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Committee on Commerce

AN OVERVIEW OF LOW-PROFIT LIMITED LIABILITY COMPANIES (L3CS)

Statement of the Issue

A Low-profit Limited Liability Company (L3C) is a new type of business entity, recognized by law in only 7 states.[1] A L3C is a hybrid of existing nonprofit and for-profit corporations, designed to attract both private and philanthropic capital in a unique manner by allowing "investments" rather than only "donations." Profits earned from such investments may be distributed to owners or investors. However, unlike a standard limited liability company (LLC), the L3C must have an explicit primary charitable mission and only a secondary profit concern.

Conceptually, L3Cs are formed to create a vehicle to bring together government, for-profit, nonprofit (mainly private foundations), individuals, and corporations to facilitate and expand investments in charitable enterprises and to eliminate the need for costly and time-consuming letter rulings from the Internal Revenue Service (IRS), which recognize contributions or investments as "program-related investments" (PRI).

Under s. 4944 of the Internal Revenue Code (IRC), private foundations are allowed to make "program-related investments" that meet three criteria:

- The investment's primary purpose must be to advance the foundation's charitable objectives.
- Neither the production of income nor appreciation of property can be a significant purpose.
- The funds cannot be used directly or indirectly to lobby or for political purposes.

To date, the IRS has not formally recognized L3Cs and therefore, some foundations may, but are not required to, seek a private letter ruling from the IRS prior to investing in a L3C to determine if such investment would meet the requirements under s. 4944 of the IRC. Consequently, it is not apparent whether businesses have benefited from forming as L3Cs or whether states that have enacted legislation to recognize L3Cs have benefited from such legislation.

Discussion

Business Organizations

Various forms of business organizations are established under state law. Business organizations vary according to:

- The level of control owners have.
- The type of administrative structure.
- The business or owner's vulnerability to lawsuits or liability.
- Tax implications.
- Expected profits or losses.
- Type of investment needed in the business.
- Accessibility to business assets.[2]

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[1] L3Cs are recognized in Illinois (805 ILCS 180/1-26), Maine (31 M.R.S.A. § 1611, effective July 1, 2011), Michigan (MCL §450.4204), North Carolina (Ch. SL 2010-187), Utah (Utah Code §48-2c-412), Vermont (11 V.S.A. §§3001-3184), and Wyoming (Wyo. Stat. §§17-29-101 through 17-29-1105). In addition, the Crow Nation (§§18-5-102, 18-5-108(a), and 18-5-705(a) of the Crow Law and Order Code) and Oglala Sioux Tribe (citation not available, *but see* Americans for Community Development; *laws*; available at http://www.americansforcommunitydevelopment.org/laws.php (last visited 9/20/2010)) recognize L3Cs.

[2] U.S. Small Business Administration (SBA), *Small Business Planner: Choose a Structure: Basic Structures*; available at

The most common forms of business organizations are the sole proprietorship, general partnership, Limited Liability Company (LLC), C Corporation, and S Corporation.[3] Examples of some special business structures recognized in some states are the Limited Liability Partnership (LLP), Professional Service Corporation (PS), Limited Partnership (LP), and nonprofit corporation.[4]

Sole Proprietorship

A sole proprietorship is a simple, informal business structure that is inexpensive to form and is usually used by a single person or marital community. The owner operates the business, is personally liable for all of the business' debts, and owns all of the business' assets and profits. Additionally, the proprietor may freely transfer all or part of the business and can report a profit or loss on personal income tax returns.[5]

General Partnership

Partnerships are formed when two or more individuals or entities enter into an agreement and jointly own and operate a business. Similar to a proprietorship, the law does not distinguish between the business and its owners. Profits, losses, and managerial duties are shared among the partners, and each partner is personally liable for partnership debts. Individual partners report their share of profits and losses on their personal tax returns.[6]

Limited Liability Company (LLC)

The LLC is a hybrid business structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. However, formation is more complex and formal than that of a general partnership. Profits and losses may be passed through the company to its members and can be reported on the members' personal income tax returns, or the LLC can elect to be taxed like a corporation.[7] Owners of a LLC are called "members" and those members, or appointed managers, manage the LLC. LLCs do not have stock and are not required to observe corporate formalities.[8]

C Corporation

The C Corporation is a complex business structure and is considered a separate legal entity from its owners, who own shares of stock in the company. A corporation may be taxed, sued, and can enter into contractual agreements. A corporation's profits are taxed both at the corporate level and again when distributed to shareholders. Shareholders are not personally liable for corporate obligations, unless corporate formalities, which provide evidence that the corporation is a separate legal entity from its shareholders, have not been observed. Corporate formalities include the following:

- Issuing stock certificates.
- Holding annual meetings.
- Recording the minutes of meetings.
- Electing directors or ratifying the status of existing directors.[9]

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http://www.sba.gov/smallbusinessplanner/start/chooseastructure/START_FORMS_OWNERSHIP.html (last visited 9/20/2010).

[3] IRS.gov; *Business Structures*; available at http://www.irs.gov/businesses/small/article/0,,id=98359,00.html (last visited 9/20/2010).

[4] U.S. Small Business Administration (SBA); *Small Business Planner: Choose a Structure: Special Structures*; available at http://www.sba.gov/smallbusinessplanner/start/chooseastructure/START_SPECIAL_STRUC.html (last visited 9/20/2010). All of these special business structures are recognized by statute under Florida law.

[5] *Supra* fn. 2.

[6] *Id*.

[7] The federal government does not recognize an LLC as a classification for federal tax purposes and therefore, an LLC must file as a corporation, partnership, or sole proprietorship. *See* IRS.gov; *Limited Liability Company (LLC)*; available at http://www.irs.gov/businesses/small/article/0,,id=98277,00.html (last visited 9/20/2010).

[8] *Supra* fn. 2.

[9] *Id*.

