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

J. William Callison[*] & Allan W. Vestal[**]

INTRODUCTION

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

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

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* Partner, Faegre & Benson LLP, Denver, Colorado.

** Dean and Professor of Law, Drake University Law School.

1. NOAM CHOMSKY, 9-11 68 (1st ed. 2001).

2. VT. STAT. ANN. tit. 21, § 3001(27) (2009).

3. Other states with L3C legislation include Illinois, Louisiana, Maine, Michigan, North Carolina, Utah, and Wyoming. *See* 805 ILL. COMP. STAT. ANN. 180/1-26 (West Supp. 2010); Act of June 21, 2010 La. Acts 417; ME. REV. STAT. tit. 31, §§ 1599, 1611 (2010); MICH. COMP. LAWS § 450.4102(m) (LexisNexis Supp. 2010); An Act to Provide for the Formation of a Limited Liability Company as a Low-Profit Limited Liability Company, S. 308, 2009 Sess. (N.C. 2009), *available at* http://www.ncga.state.nc.us/enactedlegislation/sessionlaws/pdf2009-2010/sl2010-187.pdf; UTAH CODE ANN. § 48-2c-412 (LexisNexis Supp. 2009); WYO. STAT. ANN. § 17-15-102(a)(ix) (2009).

4. According to The Foundation Center, in 2000 approximately 57,000 private community foundations made charitable distributions totaling over $30 billion. THE FOUNDATION CENTER, THE PRI DIRECTORY (2003 edition). Approximately $27.5 billion took the form of grants. *Id.* Approximately $226 million took the form of loans and other program-related investments. *Id.* In 2001, approximately 61,000 private and community foundations made $30.5 billion in grants and $233 million in PRIs. *Id.* Thus, in 2000 and 2001, PRIs constituted approximately 0.45% of the total grant and PRI output, a relatively paltry portion. Further, of the $459 million of PRI outlay in 2000 and 2001, 60% came from 10 private foundations. *Id.* Only 135 of 61,000 private foundations made any PRIs in 2000 and 2001; thus, approximately 60,865 foundations made no PRIs. *Id.* There were 667 PRI transactions in 2000 and 2001. Recent data released by The Foundation Center indicates that, in 2006 or 2007, 173 more private foundations (of more than 75,000 foundations) made at least one PRI of $10,000 or more. THE FOUNDATION CENTER, DOING GOOD WITH FOUNDATION ASSETS: AN UPDATED LOOK AT PROGRAM-RELATED INVESTMENTS (forthcoming, copy available to authors). PRIs in 2006 and 2007 totaled $742 million, out of $91.9 billion in charitable distributions. *Id.* Twenty-five foundations made PRIs totaling $545,778,000, while all remaining foundations' PRIs totaled $196,273,000. *Id.* Thus, depending on

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

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

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

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

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

I. PRIVATE FOUNDATIONS AND PROGRAM-RELATED INVESTMENTS

A. Taxonomy of Charitable Organizations

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

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

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

7. *Id.* § 170(a)(1).

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

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

10. *Id.* § 4946(a)(1).

11. *Id.* § 507(d)(2).

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

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

B. Private Foundation Excise Taxes

1. Tax on Jeopardizing Investments

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

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

13. I.R.C. § 4940 (2006).

14. *Id.* § 4941.

15. *Id.* § 4944.

16. *Id.* § 4942.

17. *Id.* § 4943.

18. *Id.* § 4945.

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

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

2. Tax on Undistributed Income

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

3. Tax on Excess Business Holdings

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

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

21. I.R.C. § 4944(c) (2006).

22. *Id.* § 4942(a).

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

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

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

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

4. Tax on Taxable Expenditures

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

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

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

C. Program-Related Investments

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

> An investment shall be considered as made primarily to accomplish one or more [charitable purposes] if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.[39]

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

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37. I.R.C. § 4944(c) (2006) (emphasis added).
38. Treas. Reg. § 53.4944-3(a)(1)(iii).
39. *Id.* § 53.4944-3(a)(2)(i).
40. *See id.* § 53.4944-3(b), *Example 4* (loan to business enterprise pursuant to *foundation's program* to assist low-income persons by providing increased economic opportunities); *Example 5* (loan to financially secure business enterprise pursuant to *program run by foundation* to enhance economic development of distressed area); *Example 6* (loan pursuant to *foundation's program* to encourage

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

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

economic redevelopment of depressed areas).

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

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

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

44. *Id.* at 3.

45. *Id.* at 4.

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

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

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

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

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

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

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

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

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

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

54. *Id.* § 7-80-203.

55. *Id.* § 7-80-801(1)(c).

56. *Id.* § 7-80-501.

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

A. The L3C Form

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

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

1. Charitable or Educational Purpose

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

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

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

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

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

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

2. No Significant Purpose of Income Production or Capital Appreciation

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

3. Attempted Statutory Repairs

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

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

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

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

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

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

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

B. Fiduciary Duty Issues

One article in this symposium issue suggests that

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

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

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

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(last visited Nov. 4, 2010).

68. *Id.*

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

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

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

72. *Id.* at 138.

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

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

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

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

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

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

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

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

III. THE L3C LEGISLATIVE ADOPTION PROCESS

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

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

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

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

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

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

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

86. *Id.* at 540–42.

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

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

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

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

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

89. *Id*. at 546.

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

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

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

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

IV. WHY L3CS ARE HARMFUL

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

CONCLUSION

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