under limited partnership or LLC operating agreements should be analyzed through the lens of good faith, a concept borrowed from contract law, rather than through that of corporate fiduciary duties. Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 14 (2007).

128. Cohen, *supra* note 112, at 487.

129. Demott, *supra* note 110, at 1057–58; Steele, *supra* note 127, at 18–19. *See also* eBay Domestic Holdings, Inc. v. Cragislist, Inc., No. 3705-CC, 2010 WL 3516473, at *18 (Del. Ct. Chan. Sept. 9, 2010) (there is an "implied covenant of good faith and fair dealing" in agreements).

130. *See* U.C.C. §§ 1-201, 1-203 (2002); Miller, *supra* note 45, at 607. *See also* Demott, *supra* note 110, at 1057 (distinguishing between subjective and objective good faith in the Uniform Commercial Code).

131. Regarding corporate governance, see *supra* text accompanying notes 45–63. Regarding the LLC context, see Miller, *supra* note 45, at 595–96, 599, 601–02 (noting that under RULLCA, good faith is the only mandatory feature that may not be contractually eliminated); Steele, *supra* note 127, at 25–26 (citing Delaware LLC Act which provides that duty of good faith and fair dealing is the only duty that cannot be eliminated). For example, waiver in an LLC operating agreement that allows managers to compete with the LLC in violation of the duty of loyalty does not eliminate the "implied covenant of good faith and fair dealing," which is rooted in contract law and presupposes honesty and fairness in arm's-length business relationships. Miller, *supra* note 45, at 595.

contractual relationship of partners to the partnership and each other.[132] The ULLCA proposes good faith and fair dealing requirements as a commercial expectation.[133] Under the RULLCA, there is an obligation of good faith overlaid upon the fiduciary duties of loyalty and care.[134] Finally, many state LLC statutes and courts hold managers accountable to a responsibility to fulfill their obligations in good faith.[135]

Therefore, the covenant of good faith becomes omnipresent as a part of the genetic code of the relationships that comprise the LLC—and by corollary the L3C—including how to interpret and apply the operating agreements and articles of organization, including terms involving waiver.[136] If that were not the case, then investors in LLCs and L3Cs might be involuntary donors; their investments might be pilfered gifts; and managers would be free to squander funds with impunity and without regard to the degree of stupidity, carelessness, or irrationality.[137] None of this is the case, at least in part, because of the covenant of good faith and the inability to eliminate it. These characteristics also help preserve the primacy of charitable purposes within the L3C form.

Even though originating in contract principles, for our purposes, the covenant of good faith protects charitable, exempt purposes in the L3C differently than it might a mere declaration of such purposes in an LLC's articles of organization or operating agreements. There is a higher hurdle and different context for good faith evaluation of whether to convert from a statutorily mandated fiduciary purpose than when assessing whether to modify a contract or governing document. The covenant operates in furtherance of the established fiduciary duties—not separate, or distinct, from them.

Of course, declaring and knowing that good faith is inherent in every LLC and L3C is not the same as defining or applying it. One approach in the LLC context somewhat vaguely and unsatisfactorily suggests that the covenant of good faith "merely prohibits subversion of the contract."[138] Similarly ambiguous is an appeal to acting reasonably in order to promote "the spirit of the agreement."[139] Another construction presupposes honesty

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132. Callison, *supra* note 108, at 115–16. Unfortunately, the drafters of RUPA chose not to further explain the meaning of "good faith."

133. Murdock, *supra* note 110, at 527.

134. Campbell, *supra* note 112, at 35.

135. Cohen, *supra* note 112, at 459–60; Demott, *supra* note 110, at 1047; Szto, *supra* note 45, at 70–72.

136. *See* Steele, *supra* note 127, at 31.

137. *See* Demott, *supra* note 110, at 1061; Campbell, *supra* note 112, at 41.

