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Purpose With Profit: Governance, Enforcement, Capital-raising And Capital-locking In Low-profit Limited Liability Companies

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Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies

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INTRODUCTION

Dr. Yunus' daughter performed one of her favorite operatic pieces, Mozart's *Alleluia*, just weeks earlier, and now he heard it again during his own moment on the stage.² As soon as the joyful motet ended, he would be giving the most important speech of his life to an audience that extended beyond the dignitaries in the room. "I call upon Muhammad Yunus," said the chairman of the nominating committee.³ The Bangladeshi economics professor who developed the concepts of microcredit and microfinance stood up, bowed to the audience, and stepped behind the podium to deliver his Nobel Peace Prize lecture.⁴

In his speech, Dr. Yunus referred to entrepreneurs motivated more by social good than profit and called for laws to recognize a new social business form:

Social business will be a new kind of business introduced in the marketplace with the objective of making a difference in the world. . . .

Once social business is recognized in law, many existing companies will come forward to create social businesses in addition to their foundation activities. Many activists from the non-profit sector will also find this an attractive option. Unlike the non-profit sector where one needs to collect donations to keep activities going, a social busi-

2. Arkansas Times Staff, *Soprano Sings Her Favorites: Monica Yunus Performs at UALR*, ARK. TIMES (Nov. 16, 2006), <http://www.arktimes.com/arkansas/soprano-sings-her-favorites/Content?oid=865691>.

3. *The 2006 Nobel Peace Prize Award Ceremony*, NOBELPRIZE.ORG (Dec. 10, 2006), <http://nobelprize.org/mediaplayer/index.php?id=104&view=1>.

4. *Id.* See *Muhammad Yunus - Biography*, NOBELPRIZE.ORG, http://nobelprize.org/nobel_prizes/peace/laureates/2006/yunus.html (last visited Aug. 21, 2011).

ness will be self-sustaining and create surplus for expansion since it is a non-loss enterprise. Social business will go into a new type of capital market of its own, to raise capital.⁵

Although nothing is new about insisting that charities be frugal or financially self-sufficient,⁶ the view that such charities should avail themselves of or commit themselves to earning income is a concept that challenges our orthodox notions of altruistic organizations. Not until recent decades was the term “social entrepreneur”⁷ even part of our collective vocabulary, where “charity in our culture became overwhelmingly and, it seems irrevocably, associated with enterprise.”⁸

The issue of whether social entrepreneurship in the United States needed new tax laws and legal forms was addressed at a 2006 Aspen Institute meeting, which drew over forty leading thinkers in the social enterprise movement.⁹ One of the ideas that garnered attention was the idea of a low-profit limited liability company, or L3C.¹⁰ A state that amended its LLC statutes to allow for an L3C would have an available new legal form, which prioritized charitable purpose like nonprofits but which allowed for taxable income distribution and more flexible capital structure like for-profit entities.¹¹ In April 2008, Vermont became the first state to adopt L3C legislation, and, as of August 31, 2011, nine

5. Muhammad Yunus, *The Nobel Peace Prize 2006 Nobel Lecture*, 13 LAW & BUS. REV. AMS. 267, 272 (2007).

6. See Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America's Tangled Nonprofit Law*, 73 FORDHAM L. REV. 2437, 2437–39 n.2 (2005). Professor Kelley contemplates charity's “double bind” of a “free-market American culture,” which expects charities to embrace efficiency and financial accountability, and a legal and tax environment, which discourages charities from commercial and marketplace activities. Kelley also observes that the nomenclature of the word “charity” is “variable and confusing” and, in its broadest sense, means “giving help to those in need.” *Id.* at 2437 n.2. We adopt this broad definition of charity in this article, unless otherwise indicated. Thus, when we use the phrase “charitable purpose,” we often mean charitable, educational, social, and exempt purpose.

7. The term “social entrepreneur” was coined or at least popularized in the 1980s by Bill Drayton. In a recent interview, Drayton noted, “Think back 25 years ago, there was no phrase [‘social entrepreneur’]—we made it up.” *Ashoka's “Changemaker” Bill Drayton Awarded Annual 2007 Leadership in Social Entrepreneurship Award*, CTR. ADVANCEMENT SOC. ENTREPRENEURSHIP (Apr. 24, 2007), <http://www.caseatduke.org/events/leadershipaward/07winner/index.html>.

8. Kelley, *supra* note 6, at 2462.

9. THOMAS J. BILLITTERI, THE ASPEN INST., MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH? 2, 10 (2007), available at http://www.communitywealth.org/_pdfs/news/recent-articles/04-07/report-billiterri.pdf. The daylong meeting, titled “Exploring New Legal Forms and Tax Structures for Social Enterprise Organizations,” was sponsored by the Aspen Institute's Nonprofit Sector and Philanthropy Program. *Id.* at 2.

10. *Id.* at 13. Throughout this article, as well as throughout material discussing low-profit limited liability companies, the abbreviations “L3C” and “L³C” appear interchangeably. In such instances within this work, both abbreviations refer to low-profit limited liability companies.

11. *Id.* at 13.

states and two Indian tribes have adopted L3C statutes.¹² Seventeen additional states are considering or have considered similar L3C bills.¹³ As of August 29, 2011, 440 L3Cs were registered.¹⁴

An L3C may be formed as a new entity or by converting from an existing entity.¹⁵ After properly forming under the L3C statute of a particular state, the L3C can do business in any other U.S. jurisdiction, assuming all necessary filings.¹⁶ Several legal scholars have given credence to the notion that the L3C may be a promising innovation for social entrepreneurs,¹⁷ whereas critics of the L3C contend that the legal

12. The following states, in order of passage, have adopted L3C legislation: Vermont, Michigan, Wyoming, Utah, Illinois, Maine, Louisiana, North Carolina, and Rhode Island. *See* Act of Apr. 30, 2008, 2008 Vt. Acts & Resolves 91; Act of Jan. 15, 2009, 2008 Mich. Pub. Acts 2583; Act of Feb. 26, 2009, ch. 55, 2009 Wyo. Sess. Laws 130; Low-Profit Limited Liability Company Act, ch. 141, 2009 Utah Laws 522; Act of Aug. 4, 2009, 2009 Ill. Laws 2583; An Act to Replace the Maine Limited Liability Act, ch. 629, 2010 Me. Laws HP 1118 (LD 1580), *available at* <http://www.mainelegislature.org/ros/LOM/LOM124th/124R2/pdf/PUBLIC629.pdf>; Limited Liability Companies, 2010 La. Acts, Act No. 417 (H.B. 1421), *available at* <http://www.legis.state.la.us/billdata/streamdocument.asp?did=721792>; Act of Apr. 3, 2010, 2010 N.C. Sess. Laws 187, *available at* <http://www.ncga.state.nc.us/Sessions/2009/Bills/Senate/PDF/S308v5.pdf>; Act of June 20, 2011, ch. 79, 2011 R.I. Pub. Laws H 5279, *available at* <http://www.rilin.state.ri.us/PublicLaws/law111/law11079.htm>. Additionally, the Oglala Sioux Tribe and the Crow Indian Nation of Montana have adopted L3C legislation. *See* Keren Raz, *L3C-An Update by Keren Raz*, CHARITY LAW. BLOG (Nov. 30, 2010), <http://charitylawyerblog.com/2010/11/30/l3c---an-update-by-keren-raz>.

13. As of May 26, 2011, seventeen other states are considering or have considered L3C legislation, including Alabama, Arkansas, Arizona, California, Colorado, Georgia, Hawaii, Indiana, Iowa, Kentucky, Maryland, Massachusetts, Montana, New York, Oklahoma, Oregon, and Rhode Island. A table of new L3C legislative activity can be found at Carter G. Bishop, *Fifty State Series: L3C & B Corporation Legislation Table* (Suffolk Univ. Law. Sch., Research Paper No. 10-11, 2011), *available at* <http://ssrn.com/abstract=156783>.

14. *Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, L³C (Aug. 29, 2011), http://www.intersectorl3c.com/l3c_tally.html.

15. Elizabeth Carrott Minnigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations*, 34 TAX MGMT. EST. GIFTS & TRUSTS J. 209, 209-10 (2009).

16. *Id.* Since L3Cs are a subset of LLCs, L3Cs will come within the foreign registration or qualification provisions of the LLC statutes of each state. *See, e.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 801(a) (2006) (“(a) The law of the state or other jurisdiction under which a foreign limited liability company is formed governs: (1) the internal affairs of the company; and (2) the liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the company.”).

17. *See* Cassidy V. Brewer & Michael J. Rhim, *Using the 'L3C' for Program-Related Investments*, TAX'N EXEMPTS, Nov.-Dec. 2009, at 11, 18 (“The arrival of the L3C potentially is a watershed moment for individuals and organizations that are dedicated to achieving social change.”); Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 377 (2010) (“[T]he low profit limited liability company, or L3C, proposed by Robert Lang and his collaborators appears to be the tool best adapted to give legal standing and structure to its hybrid social enterprises.”); Marc J. Lane, *The Lane Report September 2008: L3Cs Hold Key to Solving State's Social Woes*, CRAIN'S CHI. BUS., (Sept. 1, 2008), http://www.marclane.com/index.php?cid=106258&src=news&submenu=Media_LaneReport&srctype=detail&category=2008%20Lane%20Reports&refno=288&curlid=35; Elizabeth Carrott Minnigh, *Adding Another Trick to Your Bag of Tricks*, LAW FOR CHANGE, <http://www.lawforchange.org/lfc/NewsBot.asp?>

form is unnecessary or misleading.¹⁸ The American Bar Association has had a mixed response to L3Cs,¹⁹ and the IRS so far has not yet fully articulated an exhaustive commentary on the form.²⁰

The goals for this article include providing an objective evaluation of the characteristics and risks of the L3C entity in order to determine whether L3Cs are viable legal forms for social enterprises; reconciling the for-profit and nonprofit duties of loyalty and care in order to ascertain a governance-and-enforcement framework for L3C fiduciaries; recommending the use of emerging forms of financing (such as online crowd-funding) in order to align investor expectations and overcome practical capital-raising problems associated with charitable primacy and securities law; and, finally, recommending the locking of capital provided by social investors into the “social stream.”²¹

Part I considers the growing social enterprise movement, the limitations of existing legal forms in accommodating social enterprise, and the potential benefits of new legal entities to carry out simultaneous for-profit and nonprofit missions. It also examines how the L3C legal form is structurally designed to overcome existing legal deficiencies and work within the existing business and legal landscape. Moreover, Part I addresses the concerns of the most strident faultfinders of the L3C and the policy implications of the continued adoption of L3C legislation.

MODE=VIEW&ID=3922&SnID=2 (last visited Aug. 18, 2011) (“[T]he L3C and the Benefit Corporation are both great tools and not direct competitors because they have different benefits and drawbacks. So when looking to add social enterprise to your bag of tricks, both the L3C and the Benefit Corporation should be on your agenda.”); Marcus Owens & John Tyler, *The L³C: A Potentially Useful Tool for Promoting Charitable Purposes*, COMMUNITY DIVIDEND (Nov. 1, 2009), http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4491.

18. Daniel S. Kleinberger, *A Myth Deconstructed: The “Emperor’s New Clothes” on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 881 (2010); see also Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 245–46 (2010); J. William Callison & Allan W. Vestal, *The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures*, 35 VT. L. REV. 273, 274 (2010); David S. Chernoff, *L3Cs: Less There than Meets the Eye*, TAX’N EXEMPTS, May–June 2010, at 3; David Edward Spenard, *Panacea or Problem: A State Regulator’s Perspective on the L3C Model*, 65 EXEMPT ORG. TAX REV. 131 (2010).

19. See ABA Section of Taxation, *Comments on Proposed Additional Examples on Program-Related Investments*, ABA, 7 (Mar. 3, 2010), http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/Comments_Concerning_Proposed_Additional_Examples_on_Program_Related_Investments.authcheckdam.pdf. But see J. William Callison, *Nonbinding Opinion: L3Cs: Useless Gadgets?*, BUS. LAW TODAY, Nov.–Dec. 2009, at 55.

20. Drea Knufken, *Interview: Social Entrepreneurs and the L3C*, BUS. PUNDIT (Jan. 13, 2011), <http://www.businesspundit.com/interview-social-entrepreneurs-and-the-l3c> (“President Obama recently mentioned L3Cs in a press conference about new company opportunities, so L3Cs are now on the screen of the White House. The IRS also mentions L3C designation under LLC tax filing now, so it is gaining ground nationally.”).

21. In this article “social stream” or “stream of social commerce” refers to the capital floating in the third (charitable) and fourth (social enterprise) economic sectors.

Part II compares and contrasts the seemingly conflicting fiduciary duties in the for-profit and not-for-profit areas, before moving on to propose a blended fiduciary framework for hybrid business forms, such as L3Cs. Part II submits that a company can have multiple purposes, but can have only one primary master. While deviations from the path should be allowed under the business judgment rule, we submit that managers of L3Cs should focus primarily on the organization's "charitable purpose." Similar to the rights of members of profit-focused LLCs, we believe that members of L3Cs should have standing to sue for a breach of fiduciary duty by the entities' managers.

Part III examines the capital-raising and profit-payout puzzles faced by L3Cs and largely unaddressed by early commentators on the L3C form. Part III suggests that traditional, profit-focused investors will be unlikely to invest in an entity, like an L3C, that prioritizes purpose over profit. To fill the gap left by the absence of most traditional investors, we suggest that L3Cs utilize crowd-funding in their capital-raising, which has a number of benefits for L3Cs. Lastly, Part III proposes that capital committed by social investors to L3Cs (and profit stemming from that capital) should be locked into the "social stream," and not simply used to prop up the returns of traditional, profit-focused investors.

The article concludes that while traditional profit-focused investors may not be well suited for investment in L3Cs, the L3C form is still viable. L3Cs may pair foundation funds with money raised from social investors (including those located through online crowd-funding) who seriously value the charitable focus of the L3C. Our hope is that this article, which attempts to consider all published academic analyses of L3Cs to date,²² will serve as an informative guide for social entrepreneurs, a reference document for academics committed to a dialogue on social entrepreneurial forms, a fair assessment of the benefits and risks of L3Cs for legislators interested in adopting social enterprise legislation, and a source of ideas for improving the L3C form.

I. SOCIAL ENTREPRENEURISM, HYBRID FORMS, AND THE L3C

A. *The Fourth Sector of Social Entrepreneurship*

The United States has been described as having three economic sectors for government, business, and nonprofit activities.²³ Recently, the term "fourth sector" has been used to describe the various expres-

22. This article was written primarily from September 2010 to June 2011, with a review of all L3C literature in law reviews and business journals through May 2011.

23. Amitai Etzioni, *The Third Sector and Domestic Missions*, 33 PUB. ADMIN. REV., 314, 315 (1973) (recognizing the first sector as government, second sector as business, and also coining the

sions of social entrepreneurship, including socially responsible businesses, charitable joint ventures, municipal enterprises, cross-sector partnerships, and mission-related investing.²⁴ These fourth-sector organizations share a dedication to pursuing simultaneous economic, social, and often environmental benefits, sometimes referred to as “triple bottom line.”²⁵ Such fourth-sector entities are usually organized as corporations, partnerships, or limited liability companies. Prior to formulation, however, a thorough legal analysis and complex contractual agreements are frequently required to promote fulfillment of mission and avoid drastic tax penalties.²⁶ Even with the help of the most experienced attorneys skilled in structuring such arrangements, the lack of a convenient legal form, designed to accommodate the dual goals of profit and charity, remains the “single greatest challenge” of social enterprises.²⁷

Social entrepreneurs have been described as “society’s change agents,” creating “innovative solutions to society’s most pressing social problems.”²⁸ Whereas many business entrepreneurs see cash flow as “a

term “third sector” as encompassing “neither governmental nor private” forms, including quasi-governmental entities, voluntary associations, and nonprofit corporations).

24. HEERAD SABETI, FOURTH SECTOR NETWORK CONCEPT WORKING GRP., *THE EMERGING FOURTH SECTOR: A NEW SECTOR OF ORGANIZATIONS AT THE INTERSECTION OF THE PUBLIC, PRIVATE, AND SOCIAL SECTORS* 2–3 (2009), available at http://www.fourthsector.net/attachments/39/original/The_Emerging_Fourth_Sector_-_Exec_Summary.pdf?1253667714.

25. The term “triple bottom line” was coined in 1998 by John Elkington and describes an organization’s pursuit of “people, planet, and profit.” JOHN ELKINGTON, *CANNIBALS WITH FORKS: THE TRIPLE BOTTOM LINE OF 21ST CENTURY BUSINESS* 69 (1998). See also PETER FISK, *PEOPLE, PLANET, PROFIT: HOW TO EMBRACE SUSTAINABILITY FOR INNOVATION AND BUSINESS GROWTH* 156 (2010) (“People, planet and profit, often known as the ‘triple bottom line’ . . .”).

26. Marion R. Fremont-Smith, *A “How-To” for Joint Ventures*, NAT’L CTR. ON NONPROFIT ENTER., http://www.nationalcne.org/index.cfm?fuseaction=feature.display&feature_id=72 (last visited July 24, 2011).

27. Allen R. Bromberger, *Social Enterprise: A Lawyer’s Perspective*, PERLMAN & PERLMAN LLP, <http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf> (last visited Aug. 8, 2011) (citing Social Enterprise Alliance poll where “71% of respondents reported that finding the best legal structure for their ventures was the single greatest challenge they faced,” and for which the pool of respondents included people starting new ventures, and investors seeking both a social and financial return on investment).