S Corporation

The S Corporation structure is identical to the C Corporation, except it offers avoidance of double taxation. If a corporation qualifies as an S Corporation with the IRS, it is taxed like a partnership — the income flows through to the shareholders who report the income on their individual returns.[10]

Limited Liability Partnership (LLP)

Limited Liability Partnerships (LLPs) are organized to protect individual partners from personal liability for the negligent acts of employees or other partners that are not under their direct control. Some states that recognize LLPs only permit organizations that provide certain licensed professional services, such as legal, medical, or accounting services, to organize as a LLP.[11] Partners of a LLP report their share of profits and losses on their personal tax returns.[12]

Professional Service Corporation (PS)

The Professional Service Corporation (PS) provides limited personal liability for shareholders, who are licensed to perform certain professional services. Essentially, the owners of the business are also the employees of the business. A PS is incorporated and is recognized as a taxable entity separate from its shareholders.[13] Section 621.03, F.S., provides the following examples of service professionals permitted to form a PS:

- Certified public accountants.
- Public accountants.
- Chiropractic physicians.
- Dentists.
- Osteopathic physicians.
- Physicians and surgeons.
- Doctors of medicine.
- Doctors of dentistry.
- Podiatric physicians.
- Chiropodists.
- Architects.
- Veterinarians.
- Attorneys at law.
- Life insurance agents.

Limited Partnership (LP)

Limited Partnerships (LPs) are complex organizations, requiring at least one general partner who is fully responsible for partnership obligations and normal business operations and requiring at least one limited partner who is not involved in everyday operations and is shielded from liability for partnership obligations beyond the amount of his or her investment. Partners of a LP report their share of profits and losses on their personal returns and the LP files an informational return to the IRS.[14]

Nonprofit Organizations

Under the Internal Revenue Code (IRC) there are several types of tax-exempt organizations.[15] However, the most common form of a tax-exempt organization is an organization recognized under §501(c)(3) of the IRC, often referred to as a 501(c)(3) company. These are nonprofit organizations that are organized for religious, charitable, scientific, literary, or educational purposes.[16] Additionally, groups that test for public safety, foster national or

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[10] *Id*.

[11] Florida law does not limit LLPs to certain licensed professional services, but does require specific qualifications under s. 620.9001, F.S. In addition, those wanting to be recognized as a LLP must register as a General Partnership and file a Statement of Qualification with the Department of State's Division of Corporations. *See* http://form.sunbiz.org/cor_gp.html (last visited 9/20/2010).

[12] *Supra* fn. 4.

[13] *Id*.

[14] *Id*.

[15] IRS.gov; *Types of Tax-Exempt Organizations*; available at http://www.irs.gov/charities/content/0,,id=96931,00.html (last visited 9/20/2010). A list is provided on this webpage that includes: charitable organizations, social welfare organizations, agricultural or horticultural organizations, labor organizations, business leagues or trade associations, social clubs, fraternal societies, employee benefit associations or funds, veterans organizations, political organizations, and miscellaneous tax-exempt organizations.

[16] IRS.gov; *Publication 557 (06/2008)*, *Tax-Exempt Status for Your Organization*; revised 06/2008; available at http://www.irs.gov/publications/p557/ch03.html#d0e3190 (last visited 9/20/2010).

international amateur sports competition, or organize to prevent cruelty to children or animals may qualify as a 501(c)(3).[17]
The IRC subdivides 501(c)(3) organizations into two categories; private foundations and public charities.[18] All 501(c)(3) nonprofits are presumed to be private foundations, unless they are designated otherwise under federal law.[19] The IRS provides that "excluded categories are generally those that either have broad public support or actively function in a supporting relationship to those organizations."

Annually, private foundations must make eligible charitable expenditures, including "qualifying distributions," that equal or exceed approximately 5 percent of the value of its endowment.[20] The purpose behind the 5 percent payout requirement is to prevent foundations from simply receiving gifts, investing the assets, and never spending any funds on charitable purposes.[21] "Qualifying distributions" include:

- Grants to charities and non-charities for charitable purposes.
- All reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.
- Costs of all direct charitable activities.
- Amounts paid to acquire assets used directly in carrying out charitable purposes (computers, office furniture, a building to house the foundation).
- Set-asides (require advance approval by IRS to fund a project over multiple years).
- Program-related investments (PRIs).[22]

Philanthropy and Business Organizations[23]

Traditionally, nonprofits have served philanthropic purposes; their mission serves to "give back," not make a profit. However, with a recent movement of "social entrepreneurship," socially-conscious purposes are being carried out in more non-traditional ways. For example, more for-profit corporations are making philanthropic commitments, operating under socially conscious missions, and downplaying their primary goal of maximizing profits for shareholders. Additionally, there are new corporate structures emerging that are hybrid business organizations, which are primarily socially-minded, but also seek to profit to encourage investment and broaden the organization's philanthropic impact.

For-profit Corporations

For-profit corporations generally serve social needs by "corporate philanthropy" or by "corporate social responsibility."[24] Corporate philanthropy usually involves a parent business corporation establishing a controlled charitable entity, sustaining the entity through grants.[25] Therefore, the controlled charitable entity is a vehicle for corporate managers to use corporate funds to fund projects. Corporate social responsibility, often referred to as "CSR," allows corporate managers to look beyond the interests of its shareholders and use corporate assets to respond directly to society's needs.[26]

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[17] *Id*.
[18] *Id*.
[19] *Id*. The IRS states, "Every organization that qualifies for tax exemption as an organization described in section 501(c)(3) is a private foundation unless it falls into one of the categories specifically excluded from the definition of that term (referred to in section 509(a)(1), 509(a)(2), 509(a)(3), or 509(a)(4)). In effect, the definition divides these organizations into two classes, namely private foundations and public charities."
[20] Council *on* Foundations; *The Five Percent Minimum Payout Requirement*; available at http://www.abagmd.org/usr_doc/The_Five_Percent_Minimum_Payout_Requirement_for_ABAG_members.pdf (last visited 9/20/2010).
[21] *Id*.
[22] *Id*.
[23] This section of the Issue Brief is adapted from: Kelley, Thomas; *Law and Choice of Entity on the Social Enterprise Frontier*; 84 Tul. L. Rev. 337 (2009); available at http://works.bepress.com/cgi/viewcontent.cgi?article=1001&context=thomas_kelley(last visited 9/20/2010).
[24] *Id*. at 12-13.
[25] *Id*. at 12.
[26] *Id*. at 14.

Corporations that practice "corporate philanthropy" or "corporate social responsibility" are still responsible for, and must maintain the primary goal of, maximizing profits. Consequently, it may not be possible for corporations practicing corporate philanthropy or corporate social responsibility to be truly altruistic.