138. Booth, *supra* note 110, at 69.

139. Steele, *supra* note 127, at 18–19.

and fairness in arm's-length business relationships,[140] that parties' reasonable expectations will be enforced, and that no party may engage in "trickery, deceit, or fraud" or otherwise deprive the other party of the benefits of the contract or interfere with performance of obligations under the contract.[141] Such a construction helps establish a paradigm for the market in which "promises can be believed" and commerce can be reliably pursued.[142] Consequently, the contractual covenant of good faith and fair dealing in the LLC and L3C contexts should allow the parties to enjoy the reasonable benefits of the relationship for which they bargained, recognizing that parties to a contract may not subvert its purposes or other parties' enjoyment of its fruits, that those involved would not willingly bargain to become the victims of deceit or fraud, and that investors or members should not be presumed to have made a gift to the managers of their investment.

The L3C model is not inconsistent with the LLC and its freedom of contract and broad abilities to waive fiduciary duties, rather it is just a variation of it. If anything, the LLC model reinforces the L3C's properly-ordered priorities with its respect for the plain language of the statutes, its restrictions on the ability to waive charitable purposes, and its presumptive inculcation of good faith and fair dealing. Unfortunately, and even with the above guidance, "good faith and fair dealing" remains hard to define predictably and objectively. Every LLC suffers from this ambiguity; so too does every contract under the UCC and common law, just as do the duties of care and loyalty which incorporate a covenant of good faith. Fortunately, the lack of clarity has not prevented these forms and relationships from proceeding successfully, and it should not inhibit the development of the L3C and mechanisms for holding managers and members accountable for fulfilling properly-ordered fiduciary priorities.

B. Charity Enforcement

Fiduciary duties in the L3C form are grounded in fealty to the charitable, exempt purposes stated in the articles of organization and operating agreement. This primacy of purpose can reasonably prompt an almost immediate suggestion that enforcement mechanisms from the charitable sector must also be primary, which may not be best. The ordinary methods for holding charitable organizations accountable rely principally

140. Miller, *supra* note 45, at 583, 595.

141. *Id.* at 596. *See also* Steele, *supra* note 127, at 17–19.

142. Miller, *supra* note 45, at 597. *But see id.*, at 606–07 (explaining that remedies for violating good faith may not be appropriate in the LLC context).

on self-reporting, donor vigilance, the media, recipients of services, the state's chief charity official (usually the attorney general), and the IRS's exempt organizations division. However, only the latter two have legal authority to pursue and impose consequences, which are themselves somewhat limited. The source of authority is statutory,[143] although certain state charity official responsibilities also can emanate from a broader attorney general duty to oversee business forms and aspects of governance.

There are at least four features of the L3C that distinguish it from charitable, exempt organizations to challenge whether the charitable regiment is sufficient or appropriate, particularly when more robust possibilities exist.[144] Among these distinguishing features are an investor mindset, tax treatment, market participation, and the ability to distribute profits and have ownership value appreciate. Consequently, the normal exempt organization enforcement tools are probably inappropriate.

First, although no significant purpose of the L3C can be the generation and distribution of profit or appreciation of ownership value, this criterion does not prohibit either earning or distributing profits, nor does it restrict ownership interests in an L3C from appreciating in value—possibly even reaching or exceeding market levels.[145] In fact, by its very language, this feature more positively, directly, and clearly permits such distribution and appreciation, unlike the 501(c)(3) regiment which prohibits the same for private purposes.[146]

Second, in part because profits can be distributed and ownership interests can appreciate, L3C members are willing to put capital at risk and

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143. *See* Choudhury, *supra* note 39, at 644–46. Of course, there is a fine line for the IRS regarding enforcement of the tax code, which certainly includes making judgments about whether organizational purposes and operations are charitable, and the broader, non-tax-based role of charitable, exempt organizations in our economic, political, and social systems. *See generally* Evelyn Brody & John Tyler, *Respecting Foundation and Charity Autonomy: How Public is Private Philanthropy*, 85 CHI.-KENT L. REV. 571 (2010). In addition to oversight of charities, state attorneys general and secretaries of state are charged with certain responsibilities for monitoring of business forms generally. This will be discussed further in the next part of this Section.