28. *About*, SKOLL FOUND., <http://www.skollfoundation.org/about> (last visited Oct. 25, 2010); *What is a Social Entrepreneur?*, ASHOKA, http://www.ashoka.org/social_entrepreneur (last visited Oct. 25, 2010). Precisely defining “social entrepreneur” and distinguishing it from other social activities, such as social service provision or social activism, is a critical aspect of its study and development. Roger L. Martin & Sally Osberg, *Social Entrepreneurship: The Case for Definition*, STAN. SOC. INNOVATION REV., Spring 2007, at 29, 30. Social entrepreneurship may be defined as having three components: “(1) identifying a stable but inherently unjust equilibrium that causes the exclusion, marginalization, or suffering of a segment of humanity that lacks the financial means or political clout to achieve any transformative benefit on its own; (2) identifying an opportunity in this unjust equilibrium, developing a social value proposition, and bringing to bear inspiration, creativity, direct action, courage, and fortitude, thereby challenging the stable state’s hegemony; and (3) forging a new, stable equilibrium that releases trapped potential or alleviates the suffering of the targeted group, and through imitation and the creation of a stable ecosystem

way of measuring value creation,” wealth is often “just a means to an end for social entrepreneurs.”²⁹ In embracing market-oriented solutions to societal ills, social entrepreneurs “often structure their organizations with earned-income strategies” to minimize reliance on charitable donations.³⁰ These entrepreneurs claim that outmoded U.S. law based on a three-sector world and “inappropriate old-style legal entities hamstringing their socially transformative plans” because legitimate vehicles for social change, which are “cobble[d] together” from existing legal structures, are “expensive to create, burdensome to maintain, and, due to their novelty, legally insecure.”³¹

B. *Limitations of Existing Legal Forms*

In fulfilling their social and business ambitions in the current legal environment, social entrepreneurs may utilize various entities available in each of the three traditional economic sectors. In the first sector of government, socially minded entrepreneurs employed by a federal, state, or local agency might mobilize the public-benefit machinery of a government institution to further their social interests. Examples of such machinery include providing social-innovation funding,³² or implementing limited fee-for-service mechanisms that might satisfy the capitalistic impulses of bureaucratic entrepreneurs.³³ The government sector, how-

around the new equilibrium ensuring a better future for the targeted group and even society at large.” *Id.* at 35.

29. J. Gregory Dees, *The Meaning of “Social Entrepreneurship”*, CTR. ADVANCEMENT SOC. ENTREPRENEURSHIP, 2-3 (May 30, 2001), http://www.caseatduke.org/documents/dees_sedef.pdf.

30. Kelley, *supra* note 17, at 339.

31. *Id.* at 340-41 (giving examples of “complex structures,” such as “corporations with multiple classes of stock and detailed shareholder agreements, or the creation of multiple interlocking entities, or the use of delicately drafted joint venture agreements”). See generally Fremont-Smith, *supra* note 26, for information on nonprofit and for-profit joint venturing.

32. The federal government’s Social Innovation Fund provides capital to promising social-benefit programs. This fund is authorized under the Edward M. Kennedy Serve America Act and is managed by the Office of Social Innovation and Civic Participation, which was created by executive order in 2009. See Press Release, Office of the Press Sec’y, President Obama to Request \$50 Million to Identify and Expand Effective, Innovative Non-Profits (May 5, 2009), available at http://www.whitehouse.gov/the_press_office/President-Obama-to-Request-50-Million-to-Identify-and-Expand-Effective-Innovative-Nonprofits. Additionally, the White House Startup America initiative will be providing matching capital, reducing regulation, connecting business mentors with entrepreneurs, and considering tax reliefs and incentives for small businesses. See *Startup America*, WHITE HOUSE, <http://www.whitehouse.gov/issues/startup-america> (last visited July 24, 2011). Other examples of government funding of charity, science, and social initiatives abound.

33. See OFFICE OF MGMT. & BUDGET, CIRCULAR NO. A-76 REVISED, 1, A3 (2003), available at <http://oam.eas.commerce.gov/docs/OMB%20Circular%20A-76%20REVISED%202003.pdf>. “The longstanding policy of the federal government has been to rely on the private sector for needed commercial services,” rather than perform a commercial activity itself. *Id.* at 1. Nonetheless, the federal government does perform many activities ostensibly for public benefit, including fee-for-service activities that generate funds outside of the federal budget and appropriations process, and that subsequently can be used to reward high-performing (i.e., profit-

ever, might serve better as a nest for social activists rather than social entrepreneurs. Most social entrepreneurs who want to establish their own legal entities will thus look to either the second sector of business to set up a for-profit to do largely nonprofit work, or to the third sector of nonprofit to set up a nonprofit organization that allows for for-profit opportunities. The traditional legal forms tied to these second and third sectors, however, have significant limitations for social entrepreneurs.

1. NONPROFIT ENTITY LIMITATIONS FOR SOCIAL ENTREPRENEURS

Despite nonprofits' long history in the United States, no uniform federal law of nonprofits exists, and comparatively little authoritative law has been drafted specifically for nonprofits, with most legal treatment of nonprofits found under federal tax law.³⁴ Substantive nonprofit law is generally a state law concern, with *laissez-faire*, nonprofit-corporation statutes usually permitting organizations to be formed for "any lawful purpose,"³⁵ and with charitable trust law "accommodat[ing] a broadly construed public purpose."³⁶ The nonprofit laws that do exist can present some stifling and severe restrictions to dampen the social entrepreneurial spirit, namely the non-distribution constraint and the various operating burdens of maintaining an exempt status.

generating) employees with compensation and bonuses. For example, certain areas within the Government Accountability Office, Treasury Department, and Office of Personnel Management run like private enterprises, with fee-for-service practices. See Kimberly Palmer, *Report Criticizes Fee-for-Service Contracting Operations*, GOV'T EXECUTIVE, Aug. 2, 2005, <http://www.govexec.com/dailyfed/0805/080205k1.htm>; see also *Products and Services for a Fee*, U.S. OFF. PERSONNEL MGMT., <http://www.opm.gov/employ/html/prodserv.htm> (last updated Oct. 15, 1998).

34. Evelyn Brody, *The Legal Framework for Nonprofit Organizations*, in THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 243, 244 (Walter W. Powell & Richard Steinberg eds., 2d ed. 2006) ("[C]ompared with the law governing business corporations—which is more fully developed because of numerous suits by shareholders—it is not easy to say what 'the law' is in the nonprofit sector. . . . [T]here is no single 'law of nonprofit organizations.'"). Other sources that are of influential legal importance are the American Bar Association's Model Nonprofit Corporation Act, which was revised in 1987 (REVISED MODEL NONPROFIT CORP. ACT (1987)), and recently also in 2008, (MODEL NONPROFIT CORP. ACT (2008)); and the American Law Institute's project *Principles of the Law of Nonprofit Organizations*, started in 2001 and still several years from being complete. See *Current Projects: Principles of the Law of Nonprofit Organizations*, A.L.I., http://www.ali.org/index.cfm?fuseaction=projects.proj_ip&projectid=3 (last visited July 16, 2011). For another comprehensive review of the laws and doctrines affecting nonprofits, see generally MARION R. FREMONT-SMITH, *GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION* (2004) (giving a comprehensive review of the laws and doctrines affecting nonprofits). As Professor Kleinberger pointed out in his review of this article prior to its publication, the federal tax law nonetheless does have a significant effect on nonprofits, with some effects pertaining to issues that might not ordinarily seem to be tax-related, such as the duty of care of nonprofit managers.

35. Brody, *supra* note 34, at 246.

36. *Id.* See also REVISED MODEL NONPROFIT CORP. ACT § 3.01 ("Every corporation incorporated under this Act has the purpose of engaging in any lawful activity unless a more limited purpose is set forth in the articles of incorporation.").

As the name implies, nonprofits are *ipso juro* prohibited from distributing profits or entertaining private ownership.³⁷ This non-distribution constraint³⁸ may dissuade some social entrepreneurs who feel that they need not sacrifice income or equity while pursuing charitable purpose. The non-distribution constraint also creates practical challenges in attracting private capital, which, short of corporate philanthropy, often demands income or equity. Securing debt is also an issue, as traditional banks are reluctant to extend competitive-term loans to nonprofits because of nonprofits' perceived inability of or risk for repayment.³⁹

Even if a social entrepreneur accepts the personal financial constraints and capital-raising limitations associated with a public charity form, maintaining a nonprofit status can be an onerous operating burden. Engaging a nonprofit in any margin-generating activities could subject a tax-exempt entity to the Internal Revenue Service's Operational Test,⁴⁰ Commerciality Doctrine,⁴¹ Unrelated Business Income Tax,⁴² and the Commensurate in Scope Doctrine⁴³—any of which can be fatal to the organization's nonprofit and tax-exempt status.

The risk of injury is further exacerbated by the mixed messages of what is expected of nonprofit charities. The U.S. free-market culture increasingly expects charities to be entrepreneurial and more like commercial enterprises, to be income-earning in order to be self-sufficient, and to have as the goal social engineering beyond traditional charitable notions of helping the poor and needy.⁴⁴ On the other hand, U.S. laws

37. MODEL NONPROFIT CORP. ACT § 6.40; Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2009) (prohibiting tax-exempt public charities from “operat[ing] for the benefit of private interests”).

38. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980).

39. See Kelley, *supra* note 17, at 354.

40. See Kelley, *supra* note 6, at 2473 (“The operational test requires that an organization’s resources must be devoted to purposes that qualify as exclusively charitable within the meaning of section 501(c)(3) of the [IRS] Code and the applicable regulations.”) (citation and internal quotation marks omitted); *accord* Rev. Rul. 72-369, 1972-2 C.B. 245.

41. BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* § 25.1, at 629–30 (7th ed. 1998) (“The commerciality doctrine is essentially this: A tax-exempt organization is engaged in a nonexempt activity when that activity is engaged in in a manner that is considered *commercial*. An act is a commercial one if it has a direct counterpart in, or is conducted in the same manner as is the case in the realm of for-profit organizations.”). The Commerciality Doctrine is rather vague. Kelley, *supra* note 6, at 2476.

42. Kelley, *supra* note 6, at 2483 (charities that engage in commercial activities not “substantially related” to the performance of their exempt purposes” may be subject to an Unrelated Business Income Tax (UBIT)) (citation omitted); see also I.R.C. § 513(a) (2006); Treas. Reg. § 1.513-1(a) (2009).

43. Kelley, *supra* note 6, at 2486 (“[I]f the reviewing authority applying the doctrine finds that the organization’s charitable program is ‘commensurate in scope’ with its financial resources, it will uphold the organization’s exemption, even if the money is being produced through an activity that has nothing to do with the charitable mission.”); *accord* Rev. Rul. 64-182, 1964-1 C.B. 186.

44. See Kelley, *supra* note 6, at 2488.

insist upon the non-commerciality of a nonprofit enterprise and passively aggressively apply a traditional definition of charity as a visceral assessment of tax-exempt qualification.⁴⁵ These antagonistic expectations, coupled with the lack of uniform nonprofit law mentioned earlier in this section of the article,⁴⁶ arguably create an operational and legal uncertainty on how social entrepreneurs should utilize nonprofits. A few recent examples of social entrepreneurs who chose the nonprofit form may illustrate some non-distribution constraint and operating issues.

Atlas Service Corps, Inc. is a nonprofit that works as “a reverse Peace Corps,” where foreign charitable workers come to the U.S. to help its citizens.⁴⁷ Founded in 2006, Atlas Corps engages foreign leadership “Fellows” in an international exchange of best practices, with Fellows bringing their nonprofit leadership experiences to U.S. communities and also learning practices in the United States to return as societal change agents in their home communities.⁴⁸ Founder and social entrepreneur Scott Beale decided to organize this company as a nonprofit instead of a for-profit, ostensibly driven more by mission than money.⁴⁹ Atlas Corps has managed to fund itself through the business, governmental, and nonprofit sectors by appealing to organizations, which need leaders and are willing to pay for the Fellows, and by soliciting aid from governmental and foundation sources.⁵⁰ The choice of a nonprofit form may be a good fit in this scenario because the primary activity of providing fellowships may not be easily commercialized,⁵¹ the target consumers are other non-

45. *Id.* (“When a charitable organization today engages in what an administrator or judge feels is too much commerce—particularly where that organization combines commerce with a charitable mission that does not focus on aiding the poor and distressed—that administrator or judge will grasp for a legal mechanism to draw charity back toward its compassionate, Judeo-Christian origins.”).

46. *See supra* Part I.B.1.

47. Scott Beale, A “Reverse Peace Corps,” *SERVICEWORLD* (Nov. 2, 2010), <http://ourworld.org/2010/11/a-reverse-peace-corps/>; *see also* Nation: Reverse Peace Corps, *TIME*, June 16, 1967, <http://www.time.com/time/magazine/article/0,9171,843931,00.html>.

48. *See Mission & Method*, ATLAS CORPS, <http://www.atlascorps.org/mission.html> (last visited Aug. 18, 2011).

49. *See* Thomas Heath, *Value Added: The Nonprofit Entrepreneur*, *THE WASHBIZ BLOG* (Mar. 15, 2009, 8:00 PM), http://voices.washingtonpost.com/washbizblog/2009/03/value_added_17.html (quoting Scott Beale as saying, “I am just like a business entrepreneur, but instead of making a big paycheck I try to make a big impact”). *See also* Ken Mammarella, *The \$13,000 CEO: Nonprofit Founder Scott Beale Doesn’t Want a Lot of Money; He Wants a Better World*, *DELAWARE ONLINE* (Aug. 11, 2011), <http://www.delawareonline.com/article/20110811/NEWS/108110356/The-13-000-CEO> (quoting Scott Beale as saying, “My life’s ambition has never been to have the most comfortable life but the one that makes the most difference”).

50. *Donors*, ATLAS CORPS, <http://www.atlascorps.org/individual.php> (last visited Aug. 20, 2011).

51. Atlas Corps Founder and CEO Scott Beale explained that one of his “biggest hurdles” in launching Atlas Corps was in receiving the designation from the U.S. government to be an international exchange program, for which sponsor eligibility is detailed in the Mutual

profits, and the founding entrepreneur may have no apparent interest in financial gain for himself or for stakeholders.⁵² When the nonprofit's activities can easily become commercialized and pecuniary conflicts of interests develop, however, the nonprofit form can be a risky entity choice.⁵³ Like many other nonprofits, the growth of Atlas Corps is also significantly limited by its ability to secure continual capital from donations or revenue from nonprofits, which would annually sponsor such fellowships.

Consider also the micro-lending organization Kiva Microfunds, Inc., which is a 501(c)(3) nonprofit organization based in San Francisco.⁵⁴ Founded by Matthew Flannery and his wife Jessica in 2005,

Educational and Cultural Exchange Act of 1961. See *Career Spotlight: Scott Beale (C'98)*, GEORGETOWN ALUMNI ONLINE, <http://alumni.georgetown.edu/default.aspx?page=CareerServicesSpotlightBeale> (last visited Aug 30, 2011). See also 22 C.F.R. § 62 (2010).

52. Funding for Atlas Corps is from donations, which are largely from companies, governments, foundations, individuals, and host organizations for which the Fellow will be working. *Id.* Atlas Corps Fellows are considered volunteers who serve for twelve to eighteen months and who are provided a living stipend of 130% of the poverty line for the community where these Fellows will reside. For example, the Fellows in Washington, D.C., during the 2010–2011 year received \$14,750 annually and \$1,250 upon return to their home country. The goal of fifty Fellows in 2011 means a cash outlay of \$800,000 for volunteers and then additional overhead expenses to manage the organization. *Frequently Asked Questions*, ATLAS CORPS, <http://www.atlascorps.org/faq.html> (last visited Aug. 20, 2011).

53. Angel Food Ministries is one example of a nonprofit that began seemingly with charitable intentions by its founders, which has allegedly evolved into a significant commercial enterprise enriching its founders, who have been under public and IRS scrutiny for excessive compensation. Founded in 1994 by two pastors in Georgia, the nonprofit Angel Food Ministries (AFM) distributes pre-packaged groceries at a low-cost to mostly indigent, church-attending consumers. *What is Angel Food Ministries?*, ANGEL FOOD MINISTRIES, <http://www.angelfoodministries.com/about> (last visited Aug. 20, 2011). In February 2009, the FBI raided the charity's home office in Georgia, seizing unspecified documents. Joe Johnson, *FBI Searches Angel Food Ministries, Seizes Documents*, ATHENS BANNER-HERALD, Feb. 12, 2009, http://www.onlineathens.com/stories/021209/new_387279000.shtml. The IRS found that the pastors and their two sons showed "an astonishing jump in salaries in a recent one-year period," from \$322,755 in 2005 to \$2.1 million in 2006. *Id.* The pastor CEO's recent \$764,840 compensation in 2008 for managing a \$138 million organization far exceeded the salary of the top executive of the nonprofit foodbank Feeding America (formerly America's Second Harvest), who received \$417,799 in compensation for managing a \$635 million budget. Melissa Nann Burke, *Nonprofit Angel Food Ministries' Finances Still Under Scrutiny*, YORK DAILY REC., Dec. 27, 2009, http://www.ydr.com/ci_14073595. Additionally, the AFM executives, substantially composed of family members, did significant business with other family businesses at seemingly above-market-rate transactions and also retained a private jet and a personal chef. *Id.* One nonprofit attorney observed that "it's hard to tell whether AFM has a charitable purpose or it's a purely commercial venture." *Id.* This nonprofit is currently under investigation by federal and state authorities, and is embroiled in litigation for its business practices. *Id.* Unlike the founder of Atlas Corps, the AFM founders had a food business that was easy to commercialize and use to generate margins, and they had a strong interest in financially rewarding themselves.

54. *About Us*, KIVA, <http://www.kiva.org/about> (last visited Aug. 20, 2011); see also *infra* Part III.C.3.