Hybrid Organizations

In contrast to a for-profit corporation, which acknowledges that its core value is to maximize profits, a hybrid organization's preeminent motivation is some form of philanthropy.[27] A for-profit corporation's commitment to philanthropy may be reevaluated if its bottom-line is affected, while a hybrid organization has a permanent commitment to its philanthropic mission. There are several hybrid organization business structures, some of which are discussed here.

Some hybrids are referred to as "not-for-loss" social enterprises because they may operate with low-profits and may operate by fees for a service. The main goal of such a business is to derive enough profit to continue and expand its philanthropic purpose. Typically, these types of hybrids usually have a dedicated source of funding and do not need to rely on outside investments. With a dedicated income, the hybrid may form as a nonprofit, but may forego its federal tax exempt status under § 501(c)(3) of the IRC and still profit, allowing the organization to keep intact its status as a philanthropic organization. However, not many organizations have a dedicated income source large enough to outweigh the benefits of the federal tax exemptions under § 501(c)(3).[28]

In some instances, a for-profit and a nonprofit may be simultaneously created by persons wanting to use the for-profit to generate funds to invest in the nonprofit, which would carry out the intended philanthropic mission. The nonprofit can preserve its exempt status and attract donations, while the for-profit entity can seek venture capital, financing, and other investments. However, this is a complex strategy to fulfill a philanthropic purpose and it is expensive to organize and administratively burdensome to maintain.[29]

For-profit corporations that seek to be branded as putting philanthropy before profit-making may seek designation from an independent certification company as "B Corporations," meaning for social benefit. In addition, some corporations seek the brand of a "Socially Responsible Business Corporation" or "SRC." These corporations use such branding to assure investors of their long-term commitment to their socially beneficial missions.[30] However, such self-branding or independent certification does not carry the same merit as state or federal recognition of philanthropic purposes that a nonprofit carries and therefore, investors may still shy from these types of corporations.[31]

Another type of hybrid organization that is primarily mission-based, but seeks multiple facets of investment to continue and expand its philanthropic purpose, uses the limited liability company (LLC) business structure to accomplish its mission. LLCs are beneficial in that they offer limited liability for their members and offer immense organizational flexibility through the drafting of a membership agreement. This structure allows the members to write an agreement that dedicates the company to philanthropy and meanwhile can reward for-profit investors with larger shares of profit than those investors that invest for social benefit. However, LLCs organized in such a manner do not resolve the issue that investors cannot be guaranteed that the philanthropic mission of the organization will subside if profit-making becomes more important to the members, without some federal or state oversight or designation of the entity as mission-based.

[27] *Id.* at 16.
[28] *Id.* at 32.
[29] *Id.* at 33.
[30] *Id.* at 35-36.
[31] The United Kingdom created a new hybrid in 2004, called a "Community Interest Company" (CIC), which is a for-profit entity with a social mission and is structured to encourage financial investment to further the company's social mission. *See* Brakman Reiser, Dana; *Governing and Financing Blended Enterprise*; 85 Chi.-Kent L. Rev. 619, 630 (2010); available at http://www.cklawreview.com/wp-content/uploads/vol85no2/Brakman.pdf (last visited 9/20/2010).

There is a relatively new hybrid organization that may resolve some of the problems associated with other hybrids, such as branding as mission-based, capital investments, and organization flexibility.[32] This new hybrid is called a "low-profit limited liability company" or "L3C."

Low-profit Limited Liability Companies (L3Cs)

Robert Lang, Jr., CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation, is credited with creating the concept of a Low-profit Limited Liability Company (L3C), often encapsulated as a "for-profit with a nonprofit soul."[33] L3Cs use the same business structure as a LLC, meaning that it has organizational flexibility, limited liability for members, and has single or "pass through" taxation. However, the integral element of a L3C is that the company must meet the federal requirements for qualifying as a "program-related investment" (PRI) under the Internal Revenue Code (IRC).[34] The reason the L3C model is designed to "dovetail" with the federal IRS regulations pertaining to PRIs is to encourage and facilitate foundations to make such investments, because currently approximately only 5 percent of foundations make PRIs.[35]

PRIs are investments made by tax-exempt private foundations. These types of investments are beneficial to a foundation in that they garner two forms of special treatment by the federal government. First, the IRS permits foundations to count PRIs toward their federally required, minimum 5 percent annual payout of net assets.[36] Second, a PRI is sheltered from designation as a "jeopardizing investment," if it meets the PRI requirements under the IRC, thereby allowing the foundation to avoid costly excise tax penalties.[37] PRIs include loans, loan guarantees, real estate mortgages, and stock purchases, among other types of instruments.[38] Although not necessary, some foundations will seek a private letter ruling from the IRS to determine, prior to investment, whether the investment would qualify as a PRI to avoid the heavy excise tax penalties.[39]

To be specific, the requirements of qualifying as a program-related investment, under §4944(c) of the IRC, include the following:

- The primary purpose of the investment is the accomplishment of one or more charitable or educational purposes described in s. 170(c)(2)(b) of the IRC, and would not have been formed except to accomplish those charitable or educational purposes.
- The production of income or appreciation of property is not a significant purpose of the investment.
- The purpose of the investment does not include accomplishing or influencing one or more political or legislative objectives described in s. 170(c)(2)(d) of the IRC.[40]

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[32] The first law recognizing low-profit limited liability companies was passed in Vermont in 2008. *See* Vermont Secretary of State; *Low-Profit Limited Liability Company*; available at http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited 9/20/2010).

[33] Americans for Community Development; *FAQs: What is the L3C?*; available at http://www.americansforcommunitydevelopment.org/faqs.php (last visited 9/20/2010). *See also* Coren, Carol and Robert M. Lang, Jr.; *The L3C: The For-Profit with the Nonprofit Soul*; Bridges; Winter 2009-2010; available at http://stlouisfed.org/publications/br/articles/?id=1848 (last visited 9/20/2010) and Davis, Steve and Sue Woodrow; *The L3C: A new business model for socially responsible investing*; Community Dividend, Ninth Federal Reserve District; Nov. 2009; available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305 (last visited 9/20/2010).

[34] I.R.C. §4944(c). *See also* IRS.gov; *Program-related Investments*; available at http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html (last visited 9/20/2010).