144. Illinois and states with similarly broad charity trust laws may be different, unless specific exemptions are provided for L3Cs. The Illinois L3C statute expressly subjects managers to the provisions of the state Charitable Trust Act. 805 ILL. COMP. STAT. ANN. 180/1-26(d) (West Supp. 2010). That Act embraces any entity that operates under Illinois law in furtherance of charitable purposes, regardless of form or exemption. 760 ILL. COMP. STAT. ANN. 55/3 (West 2007). So L3C managers would come under the enforcement authority provided for in the Act, and managers and members who establish and operate L3Cs in Illinois and similar states should fully understand the implications of the Act to their circumstances. Arguably, such an application effectively negates any purposes related to profitability and distribution of profits and, in so doing, undermines opportunities for and application of the L3C as anything other than a specially branded charitable enterprise.

145. *See supra* text accompanying note 32.

146. I.R.C. § 501(c)(3) (2006).

may be presumed to operate with an investor mindset that includes expectations of preserved capital (even if at higher risk of loss) and investment returns (even if below market). They are generally not making gifts or grants for the managers to use at their pleasure without regard to accountability. The primacy of charitable purpose and generally below market terms increases the risk of losing some or all of the capital and makes market level returns less likely, but these possible outcomes should not be confused with donative intent or lack of an investor mindset.

A third feature that distinguishes the L3C from 501(c)(3) organizations is that such distributions and appreciation are taxable. L3Cs are not tax-exempt;[147] members of L3Cs pay taxes just as with any flow-through enterprise. Moreover, contributions to L3Cs are not deductible as charitable contributions, although investment losses and business expenses may be deductible as allowed by law. Consequently, the government's interest in enforceability is not driven by accounting for favorable, charity-based tax policy.[148]

Finally, because profits may be distributed for personal gain and ownership value may appreciate, L3Cs are and should be more fully submerged in the market economy and operate subject to its forces, unlike 501(c)(3) entities.[149] If this were not the case and L3Cs were allowed to

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147. As noted previously, L3C entities could pursue exempt status and the corresponding deductibility for charitable contributions just as corporate and LLC forms, but until such status is recognized by the IRS, L3Cs do not benefit from such tax-favored treatment.

148. There is an appropriate desire to protect potential donors from fraudulent solicitations by or in the name of L3C entities who misrepresent their status. L3C supporters should share this desire because of the negative effect such behavior has on the perceptions of L3C forms generally. The charitable sector generally also shares this desire to protect because of possible negative consequences to their legitimate fundraising efforts if people use the L3C to foment confusion and undermine the integrity and credibility of purely charitable efforts. However, and as is discussed below, other remedies and tools more consistent with the L3C form are available from the for-profit sector for such behavior, including prosecution of those who defraud actual or potential investors.

Private foundations are a possible target of false and even malicious assertions, including that foundations do not need to conduct expenditure responsibility if they give their money to an L3C because the L3C meets the requirements of a PRI. Even if the latter point is true, foundations still must exercise expenditure responsibility, just as any foundation must if it intends to have the investment qualify as program related, whether through an L3C or not. PRI requirements are listed at I.R.C. § 4944(c) (2006), 26 C.F.R. § 53.4944-3(a) (2010), and March 2006 I.R.S. Priv. Ltr. Rul., *supra* note 6. *See also supra* text accompanying notes 22–37 (discussing foundations' use of PRIs in the L3C context).

149. Exempt entities do operate subject to various market-like factors, such as competition for donor dollars, attracting (and often retaining loyalty of) recipients of services, enticing earned revenue, vying for volunteer time and energy, and even competing to recruit and retain quality employees. As the last couple of years demonstrated, exempt organizations also are subject to the market itself in that, if the economy experiences a downturn, donations can decrease, endowments can lose value, jobs can be lost, and credit can be even harder to come by. Even in good times, exempt organizations can have difficulty attracting capital because of the limitations imposed by the non-distribution constraint and prohibition of private benefit, which is one of the motives for creating the L3C—trying to find a creative

operate outside of or protected from the market, there is a danger that L3C businesses could interfere with the market. This protection could produce at best uncomfortable and even disruptive applications, with such interference possibly occurring at either of two extremes.[150]

At one extreme, protecting L3Cs from the market could create market dysfunction by generating artificially inflated gains for members. More precisely, there could be a false and misleading sense of sustainability and replicability, which permits unfair competition with for-profit entities. It could also inhibit innovation and creativity in finding solutions to problems and opportunities for advancing jobs, processes, products, services, and other benefits that might otherwise arise.