Kiva was originally intended to be an LLC.⁵⁵ The founders wanted Kiva to receive loans rather than donations, but given the legal issues around securitization and charging interest, they “decided that the 501(c)(3) status would help [them] form a bond with [their] users and raise a small amount of donation capital to get the idea off the ground.”⁵⁶ With over a half-million Kiva contributors who have loaned over \$200 million to almost a million Kiva users, the organization seems to remain on a path for success as measured by social impact.⁵⁷ One of the advantages that nonprofits have over for-profit firms, however, is the signal of trustworthiness that arises from the non-distribution constraint.⁵⁸ The public perceives nonprofits to be more trustworthy, because nonprofits arguably “have less incentive to profit at the expense of consumers than do [for-profits].”⁵⁹ Kiva proclaimed that it allowed for peer-to-peer lending, but when the *New York Times* reported that individuals were not in fact making microloans directly to borrowers but rather to Kiva’s microfinance institution partners, which in turn made such loans en masse, a question arose about how Kiva monies were really being used.⁶⁰ “Where [Kiva’s] homepage once promised, ‘Kiva lets you lend to a specific entrepreneur, empowering them to lift themselves out of poverty,’ [the website] now simply states, ‘Kiva connects people through lending to alleviate poverty.’”⁶¹ Though Kiva ultimately provides loans to those in need and the company continues to reach operational milestones, the danger of public expectation may be a concern that is more pronounced in the nonprofit form. Furthermore, whether Kiva would have been or could still be propelled to greater financial heights by attracting capital-endowed equity investors is unknown, but undoubtedly a convenient entity form that allowed for charitable purpose and

55. Matthew Flannery, *Kiva and the Birth of Person-to-Person Microfinance*, INNOVATIONS, Winter & Spring 2007, at 31.

56. *Id.* at 39, 53–54.

57. See *Statistics*, KIVA, <http://www.kiva.org/about/stats> (last updated Aug. 18, 2011). The executive compensation for Kiva’s top executives also seemed reasonable, with the CEO and President of Kiva each reporting total compensation of under \$150,000. More details are disclosed in the 2009 Form 990. See Kiva Microfunds, Return of Organization Exempt from Income Tax (2009) Financial Statements December 31, 2009 and 2008, <http://na3.salesforce.com/servlet/servlet.FileDownloadPkb?file=00P50000004ty2E&orgId=00D500000006svl&pPid=5015000000J8KO>.

58. See Hansmann, *supra* note 38, at 873.

59. See HELMUT K. ANHEIER, NONPROFIT ORGANIZATIONS 124 (2005).

60. Stephanie Strom, *Confusion on Where Money Lent via Kiva Goes*, N.Y. TIMES, Nov. 9, 2009, at B6. Timothy Ogden, editor in chief of Philanthropy Action, commented, “There’s a whole new generation of socially connected nonprofits that use the Internet to make the illusion of person-to-person contact much more believable The problem is that they are no more connecting donors to people than the child sponsorship organizations of the past did.” *Id.*

61. *Id.* Kiva’s President said “he could foresee a day when Kiva really [could] provide person-to-person” loans. *Id.*

investor return would have been strongly considered by Kiva's founders at the company's inception.

2. FOR-PROFIT CORPORATION LIMITATIONS FOR SOCIAL ENTREPRENEURS

Corporate entities can offer social entrepreneurs considerable operational and financial latitude. A social entrepreneur might choose to incorporate a business and engage in social benefit through corporate social responsibility, cause marketing, and corporate philanthropy—all of which can be important activities for any corporation. A more difficult challenge, however, would be to prioritize or rationalize charitable purpose above shareholder value. As some recent legal disputes suggest, a social entrepreneur may be unable to escape the financial and fiduciary confines of a corporate form that is ultimately obligated to shareholders.

Ben & Jerry's is one of the most famous for-profit corporations with a social mission. The company "advanced its social mission in many ways, such as by committing 7.5% of its profits to a charitable foundation; conducting in-store voter registration; and buying ingredients from suppliers who employed disadvantaged populations."⁶² In 2000, Ben & Jerry's was sold to Unilever, a large multi-national conglomerate, which did not have a social reputation equal to or arguably approaching Ben & Jerry's.⁶³ While the founders of Ben & Jerry's may have overestimated the actual legal risks involved in resisting an acquisition by Unilever, the founders claimed that they did not really want to sell the company to Unilever, and that "corporate law made them do it."⁶⁴ Without delving into the complexity of fiduciary duties in a takeover context, the takeaway from the Ben & Jerry's example is that the founders of a charitably focused, for-profit corporation felt pressured into choosing between possible loss or dilution of the company's social mission and potential legal liability.⁶⁵ When faced with a decision of battling for their independence to continue their social mission or taking the road of least resistance and deferring to shareholders and the acquiring company, Ben and Jerry walked.

Even social entrepreneurs who are willing to fight "the good fight" to preserve their community-first business may find that accepting investors, even minority investors, can result in the form of the corpora-

62. Antony Page & Robert A. Katz, *Freezing Out Ben & Jerry: Corporate Law and the Sale of a Social Enterprise Icon*, 35 *Vt. L. Rev.* 211, 211 (2010) (citation omitted).

63. *See id.* at 211–12; *see also* Kelley, *supra* note 17, at 360.

64. Page & Katz, *supra* note 62, at 230 (citations omitted).

65. We agree with Page & Katz on the point that the Ben & Jerry's founders could have properly resisted a takeover, but the founders would have likely had to couch their defense in terms of leading to long-term shareholder value. *Id.* at 231.

tion usurping the function of the business. In the 2010 Delaware Court of Chancery case of *eBay Domestic Holdings v. Newmark*, two shareholders of craigslist had a dispute with the company's only other shareholder, eBay.⁶⁶ In recounting the facts of the case, the court recognized that craigslist, which offers the most-used classifieds website in the United States, "largely operates its business as a community service" and "does not expend any great effort seeking to maximize its profits."⁶⁷ When eBay decided to make a competing foray into online classified advertising, the craigslist shareholders asked eBay to sell its minority stake back to craigslist or to a third party "who would be compatible with . . . craigslist's unique corporate culture."⁶⁸ Rebuffed by eBay and unable to rid itself of its profit-minded partner, the craigslist shareholders enacted a number of defensive measures to inhibit or restrict the influence of eBay's share position.⁶⁹ eBay claimed that the craigslist directors and controlling stockholders breached their fiduciary duties by enacting the defensive measures, and the court largely agreed with eBay, ordering a rescission of a majority of the challenged measures.⁷⁰

The court provided insight into the ultimate purpose of for-profit companies when it unambiguously stated, "[p]romoting, protecting, or pursuing non-stockholder considerations must lead at some point to value for stockholders."⁷¹ The court continued, stating that "[t]he corporate form in which craigslist operates . . . is not an appropriate vehicle for purely philanthropic ends" and "[h]aving chosen a for-profit corporate form, the craigslist directors are bound by the fiduciary duties and standards that accompany that form."⁷² The court concluded that because the defendants chose the for-profit corporate form, they must "promote the value of the corporation for the benefit of its stockholders."⁷³ Though social entrepreneurs who choose the corporate form can

66. 16 A.3d 1, 6 (Del. Ch. 2010).

67. *Id.* at 7–8. The court also recognized that craigslist allowed classified advertisements to be placed on its websites free of charge, did not "sell advertising space on its website to third parties," and did not "market its services," with nearly all revenue coming from certain online job postings and apartment listings in New York City. *Id.* The shareholders had expected eBay to "show appreciation for craigslist's unique mission and philosophy." *Id.* at 15.

68. *Id.* at 6.

69. *Id.*

70. *Id.* at 7. Defensive measures, such as those analyzed in *eBay*, are subject to enhanced scrutiny under Delaware law.

71. *Id.* at 33. The *eBay* court also reasoned, "Ultimately, defendants failed to prove that craigslist possesses a palpable, distinctive, and advantageous culture that sufficiently promotes stockholder value to support the indefinite implementation of a poison pill. [The defendants] did not make any serious attempt to prove that the craigslist culture, which rejects any attempt to further monetize its services, translates into increased profitability for stockholders." *Id.*

72. *Id.* at 34.

73. *Id.*

exercise significant flexibility, the ultimate obligation in corporations to maximize shareholder value may be enforceable over the social mission.⁷⁴

3. FOR-PROFIT LLC LIMITATIONS FOR SOCIAL ENTREPRENEURS

Instead of establishing a corporate entity, many social entrepreneurs choose to create a limited liability company (“LLC”), which enjoys contractual flexibility in organizational form, lighter reporting requirements, and pass-through taxation.⁷⁵ Social entrepreneurs wanting to establish a social enterprise, however, may find that the LLC is not an optimal vehicle for several reasons.

One problem of forming social enterprises as LLCs is branding. A company appended with “LLC” does not immediately identify the entity as a social enterprise and may connote profit motives.⁷⁶ As discussed previously,⁷⁷ the non-distribution constraint of nonprofits signals a level of trustworthiness in these institutions⁷⁸ and a labeling of these entities as “nonprofit,” “not-for-profit,” or “501(c)(3)” communicates a valuable message that this entity prioritizes charitable or social purpose. On the other hand, for-profit entities engaged in social benefit—through their vision, mission, or programs—must still overcome suspicion so that the public and potential investors understand the difference between a “good company” and just “good marketing.”⁷⁹ Not only does an LLC suffix predispose the public into assuming that such a social enterprise is primarily for-profit with charitable purpose as a residual benefit, but such a branding signal may also be confusing both to foundations and private

74. For an analysis of a different example, where a corporation created a unit within its company (and not a separate legal entity) for charitable purposes, consider Google’s establishment of Google.org, as examined in Christopher Lim, *Google.org, For-Profit Charitable Entity: Another Smart Decision by Google*, 17 KAN. J.L. & PUB. POL’Y 28 (2008). Without a legal entity separation between Google.org and Google, Google.org could be forced to resign or diminish its charitable purpose if Google’s board made such a decision. *See generally id.*

75. Brewer & Rhim, *supra* note 17, at 14.

76. Professor Kleinberger in his review of this article observes that “[s]uch branding has never been the function of the law of business organizations” and that numerous and powerful private means, such as the Sullivan Principles and Halo Awards, exist for such branding purposes. We recognize, however, that while branding may not be an explicit consideration in developing organizational forms, the organizational form suffix appended to a for-profit organization’s name may invite profit-making assumptions by consumers and investors. A legal entity type, such as the L3C, acknowledges the focus on social purpose over profit and could also signal a distinction in legal duties owed. Furthermore, start-up organizations are rarely sufficiently mature in infrastructure or results to qualify for industry accolades, such as the Halo Awards. L3Cs are recognized from their inception as entities with social purpose, and unlike for-profit forms, have that social purpose woven into the form’s DNA.

77. *See supra* Part I.B.1.

78. *See* Hansmann, *supra* note 38, at 873.

79. *See* Billitteri, *supra* note 9, at 9–10.

investors. Foundations may not immediately recognize certain LLCs as potential charitable-focused entities eligible for investment, and private investors may not be expecting the below-market returns often associated with social enterprises if the organization is formed as a traditional LLC. Not surprisingly, many social entrepreneurs argue that a distinct brand for hybrid organizations is needed for gaining support from the general public and for increasing access to various sources of charitable, governmental, and private capital.⁸⁰

Another problem in choosing the LLC form for social enterprises is the lack of assurance that an LLC is either intended to be or will remain an organization committed to charitable primacy.⁸¹ The attribute of contractual flexibility that makes the LLC prized by entrepreneurs is the same characteristic that should give pause to social entrepreneurs, who may want to ensure that their company prioritizes its charitable purpose. Social investors and the public may have similar concerns about an LLC form, its articles of organization, and operating agreement, which could be altered to a dramatic change in organizational course, especially in a change of control situation.⁸²

The obstacle in raising capital is sometimes said to be the most significant challenge for social entrepreneurs who turn to existing for-profit forms.⁸³ Charitably inclined, for-profit entities face difficulties in attracting individual or institutional investors, who want market rates of return that “multi-bottom-line organizations are rarely in a position to offer.”⁸⁴ Social entrepreneurs using for-profit forms, such as the LLC, also generally find themselves cut-off from sources that traditionally have funded charitable causes, namely foundations and governments.⁸⁵ Foundations in particular are at tax and public-image risk if they make a program-related investment (“PRI”) in such for-profit endeavors that does not qualify as a PRI.⁸⁶ Even if informed investments are made in existing social enterprise forms, particularly vexing is ensuring that a

80. See Kelley, *supra* note 17, at 361 (citations omitted).

81. The statutory language enabling L3Cs assures investors that the form requires commitment to charitable primacy. Currently, however, investors in L3Cs have little assurance that the form will *remain* an L3C. Our recommended solutions to this issue are addressed in Part III.D.

82. See *infra* Part III.D for discussion on proposed safeguards for socially invested capital when an L3C experiences a change of control or converts to a profit-focused LLC.

83. SUSTAINABILITY LTD., GROWING OPPORTUNITY: ENTREPRENEURIAL SOLUTIONS TO INSOLUBLE PROBLEMS, 4, 15 (2007), available at http://tidescanada.org/wp-content/uploads/files/causeway/Growing_Opportunity.pdf. The top five challenges cited by social entrepreneurs were, in order of most to least challenging: accessing capital, promoting/marketing, maturing/professionalizing, recruiting talent, and adapting to landscape. *Id.*

84. See Kelley, *supra* note 17, at 354 (citing SUSTAINABILITY LTD., *supra* note 83, at 18).

85. See Kelley, *supra* note 17, at 354.

86. See Billitteri, *supra* note 9, at 5–6.

portion, if not all, of the enterprise capital will be locked into the “social stream” and not be converted into private wealth.

Difficulties in branding, locking in charitable capital, and raising capital, however, are not necessarily enough to dissuade some social entrepreneurs from engaging the LLC form for their enterprises. Some entrepreneurs may feel that their marketing can overcome choice of entity, that legal and operating measures can ease the concerns of investors and the public, and that a business model with a lack of dependence on donations, grants, and PRIs make the capital-raising issue no more challenging than any other enterprise. What have been deal-breaking deterrents for many social entrepreneurs, however, are the legal complexity and cost of setting up an LLC that can prioritize charitable purpose and that can contract around fiduciary duties and financial obligations to LLC members.

4. EXISTING ENTITY WORKAROUNDS FOR SOCIAL ENTREPRENEURS

For social entrepreneurs who want to dovetail social benefit and business, more complex arrangements—which might be patched together through existing legal mechanisms, such as joint ventures structured as corporations, partnerships, or LLCs, or cooperative agreements among individuals, nonprofit, and corporate entities—can be ideal but are also expensive, time-consuming, and sometimes still not an assurance of legitimacy.⁸⁷ Social entrepreneurs who want charitable purpose as an inextricable part of their operations will need, among other things, expert and invariably costly legal counsel in creating and maintaining the organization.⁸⁸ Some social enterprises have also satisfied their dual-purpose ambitions through multiple-entity arrangements, most notably for-profits with nonprofit subsidiaries or nonprofits with for-profit subsidiaries. Such arrangements, however, have encountered litigation risk, tax issues, and criticism by social advocates.

Corporations engaged in corporate philanthropy or corporate social responsibility sometimes form their own nonprofit organizations or foundations. In 2006, social entrepreneur Blake Mycoskie created TOMS Shoes Inc. at least partly motivated by the idea of providing footwear to shoeless children.⁸⁹ The company matches every pair of shoes purchased from it with a pair of new shoes given to a child in need, and as of September 2010, TOMS Shoes has given away over one million

87. See Kelley, *supra* note 17, at 341 (citation omitted).

88. For example, “charitable LLCs” can also “be structured as a partnership or joint venture . . . with the charitable activity free from income taxes” though “IRS rules severely limit the circumstances” for this approach. Billitteri, *supra* note 9, at 6.

89. *One for One Movement*, TOMS SHOES, <http://www.toms.com/our-movement> (last visited Aug. 18, 2011).

pairs of shoes.⁹⁰ To deliver these shoes, TOMS Shoes operates its 501(c)(3) nonprofit affiliate, Friends of TOMS.⁹¹ TOMS Shoes, however, has received a fair amount of criticism⁹² for using the plight of children as an alleged marketing ploy to generate profits,⁹³ “greenwashing”⁹⁴ its image, making little social impact, and potentially doing more harm than good.⁹⁵ TOMS Shoes describes itself as a “for-profit company with giving at its core,”⁹⁶ and despite the best intentions of a for-profit company to further philanthropy, such companies are often met with skepticism.⁹⁷

Another alternative is for a nonprofit to create a for-profit, corporate subsidiary. In 2005, “the Mozilla Foundation, a non-profit public benefit software development organization, launched a wholly owned subsidiary, the Mozilla Corporation,” which serves as the for-profit vehicle for the Firefox Internet browser.⁹⁸ In 2008, the Mozilla Foundation announced that the IRS had launched a review of the foundation’s tax-exempt status for 2003 and 2004, and in 2009, the IRS expanded its investigation to subsequent tax years.⁹⁹ The Mozilla Foundation argued that search revenues it received were royalties that should not be taxed and eventually settled with the IRS on a penalty for some of those tax

90. *One for One—Official Store*, TOMS SHOES, <http://www.toms.com/our-movement/movement-one-for-one> (last visited Aug. 18, 2011).

91. *Our Commitment*, TOMS SHOES, <http://www.toms.com/movement-our-commitment> (last visited Aug. 18, 2011).

92. Jeff Rosenthal, *Products with Purpose Will Change the World*, THE HUFFINGTON POST (Jan. 27, 2010, 12:17 PM), http://www.huffingtonpost.com/jeff-rosenthal/products-with-purpose-wil_b_437917.html. See also Megan Hoyer, *Are TOMS Shoes Best Fit for Philanthropy?: Better Ways to Give Efficiently*, THE FALCON, Oct. 14, 2009, <http://www.thefalcononline.com/article.php?id=6589>.

93. Krystina Martinez, *Students Bring Some Criticism for Shoe Program*, THE PRAIRIE, Apr. 26, 2011, <http://www.theprairienews.com/2011/04/26/students-bring-criticism-shoe-program/>.

94. *About Greenwashing*, GREENWASHING INDEX, <http://www.greenwashingindex.com/what.php> (last visited Aug. 21, 2011) (Greenwashing is “when a company or organization spends more time and money claiming to be ‘green’ through advertising and marketing than actually implementing business practices that minimize environmental impact.”).