[35] Americans for Community Development LLC; *What is the L3C? Basic Explanation*; available at http://www.americansforcommunitydevelopment.org/downloads/WhatIsTheL3C.pdf (last visited 9/20/2010). *See also* Davis, Steve and Sue Woodrow; *The L3C: A new business model for socially responsible investing*; Community Dividend, Ninth Federal Reserve District; Nov. 2009; available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305 (last visited 9/20/2010).

[36] *Supra* fn. 20.

[37] Brakman Reiser; 85 Chi.-Kent L. Rev. at 622. *See also* IRS.gov; *Taxes on Jeopardizing Investments*; available at http://www.irs.gov/charities/foundations/article/0,,id=137787,00.html (last visited 9/20/2010).

[38] Baxter, Christie I.; *A Basic Guide to Program-Related Investments*; The Grantsmanship Center; Fall 1997; available at http://www.community-wealth.org/_pdfs/articles-publications/pris/article-baxter.pdf (last visited 9/20/2010).

[39] Interview with Holly Paz, representative of IRS Division of Exempt Organizations, on August 2, 2010.

[40] *See* IRS.gov, *Program-related investments*, for a description of PRIs; available at http://www.irs.gov/charities/foundations/article/0,,id=137793,00.html (last visited 9/20/2010).

However, if an investment incidentally produces significant income or capital appreciation, such income or appreciation is not conclusive evidence that the significant purpose of the investment is the production of income or the appreciation of property.[41]

It is important to note that should a foundation make an investment, it is only "program-related" if it significantly furthers the foundation's exempt activities.[42] In other words, not only are foundations limited to making investments to those L3Cs with a related mission, but also the investment must ensure that the foundation's mission is considerably advanced.

Overall, the key purpose of the L3C business structure is to attract and facilitate investments from foundations to aid L3Cs in carrying out their philanthropic purposes.

Mr. Lang's model for L3Cs was intended to fit easily into various states' LLC acts to create homogeneity among the various state enactments.[43] Therefore, each adopting jurisdiction has amended its LLC act to define an L3C as organized for business purposes and operated to satisfy the requirements for a PRI under §4944(c) of the IRC.[44] Because the L3C definition and designation is provided for within each of the states' LLC acts, this new business model automatically assumes all of the other characteristics and regulations of a LLC.

Although only seven states[45] have enacted legislation to formally recognize L3Cs, every state in the U.S. must recognize L3Cs formed in other states by giving them full faith and credit under the U.S. Constitution's Full Faith and Credit Clause.[46] The Full Faith and Credit Clause states, "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State…."[47]

Examples

Perhaps the best way to understand L3Cs is to examine those that are currently in operation. However, because the L3C is a new type of business entity, there are only a few examples of reportedly successful L3C entities. One such entity is **Maine's Own Organic Milk Company L3C** (MOOMilkCo L3C or MOOMilk).[48] Ten dairy farmers formed MOOMilk in 2009 after their contracts were not renewed by their large milk distributor H.P. Hood LLC, due to surplus supply and a decrease in demand for organic milk, which stemmed from the recession.[49] Without a major distributor, the farmers were faced with selling their livestock, going out of business,

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[41] *Id*.
[42] *Id*.
[43] Brakman Reiser; 85 Chi.-Kent L. Rev. at 622.
[44] *Id*. at 621.
[45] L3Cs are recognized in Illinois (805 ILCS 180/1-26), Maine (31 M.R.S.A. § 1611, effective July 1, 2011), Michigan (MCL §450.4204), North Carolina (Ch. SL 2010-187), Utah (Utah Code §48-2c-412), Vermont (11 V.S.A. §§3001-3184), and Wyoming (Wyo. Stat. §§17-29-101 through 17-29-1105). In addition, the Crow Nation (§§18-5-102, 18-5-108(a), and 18-5-705(a) of the Crow Law and Order Code) and Oglala Sioux Tribe (citation not available, *but see* Americans for Community Development; *laws*; available at http://www.americansforcommunitydevelopment.org/laws.php (last visited 9/20/2010)) recognize L3Cs.
[46] U.S. Const. art. IV, s. 1, *See also* Collins, Bruce D.; *Low-Profits: L3C designation allows foundations to support businesses working for the public good*; Inside Counsel; January 2, 2008; available at http://www.insidecounsel.com/Issues/2008/January%202008/Pages/LowProfits.aspx (last visited 9/20/2010).
[47] *Id*.
[48] *See* Schmidt, Elizabeth; *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*; August 10, 2010; VERMONT LAW SCHOOL LEGAL STUDIES RESEARCH PAPER SERIES
Research Paper No. 10-49; available at http://www.americansforcommunitydevelopment.org/downloads/VermontsSocialHybridPioneers8_22_10.pdf (last visited 9/20/2010).
[49] CNNMoney.com; *For L3C companies, profit isn't the point*; February 9, 2010; available at http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies/ (last visited 9/20/2010). *See also* Maine's Own Organic Milk Company, L3C; *Our Story*; available at http://moomilkco.com/moo-milk-our-story (last visited 9/20/2010) and Bangor Daily News; *Organic milk boom in Maine going bust*; March 1, 2009; available at http://www.bangordailynews.com/detail/100620.html (last visited 9/20/2010).

or going back to conventional dairying.[50] However, with ingenuity, and with the help of the Maine Farm Bureau, the Maine Organic Farmers and Gardeners Association (MOFGA), and the Maine Department of Agriculture, the farmers set up their own distributorship by forming an L3C in Vermont and kept the organic farmers in business.

Demonstrating the benefits of membership and governance flexibility of the L3C business structure, MOOMilk claims that the 10 farmers collectively own 45 percent of the voting units of the company and the farmers are to elect three of the seven board members that will govern the L3C, while investors will elect three board members.[51] Currently, Agricultural Consultant Bill Eldridge is the Chairman of the board. Another 45 percent of the L3C will be owned by investors being sought to provide $0.5 million in equity. Exemplifying that various types of organizations and persons may invest in an L3C, the Maine Farm Bureau and MOFGA, both of whom helped MOOMilk in its formation, each own one half of one percent; 4 percent will be owned by a three-person team, all Farm Bureau members, who formulated and executed the company's development plan;[52] and the last 5 percent is being withheld for future employee performance incentives.