At the other extreme, subjecting L3Cs to unduly restrictive approaches that undermine the ability to earn and distribute profits and allow values to appreciate could impose artificial burdens on L3Cs. These burdens may discourage investors, create confusion for creditors, cause ambiguity among managers about fiduciary obligations, or otherwise interfere with the ability of legitimate L3C enterprises to succeed by suffocating their potential to achieve charitable, exempt purposes.

In addition to the features that distinguish L3Cs from 501(c)(3)s, long-standing precedent regarding relationships between charities and for-profit enterprises—whose ultimate purposes are maximizing value to the owner—also counters charitable, exempt enforcement approaches as proper enforcement vehicles for the L3C. For instance, a non-exempt entity that receives a PRI from a foundation does not thereby become subject to 501(c)(3) enforcement tools or consequences.[151] The foundation remains subject to that regiment, but its tentacles do not necessarily extend more deeply to remove the enterprise from the market or for-profit enforcement schemes. The same result attends joint ventures between for-profit and exempt organizations. The exempt organization must comply with certain requirements and even impose some of them on the venture. However, for-profit parties to the venture are not thereby subject to enforcement action (absent private benefit that inappropriately accrues to them). Nonetheless, they may suffer indirectly because of the implicit effects of enforcement on the venture. Finally, for-profit companies that operate in the realm of

way to attract more capital to charitable, exempt purposes.

150. Note that these extremes are not necessarily mutually exclusive. It is possible to be overly permissive with regard to certain L3C activities or issues and overly restrictive with others, which only exacerbates the potential problems.

151. Of course, existing PRIs do not benefit from the broad-based branding that accompanies the L3C, but it is not clear whether that benefit justifies additional burdens and layers of scrutiny.

traditional charity, such as education and health care, are not subject to charitable, exempt enforcement approaches.

Consequently, even though L3Cs must organize and operate primarily in furtherance of charitable, exempt purposes, other characteristics of the L3C suggest that the form should not generally be subjected to charitable enforcement tools and consequences. These characteristics include essential features of the L3C that distinguish it from 501(c)(3) organizations and existing precedent for enforcement involving for-profit enterprises with charitable participants and causes. This conclusion is also supported by the fact that reasonable mechanisms are available in the for-profit sector, and under the circumstances, these mechanisms should be the starting point for developing enforcement and accountability regiments for the L3C and its participants.

C. For-Profit Enforcement Tools

There is a school of thought that the business judgment rule, officer and director indemnification, and burdens and standards of proof that favor directors and managers have watered down the fiduciary duty of care so much in the for-profit sector that it is nearly non-existent in practice or meaningful reality. There certainly are examples of enforcement failures in the sector where people have successfully abdicated responsibility, adopted a loophole mentality justified by legal technicality, and exercised judgment not well-grounded in ethics or morality. I submit that we generally only hear or read about situations in which fiduciary failures happened or are alleged. However, fiduciary duties actively and overwhelmingly guide and successfully inform for-profit decision-making to a great extent.

This section considers how various for-profit enforcement mechanisms might apply to the L3C, particularly to preserving primacy of charitable, exempt purposes. Normally, such mechanisms rely heavily on members and investors, but such reliance is not as robust for the L3C context. Fortunately, other claims and remedies could be adapted from the for-profit sector. Finally, this section closes by explaining how the L3C conversion is not an enforcement problem but instead motivates remedies for the circumstances that gave rise to the charitable, exempt purposes in the first place.