95. Zac Mason, *Do You Cause More Harm Than Good by Giving TOMS Shoes to the Poor?*, ZACSTRAVAGANZA! (Oct. 4, 2010, 10:28 AM), <http://zacstravaganza.blogspot.com/2010/10/does-toms-cause-more-harm-than-good-by.html>.

96. *TOMS Frequently Asked Questions*, TOMS SHOES, <http://www.toms.com/faq> (last visited Aug. 18, 2011).

97. Ellen McHugh, *A Closer Look at TOMS*, THE FINE PRINT (May 1, 2011), <http://www.thefineprintuf.org/2011/05/01/a-closer-look-at-toms/>.

98. *Mozilla Foundation Reorganization*, MOZILLA, <http://www-archive.mozilla.org/reorganization> (last modified Aug. 5, 2005); *The State of Mozilla: Sustainability*, MOZILLA (Nov. 18, 2010) <http://www.mozilla.org/foundation/annualreport/2009/sustainability.html>.

99. Cade Metz, *Mozilla Millions Still 86% Google Cash: Mountain View Sugar Daddy Tax Audit Rolls on*, THE REGISTER (Nov. 18, 2010, 8:53 PM), http://www.theregister.co.uk/2010/11/18/google_still_mozilla_sugar_daddy/.

years, with other tax issues still unresolved.¹⁰⁰

Other workarounds include social enterprise designations, such as B-Corp certification,¹⁰¹ and newer hybrid legal forms, such as the Benefit Corporation,¹⁰² the Flexible Purpose Corporation,¹⁰³ the Benefit LLC,¹⁰⁴ and the L3C.¹⁰⁵ The demand for hybrid forms is also advancing on the international front, with entities such as the Community Interest

100. Steve Bobson, *Mozilla Issues Audited Financials, Faces Audit by IRS*, INAUDIT (Nov. 19, 2010), <http://inaudit.com/audit/external-audit/mozilla-issues-audited-financials-faces-audit-by-irs-2083>; Hood & Strong LLP, *MOZILLA FOUNDATION AND SUBSIDIARIES DECEMBER 31, 2009 AND 2008: INDEPENDENT AUDITORS' REPORT AND CONSOLIDATED FINANCIAL STATEMENTS 15* (Aug. 23, 2010), <http://www.mozilla.org/foundation/documents/mf-2009-audited-financial-statement.pdf>.

101. A Certified B-Corp or Certified B-Corporation is a voluntary certification process run by B Lab. Any company, even an L3C, may apply for a B-Corporation designation and may maintain such a designation through adherence to certain social and environmental standards and regular self-reporting, providing alleged branding advantages. See *B Corporation-FAQ*, B CORP., <http://www.bcorporation.net/faq> (last visited July 24, 2011). As of July 24, 2011, 427 B-Corps were in existence. See B-CORP, <http://www.bcorporation.net/> (last visited July 27, 2011). A B-Corp differs from a new statutory form called the Benefit Corporation. See *infra* note 97; see also Minnigh, *supra* note 15.

102. A Benefit Corporation is a statutory form of corporation that is created to provide a general public benefit, though such a benefit is not necessarily a section 170(c)(2)(B)-exempt purpose. See Minnigh, *supra* note 15 (“A general public benefit is defined as ‘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.’” (citation omitted)); *Benefit Corporation—Legal Provisions & FAQs*, B-CORP., <http://www.bcorporation.net/resources/bcorp/documents/Benefit%20Corporation%20-%20Legal%20Provisions%20and%20FAQ.pdf> (last visited Aug. 1, 2011) (“A Benefit Corporation: 1) has a corporate purpose to create a material positive impact on society and the environment; 2) has an expanded fiduciary duty that requires consideration of non-financial interests when making decision; and 3) reports on its overall social and environmental performance as assessed against a third party standard.”). As of August 1, 2011, statutes for Benefit Corporations have been adopted in five states: Hawaii, Maryland, New Jersey, Vermont and Virginia. *Public Policy*, B-CORP., <http://www.bcorporation.net/publicpolicy> (last visited Aug. 1, 2011). At least six other states (California, Colorado, Michigan, New York, North Carolina, and Pennsylvania) have pending legislation regarding Benefit Corporations. *Id.*

103. The Flexible Purpose Corporation will permit a corporation’s board of directors to engage in charitable purpose; specifically, the corporation is required to include charitable and public purpose activities that could be carried out by a nonprofit corporation. See S. 201 (Ca. 2001), available at http://www.leginfo.ca.gov/pub/11-12/bill/sen/sb_0201-0250/sb_201_bill_20110314_amended_sen_v98.pdf. The bill was approved overwhelmingly by the California Senate by a vote of 37–1 and now moves to the California Assembly. Ken Priore, *Flexible Purpose Corporation*, CAL. BUS. ATT’Y BLOG (June 10, 2011), <http://www.thecaliforniabusinessattorney.com/2011/06/10/flexible-purpose-corporation>.

104. The Benefit LLC will allow for an LLC to put social or environmental causes ahead of profit-making and protect against LLC member lawsuits. On May 19, 2011, the Maryland Governor signed the Benefit LLC into law, to be effective on June 1, 2011. See S. 595 2011 Gen. Assemb., Reg. Sess. (Md. 2011), available at <http://mlis.state.md.us/2011rs/billfile/sb0595.htm>.

105. See *infra* Part I.C.

Company (“CIC”)¹⁰⁶ and Social Enterprise LLP (“SELLP”),¹⁰⁷ both developing recently in the United Kingdom.

5. EVALUATING NONPROFIT, FOR-PROFIT, AND WORKAROUND SOLUTIONS

A social entrepreneur may choose a nonprofit form when the perception of “mission above all else,” a prohibition on profiteering, the tax-deductibility of donations, and the non-taxing of income, are essential attributes for the organization. The non-distribution constraint limitations on income and equity, however, can deter engagement by employees, investors, and lenders, and the maintenance of a tax-exempt nonprofit status reduces operational flexibility. Most significantly, the limitations of the social sector fail “to foster, support, and scale innovation.”¹⁰⁸ As professor Clayton Christensen of the Harvard Business School recently observed, “Fundamental shifts need to occur in the structure of the social sector in order for systems of innovation to truly take hold.”¹⁰⁹

A social entrepreneur may choose a corporate or LLC form when the following considerations are prevalent: when highly desirable or crucial activities include generating financial returns and developing equity; when having operational flexibility is paramount; and when raising investor capital is required. Traditional corporate forms, as demonstrated by Ben & Jerry’s and craigslist above,¹¹⁰ must ultimately prioritize shareholder wealth over social mission, and even LLC forms have similar obligations unless otherwise specified.

Social entrepreneurs who want to ensure charitable primacy, while allowing for maximum flexibility in pursuing profit, are often led to an LLC form with socially focused specifications and safeguards. Creating one of these custom, socially focused LLCs is inconvenient, time-consuming, and expensive. For many social entrepreneurs, crafting single or multiple-entity LLC vehicles to deliver social value exacerbates an already low-profit proposition.

106. See generally Stephen Lloyd, Transcript, *Creating the CIC*, 35 VT. L. REV. 31 (2010); Regulator of Community Interest Companies, *Community Interest Companies: Frequently Asked Questions*, BIS: DEP’T FOR BUS <http://www.cicregulator.gov.uk/CICleaflets/FAQ%20-%20October%202009%20V7.00%20Final.pdf> (last updated Oct. 1, 2009).

107. See Stephen Lloyd, *The Social Enterprise LLP—What Is It; and What Is It For?*, BARRISTER MAG. (2010) <http://www.barristermagazine.com/article-listing/current-issue/the-social-enterprise-llp-%E2%80%93-what-is-it;-and-what-is-it-for.html>.

108. Clayton M. Christensen et al., *The White House Office on Social Innovation: A New Paradigm for Solving Social Problems*, THE HUFFINGTON POST (July 1, 2009, 9:39 AM), http://www.huffingtonpost.com/clayton-m-christensen/the-white-house-office-on_b_223759.html.

109. *Id.*

110. See *supra* Part I.B.2.

The most compelling solution may be fourth-sector hybrid forms for social enterprises, which have built-in nonprofit attributes and for-profit allowances and which avail themselves to scrutiny and interpretation under the penumbra of existing legal doctrines. An ideal hybrid for the social entrepreneur would offer advantages or clarity in branding, governance, enforcement, and capital-raising. A contender for that mantle, the low-profit limited liability company, shows early promise and an equal measure of formidable challenges.

C. *Novelty and Impact of the L3C Form*

One of the newest breeds of social enterprise, the low-profit limited liability company, or L3C, attempts to overcome social entrepreneurs' perceived shortcomings of existing nonprofit and for-profit forms while preserving the most compelling aspects of each form to create a best-of-both-worlds approach. Called the "for-profit with a nonprofit soul," the L3C is essentially a for-profit business that must be driven primarily by charitable purpose.¹¹¹ The L3C differs in three key ways from existing legal structures. First, L3Cs by statute must use the distinct L3C suffix in identifying itself, which has an impact on branding.¹¹² Second, L3C statutes mandate charitable primacy by adopting, nearly *verbatim et literatim*, program-related investment (PRI) language, which stipulates that L3Cs are in existence only because of "one or more charitable or education purposes" and "[n]o significant purpose of the company is the production of income or the appreciation of property."¹¹³ Third, the hybrid legal form of the L3C purportedly allows it to attract nonprofit capital via foundation PRIs and for-profit private investor capital through a tranche investment mechanism; that is, given that most social enterprises average "low-profit" (below-market) returns, near market-rate returns may be offered to private investors if foundations will accept grant-like, near-zero-rate returns. These L3C attributes have various effects with important advantages and caveats. In the following sub-sections, we will examine some of these attributes using the convenient framework of the first L3C statutory provisions, as adopted by Vermont in 2008.

1. THE L3C BRAND

The name of a low-profit limited liability company . . . shall contain the abbreviation L3C or l3c.¹¹⁴

111. Robert Lang, *What is the L3C?*, AMS. FOR CMTY DEV., <http://www.americansforcommunitydevelopment.org/downloads/What%20is%20the%20L3C-101010.pdf> (last visited Aug. 11, 2011).

112. VT. STAT. ANN. tit. 11, §§ 3001(27), 3005(a), 3023(a) (2011).

113. *Id.* § 3001(27). Other state L3C statutes reflect the substantially similar PRI language.

114. *Id.* § 3005(a)(2).

Many social entrepreneurs believe that their fourth-sector enterprises need to be seen as entirely unique charitable and capitalistic entities, to be differentiated from nonprofits, which are perceived to be less efficient than for-profits, and to be differentiated from for-profits, which are fixated primarily on financial value. The creator of the L3C writes that “[p]robably more importantly than anything else, the L³C is a brand which signifies to the world that it puts mission before profit yet is self sustaining. As a brand it makes these concepts easy to grasp and thereby will be frequently used.”¹¹⁵ The unique L3C designation allows social enterprises to distinguish themselves by name from other legal forms (e.g., The Paradigm Project, L3C), and offers an opportunity for all social entrepreneurs to work collectively to build their own coherent and respected brands.¹¹⁶ An L3C brand puts the public on notice of the pursuit of “[b]lended value,”¹¹⁷ and signals investors to temper their expected financial returns.

2. L3C TRANSLITERATION OF PRI LANGUAGE FOR CHARITABLE AND FINANCIAL PURPOSES

A second attribute of L3Cs is their mandate on charitable primacy through the adoption of certain program-related investment (PRI) language. The Vermont L3C statutory provisions of title 11, section 3001 of the Vermont Statutes Annotated reads:

(27) “L3C” or “low-profit limited liability company” means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements:

(A) The company:

(i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(B); and

(ii) would not have been formed but for the company’s relationship to the accomplishment of charitable or educational purposes.

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

115. Lang, *supra* note 111.

116. Arguably, the similarity of the L3C moniker to the widely used LLC designation suggests the L3C’s heritage is a for-profit LLC variant, whereas the juxtaposed “3” connotes a distinctive and modern entity.

117. Jed Emerson, *The Nature of Returns: A Social Capital Markets Inquiry into Elements of Investment and the Blended Value Proposition* 30 (Harvard Bus. Sch. Soc. Enters. Series, Working Paper No. 17, 2000).

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.¹¹⁸

Before turning to the impact and interpretation of these provisions, it may be useful to give some background on PRIs, explain what PRI language was transliterated, and evaluate the appropriateness of such language as L3C statutory provisions.

a. Program-Related Investments (“PRIs”) Background

Program-related investments (“PRIs”)¹¹⁹ have been part of the U.S. law of charitable giving since the Tax Reform Act of 1969, which created a distinction between public charities and private foundations and restructured some rules surrounding them.¹²⁰ As a general rule, foundations are prohibited from making jeopardy investments.¹²¹ Jeopardy investments are investments in which the market risks overwhelm a prudent investment standard.¹²² An exception to the prohibition against foundations engaging in jeopardy investment is a PRI, which is a debt or equity investment by a private foundation in socially beneficial activities, regardless of whether the activities are performed by a nonprofit or for-profit entity.¹²³ A PRI must meet three criteria: (1) the foundation must be motivated solely by a desire to further its exempt charitable purpose;¹²⁴ (2) the production of income or the appreciation of property may not be a significant factor behind the foundation’s investment; and (3) only limited lobbying purposes, and no electioneering, may be served by the investments.¹²⁵ If the private foundation satisfies these three criteria and has in place expenditure oversight requirements of reporting or other means to monitor its investment, the foundation may invest in the socially beneficial venture with an expectation that capital will be returned at a below-market interest rate on a risk-adjusted basis, typically 1% to 4%.¹²⁶ Furthermore, the investment itself will count towards IRS requirements that foundations annually spend 5% of their

118. § 3001. Other state statutes have slight but inconsequential variations in wording.

119. I.R.C. § 4944 (2006).

120. James P. Joseph, *Program-Related Investments and You—Perfect Together?*, TAX’N EXEMPTS, Mar.–Apr. 2010, at 10.

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

122. *Id.*

123. *Id.*

124. The purposes are in § 170(c)(2)(B) of the Code (e.g. “religious, charitable, scientific, literary, or educational”).

125. Treas. Reg. § 53.4944-3(a)(1).

126. Francie Body et al., *Current Practices in Program-Related Investing*, BRODY WEISER BURNS 2, http://www.cof.org/files/Documents/Family_Foundations/Financial-Management/Current-Practices-in-PRI.pdf (last visited Aug. 18, 2011).

net worth annually.¹²⁷

Social entrepreneurs have argued that foundations are risk-averse in making PRIs, given high transaction costs and substantial financial risks.¹²⁸ Currently, PRI regulations may not appear to meet the specific needs of fourth sector enterprises, as PRIs were conceived at a time when the concept of nonprofit/for-profit hybrids did not exist and social investment was much more limited than it is today.¹²⁹ Additionally, IRS guidance on acceptable PRIs is limited and narrow.¹³⁰ A reexamination of PRI effectiveness and any subsequent changes should be done through Congress enacting new legislation or the IRS issuing rulings. In fact, L3C proponents have already petitioned Congress with a proposal for a Philanthropic Facilitation Act, which includes proposed amendments to the Internal Revenue Code and Treasury regulations thereunder to clarify and facilitate PRIs to L3Cs.¹³¹

“[O]nly one known public [revenue] ruling has been released” regarding PRIs.¹³² It involved a foundation that provided low-interest rate loans to blind persons to allow them to establish their own businesses.¹³³ “Because the foundation was created to aid blind persons to secure gainful employment, and the blind persons were unable to secure similar market loans through commercial sources, the investment was characterized as a PRI.”¹³⁴ The IRS has also “issued only one [known] private letter ruling concerning a PRI to a [LLC].”¹³⁵ In that private letter ruling, the IRS stated that a foundation investment in an LLC may qualify as a PRI, so long as the foundation could exercise its expenditure

127. See Kelley, *supra* note 17, at 356.

128. See Brewer & Rhim, *supra* note 17, at 12.

129. Kelley, *supra* note 17, at 357; see also I.R.C. § 4944 (2006).

130. Treas. Reg. § 53.4944-3(b) (providing illustrative examples of acceptable and unacceptable investments).

131. The Philanthropic Facilitation Act is coordinated through the Americans for Community Development, led by the L3C founder Bob Lang. See *Philanthropic Facilitation Act of 2010*, AMNS. FOR CMTY. DEV., <http://americansforcommunitydevelopment.org/downloads/PhilanthropicFacilitationAct2010.pdf> (last visited Aug. 21, 2011).

132. Bishop, *supra* note 18, at 261–62 (citing Rev. Rul. 78-90, 1978-1 C.B. 380).

133. Rev. Rul. 78-90, 1978-1 C.B. 380.

134. Bishop, *supra* note 18, at 261 (citing Rev. Rul. 78-90, 1978-1 C.B. 380).

135. The IRS has found a valid PRI in other private letter rulings, including I.R.S. Priv. Ltr. Rul. 2001-36-026 (Mar. 10, 2006) (investment in economic development); I.R.S. Priv. Ltr. Rul. 2000-43-050 (Oct. 27, 2000) (deposit and loan guaranty); I.R.S. Priv. Ltr. Rul. 1999-43-058 (Oct. 29, 1999) (below market-rate loan in foreign business); I.R.S. Priv. Ltr. Rul. 90-33-063 (May 24, 1990) (participation interest in a letter of credit to secure favorable bond rating); I.R.S. Priv. Ltr. Rul. 87-10-076 (Dec. 10, 1986) (investment in limited partnership that provides capital to other businesses); I.R.S. Priv. Ltr. Rul. 83-01-110 (Oct. 8, 1982) (construction loan in a blighted area); I.R.S. Priv. Ltr. Rul. 81-41-025 (July 20, 1981) (low-income housing loan); & I.R.S. Priv. Ltr. Rul. 80-30-079 (Apr. 30, 1980) (urban renewal loan).

oversight requirements to monitor the LLC's use of PRI funds.¹³⁶ Other facts of note in the case were that the foundation's purpose was congruous with the LLC's investment purpose, the foundation's rate of return was predicted to be lower than comparable market investments, and the foundation's rate and risk were the same as those of other members of the LLC.¹³⁷

b. L3C Transliteration of PRI Language

In sanctioning the use of PRIs, Congress wanted to encourage foundation investments in certain charitable activities conducted by for-profit, or rather, not exclusively nonprofit, organizations.¹³⁸ Congress, however, likely did not contemplate that, one day, an entire organizational form would spring up and tie its very existence to the PRI requirements.