MOOMilk's mission is "to educate the consuming public on the value and intrinsic worth of preserving the local family farm while developing a line of premium quality milk products that support this mission."[53] This mission is in-keeping with the IRC and Vermont's L3C statute, which require the company to significantly further the accomplishment of a charitable or educational purpose, not be significantly purposed for profit, and not seek to accomplish one or more political or legislative purposes.[54]

The **North Carolina furniture industry** also has a vision and a use for the L3C business structure. Mr. Lang, credited as the founder of L3Cs, has promoted L3Cs as a way for North Carolina to rescue its flailing furniture industry. Within 5 years, North Carolina lost approximately 60,000 manufacturing jobs due to competition from China in the form of low labor costs, looser environmental and labor laws, and subsidized buildings and equipment.[55] Outsourcing furniture manufacturing to China is making what was once a profession passed on from generation to generation a dying trade; consequently, communities are dying along with it.[56]

Lang proposes that L3Cs be created to buy factories to house furniture manufacturing plants, which would be furnished with the greenest and most efficient cutting edge equipment possible.[57] The L3Cs can charge furniture manufacturing companies lower rent and equipment lease rates, which in turn reduces costs for the manufacturers and puts them in a stronger position to compete and thrive. The social benefit is saving jobs, a culture, and promoting community economic development.[58]

The increasing frequency of people using the Internet as a news source, the collapsing advertising-supported model of journalism, and the economic downturn has created a "perfect storm" for **newspapers**, causing many of them to shut down.[59] In response, newspapers have been looking for alternative means to revive the languishing industry. Many are promoting the L3C as the way forward for some newspapers.[60]

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[50] *Id*.
[51] Maine's Own Organic Milk Company, L3C; *Our Story*; available at http://moomilkco.com/moo-milk-our-story (last visited 9/20/2010). *See also* Maine's Own Organic Milk Company, L3C; *Vision/Mission Statement*; available at http://moomilkco.com/moo-milk-our-company (last visited 9/20/2010).
[52] The three-person development team who put the project together is Agricultural Consultant Bill Eldridge of Bar Harbor, Farm Bureau Aroostook County staffer Rommy Haines, and David Bright, a member of the Farm Bureau Marketing Committee. Maine's Own Organic Milk Company, L3C; *Vision/Mission Statement*; available at http://moomilkco.com/moo-milk-our-company (last visited 9/20/2010).
[53] Maine's Own Organic Milk Company, L3C; *Vision/Mission Statement*; available at http://moomilkco.com/moo-milk-our-company (last visited 9/20/2010).
[54] *See* I.R.C. §4944(c) and 11 V.S.A. §§3001-3184.
[55] The Mary Elizabeth & Gordon B. Mannweiler Foundation, Inc.; *The L3C: The for profit with a nonprofit soul*; Presentation; July 5-7, 2007; available at http://www.americansforcommunitydevelopment.org/downloads/L3CUBSPresentation.pdf (last visited 9/20/2010).
[56] *Id*.
[57] *Id*.
[58] *Id*.
[59] Pickard, Victor, et al.; *Saving the News: Toward a National Journalism Strategy*; pg. 7; Free Press; May 12, 2009;

The first newspaper to organize as a L3C is the "Point Reyes Light," which was formed under Vermont L3C laws, but operates out of California.[61] Many newspapers are watching this paper to determine if it will be a feasible model for the newspaper industry. However, there is some speculation as to whether the L3C will be appropriate for some newspapers as traditionally, the IRS has refused to recognize reporting the news as a kind of social or educational benefit that would qualify as exempt activities under the IRC. As discussed previously, a company only qualifies as a PRI under the IRC if its purpose meets one or more charitable or educational purposes described in s. 170(c)(2)(b) of the IRC. According to the Point Reyes Light Editor Tess Elliot, the L3C's mission is to encourage "village journalism."[62] The L3C business model may offer little recourse to some papers that have traditionally taken sides on the political matters, because such activities could conflict with the federal rules forbidding PRIs to be used to accomplish or influence one or more political or legislative objectives described in s. 170(c)(2)(d) of the IRC.

A few reports that have tracked L3C start-ups suggest that L3Cs are formed in a **variety of other industries**; all having unique social missions.[63] Some fields of industry under which L3Cs have formed, or those industries possibly well-suited for L3Cs, include:

- Farming and agriculture.
- Real estate and housing.
- Environmental services.
- Healthcare.
- Low-income assistance.
- Journalism and publishing.
- Sports and recreation.
- Entertainment.
- Food.
- Socially responsible consulting.
- Education.
- Marketing and event planning.
- Construction services.
- Arts and preservation.
- Financial and legal services.
- Travel and tourism.[64]
- Carbon trading.
- Alternative energy.
- Job creation.
- Economic development.
- Medical research.[65]
- Biotech.[66]

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available at http://www.americansforcommunitydevelopment.org/downloads/saving_the_news-1.pdf (last visited 9/20/2010).

[60] *See id*. at 16-17. *See also* Mitchell, Bill; *L3Cs a "Low Profit" Business Model for News*; March 2, 2009; available at http://www.poynter.org/column.asp?id=131&aid=159320 (last visited 9/20/2010) and Duros, Sally; *How to Save Newspapers*; February 9, 2009; available at http://www.huffingtonpost.com/sally-duros/how-to-save-newspapers_b_164849.html (last visited 9/20/2010).

[61] Downs Rachlin Martin; *Pulitzer Prize-winning weekly first in US saved by Vermont L3C formation*; June 29, 2010; available at http://www.vermontbiz.com/news/june/pulitzer-prize-winning-weekly-first-us-saved-vermont-l3c-formation (last visited 9/20/2010).

[62] Fitzgerald, Mark; *Point Reyes Shines 'Light' on L3C Ownership*; Editor & Publisher; August 12, 2010; available at http://www.editorandpublisher.com/printarticle.aspx?ArticleID=62269 (last visited 9/20/2010).

[63] *See* Capriccioso, Caryn, et al.; *Who is the L3C Entrepreneur?: The pioneers of social enterprise's revolutionary new suffix*; interSector Partners, L3C; May 2010; available at http://www.americansforcommunitydevelopment.org/downloads/WhoistheL3CEntrepreneur.pdf (last visited 9/20/2010); providing a detailed list and analysis of a variety of L3Cs operating throughout the United States. *See also supra* fn. 48.