1. Problems with Relying too Greatly on L3C Members and Managers to Preserve and Enforce Primacy of Charitable, Exempt Purposes

One of the major problems with relying on enforcement from the for-profit context is the disconnect between what those approaches protect—maximizing shareholder value—and the priority of charitable purposes in the L3C form. Normally, shareholders or owners are first in line to pursue direct or derivative claims against directors or managers who breach their fiduciary duties or to have prosecutions or claims commenced in part on their behalf. Courts have also developed standards for defining and enforcing the rights of shareholders and owners and the duties of loyalty, care, and the covenant of good faith that are grounded in maximizing shareholder value. So a question legitimately emerges about the value of relying broadly on members of L3Cs to hold managers accountable for charitable purposes that may be counter to the members' economic interests.

Members are presumably motivated to engage with and invest in the L3C in the first place because of their desire to achieve charitable objectives. While such motivations may be true for some (or even most) L3C investors or members, it cannot be safely presumed for every investor or member. Moreover, even though proper motives may exist for initially engaging with the L3C, those motives and the desire for charitable objectives may change as circumstances change, particularly economic considerations.[152] Such changes could affect, or at least tempt, the priority of charitable purposes for some of the relevant people.

However, because the primacy of charitable purpose is a fiduciary matter, even one member or manager can hold the others accountable, which is a distinct advantage of the form for foundations and other charities that are going to be more likely to remain vigilant and expect loyalty to charitable purposes. Therefore, a conspiracy to undermine the L3C's priority of purposes must be, and remain, unanimous. Even so, relying exclusively on members or managers for enforcement does not suffice, even for 501(c)(3) organizations.

Fortunately, there are other approaches that might guide the development of the L3C and preserve the priority of charitable purposes.

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152. *See*, *e.g.*, Brakman Reiser, *supra* note 42, at 2440, 2442 (discussing how one of the most public examples of such a change may be the experience of Google.org). Google, Inc. launched its philanthropic operating division with great fanfare, pronouncements about its innovative approach as a hybrid enterprise, and presumptively corresponding levels of goodwill and charitable motive for success. *Id.* at 2442. However, Google, Inc. changed course regarding Google.org, as was its right (and maybe even fiduciary responsibility) given its structure, as the economy changed and other factors asserted influence. *Id.* at 2452.

None of these strategies will guarantee complete compliance, nor will they catch every abuse. However, neither for-profit nor charitable approaches to accountability and enforcement are characterized as perfect, and it could be disingenuous to expect perfection as the standard for the L3C.[153] This is not to suggest that enforcement should be other than robust, reliable, or credible—and perceived as such.

2. Applying For-Profit Claims and Remedies to the L3C

There are at least three additional methods for enforcing the L3C's properly-ordered fiduciary priorities. They include claims for fraud, *ultra vires* acts, and piercing the veil of limited liability. While these approaches have potential, they are not without problems.

One approach is the ability to pursue criminal and civil claims for fraud and misrepresentation with regard to investments in, or extensions of credit to, the L3C. This strategy, however, depends on complaints from members or potential investors; it presumes economic damage to them or their interests; and it benefits from their cooperation. Such dependence may not be fully reliable if all involved have conspiratorial tendencies or lack developed consciences. Even so, criminal and civil claims alleging fraud and misrepresentation are a rational part of the enforcement arsenal.

Another strategy vests authority in the state attorney general's business oversight function to pursue members and/or managers for *ultra vires* acts based on failure to properly prioritize charitable purposes.[154] The L3C statutes specifically vest life into these enterprises, endow them with specific characteristics, and grant certain authority as long as conditions are met, including the priority of charitable, exempt purposes. As such, the members and managers who operate the L3C for other purposes do so extraneous to authority of law and as *ultra vires* acts for which processes and remedies exist.

One of the problems with this approach is the potential for divergent positions within a state about what constitutes "charitable" or "exempt" activity. The agency responsible for charities enforcement could have a different application than the attorney general's office that pursues *ultra*

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153. *See* VOLTAIRE, *Art Dramatique*, *in* QUESTIONS SUR L'ENCYCLOPEDIE 215 (1764) (trans. Wikiquote, http://en.wikiquote.org/wiki/Voltaire (last visited Oct. 12, 2010) ("Il meglio è l'inimico del bene," literally translated as "the best is the enemy of the good")).