One important distinction between the original PRI language¹³⁹ and the transliterated L3C statutes is a change in certain words.¹⁴⁰ Whereas Treas. Reg. § 53.4944-3(a)(1) refers to "investment," L3C statutes replaced every instance of "investment" with "company."¹⁴¹ This change means that it is not just a single investable activity that must qualify as a PRI, but rather that the L3C company, as a whole, must qualify as a PRI. In other words, the L3C as a company must further a charitable purpose and simultaneously not have the production of income or the appreciation of profit as a significant purpose. Though some critics have cited that holding the entire company to the high and conflicting standards of PRI qualification is unattainable and a fatal error

136. See I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006); see also Kleinberger & Callison, *infra* note 142; Tyler, *infra* note 142, at 121 n.18.

137. See *id.*

138. In examining the original congressional bills prior to the Tax Reform Act of 1969, the legislative intent of PRIs is minimally articulated, with Congress only recognizing that foundations should be able to invest, and not merely grant, in ways that could recoup a charitable investment that could be reshown in furtherance of the foundation's mission. The House report mentions only that the same rationale for allowing tax exemptions for donations which help charities is the same rationale that should be applied to allowing tax exemptions for jeopardizing investments to help charities, because it is preferable to allow such exemptions with penalties for imprudent investing rather than to not allow the exemptions at all. See H.R. REP. No. 91-413, at 31 (1969), reprinted in 1969 U.S.C.C.A.N. 1645, 1675. The Senate bill cautions against exemptions for investments such as warrants, futures, options, and margin purchases. See S. REP. No. 91-552, 45 (1969), reprinted in 1969 U.S.C.C.A.N. 2027, 2073; see also Bishop, *supra* note 18, at 255-56.

139. See I.R.C. § 4944 (2006); Treas. Reg. § 53.4944-3 (1972).

140. VT. STAT. ANN. tit. 11, § 3001 (2011).

141. Compare Treas. Reg. § 53.4944-3 (traditional statute using "industry," original PRI language) with VT. STAT. ANN. tit. 11, § 3001 (L3C statute that replaced "industry" with "company").

in legislative drafting,¹⁴² as we discuss in Part II, the proposed governance framework for L3Cs offers a workable solution.

A second important distinction between the original PRI language and the transliterated L3C statutes has to do with the context of the language. The original PRI language was written from the perspective of the foundation. It specifically mandated that the foundation's program-related investment significantly further the accomplishment of one or more of the foundation's charitable or educational purposes, that the foundation's PRI would not have been made but for the relationship of the PRI to the accomplishment of the foundation's charitable or educational purposes, and that no significant purpose of the foundation's PRI is the production of income or the appreciation of property. The assumption in adopting the PRI language for use in L3Cs is that when a foundation's charitable or educational aims are in sync with an invested company's aims, the invested company's aims could be inferred to be charitable or educational as well. Furthermore, the original PRI concept that an investment would not have been made but for the investment's relationship to the accomplishment of the foundation's charitable or educational purpose is not necessarily equivalent to the L3C transliterated language that the company would not have been formed but for the company's relationship to the accomplishment of the company's charitable or educational purposes. When considering context, and understanding that foundations are not relieved from either an upfront fact-intensive analysis to determine whether a PRI can be made or expenditure responsibility to monitor the investment, the transliteration is less of an easy qualification for L3Cs to meet than what some L3C proponents may suggest. Nonetheless, the transliterated language may stand on its own as an aspiration and assurance of an L3C being able to prioritize a charitable purpose and accommodate a financial purpose, though with a caveat that such state L3C statutes may neither expedite nor simplify an appropriate federal tax analysis.

c. L3C Integration of PRI Language for Charitable Purpose

L3Cs must further the accomplishment of one or more charitable or

142. Daniel S. Kleinberger & J. William Callison, *When the Law is Understood—L3C No 4* (William Mitchell C. L. Legal Stud. Res. Paper Series, Working Paper No. 2010-07, 2010), available at <http://ssrn.com/abstract=1568373> (“how is it possible to have a low profit limited liability company when no significant purpose of the company is the production of income or the appreciation of property?”). *But see* I.R.S. Priv. Ltr. Rul. 2006-10-020, *supra* note 136 (necessarily defeats the unattainability argument); *see also generally* John Tyler, *Negating the Legal Problem of Having “Two Masters”: A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 131 (2010).

educational purposes under section 170(c)(2)(B) of the Code.¹⁴³ Much like managers who have a duty of loyalty to their LLC and directors who have a duty of loyalty to their 501(c)(3) organization,¹⁴⁴ L3C managers arguably have a duty of loyalty to the L3C and its charitable purpose. Though L3C statutes make no direct reference to personal benefit or non-distribution,¹⁴⁵ the L3C manager's undivided and unselfish duty of loyalty to the enterprise necessarily subordinates one's personal interests and generally precludes misconduct associated with self-dealing, conflicts of interest, fraud, usurpation of corporate opportunity, lack of disclosure, misappropriation, and other situations where a manager may use a position of trust or confidence to further private interests.¹⁴⁶

The addition of provision (A)(ii) in the Vermont L3C statute is not only a "but for" legal phrase of art in parroting the original PRI language,¹⁴⁷ but it is also an assurance of charitable primacy; that is, that the reason for the L3C's existence is for the accomplishment of its charitable purpose. Taken together, (i) and (ii) convey a mandate for an L3C manager to prioritize the organization's charitable purpose above all other things and to consider such priority as a framework for fiduciary duties of loyalty and care.¹⁴⁸

d. L3C Integration of PRI Language for Financial Purpose

Though it is clear that L3Cs must pursue a charitable purpose, what is less clear is whether L3C statutes permit or restrict profit-seeking. According to the Vermont L3C statute, on which most of the current L3C statutes are based, L3Cs must ensure that "no significant purpose of

143. See I.R.C. § 170(c)(2)(B) (West Supp. 2010) ("organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals"). Cf. I.R.C. § 501(c)(3) (relating to exempt purposes of 501(c)(3) nonprofit organizations).

144. 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, 428 (2002) (directors of charitable, exempt organizations have fiduciary duty to organization's charitable purpose (citing Shelley A. Sackett, *Conversion of Not-For-Profit Health Care Providers: A Proposal for Federal Guidelines on Mandated Charitable Foundations*, 10 STAN. L. & POL'Y REV. 247, 250 (1999))).

145. I.R.C. § 170(c)(2)(C) ("no part of the net earnings of which inures to the benefit of any private shareholder or individual").

146. Randy J. Holland, *Delaware Directors' Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 683 (2009).

147. Treas. Reg. § 53.4944-3(a)(2)(i) (1972) ("An investment shall be considered as made primarily to accomplish one or more of the purposes described in section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.").

148. See generally Tyler, *supra* note 142.

the company is the production of income or the appreciation of property.”¹⁴⁹ Some commentators¹⁵⁰ have warned that the inclusion of such language is poor drafting in that it restricts profit-seeking by any L3C investor but is contrary to the premise of funding flexibility of an L3C, which is to use tranching and various kinds of activities, both profit-seeking and non-profit-seeking, that a normal LLC may undertake.¹⁵¹

The Vermont PRI language¹⁵² offers some relevant guidance on what “no significant purpose” means. In the context of foundations making PRIs to a certain charitable activity and profit-seeking private investors also investing in that same activity, one relevant factor would be whether the investor would likely make the investment on the same terms as the foundation.¹⁵³ If the foundation’s investment intercedes where the marketplace would not, then the foundation’s jeopardy investment would likely not qualify as having a “significant purpose” being income or capital appreciation.¹⁵⁴ Even if such an investment generated significant income or capital appreciation, that alone would not be determinative of significant purpose.¹⁵⁵

In the L3C context, if an L3C enters into a charitable line of business, it must consider whether such an opportunity is one where a competitor demanding market rates of return would easily enter. By this logic, if an L3C is focused on providing job-assistance programs for low-income residents who have been underserved by the marketplace, then it is likely that, on these facts alone, no significant purpose of the L3C would be for income or appreciation of property.¹⁵⁶ If this same

149. VT. STAT. ANN., tit. 11, § 3001 (2011).

150. See Kleinberger & Callison, *supra* note 142, at 4.

151. See Kleinberger, *supra* note 18, at 908–09.

152. Treas. Reg. § 53.4944-3(a)(2)(iii) (1972). (“In determining whether a significant purpose of an investment is the production of income or the appreciation of property, it shall be relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation. 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.”).

153. See *id.*

154. See, e.g., *id.* § 53.4944-3(b) at ex. (6). A below-market loan to a business enterprise owned by a nonprofit community development corporation that markets agricultural products of low-income farmers in a depressed rural area will qualify as a program-related investment. See also, e.g., *id.* at ex. (1) (stating that a below-market loan to a business owned by an “economically disadvantaged minority group” located in a “deteriorated urban area” will be a program-related loan when conventional lenders are unwilling or unable to provide financing.).

155. See *id.* § 53.4944-3(a)(2)(iii).

156. Cf. § 53.4944-3(b) at ex. (4) (“X is a business enterprise which is not owned by low-income persons or minority group members, but the continued operation of X is important to the economic well-being of a deteriorated urban area because X employs a substantial number of low-income persons from such area. Conventional sources of funds are unwilling or unable to provide funds to X at reasonable interest rates. Y, a private foundation, makes a loan to X at an interest

L3C becomes aware of a government stimulus program recently implemented to help underserved communities and can now generate more income, it is still likely that the L3C has no significant purpose for income or appreciation of property because the L3C would not have been formed “but for” the underserved need. If the L3C is formed because it became informed of this stimulus program, and it wanted to use the L3C form to undercut traditional for-profit competitors that now want to serve the same marketplace, then the facts are less in favor of the L3C’s significant purpose of not profiteering. Like the analysis that foundations regularly engage in when making PRIs, the analysis for “no significant purpose” is an intensively fact-based exercise fraught with potential legal hazards.

Under PRI regulations, when circumstances change, like the above L3C learning about and being able to benefit from a recent stimulus program, an investment does not automatically cease to qualify as a PRI, but a closer examination may be required.¹⁵⁷ For example, if the L3C were formed *pre factum*, its ability to profit may still qualify as “no significant purpose”; however, should significant time go by where such a stimulus program, by its perceived interminable existence, becomes a *de facto* regularly budgeted welfare service, or should the L3C prove to be an unabashed financial success, then the ability for the L3C to exist with no significant purpose as profitability becomes compromised. At that point, L3Cs, as a matter of to-be-determined policy, may be encouraged to convert to LLCs or another legal form (some L3C operating agreements foreseeably have such provisions), to divest some of their “significant purpose” activities, or, if policy makers allow and social entrepreneurs agree, to continue on such that L3Cs are not an arguably temporary and provisional legal form, but are a permanent fixture in the fourth-sector firmament.

The assumption of L3Cs as “low-profit” is understandable in its namesake designation as low-profit limited liability company, though some social entrepreneurs may consider this to be a misnomer.¹⁵⁸ The

rate below the market rate for commercial loans of comparable risk. The loan is made pursuant to a program run by Y to assist low-income persons by providing increased economic opportunities and to prevent community deterioration. No significant purpose of the loan involves the production of income or the appreciation of property. The investment significantly furthers the accomplishment of Y’s exempt activities and would not have been made but for such relationship between the loan and Y’s exempt activities. Accordingly, the loan is a program-related investment.”).

157. See *id.* § 53.4944-3(a)(3)(i) (explaining that even if there is a “critical change in circumstances” whereby the investment “ceases to be program-related,” this alone will not subject it to the tax imposed by § 4944(a)(1), as there are requirements that “the foundation (or any of its managers) has actual knowledge of such critical change in circumstances”).

158. See Tyler, *supra* note 142, at 124 n.32.

term was originally used to signal an expectation of low returns to the public and investors.¹⁵⁹ As evidenced above, however, “low-profit” also is similar to “below-market” situations, which are important factors in foundation PRI decisions. Though profit-seeking behavior on the part of L3Cs is collateral to charitable purpose, the weight that financial purpose has in an L3C, especially in the minds of its managers, is less ascertainable and fact-dependent.

e. Other Criticisms of the L3C

Returning to concerns of oversimplifying PRI qualification, Professor Daniel Kleinberger is correct that foundations must conduct a fact-intensive analysis of whether to make a PRI and must exercise expenditure responsibility to monitor their investment.¹⁶⁰ His conclusion that organizing as an L3C “does nothing to facilitate the analysis,”¹⁶¹ however, may be predicated on an assumption that an investment in an LLC with PRI language infused into its articles, organization, or operating agreement is the same as an investment in an L3C with PRI language infused into its governing L3C statute. Under LLC law, the contract or operating agreement is king¹⁶² (the articles are usually a single page of state-required elements of registered agency and declared lawful purpose), with the statute as the gap-filler.¹⁶³ An L3C statute, on the other hand, imposes inviolate principles of adherence to PRI’s charitable purpose primacy for which abandonment results in an “immediate” cessation of the company as an L3C, though the company can continue to exist as an LLC.¹⁶⁴ Here, the L3C statute is not a mere gap-filler, and this cessation provision cannot be circumvented by modification of the

159. Robert M. Lang, Jr., *The L3C: The New Way to Organize Socially Responsible and Mission Driven Organizations*, 36 A.L.I.-A.B.A. 251, 4 (2007).

160. See Kleinberger, *supra* note 18, at 890–91; Tyler, *supra* note 142, at 120 n.8. See also Treas. Reg. § 53-49441(a)(2)(i) (1973) (when determining whether an investment has “jeopardize[d] the carrying out of the exempt purposes of a foundation,” it is necessary to consider whether “the foundation managers . . . have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment”).

161. Kleinberger, *supra* note 18, at 899.

162. See R.U.L.L.C.A. § 102 (2006). The operating agreement is the essential contract that governs the affairs of a limited liability company.

163. LARRY E. RIBSTEIN & JEFFREY M. LIPSHAW, UNINCORPORATED BUS. ENTITIES 826 (4th ed. 2009).

164. VT. STAT. ANN. tit. 11, ch. 21, §§ 3001(27), 3005(a), 3023(a) (2010). The Vermont L3C statute, like all other L3C statutes, states that, “If a company that met the definition of this subdivision [PRI requirements of charitable purpose, no significant purpose is income or asset appreciation, no electioneering or lobbying] at its formation at any time ceases to satisfy any one of the requirements, it shall immediately cease to be a low-profit limited liability company, but by continuing to meet all the other requirements of this chapter, will continue to exist as a limited liability company.” The mechanism and enforcement of a forced conversion from an L3C immediately to a LLC is unclear and potentially problematic.

L3C articles, organization, or operating agreement. Though the L3C is an LLC variant, it differs in this subtle but crucial way: an L3C may not abandon its devotion to PRI without sacrificing its very existence as a legal entity. The tax risk to a foundation is consequently reduced if pre-scient drafting of the foundation-L3C agreement includes a stop-loss provision or other reinvestment options upon an L3C cessation.¹⁶⁵

The inclusion of mandatory and mirrored PRI language in L3C statutes that requires charitable primacy and subordinates income generation is also likely to reinforce clear branding and public trust in L3Cs, as well as set investor expectations on social and financial returns.¹⁶⁶ L3Cs may also support tranching investments as described in Part II.A., though further analysis of this mechanism requires a detailed tax analysis outside of the scope of this article.¹⁶⁷

The dual charitable and financial purposes of L3Cs invite an apparent conflict of fiduciary duties.¹⁶⁸ In general, hybrid legal forms with multiple bottom lines may, at first glance, seem to be innately beset with conflicting priorities for various stakeholders. Leaders in these organizations may be unclear about how to prioritize and decide among competing mission and economic interests and about what their duties and resulting liabilities are to various stakeholders. Investors may not be sure about how to measure returns that are a mix of quantitative financial results and qualitative social outputs. Creditors may not comprehend to what standards of behavior they can hold a mixed-motive organization or even what their recourse is in collecting on assets potentially dangled or locked into the charitable stream. Policymakers and politicians are likely inspired by the public appeal of capitalistic vehicles that promote charitable purposes with a likely reduced burden to government social services, but they understand that for all good intentions, the devil is in the details.

These are some of the questions that arise when we are asked to examine organizational forms, which must function at the convergence

165. As a personal observation, L3Cs are arguably more akin to nonprofit LLCs than for-profit LLCs, which is a further area of exploration that this article will not address. Many LLC statutes now no longer require or assume LLCs to be for-profit. R.U.L.L.C.A. § 104(b) (2006) (“A limited liability company may have any lawful purpose, regardless of whether for profit.”). The risk of improper L3C-to-LLC conversions may also be addressed through the operating agreement, where veto power may be given to each member or to someone who is not a member. *See, e.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 112(a) (2006) (“An operating agreement may specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition. An amendment is ineffective if its adoption does not include the required approval or satisfy the specified condition.”).

166. *See* Bromberger, *supra* note 27, at 9–10.

167. For an in-depth analysis of tranching and its benefits, *see generally* Brewer & Rhim, *supra* note 17.

168. *See also* Tyler, *supra* note 142, at 118.

of the government, business, and nonprofit sectors. Each of the above parties' expectations and accountabilities require a more thorough analysis, but the central character of interest here is the social entrepreneur who leads the organization. An understanding of his or her fiduciary duties and suggested decision-making approach will be crucial in determining whether L3Cs will be able to mature and take flight or whether such promising innovations will be relegated to further incubation.