[64] The above-listed industries are referred to in Capriccioso et al., interSector Partners, L3C: *Who is the L3C Entrepreneur?: The pioneers of social enterprise's revolutionary new suffix*; May 2010; pg. 6; available at http://www.americansforcommunitydevelopment.org/downloads/WhoistheL3CEntrepreneur.pdf (last visited 9/20/2010).

[65] *See* Witkin, Jim; *The L3C: A More Creative Capitalism*: January 15, 2009; available at http://www.triplepundit.com/2009/01/the-l3c-a-more-creative-capitalism/ (last visited 9/20/2010), providing the examples of carbon trading, alternative energy, job creation, economic development, and medical research, in addition to some examples already cited above.

[66] *See* Larson, Chris; American Chemical Society, San Diego Section; *L3C-The Next Generation of Small Biotech?*; October 15, 2008; available at http://www.americansforcommunitydevelopment.org/downloads/ChrisLarsonNextGenBiotech.pdf (last visited 9/20/2010).

Benefits for Businesses

Compared to nonprofit and for-profit corporations or other types of hybrids, the L3C business structure may have several unique benefits allowing businesses to be more sustainable and better able to expand their charitable purposes. These benefits include:

- Greater flexibility in its operation.
- Option to use a tiered investment strategy.
- Unique branding to promote its mission.

The business structure of a LLC allows for greater flexibility in its operation.[67] A LLC is typically governed either by all members or by a managing member. Under an operating agreement, members of the LLC may agree on how the LLC is to be managed, as well as other operations, including the withdrawal of members, transferability of membership interests, the allocation of distributions, and dissolution of the LLC.

The most important facet of this flexibility for an L3C is that the members can allocate a larger distribution of profits to one member over another, meaning the L3C may have tiered membership and therefore, tiered investors.[68] Membership rights do not need to be equal in nature, and management rights do not need to equate to financial contributions.[69]

This flexibility allows for, and it encourages, diverse investments. Ideally, the structure of an L3C allows for three tranches of investment; the equity tranche, the mezzanine tranche, and the senior tranche.[70]

The first level of investment, the equity tranche or junior tranche, consists of investors that seek little or no returns on their contribution. For L3Cs, equity tranche investors are likely to be private foundations making program-related investments (PRIs) as they are prohibited by federal regulations from contemplating a financial return as their motive for investment.[71] Once this initial equity investment is made in the L3C, it absorbs most of the financial investment risk, making the L3C a more attractive investment for the mezzanine tranche of investors. In return for its risky investment, the equity tranche of investors may be granted significant voting power and management rights.[72]

The mezzanine tranche, or intermediate tier, consists of socially-conscious investors who are willing to forego market-rate financial returns for the sake of community or social welfare. Investors in this tranche may consist of individuals wanting to contribute to a cause, but with small or average returns. This tranche of investment, coupled with the equity tranche of investment, makes the L3C ripe for senior tranche investments.[73]

Senior tranche, or third tier, investments are provided by investors that seek market-rate returns. These types of investors are likely to make investments with guaranteed returns or returns that are keyed to the L3C's profits, which is possible given that the equity tranche and mezzanine tranche of investments take on most of the financial risk. Institutional investors, such as banks, pension funds, or investment banks are examples of those investors potentially interested in L3Cs that have established tranches of investment.[74] For illustration purposes, the chart below demonstrates a potential tiered investment strategy for an L3C.[75]

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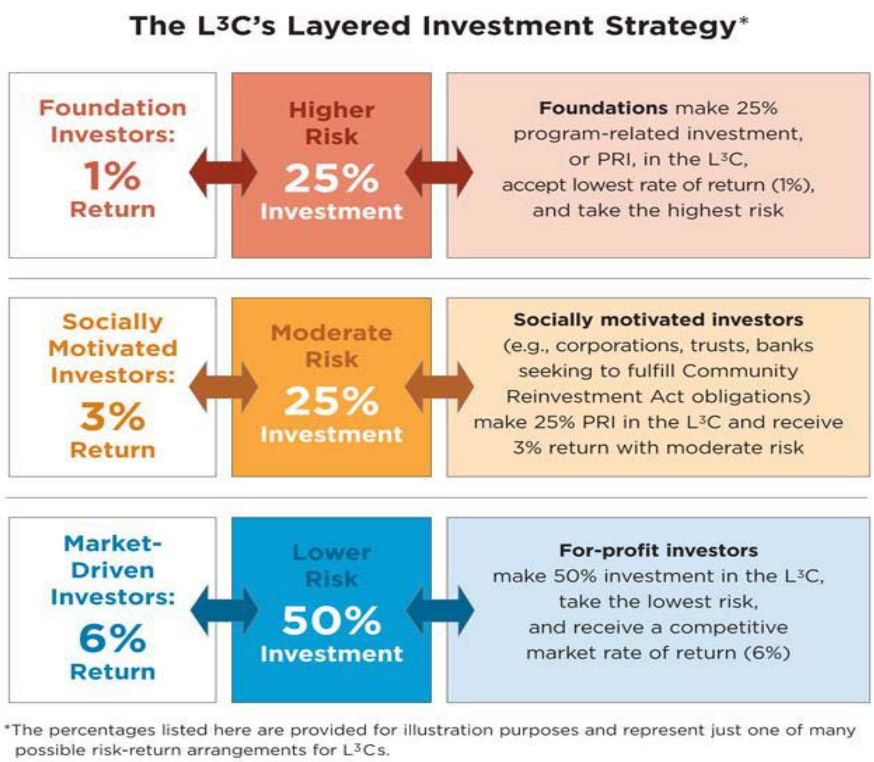
[67] Kleinberger, Daniel S., *The Snare and Delusion of the L3C* retitled *A Myth Deconstructed: The 'Emperor's New Clothes' on the Low Profit Limited Liability Company*; William Mitchell Legal Studies Research Paper No. 2010-03; available at http://meetings.abanet.org/webupload/commupload/RP519000/relatedresources/Kleinberger-L3C_Snare_and_Delusion-2-16-10.pdf (last visited 9/20/2010).
[68] Brakman Reiser; 85 Chi.-Kent L. Rev. at 625-628.
[69] *Id*. at 627.
[70] *Id*. at 628. *See also* Dinning, B. Ray; *Using the L3C to Structure Social Ventures*; December 7, 2009; available at http://lawpartners.wordpress.com/2009/12/07/using-the-l3c-to-structure-social-ventures-by-ray-dinning-jd-llm/ (last visited 9/20/2010).
[71] *Id*.
[72] *Id*.
[73] *Id*.
[74] *Id*.
[75] This chart is used with the written permission of Steven Davis, the drafter of the chart.