154. For a discussion of the u*ltra vires* doctrine, see Stephen J. Leacock, *The Rise and Fall of the Ultra Vires Doctrine in United States, United Kingdom, and Commonwealth Carribean Corporate Common Law: A Triumph of Experience Over Logic*, 5 DEPAUL BUS. & COMM. L.J. 67, 95–97 (2006). *See also* Kent Greenfield, *Ultra Vires Lives! A Stakeholder Analysis of Corporate Illegality*, 87 VA. L. REV. 1279, 1319, 1359–60 (2001); MODEL BUS. CORP. ACT, §§ 3.04, 14.30, 14.31 (2002).

vires acts. To the extent that both responsibilities are consolidated under the state attorney general, the ability to prevent such confusion is more manageable because of the shared reporting line to the attorney general.

A related enforcement mechanism could be to permit piercing the veil of limited liability that otherwise protects the actors, decision-makers, and those with knowledge of the deviation from ordered priorities, particularly when such variance is grossly negligent, willful, or intentional.[155] One of the primary benefits of the LLC structure is its limited liability; however, that benefit is not without limits. Failure to abide by well-established, recognized standards for respecting the separateness and individuality of the enterprise can lead to forfeiture of the right to expect limited liability.[156] For the L3C structure, those standards should include respect for the priority of charitable, exempt purposes such that failure to do so compromises limited liability protections.

Problems with this strategy include determining who has standing to invoke this remedy and what the damages are. Regarding standing, members (including private foundations and other charities) can pursue other members and the managers. Certain creditors (including foundations and other charities) may be motivated to preserve the priority of charitable, exempt purposes, particularly if the creditors provide favorable terms because of the charitable purposes, and their documents may permit standing. Finally, as with *ultra vires* acts, the attorney general's office should also be able to pierce the veil.

Determining the actual remedy, including damages, is a harder problem to address because the failure to prioritize charitable, exempt purposes may not result in financial loss and could actually produce financial gain. If proper purposes are neglected and profits are earned or value appreciates, those involved who have breached their duties could be required to forfeit their gains; but to whom? Also, the priority of charitable, exempt purpose is not adequately protected if remedies are only effective when there are financial gains. Therefore, another approach might be to use expenditures as a measure of damages or to formulate a schedule of "excise taxes" similar to those that apply to private foundations.[157]

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155. For a discussion of piercing the veil of limited liability in the context of a limited liability company, see Elizabeth S. Miller, *Are the Courts Developing a Unique Theory of Limited Liability Companies or Simply Borrowing from Other Forms*?, 42 SUFFOLK U. L. REV. 617, 632–34 (2009).

156. Katy O'Leary, *A Free Pass for Corporate Conspirators?: Inconsistent Distinctions Between Civil and Criminal Corporate Conspiratorial Liability*, 14 SUFFOLK J. TRIAL & APP. ADVOC. 58, 61 (2009) ("Courts will only pierce this corporate veil of liability and hold individual actors personally liable in very rare instances, usually when there is evidence of intermixture of affairs, lack of corporate formalities, or inadequate capitalization.") (citation omitted).

157. I.R.C. §§ 4941(a)–(c), 4942(a)–(b), 4943(a)–(b), 4944(a)–(b), (d), 4945(a)–(c) (2006).

3. Success Does Not Need to be Remedied

Ironically, a successful L3C could find itself in violation of the L3C criteria because the L3C achieves its charitable purposes and/or profit and value appreciation may become significant because of the L3C's economic success. Considering such success an "enforcement problem" risks infusing incentives to fail that are inimical to the charitable, exempt purposes being served. For instance, if an L3C's purpose is economic revitalization of a disadvantaged area, the charitable nature of the L3C may change when the area becomes vibrant. In that case, the members may need to dissolve and liquidate the enterprise, sell it as a for-profit business, or convert it into an LLC and continue operations.[158]