Professor Kleinberger, a vocal critic of the L3C form, cautions that the proposed simplicity of the L3C brand belies the regulatory complexity and risk of investing in an entity which is not yet tested in the courts and not yet recognized by the IRS.¹⁶⁹ Particular concern may be that the mirrored inclusion of PRI language in L3C statutes, articles of organization, and operating agreements, as well as in private placement memos, side letters, and purchase agreements,¹⁷⁰ may lull all parties into assuming L3Cs automatically qualify for PRIs when, as contended, making PRIs in L3Cs is currently no different than making PRIs in LLCs.¹⁷¹

II. GOVERNANCE AND ENFORCEMENT IN L3CS

A. *Fiduciary Duties in For-Profit Entities*

Directors of for-profit corporations owe "duties of care and loyalty to the corporation and its shareholders."¹⁷² Under Delaware law, which often cues the market for corporate law, the directors' conduct is measured against a gross negligence standard in duty of care cases.¹⁷³ Duty

169. See Kleinberger, *supra* note 18, at 879 ("The L3C is not on track (let alone a fast track) to any special status under the Code"); see also Bishop, *supra* note 18, at 266 ("At this writing, no federal tax authority has been forthcoming to bless the L3C-PRI concept broadly. Therefore, the PRI determination must continue to be made on a case-by-case basis.").

170. Chernoff, *supra* note 18, at 3, 4.

171. Marcus Owens & Sharon Nokes, RESPONSE TO QUESTIONS POSED IN NASCO'S LETTER DATED MARCH 19, 2009, 3 (Apr. 17, 2009), available at <http://americansforcommunitydevelopment.org/downloads/NASCO.pdf> (claiming that "most, if not virtually all, L3Cs will be structured to qualify as recipients of PRIs, with both taxable and tax-exempt ownership interests.").

172. *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1988) (Under well-established Delaware law, "directors owe fiduciary duties of care and loyalty to the corporation and its shareholders." (citing *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939))).

173. See *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 64 (Del. 2006) ("The second category of conduct . . . involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent."); see also STEPHEN M. BAINBRIDGE, *CORPORATE LAW* 125–26 (2d ed. 2009) (stating that "several jurisdictions adopt ordinary negligence as the relevant standard in duty of care cases" but that Delaware, where the majority of the large U.S. companies are incorporated, and various other states opt for a gross negligence standard. Bainbridge also notes the paucity of cases "imposing liability on directors for negligence in the absence of a concurrent breach of the duty of loyalty or other conflict of

of care claims against directors may include claims for oversight in managing the affairs of the corporation.¹⁷⁴ Under the companion and more potent duty of loyalty, directors are “not permitted to use their position of trust and confidence to further their private interests” and must also act in good faith.¹⁷⁵ Commentators disagree on whether directors of for-profit corporations should focus on the “corporation” or the “shareholders” in carrying out their fiduciary duties.¹⁷⁶ As a practical matter, however, the business judgment rule and exculpatory provisions enabled by statutory provisions—like Delaware General Corporation Law § 102(b)(7)—protect the vast majority of directorial decisions, as long as those decisions can be rationally described as potentially benefiting the corporation and ultimately increasing shareholder wealth.¹⁷⁷ Managers of limited liability companies owe similar fiduciary duties to their members, unless those duties are altered, within the bounds of the law,

interest.”) (citations omitted); see generally 1 R. FRANKLIN BALOTTI & JESSE A. FINKLESTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 4.15, at 4-100 (3d ed. Supp. 2010).

174. See BAINBRIDGE, *supra* note 173, at 130–31; see generally *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

175. *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 750–51 (Del. Ch. 2005) (citing *Guth*, 5 A.2d at 510); *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (“[T]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.”); see also *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) (“Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders”) (citation omitted); see also Holland, *supra* note 146, at 676 (“loyalty is now the central theme in the Delaware judiciary’s stories or opinions about the fiduciary duties of directors.”); see generally BALOTTI & FINKELSTEIN, *supra* note 173; 1 STEPHEN A. RADIN, *THE BUSINESS JUDGMENT RULE* 787–94 (6th ed. 2009).

176. Compare Ronald M. Green, *Shareholders as Stakeholders: Changing Metaphors of Corporate Governance*, 50 WASH. & LEE L. REV. 1409, 1419 (1993) (arguing that directors’ abilities to make decisions in favor of “constituencies cannot readily be justified in terms of long-term shareholder gain.”) with Stephen M. Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green*, 50 WASH. & LEE L. REV. 1423, 1446–47 (1993) (arguing that “the basic rule that shareholder interests come first has governed public corporations” and should continue to do so.) (footnotes omitted).

177. Most directorial decisions are protected by the business judgment rule and often also by exculpatory charter provisions enabled by statutory provisions like Delaware General Corporate Law section 102(b)(7). Under the business judgment rule, “[d]irectors are entitled to a presumption that they were faithful to their fiduciary duties.” *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004) (citations omitted); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 95 (2004) (“[T]he whole point of the business judgment rule is to prevent courts from even asking the question: did the board breach its duty of care?”). Delaware General Corporation Law section 102(b)(7) authorizes corporations to include provisions in their certificates of incorporation that protect “directors from personal monetary liability for breaches of the duty of care.” *In re NYMEX S’holder Litig.*, C.A. Nos. 3621-VCN, 3835-VCN, 2009 WL 3206051, at *6 (Del. Ch. Sept. 30, 2009).

in the company's operating agreement.¹⁷⁸

Academics debate whether the law guides directors to pursue shareholder wealth maximization (primarily or exclusively), or, more generally, advises directors to seek the health and welfare of the corporation as a whole.¹⁷⁹ Traditionally, the law has tasked directors of for-profit companies primarily with maximizing shareholder wealth.¹⁸⁰ The business judgment rule and various constituency statutes, however, provide directors with wide latitude in how they go about attempting to achieve this end.¹⁸¹ Directors of for-profit companies are generally free to cause their corporation to engage in charitable actions, or actions that benefit

178. See, e.g., *Bay Ctr. Apartments Owner, LLC v. Emery Bay P.K.I., C.A. No. 3658-VCS, 2009 WL 1124451, at *8* (Del. Ch. Apr. 20, 2009) (“in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC.”) (citation and footnotes omitted); see generally LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* 165–78 (2010).

179. Compare Bainbridge, *supra* note 176, at 1423 (“Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers”) and KENT GREENFIELD, *THE FAILURE OF CORPORATE LAW: FUNDAMENTAL FLAWS AND PROGRESSIVE POSSIBILITIES* 41–42 (2006) (arguing that “[t]here is no principle of corporate law that is more central to the way businesses are organized and regulated within the United States” than that of shareholder wealth maximization) with Lynn A. Stout, *Why We Should Stop Teaching Dodge v. Ford*, in *THE ICONIC CASES IN CORPORATE LAW* 1, 5 (2008) (“shareholder wealth maximization is not a modern legal principle”) and Judd F. Sneirson, *Green is Good: Sustainability, Profitability, and a New Paradigm for Corporate Governance*, 94 *IOWA L. REV.* 987, 1007 (2009) (“In sum, corporate law contains no general requirement that directors and officers maximize shareholder profits and only departs from this view in rare instances that should not affect most green business decisions.” (citing *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989))).

180. *Dodge v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (“A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.”); see also Bainbridge, *supra* note 176, at 1423; Fairfax, *supra* note 144, at 430–34 (noting that there was a traditional notion that directors have a duty to maximize shareholder wealth, and discussing the ongoing debate regarding how much focus directors should place on shareholder wealth maximization).

181. See *supra* note 177. Constituent statutes generally authorize directors “to consider the effect of their actions on nonshareholder groups such as employees, creditors, bondholders, suppliers, and communities.” JAMES D. COX & THOMAS LEE HAZEN, *CORPORATIONS* § 4.05 (2d. ed. 2003). Over one-half of states have enacted some type of constituent statute. *Id.* Accord Virginia Harper Ho, “*Enlightened Shareholder Value*”: *Corporate Governance Beyond the Shareholder-Stakeholder Divide*, 36 *J. CORP. L.* 59, 75 (2010); see also Tyler, *supra* note 142, at 131 (stating that thirty-one states have constituency statutes of some variant); see also Green, *supra* note 176, at 1411–12 (constituency statutes generally “permit directors, while acting in the best interests of the corporation, to take into account a variety of constituencies other than shareholders, including employees, communities, customers, and suppliers. Because these statutes, with few exceptions, specify that the impact on other constituencies *must have a relationship to the best interests of the corporation, understood in terms of shareholder gain*, they represent little more than codifications of the business judgment rule as it has recently been interpreted by the Delaware courts.”) (second emphasis added) (citation omitted).

non-shareholder stakeholders such as the community or employees.¹⁸² In the for-profit context, courts are often careful to point out that actions taken on behalf of non-shareholder constituencies in the short term could lead to shareholder profits in the long term.¹⁸³ With a long-term outlook, almost any action on behalf of non-shareholder constituency *could* lead to an increase in shareholder wealth.¹⁸⁴ Charitable donations or raising employee pay, for example, could increase goodwill, and at some later point in time, increase profits.¹⁸⁵ In fact, for-profit corporations increasingly are marketing their philanthropic actions to the public.¹⁸⁶

As discussed above and due to business judgment rule protection, directors of for-profit corporations, as a practical matter, are unlikely to face liability for taking actions that favor non-shareholder constituents, so long as those actions involve no conflicts of interest.¹⁸⁷ When a sale

182. See, e.g., DEL. CODE ANN. tit. 8, §122(9) (West 2011), which explicitly states that for-profit corporations have the power to “[m]ake donations for the public welfare or for charitable, scientific or educational purposes, and in time of war or other national emergency in aid thereof”); see also *A. P. Smith Mfg. Co. v. Barlow*, 98 A.2d 581, 590 (N.J. 1953) (rejecting shareholders’ challenge to a corporate donation made to a local university); accord *Theodora Holding Corp. v. Henderson*, 257 A.2d 398, 405–06 (Del. Ch. 1969); Fairfax, *supra* note 144, at 414 (“[T]he current status of the for-profit director’s duties reveals that the social entity model of the corporation governs most of a director’s decision-making. This means that corporate law allows directors of post-conversion companies to take actions that advance the interests of their beneficiaries, even when those actions fail to generate the maximum level of shareholder profit.”).

183. *A. P. Smith*, 98 A.2d at 590 (stating that a corporate donation to Princeton University “was made to a preeminent institution of higher learning, was modest in amount and well within the limitations imposed by the statutory enactments, and was voluntarily made in the reasonable belief that it would aid the public welfare *and advance the interests of the plaintiff as a private corporation* and as part of the community in which it operates.”) (emphasis added); *Theodora Holding Corp.*, 257 A.2d at 405 (noting the “relatively small loss of immediate income otherwise payable to plaintiff and the corporate defendant’s other stockholders, had it not been for the gift in question . . . [and the benefit to the] plaintiff in the long run.”).

184. See Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 ALA. L. REV. 1385, 1425 (2008) (noting “the board’s substantial de facto discretion to deviate from shareholder wealth maximization in the day-to-day business of the corporation under the business judgment rule, so long as some plausible long-term benefit to the shareholders can be articulated.”).

185. See Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U. L. REV. 733, 835–36 (stating that “corporate donations do have considerable efficiency and tax advantages. The efficiency advantage is that even profit-sacrificing corporate donations will have some goodwill effect that reduces the net outlay.”).

186. See Usha Rodrigues, *Entity and Identity*, 60 EMORY L.J. 1257, 1259 (2011) (discussing the marketing of their philanthropic actions by Starbucks and Whole Foods, among other for-profit companies); Barbara Stark, *Theories of Poverty/The Poverty of Theory*, 2009 BYU L. REV. 381, 429 n.248 (2009) (stating that cause marketing “has been criticized by some activists who claim that the primary beneficiaries are businesses. . . . [For example,] Red companies collectively spent as much as \$100 million in advertising and raised only \$18 million”) (citations and internal quotations omitted).

187. See *supra* note 177; see also Page & Katz, *supra* note 62, at 232 (stating that “[a]lthough it is fair to claim that there is a norm, and possibly even a legal requirement, of shareholder wealth maximization (i.e. that directors must make decisions in order to maximize corporate

of a company is inevitable, however, the law increases its scrutiny of directorial actions and courts more strongly steer directors of for-profit corporations towards shareholder wealth maximization.¹⁸⁸ In the cases involving Ben & Jerry's and craigslist, discussed above, the founders of the companies at issue appeared dedicated to the social mission of their respective companies but were waylaid in their efforts to preserve strict adherence to the mission by the threat of, or actual force of, for-profit corporate law.¹⁸⁹

B. *Fiduciary Duties in Nonprofit Entities*

Similar to their for-profit counterparts, directors of nonprofit boards owe duties of loyalty and care in carrying out their responsibilities.¹⁹⁰ Unlike for-profit companies, however, the primary focus of the nonprofit form is not wealth creation but rather charitable purpose.¹⁹¹ In some jurisdictions this requisite focus on charitable purposes is embodied in the "duty of obedience."¹⁹² The duty of obedience does not have a counterpart in the law governing for-profit organizations and has been said to be "key to holding directors legally accountable to their organization's charitable purpose and to donors' legitimate expectations."¹⁹³ There is some debate over whether the duty of obedience "actually exists as a separate duty, or whether it is best described as an element of

profitability), commentators on both the right and left recognize that shareholder wealth maximization is effectively unenforceable by courts.") (citations omitted); *Shlensky v. Wrigley*, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (the court famously deferred to the directors of the Chicago Cubs in their decision to not install lights in the baseball stadium. The court stated that "it appears to us that the effect on the surrounding neighborhood might well be considered by a director who was considering the patrons who would or would not attend the games if the park were in a poor neighborhood. Furthermore, the long run interest of the corporation in its property value at Wrigley Field might demand all efforts to keep the neighborhood from deteriorating. By these thoughts we do not mean to say that we have decided that the decision of the directors was a correct one. That is beyond our jurisdiction and ability. We are merely saying that the decision is one properly before directors and the motives alleged in the amended complaint showed no fraud, illegality or conflict of interest in their making of that decision.").

188. Sneirson, *supra* note 179, at 1007. ("In *Revlon* situations, since there will be little left of the company following its sale, it is perfectly sensible and consistent with the principles described earlier in this Section to require boards to focus exclusively on shareholders.") (citation omitted).

189. *See supra*, Part I.B.2.

190. *See, e.g.*, Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 632 (1998) ("Nonprofit directors and officers generally operate under the same legal standards under state law in terms of managerial obligations and the duties of loyalty and care as their for-profit peers.").

191. *Developments in the Law-Nonprofit Corporations*, 105 HARV. L. REV. 1581, 1582 (1992) (in the nonprofit world, the "non-distribution constraint prevents the organization from distributing its net earnings to those in control of the corporation").

192. DANIEL L. KURTZ, *BOARD LIABILITY: GUIDE FOR NONPROFIT DIRECTORS* 84-90 (1988).

193. Jeremy Benjamin, Note, *Reinvigorating Nonprofit Directors' Duty of Obedience*, 30 CARDOZO L. REV. 1677, 1679-80 (2009).

the duty of loyalty and the duty of care as applied to [nonprofit] organizations.”¹⁹⁴ The duty of obedience is a rather “nebulous” duty to carry out the mission of the organization and has been described as “essentially prohibit[ing] directors from ‘deviat[ing] in any substantial way from their duty to fulfill the particular purpose for which the organization was created,’ unless, the particular deviation is permitted by law.”¹⁹⁵

Fiduciary duty law tasks directors of nonprofits with furthering the charitable purpose of the organization. Fiduciary duty law does not, however, focus on holding nonprofit directors directly accountable to donors.¹⁹⁶ Generally, the law provides that the fiduciary duties owed to nonprofits may only be enforced by directors and officers of that organization, members (if any exist), the state Attorney General, and persons with a special interest.¹⁹⁷ Most nonprofits do not have members, and directors and officers are often hesitant to bring suit against one another, which leaves only the state Attorney General responsible.¹⁹⁸ The state Attorney General’s office is already stretched thin and does not have the same vested interest in ensuring the proper management of an organization as do shareholders or members in a for-profit company.¹⁹⁹ As a

194. Jill S. Manny, *Governance Issues for Nonprofit Religious Organizations*, 40 CATH. LAW. 1, 20 (2000).

195. *Id.* (quoting JAMES J. FISHMAN & STEPHEN SCHWARZ, *NONPROFIT ORGANIZATIONS* 228 (1995); see also *In re Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 186 Misc.2d 126, 152 (N.Y. Sup. Ct. 1999) (“It is axiomatic that the board of directors is charged with the duty to ensure that the mission of the charitable corporation is carried out. This duty has been referred to as the ‘duty of obedience.’ It requires the director of a not-for-profit corporation to ‘be faithful to the purposes and goals of the organization,’ since ‘[u]nlike business corporations, whose ultimate objective is to make money, nonprofit corporations are defined by their specific objectives: perpetuation of particular activities are central to the *raison d’être* of the organization.’”) (citations and internal quotations omitted).

196. Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Forms*, 40 N.Y.L. SCH. L. REV. 457, 465 (1996) (“[I]n most nonprofits there is no clear category of principals. Under law, the nonprofit firm is not the agent of a particular donor or client or beneficiary. As a result, most state nonprofit laws, perhaps without intending to, create agents without principals.”).

197. See KURTZ, *supra* note 192, at 92–93.

198. Benjamin, *supra* note 193, at 1697–98 (stating that “[i]f the trustees breach their duties, any individual’s allegation of injury is too abstract to convey standing. The state Attorney General (‘AG’), as the representative of the public interest, has standing to sue in such cases.”) (citations omitted); see also KURTZ, *supra* note 192, at 93–96.