One of the most salient and promising features of the L3C concept is its "branding" feature. As discussed earlier, branding is a problem for other forms of hybrids or companies having blended social and for-profit missions.[76] Specifically, the problem inheres to for-profit businesses that have traditionally sought primarily profits, especially corporations having to answer to shareholders. Without a formal, independent agency that recognizes and enforces an organization to be primarily mission-based, it is challenging to gain foundations and other investors' confidence that an organization is truly mission-based.

Entrepreneurs electing to form L3Cs have reported that they chose this business structure for its "halo" effect, meaning that the L3C offered a specific branding advantage, giving entrepreneurs an opportunity to project their business values to customers and investors.[77] As one L3C owner explained, "[t]here are millions of LLCs out there. How can you tell, just from their name, that they have a social mission?"[78] However, until the L3C business model becomes well-known and synonymous with being a socially mission-based, the branding benefit not be realized by L3Cs for some time.[79]

Benefits for the State

While the option to organize under the L3C structure may have unique benefits to businesses, there may also be some economic benefits to the State of Florida, should these organizations be recognized by law. These benefits include:

- Attracting entrepreneurs to the state.
- Encouraging out-of-state and in-state capital investing in Florida L3Cs.
- Direct and indirect increases in state and local tax collections, including corporate income taxes, should L3Cs file as corporations on their federal income tax returns.

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[76] Brakman Reiser; 85 Chi.-Kent L. Rev. at 623.
[77] *Supra* fn. 48 at pg. 20.
[78] *Id*. Quote was from author's interview with Rick Zwetsch of intersector Partners L3C.
[79] *Supra* fn. 48 at pg. 24.

First, it may be a useful strategy in attracting entrepreneurs seeking to form as an L3C to establish businesses in Florida. As only seven states[80] now allow businesses the option to form as an L3C, Florida could be an attractive destination for businesses with an explicit primary charitable mission and secondary profit goal.

Second, the presence of L3Cs in the state may encourage out-of-state and in-state capital investing in Florida L3Cs. In 2007, there were approximately 75,187 grantmaking foundations in the U.S.;[81] approximately 4,000 of them were based in Florida.[82] Despite Florida being ranked as the fourth most populated state[83] and having the fourth largest Gross Domestic Product (GDP) out of the ten most populous states,[84] it does not rank as one of the top ten states that received foundation grant dollars.[85] Some may argue that the adoption of L3C laws in Florida would encourage out-of-state and in-state foundations to direct their grant money to mission-related L3Cs formed in Florida, making PRIs instead of grants.

Attracting entrepreneurs to, and encouraging capital investing in, Florida is likely to result in economic development and new job opportunities for Floridians.

LLCs are not recognized federally as a business structure and therefore, they must file their federal tax returns as a sole proprietor, partnership, or corporation.[86] Florida law requires those entities filing as corporations to pay corporate income tax.[87] To the extent that a start-up business chooses to become a L3C instead of a nonprofit and files as a corporation with the IRS, the state would experience an increase in corporate tax revenue.

Criticisms and Consequences

The L3C concept has not been without criticism or controversy.[88] The chief complaints about the L3C business model are that it is:

- Unnecessary.
- Misleading.

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[80] *Supra* fn. 45.

[81] The Foundation Center; *FC Stats: The Foundation Center's Statistical Information Service: Number of Grantmaking Foundations, 1975 to 2007*; available at http://foundationcenter.org/findfunders/statistics/pdf/02_found_growth/2007/03_07.pdf (last visited 9/20/2010). This number includes both private and community foundations.

[82] The Foundation Center: *FC Stats: The Foundation Center's Statistical Information Service: Fiscal Data of Grantmaking by Region and State, 2007*; available at http://foundationcenter.org/findfunders/statistics/pdf/01_found_fin_data/2007/01_07.pdf (last visited 9/20/2010).

[83] U.S. Census Bureau; United States—States: GCT-T1-R. Population Estimates (2009); available at http://factfinder.census.gov/servlet/GCTTable?_bm=y&-geo_id=01000US&-_box_head_nbr=GCT-T1-R&-ds_name=PEP_2009_EST&-format=US-40S (last visited 9/20/2010).

[84] Enterprise Florida, Inc.; Gross *Domestic Product & Income: Gross Domestic Product of the Ten Most Populous States, 2008*; available at http://www.eflorida.com/ContentSubpage.aspx?id=1898 (last visited 9/20/2010).

[85] The Foundation Center; *FC Stats: The Foundation Center's Statistical Information Service: Top Ten States by Foundation Grant Dollars Received, 2008*; available at http://foundationcenter.org/findfunders/statistics/pdf/03_fund_geo/2008/17_08.pdf (last visited 9/20/2010).

[86] IRS.gov; *Limited Liability Company (LLC)*; available at http://www.irs.gov/businesses/small/article/0,,id=98277,00.html (last visited 9/20/2010).

[87] *See* s. 220.02(1), F.S., stating, "It is the intent of the Legislature to subject such corporations and other entities to taxation hereunder for the privilege of conducting business, deriving income, or existing within this state. This code is not intended to tax, and shall not be construed so as to tax, any natural person who engages in a trade, business, or profession in this state under his or her own or any fictitious name, whether individually as a proprietorship or in partnership with others, or as a member or a manager of a limited liability company classified as a partnership for federal income tax purposes…."

[88] *See supra* fn. 67. *See also* CNNMoney.com; *For L3C companies, profit isn't the point*; February 9, 2010; available at http://money.cnn.com/2010/02/08/smallbusiness/l3c_low_profit_companies/ (last visited 9/20/2010); Cohen, Rick; *Updates on Some Sacred Cows*; June 20, 2010; available at http://www.blueav.org/category/topic/nonprofits-government?page=1 (last visited 9/20/2010); and Davis, Steve and Sue Woodrow; *The L3C: A new business model for socially responsible investing*; Community Dividend, Ninth Federal Reserve District; Nov. 2009; available at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305 (last visited 9/20/2010).