Another example could be an L3C whose purpose is to develop and distribute a pharmaceutical to treat a disease endemic in the third world. The nature of that L3C may change when researchers discover that the pharmaceutical also treats or prevents a condition for which there is a commercial market in the developed world. In both instances, members must make choices governed by their fiduciary responsibilities. Options might include the following: (a) dissolve and liquidate; (b) continue operating with a focus on the charitable, exempt purpose without pursuing the commercial application (which could have ethical and moral implications in addition to economic consequences); (c) license commercial applications to a third party while continuing to focus on its own charitable efforts and applications; (d) set up a for-profit subsidiary to maximize the commercial potential while the L3C continues serving charitable purposes; or (e) convert the enterprise to for-profit status as an LLC.

In both of these examples and other similar instances, public policy must not discourage success. In some ways, charities already lack motivation to evolve or there are impediments to doing so that effectively perpetuate the status quo—essentially imposing an institutional bias towards failure. To subject L3Cs to the same scheme risks inhibiting innovations that could contribute to economic growth and/or otherwise advance human welfare, such as revitalizing an economy or providing treatment or prevention of disease. Society and human welfare are better-served as a matter of policy if successful L3Cs are able to convert to for-profit status or pursue other reasonable strategies for managing their success.

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158. Note that profitability and appreciation of value alone, even if at market or above, may not be enough to tip a PRI or L3C into pure for-profit status as long as the charitable, exempt purposes remain primary and unfulfilled. 26 C.F.R. § 53.4944-3(a)(2)(iii) (2010); March 2006 I.R.S. Priv. Ltr., *supra* note 6.

Fortunately, the L3C statutes expressly contemplate this possibility by providing the ability to smoothly shift to a traditional LLC structure, thus allowing adjustments for success of charitable efforts and ensuring ongoing societal benefits. This possibility is transparently provided for in the statutes and is neither surreptitious nor veiled. It is arguably even more clearly stated than the same possibilities under the PRI regiment that inspired the L3C. Additionally, it would be wise for L3C organizing documents to provide for the prospects of success, particularly if there are foundation members or creditors.

Some might contend that such strategies allow investor-members to inappropriately reap economic benefit from the charitable, exempt purposes, operations, and accompanying goodwill (or "halo effect") of the L3C or its PRI predecessor. In addition to the aforementioned policy positions, there are at least five other reasons that this concern should not impede L3C success and subsequent transformation.

First, the underlying presumption of this contention—success—is more likely to be the exception than the rule, and to allow concerns about rare events to prevent the broad benefits to be gained from the more likely outcomes seems unwarranted and overreaching under the circumstances. A better course seems to be to find reasonable ways to permit and manage success when it happens.

Second, PRIs currently "suffer" from the same ailment—prospects for success—and the law allows foundations to manage those prospects, including the possibility of realizing a return on the qualifying distribution and converting the original PRI into a regular investment.

Third, there is precedent for converting charitable, exempt operations into for-profit enterprises, most notably in health care. Such conversions involve an exchange of market value, usually with the for-profit enterprise paying money into a tax-exempt foundation in order to prevent private benefit and to acknowledge that the entity was exempt from taxes and could accept deductible, charitable contributions. In both cases, there is a responsibility to preserve these funds for charitable, exempt purposes, which the foundation can accomplish. The important point for our purposes is not the mechanics of such conversions, but the example such conversions provide for a policy that permits private financial benefit from charitable operations.

Fourth, for-profit businesses, including joint ventures that include charities, pursue purposes normally viewed as charitable (e.g., health care, education) or even governmental (e.g., highways). Although originally refusing to permit joint ventures, the IRS's position has evolved such that joint ventures have become permissible under certain circumstances as long

as the charity can preserve its charitable purposes, usually with specific capacities to exert control.[159] The joint venture may earn and distribute profits even though trading on the endeavor's charitable objectives. In addition, for-profit entities are subject to normal for-profit accountability and oversight without special attention from society or regulators even though they operate in the charity space and earn and distribute profits. Nor is there concern about the owners benefiting financially from serving charitable purposes.