199. Benjamin, *supra* note 193, at 1698–99; James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218, 262 (2003) (“Staffing problems and a relative lack of interest in monitoring nonprofits make attorney general oversight more theoretical than deterrent.”); Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1406 (1998) (“We might expect close regulation of charities, but this is not the case. The state attorney general enjoys nearly exclusive authority and discretion to challenge a charity manager’s actions. Such a structure puts pressure, as the Delaware Attorney General once complained, on ‘the inclination and budget of a public official to vindicate [the beneficiaries’] rights.’”) (citation omitted).

result of the limited standing, there is a dearth of fiduciary duty cases in the nonprofit arena.²⁰⁰ The proffered reasons for not expanding standing include: (1) preventing the destruction of many nonprofits which are already on tight budgets and could not withstand the increase in lawsuits; (2) avoiding second guessing of directorial decisions by those unfamiliar with the given nonprofit or by those promoting a personal agenda; and (3) deterring individuals, many of whom currently volunteer their services, from serving on nonprofit boards.²⁰¹ While there may be valid reasons for not increasing standing in nonprofit fiduciary duty cases, there is “wide agreement that the current scheme does not provide effective oversight” of nonprofit director or manager conduct.²⁰²

C. Proposed Fiduciary Duty Framework for L3Cs

“[A] manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither.”²⁰³ L3Cs, as hybrid entities, were created to serve, at least to some extent, both the profit master and the charitable master. A number of early commentators have noted this “two masters problem,” which plagues social enterprise or hybrid organizations.²⁰⁴ This section submits that charitable purpose must be the primary focus of L3Cs, notes the implications if L3C managers stray from the charitable purpose focus,

200. See Thomas L. Greaney & Kathleen M. Boozang, *Mission, Margin, and Trust in the Nonprofit Health Care Enterprise*, 5 YALE J. HEALTH POL'Y L. & ETHICS 1, 37 (2005) (“The efficacy of fiduciary principles [in the nonprofit context] is further hampered by the scarcity of precedents. Only a handful of cases address the duties of care and loyalty; mention of the duty of obedience is even rarer. This is in part due to state law limiting standing to challenge breaches of the fiduciary duties to attorneys general, members, and directors.”); see generally Fishman, *supra* note 199, at 256–61.

201. Benjamin, *supra* note 193, at 1698.

202. *Id.* (citing Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 640 (1998); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 608 (1981); Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 437 (1960); Rob Atkinson, *The Low Road to Cy Pres Reform: Principled Practice to Remove Dead Hand Control of Charitable Assets*, 58 CASE W. RES. L. REV. 97, 143–45 (2007)); see also Fishman, *supra* note 199, at 262–63.

203. FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 38 (1991). See also Tyler, *supra* note 142, at 138, 141–43.

204. See, e.g., Tyler, *supra* note 142, at 117–18 (noting the “arguably conflicting, dual purposes” of L3Cs and other hybrid business forms such as B-Corporations, and the need for “predictability and consistency”); Linda O. Smiddy, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship*, 35 VT. L. REV. 3, 7 (2010) (“The governance structure of a social enterprise is complicated regardless whether new or existing forms are used. At its simplest level, the fundamental question of social enterprise governance is how does management balance the company’s profit-making endeavors with furthering company social objectives when the two conflict or when furthering one may impede progress toward the other? The biblical admonition against serving two masters could have been written with social enterprises in mind.”).

and proposes an enforcement scheme that resembles that of for-profit companies, with fiduciary duties enforced primarily by the owners of the entity.

1. PROPER ORDERING: CHARITABLE PURPOSE AT THE HELM

Managers and directors can serve only one *ultimate* master, but that does not mean L3Cs are doomed to fail or be redundant of other business forms.²⁰⁵ The PRI requirements built into the L3C statute mandate that the L3C's *ultimate* master be "charitable purpose."²⁰⁶ The L3C's primary master is, and must be, markedly different than the primary master of corporations, shareholder wealth maximization.²⁰⁷ Just as the law allows corporations to engage in a wide range of charitable activity, however, L3Cs should be allowed to engage in profit-making activity.²⁰⁸ L3C managers should merely make their decisions regarding the organization with their primary focus on "charitable purpose." In for-profit entities, certain actions, such as giving employees a raise or making a charitable donation, may lessen profitability in the short term, but arguably will lead to greater profits in the long term.²⁰⁹ Similarly, L3Cs should be allowed to pursue profit on the rationale that doing so will ensure the viability of their company and allow them to better raise capital in the future. This profitability should not be pursued for the ultimate sake of profit by the managers of the L3Cs, but for the ultimate sake of the longevity and vitality of the "charitable purpose." When the profit master and the charitable purpose master irreconcilably conflict in the operation of an L3C, however, the charitable purpose master must rule.

2. IMPLICATIONS OF LOSING A CHARITABLE PURPOSE FOCUS

If managers of L3Cs take their eyes off of the charitable purpose goal, the IRS will be more likely to disallow PRI investments because the IRS intends PRI investments to be focused on a charitable purpose. The IRS has yet to rule on whether it will assume L3Cs to be appropriate vehicles for PRIs, but the IRS would likely look less favorably on L3Cs if L3Cs are seen either as entities focused on profits or even entities with an equal focus on profits and charitable purpose.²¹⁰ To survive, L3Cs

205. See EASTERBROOK & FISCHER, *supra* note 203.

206. See *supra* Part I.C.2; see also Tyler, *supra* note 142, at 143 ("There is but one master in the L3C—charitable, exempt purposes.").

207. See *supra* Part II.A.

208. *Id.* (discussing the various charitable activities in which for-profit corporations may, and do, engage).

209. *Id.*

210. Minnigh, *supra* note 15, at 209 ("Because the IRS has not explicitly ruled on whether L3Cs qualify as [recipients of] PRIs, a private foundation's investment in the L3C could be considered a jeopardy investment under § 4944 and a 10% excise tax would be imposed on both

must be seen as focusing on charitable purpose, and not as entities that use cheap foundation funding to cater to their “market-rate” investor needs. The proper ordering, with charitable purpose at the helm, must be clear and legally enforceable.²¹¹

D. *Enforcement of L3C Fiduciary Duties*

As discussed above, “charitable purpose” must be the L3C’s primary objective.²¹² As such, the substance of the fiduciary duties imposed on managers of L3Cs should most closely resemble those of a nonprofit. The *enforcement* of those duties, however, should, in our opinion, resemble the for-profit model. The state Attorney General’s office is overworked, underfunded, and under incentivized to keep nonprofits accountable.²¹³ Similarly, with L3Cs, the state Attorney General’s office will likely have neither fully adequate resources nor the driving personal motivation of an owner to curb fiduciary duty violations.²¹⁴ On the other hand, members of the L3Cs will be much more likely to have both the resources and strong personal motivation to better prevent managerial abuse.²¹⁵

As discussed in Part III, however, members with a *primary* profit motive should be discouraged from investing in L3Cs in the first place.²¹⁶ Investors who are profit-focused could initiate expensive litigation that would drain L3Cs dry when the L3C does not pursue profit as aggressively as the profit-focused investor prefers. While the law should direct L3C managers to primarily pursue charitable purpose and allow members to sue to enforce the managers’ fiduciary duties, the law should also provide business judgment rule protection to L3C managers for the same reasons that protection is afforded to directors of for-profit corporations.²¹⁷

the private foundations and its managers. Moreover, under § 4942 if the investment were intended as a qualifying distribution then there could also be an excise tax of 30% on the amount distributed to the L³C.”).

211. Tyler, *supra* note 142, at 143 (“There is but one master in the L3C—charitable, exempt purposes.”).

212. *See supra* Part II.C.1.

213. *See supra* note 187; *see* Tyler, *supra* note 142, at 154, 156–57.

214. *See supra* Part II.B.

215. *Cf. Smithers v. St. Luke’s-Roosevelt Hosp. Ctr.*, 723 N.Y.S.2d 426, 434 (N.Y. App. Div. 2001) (stating, in the nonprofit context, that “[t]he donor of a charitable gift is in a better position than the Attorney General to be vigilant and, if he or she is so inclined, to enforce his or her own intent.”).

216. *See infra* Part III.

217. *See, e.g., J. Haskell Murray, “Latchkey Corporations”: Fiduciary Duties in Wholly Owned, Financially Troubled Subsidiaries*, 36 DEL. J. CORP. L. (forthcoming Sept. 2011) (“Courts employ the business judgment rule because: (1) it encourages board service; (2) it encourages risk taking; (3) courts recognize that directors are generally better situated to make business decisions

III. SOCIAL ENTERPRISE CAPITAL PUZZLES AND PROPOSED SOLUTIONS

A. *Hesitance of Traditional Investors and the Model Investor for the L3C*

Traditional early-stage investors,²¹⁸ such as your average venture capitalist, are currently confused by the L3C form.²¹⁹ When traditional investors learn that “charitable purpose” is king for the L3C, most are likely to run in the other direction.²²⁰ Even more socially-conscious investors, who embrace the “doing well by doing good” mantra, may hesitate to invest if they recognize that the managers have a clear fiduciary ordering, and where profit is merely a possible byproduct, rather than the ultimate objective.²²¹ L3Cs may in fact “do well by doing good,” but again, the ultimate purpose must be “doing good.”²²²

The model investor for an L3C would have priorities that match the priorities engrained in the L3C form. Thus, the model L3C investor must

than judges; (4) courts recognize the statutory regime provides responsibility for managing the corporation to directors, not shareholders; and (5) courts recognize that unhappy shareholders can always vote the directors out of office.”) (citations and internal quotations omitted). This rationale also largely applies to L3Cs and suggests that courts should give broad business-judgment rule protection to L3C managers.

218. In this article, the phrase “traditional investors” refers, generally, to investors who focus primarily on profit and have at least millions, if not billions, of dollars in capital at their disposal.

219. Elizabeth Schmidt, *Vermont’s Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VT. L. REV. 163, 177 (2010) (“the L3C business form has actually confused some [of the companies’] funders and customers.”).

220. See, e.g., Kelley, *supra* note 17, at 354 (“[V]enture capitalist and institutional investors such as pension funds . . . do not line up neatly with the needs of hybrid social enterprises. Those investors typically expect market rates of return, which hybrid, multiple-bottom-line organizations are rarely in a position to offer.”) (citing Victor Fleischer, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 95 (2007)); see also Dana Brakman Reiser, *Blended Enterprise and the Dual Mission Dilemma*, 35 VT. L. REV. 105, 111 (2010) (expressing doubt that an L3C will be able to attract market-rate investors if it “allocates complete or dominant control to foundations or socially-responsible investors.”); Bishop, *supra* note 18, at 243 (“Capital formation is particularly difficult. To attract capital from the business world, the L3C must offer market risks and returns, a difficult task for a hybrid social entity.”); see also Kleinberger, *supra* note 18, at 908–09 (arguing that market-rate investors will not be comfortable with the contradiction between the L3C’s statutory language which says that “no significant purpose of the company is the production of income” and statements by L3C proponents that tranching investing in an L3C will yield a “particularly favorable equity investment.”) (citations and internal quotations omitted). We agree with Professor Kleinberger that the “no significant purpose of the [L3C] is the production of income” language is troubling and should be revisited.

221. See Kelley, *supra* note 17, at 359 (“[A]lthough some SRI [Socially Responsible Investment] funds may be willing to accept marginally lower financial returns in exchange for a demonstrated social benefit, many will not.”) (citing Michael S. Knoll, *Ethical Screening in Modern Financial Markets: The Conflicting Claims Underlying Socially Responsible Investment*, 57 BUS. LAW. 681, 689 (2002)).

222. See *supra* Part II.C.1.

be *primarily* interested in the “return” produced by being involved in a charitably focused venture. Some have called this “return” a “warm glow.”²²³ Secondly, and permissibly, in certain cases, investors in an L3C *may* expect a profit, but this expectation of profit may lead to security law complications described in the following section.²²⁴

B. *The Securities Law Minefield*

The definition of “security” under U.S. securities laws is extremely broad.²²⁵ The Securities Act of 1933’s definition of “security” includes any “investment contract.”²²⁶ In the seminal case of *S.E.C. v. W. J. Howe Co.*, the U.S. Supreme Court stated that an “investment contract,” in the context of the securities laws, means “a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party.”²²⁷ Over fifty years later, in *S.E.C. v. Edwards*,²²⁸ the U.S. Supreme Court clarified that a transaction that promises fixed returns also falls within the definition of “investment contract,” alongside a transaction that promises variable returns.²²⁹ Typically, “the ‘investment contract’ analysis applies to determine whether a membership interest in an LLC [and presumably also membership in an L3C] is

223. *See, e.g.*, Rodrigues, *supra* note 186, at 2 (“Economists call ‘warm glow’ the utility one derives from giving.”).

224. Professor Kleinberger correctly notes that profit-making cannot be a *significant* purpose of the L3C, but this limitation does not prevent L3Cs from making money nor does it totally bar investors from being allowed to expect some return. *See* Kleinberger, *supra* note 18, at 908–09; *see also* Tyler, *supra* note 142, at 124 n.32.

225. *See, e.g.*, *Marine Bank v. Weaver*, 455 U.S. 551, 555–56 (1982) (“The definition of ‘security’ in the Securities Exchange Act of 1934 is quite broad. . . . [T]he term ‘security’ was meant to include ‘the many types of instruments that in our commercial world fall within the ordinary concept of a security.’”) (citations and internal quotations omitted).

226. 15 U.S.C.A. § 77b(a)(1) (2006). The law states that “[t]he term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, *investment contract*, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.” (emphasis added).

227. 328 U.S. 293, 298–99 (1946).

228. 540 U.S. 389 (2004).

229. *Id.* at 394. (“There is no reason to distinguish between promises of fixed returns and promises of variable returns for purposes of the test [for “investment contract” as defined by the securities law], so understood. In both cases, the investing public is attracted by representations of investment income”).

a security.”²³⁰ The analysis is “complex, but essentially turns on whether a person is investing in a common enterprise with the expectation of profits to be made chiefly through the efforts of others.”²³¹

The combination of federal and state securities laws in the United States are notoriously difficult to navigate.²³² The securities laws are traps for the unwary and can add significant costs to the capital-raising process. Due to the significant costs involved in registering a securities offering, much effort is often expended attempting to find a way to fall within one of the accepted exceptions to the registration requirements.²³³ The federal securities laws provide certain exceptions to the registration requirements for securities offered to “accredited investors.”²³⁴ For the purposes of federal securities law, “accredited investors” includes, *inter alia*: (1) persons with a net worth (with or without spouse) of over \$1 million at the time of purchase; (2) persons with an income in excess of \$200,000 (or in excess of \$300,000 with a spouse) in each of the two most recent years and “a reasonable expectation of reaching the same income level in the current year;” (3) a corporation, partnership or charitable organization with assets in excess of \$5 million; (4) a trust with assets in excess of \$5 million, charitable organization, “not formed for the specific purpose of acquiring the securities offered, whose purchase is directed by a sophisticated person;” and (5) “any director, executive officer, or general partner of the issuer of the securities being offered or sold.”²³⁵

Raising capital primarily from “accredited investors” would help L3Cs find shelter in an exception to the onerous federal securities registration requirements, but “accredited investors” may be wary of committing *substantial* sums of capital to an L3C for fear of having limited

230. See Kleinberger *supra* note 18, at 902 (citing CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW* (2006)).

231. See Kleinberger, *supra* note 18, at 902.

232. See, e.g., Stefania A. Di Trolio, Note, *Public Choice Theory, Federalism, and the Sunny Side to Blue-Sky Laws*, 30 WM. MITCHELL L. REV. 1279, 1299 (2004) (noting that some commentators have argued that state securities laws “are too complex—they are a ‘crazy-quilt of state regulations no longer significant or meaningful in purpose, and usually stultifying in effect, or just plain useless.” (quoting J. Sinclair Armstrong, *The Blue Sky Laws*, 44 VA. L. REV. 713, 714–15 (1958))).

233. Q&A: *Small Business and the SEC: Are There Legal Ways to Offer and Sell Securities Without Registering with the SEC?*, SEC, <http://www.sec.gov/info/smallbus/qasbsec.htm#eod6> (last updated Nov. 14, 2009).

234. See, e.g., 17 C.F.R. § 230.501(e) (2010) (noting that accredited investors are exempted from the calculation of the number of purchasers for the purposes of complying with the limits imposed by Rules 505 and 506. Rules 505 and 506 provide exceptions to the federal securities laws registration requirements). *Accord* Lopes v. Vieira, 543 F. Supp. 2d 1149, 1169–70 (E.D. Cal. 2008). This article does not attempt to delve into the complexity of the various state securities laws.

235. See 17 C.F.R. § 230.501(a).

ability to push a profit-making agenda. Investors, both accredited and non-accredited, may be willing to commit smaller amounts of money to an L3C that focuses on a charitable purpose that the investor feels passionately about.²³⁶ If the investors feel strongly enough about the cause championed by the L3C, investors may even be willing to commit small amounts of capital with absolutely no expectation of any return on their investment, but merely an expectation of the return of their capital.²³⁷ If the L3C is clear that *no* profit should be expected, the L3C may be able to steer clear of the onerous federal securities registration requirements, because imbedded in the definition of a security is the concept that an investor “expects profits” from the investment in the security.²³⁸ Without the expectation of profit, it may be difficult to convince a few individuals to each contribute a large sum of capital. As discussed below, however, it may be much easier to raise the same significant sum needed by using crowd-sourcing and convincing a large number of people to each contribute a small amount of money.²³⁹ With only a small amount of money committed per investor, each individual investor may be satisfied with the expectation of only the return of their capital and a dollop of “warm glow.”

C. *Calling the Crowd: Crowd-Funding for L3Cs*

Unlike traditional early stage capital-raising, which generally relies on a few individuals to each provide a substantial investment, crowd-funding (a/k/a crowd-sourcing of financing) generally relies on many individuals to each provide a relatively small investment.²⁴⁰ Crowd-funding also typically targets individuals who have some personal connection to the purpose for which money is being raised.²⁴¹ Due to the relatively small investment and relatively strong connection to the purpose, crowd-funding participants are more likely to accept a low or no

236. *See infra* Part III.C.

237. *Id.*

238. S.E.C. v. W. J. Howey Co., 328 U.S. 293, 298–99 (1946).

239. *See infra* Part III.C.