- Void of an enforcement mechanism to make sure the L3C meets, and continues to meet, statutory requirements.

In addition, some believe that nonprofit corporations could be adversely affected should the L3C concept gain momentum.

Although states have enacted legislation allowing L3Cs to form if the companies have a primarily social-based mission and mimic the federal PRI requirements, nothing currently prevents a LLC from being primarily mission-based, adhering to PRI requirements, and seeking different levels of investors.[89] Therefore, it has been argued that it is unnecessary to create an entity that only does what can already be done under state law as an LLC.[90] However, in response, proponents of L3Cs have argued that they still believe that formation as an L3C, rather than an LLC, offers an important "branding" mechanism.[91] Nevertheless, the proponents' branding argument has also been countered by foundations, suggesting that the lack of PRIs is more of a cultural phenomenon and not based on a lack of knowledge or ability to overcome administration or other hurdles associated with PRIs.[92]

Although the concept of the L3C was created to coincide with the federal requirements over PRIs, the IRS has not acted, nor does it intend to act in the near future, to formally or automatically recognize L3Cs as PRIs.[93] Furthermore, there is no indication that the U.S. Congress is willing to take up any legislation to amend the IRC to formally recognize L3Cs as PRIs.[94] If states enact legislation recognizing L3Cs, it may be misleading for some unsophisticated entrepreneurs who rely on the state sanctioning this type of entity. Consequently, some L3C owners may be surprised when the IRS audits the company and the investment in the company does not meet the strict federal requirements for a PRI, the foundation investing in the company becomes subject to steep tax penalties and the company loses its investor.

In addition, some may assume that because the L3C is based on the LLC business model that it is a relatively simple business to organize and run. To the contrary, the L3C may need a well-drafted and thought-out operating agreement in contemplation of the complex business relations formed between foundations, intermediary investors, and market-rate investors.[95]

For investors, the legitimacy of L3Cs may rely on enforcement mechanisms to ensure that the L3C has, and keeps, a truly philanthropic purpose.[96] Moreover, foundations that are making the initial investments and assuming most of the risk will want to be assured that the L3C adheres to the state, and thus federal, PRI requirements. Currently, because the IRS only audits PRIs after they have been made, it is up to the foundations to thoroughly scrutinize a company prior to making an investment.[97] Almost all of the states that have enacted legislation recognizing L3Cs have not expressly provided provisions for enforcing the specific mission requirements of an L3C.[98] Indirectly, the state statutes offer some incentive for L3Cs to not stray from their

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[89] *Supra* fn. 67 at 21-22.
[90] *Id*.
[91] *See* Capriccioso, *supra* fn. 63 at pg. 9.
[92] Bradfield, Jason, et al.; *The Low-Profit Limited Liability Company (L3C)*; The Tuck School of Business at Dartmouth College; 2009; available at http://www.scribd.com/doc/16583284/L3C-Report-from-the-Tuck-School-of-Business-at-Dartmouth-2009 (last visited 9/20/2010).
[93] Interview with Holly Paz, representative of IRS, Division of Exempt Organizations, on August 2, 2010.
[94] *See* Letter from Max Baucus, Chairman of the U.S. Senate Committee on Finance, and Charles Grassley, Ranking Member of the U.S. Senate Committee on Finance, dated March 20, 2009, to the National Association of State Charity Officials. A copy of the letter is on file with Senate Commerce Committee staff.
[95] *Supra* fn. 67 at pgs. 23-24, discussing fiduciary responsibilities and conflicts of interest between members with differing investment purposes. Other complexities addressed by Kleinberger include securities law questions and member "exit rights."
[96] Brakman Reiser; 85 Chi.-Kent L. Rev. at 650.
[97] *Supra* fn. 39.
[98] Michigan's law is the exception for it permits the Attorney General to bring an action to dissolve a L3C if the L3C has ceased to meet any of the statutory requirements and has failed, after 60 days of ceasing to meet such requirements, to file a certificate to amend its name to conform to a LLC. *See* MCL §450.4803. Wyoming's law contains a similar measure that requires a L3C to be automatically deemed "transacting business without authority" in the state if the L3C ceases to meet statutory requirements and does not amend its articles of organization with the Secretary of State within 30 days of ceasing

purpose as they generally require L3Cs to automatically convert to a LLC should they abandon their philanthropic mission or depart from the specific requirements of a PRI.[99] Ideally, states would have an independent state agency reviewing L3Cs operating agreements and perform audits to determine whether the L3Cs are abiding by their missions and meeting statutory requirements. However, this may require resources beyond most states' means, especially considering the current fiscal condition of many states.

Finally, the proliferation of L3Cs may have an adverse impact on donations to nonprofits. According to a survey conducted in 2010 by Guidestar®, a 501(c)(3) nonprofit organization that performs philanthropic research, 2010 "has been, and continues to be, a difficult financial environment for nonprofits."[100] Specifically, 40 percent of survey respondents saw declines in contributions than the previous year.[101] Considering that nonprofits are vying for what resources they can to survive, it is likely that nonprofits, who are not interested in converting to a L3C, would be concerned about L3Cs competing for donations.

Summary

Proponents envision the L3C business model as an innovative answer to foundations' lack of PRI participation, while opponents suggest that the L3C is unnecessary and may cause confusion for not only the businesses running them, but also potential investors. Although the L3C is controversial, the trend seems to indicate that states (seven in 2 years) are interested enough to enact legislation and recognize them, hoping that these new entities will encourage economic development. However, states may discover that economic development stemming from the L3C may be hindered until some type of enforcement mechanism or IRS approval of L3Cs is forthcoming.

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such requirements. *See* Wyo. Stat. §17-29-705(e).

[99] Brakman Reiser; 85 Chi.-Kent L. Rev. at 650-651.

[100] Guidestar®; *The Effect of the Economy On the Nonprofit Sector*; June 2010; available at http://www2.guidestar.org/ViewCmsFile.aspx?ContentID=2963 (last visited 9/20/2010).

[101] *Id*. at pg. 2.