Fifth, unlike charities and other exempt organizations, the L3C (like PRIs) expressly contemplates and provides for profitability, distribution of those profits, and realized appreciation of value. Therefore, there is at least an implicit, if not express, public policy imprimatur on allowing accrual of financial benefits earned in service of charitable purposes. This policy makes sense, particularly when L3C member investments risk being lost. In a capitalist economic system such as ours, those who risk losing investment capital generally are entitled to benefit from the rewards earned on their investment and must pay taxes on the same. An L3C system that does not permit reasonable, orderly conversion of some sort could undermine that fundamental economic principle, particularly when other, long-standing public policy precedent exists for doing so.

Consequently, at least until demonstrated to the contrary, the for-profit sector has workable enforcement and accountability mechanisms that may be reasonably applied to the L3C form without the complications and problems that arise from relying on charitable mechanisms.

CONCLUSION

Prior to creation of the L3C, the only enforceable options available for a business form's ultimate purposes were either the for-profit duty to maximize shareholder value with some permissible consideration of non-shareholder interests or the non-profit duty to pursue charitable, exempt purposes with no ability to distribute profits for personal gain. Various hybrid situations have emerged in unique circumstances, but none effectively modified fiduciary duties and the ultimate legal purposes of the enterprise. Examples include Google.org, various corporate social responsibility efforts, and the benefit corporation (B Corporation).[160]

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159. *See* St. David's Health Care System v. United States, 349 F.3d 232, 238 (5th Cir. 2003); Redlands Surgical Servs. v. Comm'r, 242 F.3d 904, 904–05 (9th Cir. 2001); Plumstead Theatre Soc'y, Inc. v. Comm'r, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982); Rev. Rul. 2004-51, 2004-1 C.B. 974; Rev. Rul. 98-15, 1998-1 C.B. 718; I.R.S. Gen. Couns. Mem. 37,852 (Feb. 15, 1979).

160. See *supra* note 88 for a discussion of the Maryland law that permitted creation of the first

Without modification of fiduciary duties, either charitable exempt purposes could not be effectively guaranteed in a for-profit form, or profits and value could not be legally distributed or appreciated from a non-profit entity. Without a clearer, more consistent approach to fiduciary duties in a hybrid pursuit, the best means of ensuring charitable, exempt purposes in a for-profit entity were limited to unique claims for breach of contract and the accompanying remedies, which generally require economic damage to be meaningful—although an injunction or specific performance might also provide some relief.

The L3C embodies an approach that extends beyond mere contractual claims and remedies by imposing fiduciary duties and making corresponding claims and remedies available. These duties emphasize the primacy of charitable, exempt purposes and still permit distribution of profits as long as profits and value are not a significant purpose of the enterprise. There also are reliable methods of enforcement to ensure faithfulness to this proper ordering of priorities. Consequently, the L3C presents one resolution of the "two masters" problem that plagues hybrid enterprises by offering a degree of clarity and consistency that should provide reasonable confidence to investors, managers, creditors, policy-makers, and regulators that the form is legally viable for the appropriate circumstances.

That confidence should come, in part, from the fact that the L3C evolved from a body of law that is over forty years old—the program-related investment. It also builds on treatment of joint ventures among for-profit and 501(c)(3) entities. In some ways, the L3C is like many entrepreneurial endeavors that see and deploy existing products or processes in new and different ways. Among these could be efforts to revitalize an economically disadvantaged area with new jobs and innovations; to bridge the "valley of death" from discovery of an innovation in a university lab to its commercial application; to attract investment for a new but still unproven approach to clean energy; and many other potential applications. These businesses might benefit from the L3C form by better positioning themselves to attract investments or loans from private foundations wanting to make more PRIs, mission-related investors, certain government investment funds, social enterprise funds, and for-profit investors, despite likely increased risks and unlikely market returns for all investors.

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benefit corporation as a business form and as a matter of law.