240. Daniel M. Satorius & Stu Pollard, *Crowd Funding: What Independent Producers Should Know About the Legal Pitfalls*, ENT. & SPORTS LAW., Summer 2010, at 15. (“Crowd funding is the use of fans as financiers. Sums—generally in small increments—are collected from a wide breadth of people who generally have little to no prior experience in financing entertainment ventures. Crowd funding often implicates the use of Internet-based social media tools to raise awareness of opportunities for fans to contribute funds for a project. While mammoth sites such as Facebook, YouTube, Twitter, and MySpace can be utilized for this purpose, several specialty sites have gained notoriety as the leaders in the crowd-funding arena, including Kickstarter (<http://www.kickstarter.com>) and IndieGoGo (<http://www.indiegogo.com>).” The crowd-funding referred to in this article refers to use of large number of investors outside of the public markets, and generally at a time well in advance of an initial public offering.

241. *Id.*

return on their money and may also be more eager to support the charitable mission of the L3C than traditional investors.²⁴²

Two obvious questions arise: (1) Could crowd-sourcing provide enough money to support a decent-sized social enterprise? and (2) Would people really contribute with no expectation of a return? While the following examples provide merely anecdotal evidence, they do show the substantial capital-raising potential of the crowd, even when the crowd is not promised a return.²⁴³

1. GREEN BAY PACKERS

While crowd-funding has become more popular in recent years and more practical with the advent of the Internet, crowd-funding is not a new concept. In 1923, 1,000 fans of the Green Bay Packers bought shares in the football team for \$5 each.²⁴⁴ The thirteen-time world-champion Green Bay Packers continue to raise money through fans and continue to have an unconventional ownership structure today.²⁴⁵ The National Football League football team is owned by fans in the form of a nonprofit corporation.²⁴⁶ The fans are not paid dividends, the stock does not appreciate, and the stock may not be resold to anyone except the franchise itself.²⁴⁷ If the team is ever sold, “all proceeds must go to a foundation for distribution to local charities.”²⁴⁸ The Green Bay Packers have sold shares three times since 1923, and the most recent capital raise in 1997 brought in \$24 million for the redevelopment of Lambeau Field, the team’s home stadium.²⁴⁹ Despite the fact that the shares have little-to-no income-producing value, “owners” have called the shares their “favorite security” and said that the shares have “great intangible

242. Satorius & Pollard, *supra* note 240, at 16 (“Perhaps the biggest advantage is that if the [crowd-funding] arrangement is properly structured, the funds raised are untethered—there is no obligation for the producer to repay backers.”).

243. Though it is outside the scope of this article to analyze whether these examples would be more conducive to using a hybrid legal form or whether enhanced benefits in fundraising or operations might be conferred from such use, the examples arguably support that entities such as nonprofit corporations and perhaps L3Cs could be substantially sustained on crowd-funding, which we discuss in Part III.D as a preferred alternative to tranced investing and an important funding component for L3Cs.

244. Eben Novy-Williams, *Packers \$200 Share That Can’t Rise or Trade is Banker’s Favorite Security*, BLOOMBERG (Feb. 3, 2011, 12:01 AM), <http://www.bloomberg.com/news/2011-02-03/packers-200-share-that-can-t-rise-or-trade-is-banker-s-favorite-security.html>.

245. See generally *History-Super Bowls & Championships*, PACKERS.COM, <http://www.packers.com/history/super-bowls-and-championships.html> (last updated Mar. 2, 2011); Patrick Hruby, *The Right Way? The Green Bay Way*, ESPN.COM (Jan. 31, 2011), <http://sports.espn.go.com/espn/commentary/news/story?page=hruby/11013>.

246. Hruby, *supra* note 245.

247. *Id.*; see also Novy-Williams, *supra* note 244.

248. Hruby, *supra* note 245.

249. Novy-Williams, *supra* note 244.

value.”²⁵⁰

2. BLUE LIKE JAZZ

Blue Like Jazz was a *New York Times* best-selling book by author Donald Miller.²⁵¹ The book sold well over one million copies, and, as described in the book’s subtitle, is made up of a collection of “nonreligious thoughts on Christian spirituality.”²⁵² A few years after the book was published, the author and others decided to make a film loosely based on the book.²⁵³ After raising a portion of the funds needed to shoot the film, money from traditional sources dried up.²⁵⁴ The poor economy hurt the fundraising efforts, and the content of the proposed film made it a difficult sell to traditional investors. Some traditional investors did not want to invest in a film with a faith-based message, while others did not want to invest in a film that would include secular scenes leading to a PG-13 rating.²⁵⁵ The author of *Blue Like Jazz* thought the film would not be made due to lack of funding, and he said so publicly on his blog.²⁵⁶ Fans of the book wanted the movie made and set up a website on Kickstarter.com to raise money.²⁵⁷ In less than a month, the fans raised \$345,992 with 4495 donors participating.²⁵⁸ Only nine donors donated over \$3000, and the average donor contributed only \$76.97.²⁵⁹ While demographic statistics are unknown, it is likely (judging from the comments on the Kickstarter website) that the donors were younger and much less wealthy than the traditional investor.²⁶⁰ The online contributors to the film *Blue Like Jazz* had no expectation of profit, no expectation of getting *any* of their money returned, and no

250. *Id.*

251. *Paperback Nonfiction*, N.Y. TIMES, Oct. 29, 2006, <http://www.nytimes.com/2006/10/29/books/bestseller/1029bestpaperonfiction.html>.

252. DONALD MILLER, *BLUE LIKE JAZZ: NONRELIGIOUS THOUGHTS ON CHRISTIAN SPIRITUALITY* (2003).

253. Professor Murray’s father, V. T. “Chip” Murray, Jr. and Chip Murray’s firm, The Panda Fund, were involved in financing the film *Blue Like Jazz*.

254. Donald Miller, *Blue Like Jazz the Movie, the Update*, DONALD MILLER’S BLOG (Sept. 16, 2010), <http://donmilleris.com/2010/09/16/blue-like-jazz-the-movie-the-update/>.

255. *Id.* The author, Donald Miller, explained the difficulty of raising money from traditional investors in Christian films by stating on his blog that “there is language, drug use and a scene where the protagonists put a giant condom on a steeple. To me, it’s the only movie that takes an honest look at a Christian kid coming of age in America, a story experienced by tens of millions of students each year. *But students don’t fund Christian movies, older white guys do, and they find it hard to relate to the theme.*” (emphasis added).

256. *Id.*

257. *SAVE Blue Like Jazz! (The Movie)*, KICKSTARTER, <http://www.kickstarter.com/projects/2128223578/save-blue-like-jazz-the-movie-0> (last visited May 6, 2011).

258. *Id.*

259. *Id.*

260. *Id.*

expectation of a tax deduction.²⁶¹ The individual contributions were not large, but collectively, they accounted for a significant sum. Through Kickstarter, the *Blue Like Jazz* team reached non-traditional investors—passionate fans of the book—and raised a sizeable amount of money when the traditional investors were largely unavailable.

3. KIVA

As mentioned in Part I, users of nonprofit Kiva have pumped over \$200 million into developing countries by way of small or micro-loans made by the over 573,000 users of the site.²⁶² The minimum “investment” is only \$25 and the lenders do not expect any interest but merely the return of their investment.²⁶³ Kiva loans boast a repayment rate of over 98% and the website has become a model for other similar websites.²⁶⁴

IV. THE POWER AND POTENTIAL OF CROWD-FUNDING FOR L3Cs

The above three examples, while obviously handpicked for their relative success, at least show the immense *potential* of crowd-funding for projects close to the heart of investors. In all three examples, the investors expected no return on their money, thus avoiding the onerous federal securities registration requirements discussed above.²⁶⁵ Crowd-funding may allow an L3C to: (1) access a large number of investors; (2) allow each of the many investors to contribute a relatively small amount, which may increase the likelihood that the investor will forego the expectation of profit; (3) reach investors who support the charitable mission of the L3C; and (4) avoid onerous federal security law registration requirements if crowd-funders forgo the expectation of profit.

Of course crowd-funding from individuals who do not expect a profit would not be the only way that L3Cs could raise capital. If it were, one could rightly argue that the business should be formed as a nonprofit entity. The L3C can also receive funding from foundations, and even traditional investors. Using crowd-funding to finance a substantial portion of the needs of an L3C, however, lessens the need for traditional

261. The donors were only given small gifts, based on their level of contribution, such as a call from the producer of the film, memorabilia and/or listing as an “associate producer” in the credits of the film. *Id.*

262. *Kiva-About Us*, KIVA, <http://www.kiva.org/about> (last visited May 6, 2011). Professor Murray received \$25 in Kiva dollars from a friend, Megan Howard, in 2009 and was thereby able to experience, first hand, the “warm glow” associated with providing no-interest loans to those in need. Since that time, Professor Murray has continued to “invest” with Kiva. *See also supra* Part II.B.

263. *Id.*

264. *Id.*

265. *See supra* Part III.B.

investors who may guide L3Cs away from their charitable mission in search of profit.²⁶⁶ In addition, traditional investors, while able to invest in L3Cs, should be made well aware of the primary purpose of L3Cs. Likewise, venture capitalists should advise their clients of the primary purpose of L3Cs before investing, or even set up a separate fund for social-based investing and let their clients know that L3Cs that have a charitable mission as their primary purpose will be included in the portfolio.

A. *Avoiding Wealth Transfer: Locking Profits into the “Social Stream”*²⁶⁷

Critics of L3Cs have focused on the potential for wealth transfer from tax-advantaged foundations to profit-seeking investors.²⁶⁸ These critics rightly note that profit-seeking investors in L3Cs may piggyback off of the cheap capital provided to L3Cs by foundations and other social-minded investors.²⁶⁹ To address this fair criticism, we suggest that crowd-funders take the place of traditional investors who are unwilling to accept the primacy of charitable purpose in the L3C. We also suggest that profits associated with the capital provided by tax-advantaged foundations or stemming from the capital provided by charity-focused crowd-funders be locked into the “social stream.” Rather than using the cheap capital of the foundations and crowd-funders to inflate the returns of the profit-seeking investors, we suggest mandating that L3Cs either return to the foundations and crowd-funders their pro-rata share of profits (above their initial investments) or retain those profits in the L3C to further the L3C’s charitable purpose.²⁷⁰

To further clarify our proposal, let us look at a simple example. A foundation, crowd-funders, and social investors help an L3C raise

266. See Kleinberger, *supra* note 18, at 899–900 (discussing the problems that may arise when “the interests of the foundation and those of the ‘top tranche’ investors substantially diverge.”).

267. As defined above, the phrase “social stream,” as used in this article refers to the capital floating in the third (charitable) and fourth (social enterprise) economic sectors.

268. Kleinberger & Callison, *supra* note 142, at 3 (arguing that L3Cs may simply transfer wealth from foundations to private investors.); Bishop, *supra* note 18, at 265 (“The tranche-investment notion potentially violates the private-inurement restriction. As such, it raises the specter of impropriety regarding whether the foundation is allowing its assets to be used to inure private benefit to the commercial or market tranche in the L3C.”).

269. See generally *id.* “Socially-minded investors” include the crowd-funders discussed in Part III.C.

270. Currently, L3C legislation allows L3Cs to convert to LLCs with relative ease. While the exact mechanism is beyond the scope of this article, we believe that statutory safeguards should be put in place to assure that the profits created on the back of foundations and crowd-funders is not hijacked by traditional investors. A mechanism to keep the pro-rata share of profits earned on foundation/crowd-funder capital should be kept in the “social stream,” and foundations often do ensure certain contractual provisions to protect from improper conversions.

\$150,000 in capital. Each group contributes \$50,000. If the L3C turns a profit of \$180,000, then \$60,000 would be returned to the social investors, who would typically be “accredited” investors within the meaning of the securities laws. The crowd-funders receive their \$50,000 investment back (if they so choose) and the remaining \$10,000 of their share would be retained by the L3C. We suggest that the profits associated with the crowd-funders’ contributions, above the initial investment amount, be retained by the L3C in an attempt to avoid costly security registration requirements that would be incurred if a large number of unaccredited investors expected a profit.²⁷¹ Finally, the \$60,000 earned by the foundation could be returned to the foundation, or all or a portion of the funds could be retained by the L3C, depending on the particular arrangement between the L3C and the foundation.

Our suggestion differs from the tranching approach championed by Robert Lang and others.²⁷² Lang suggests that traditional investors could achieve market-rate returns by hitchhiking on the low-cost capital provided by foundations.²⁷³ As a simple example, if a foundation and a traditional investor both invest an equal amount of capital, and the market rate of return is 10%, the traditional investor could make a market rate of 10%, even if the L3C only made a 5% profit, if the foundation agreed to take no return on its money. We believe, however, that both socially minded investors and the IRS will not look favorably on this type of arrangement. Socially minded investors, including crowd-funders, who are passionate about the social purpose of the L3C, will be less likely to invest if it becomes evident that their funds are simply going to provide market-rate profits for traditional investors. Foundations may also face wealth transfer issues if they go into an arrangement knowing that a likely or expected result is that their investment return will be essentially assigned to market-rate investors. With the foundations receiving their pro-rata share of the profits and the crowd-funders’ share of the profits being retained by the L3Cs, traditional investors will receive less of a return than under a tranching system, if everything else remains equal. This fact means that only traditional investors with a seri-

271. See *supra* Part III.B.

272. See Robert Lang & Elizabeth Carrott Minnigh, *The L³C, History, Basic Construct, and Legal Framework*, 35 VT. L. REV. 15, 17 (2010) (“For those for whom the term is not familiar, tranching refers to layering. Normally each tranche represents a class of members and each class has a different level of risk and receives different returns on their investment in addition to other rights and privileges of the class. . . . Because the whole entity will operate in the low-profit zone, and it does not have to pay any tranche of investor a high return, the result can be a market rate of return for market-rate investors who are investing in the enterprise alongside the foundation [who accepts little or no return on its investment].”) This arrangement is one but not the only tranching arrangement available under L3Cs. *Id.*

273. *Id.* at 17.

ous commitment to the charitable mission of the L3C will invest. We submit that this is as it should be and will decrease the power of the pull between purpose and profit.²⁷⁴

Currently, L3Cs may be converted into profit-focused LLCs.²⁷⁵ L3Cs may also be purchased by profit-focused entities. If those events occur, what happens to the capital of the socially minded investors? We believe that the capital attributable to socially minded investors should be retained in the social stream. Upon conversion to or purchase by a profit-focused entity, the law should require the L3C to cash out the socially minded investors. For the crowd-funders, who contributed mainly due to the charitable purpose of the L3C and who, due to security law restrictions, cannot expect a return; their share of the L3C should be paid to a foundation, nonprofit, or L3C with a similar charitable purpose. With these requirements, social investors who contribute to an L3C can be better assured that their contribution will be used to further the charitable purpose and not to line the pockets of profit-focused investors.

B. *Benefits of the L3C*

If you remove investors who are primarily motivated by profit from the L3C picture, what benefits does an L3C form offer beyond what is already available in the nonprofit form? First, the L3C form offers a possibility of profit to accredited investors, a possibility of enhanced returns or preserved capital to foundations, and a possibility of the return of their investment to the crowd-funders. Second, the L3C form offers a new, fresh brand. This brand strives towards pulling the best from both for-profit and nonprofit entities. And third, the L3C is more flexible than a 501(c)(3) nonprofit entity and can be easier to form than a 501(c)(3).²⁷⁶

CONCLUSION

In addition to reviewing the literature and arguments surrounding L3Cs, our article offered four concrete suggestions on how to make the

274. This is not to say that our proposal will eliminate all leakage from the “social stream.” It will not. We hope, however, that the proposal will help assure the IRS, foundations and crowd-funders that the vast majority of their money is going to address the charitable purpose of the L3C and not merely going to line the pockets of the market-rate investors.

275. See VT. STAT. ANN. tit. 11, § 3001(D) (2010) (“If [an L3C] . . . ceases to satisfy any one of the [statutory] requirements, it shall immediately cease to be a low-profit limited liability company, but . . . will continue to exist as a limited liability company.”).

276. Obviously, the operating agreements of L3Cs can also be as complex as the parties involved desire within the bounds of the law. What we mean by “easier to form” is that an L3C can be very simple to create, while a 501(c)(3) requires the observation of numerous formalities to create.

L3C more workable for its socially conscious managers, investors, and the public.

First, from a governance perspective, and in resolving the L3C's seemingly conflicting priorities of charity and profit, we recognized that L3C managers are bound by charitable primacy, yet argue that managers should be given latitude vis-à-vis the business judgment rule to pursue profit-making that may ultimately serve the L3C's charitable purpose.

Second, from an enforcement perspective, we recommended that L3C members should be given standing to sue L3C managers for deviations from charitable primacy. Again, however, the business judgment rule, should, in our opinion, provide L3C managers with significant protection. We agreed with other commentators who suggest Form 990 information self-reporting as a practical way to ensure an L3C's commitment to its charitable purpose.

Third, in addressing the capital-raising issues surrounding L3Cs, we submitted that most traditional investors will be unlikely to invest in an entity that prioritizes purpose above profit. To fill the gap, we suggested that L3Cs rely on crowd-funding capital in addition to capital from foundations, nonprofits, and other socially-conscious investors. Through crowd-funding, L3Cs may: (1) access a large number of investors; (2) allow each of the many investors to contribute a relatively small amount; (3) reach investors who support the charitable mission of the L3C, and (4) avoid onerous federal security law registration requirements by reaching investors who will acknowledge that they are not investing with an expectation of profit but rather only for a return of their capital.

Fourth, we argued that the capital committed by social investors to L3Cs should be locked into the "social stream." By this we meant that social investors, such as foundations, nonprofits, and socially conscious crowd-funders, should either receive their pro-rata share of L3C profits or those profits should be retained by the L3C. Moreover, we suggest that if an L3C converts to a profit-focused LLC or if the L3C is purchased by profit-focused entity, the law should mandate either the return of social investors' interest in the L3C or require that the value of that interest be paid to an entity with a similar, required charitable focus.

By implementing these and other suggestions, we believe the L3C could be a promising entity form for social entrepreneurs in the twenty-first century and beyond.