

SEVEN WAYS TO STRENGTHEN AND IMPROVE THE L3C

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INTRODUCTION

The *raison d'être* for the low-profit limited liability company (“L3C”) is to encourage program-related investments (“PRIs”) by private foundations.¹ PRIs are special types of investments that can be both charitable and profitable.² A classic example of a PRI is a low-interest rate loan made by a private foundation to spur economic growth in an economically depressed community.³ Due to certain tax risks and added compliance burdens, PRIs remain underutilized.⁴ One report indicates that during the 2006–2007 timeframe, PRIs amounted to less than one percent of charitable dollars distributed by U.S. private foundations.⁵ Nevertheless, knowledgeable scholars, practitioners, and foundation managers believe that encouraging PRIs is a laudable goal,⁶ and apparently even the U.S. Department of the Treasury agrees, as evidenced by recently issued regulations with new examples of PRIs.⁷ Thus, the L3C would seem to be in the right place at the right time and should have the full support of the charitable sector, practitioners, and lawmakers.

Yet, after a fast start, adoption of L3C legislation across the United States has stalled.⁸ In fact, at least eighteen states have considered the

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¹ Professor Carter Bishop is credited for coining this very apt phrase in describing the purpose of the L3C. See Carter G. Bishop, *Sectorization & L3C Regulatory Arbitrage of Joint Ventures with Nonprofits* 5 (Suffolk Univ. Law Sch. Legal Studies Research Paper Series, Research Paper No. 12-19, 2012), available at <http://ssrn.com/abstract=2045034>.

² See I.R.C. § 4944(c) (2006).

³ See Treas. Reg. § 53.4944-3(b) ex. 1 (1973).

⁴ Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 257–59 (2010).

⁵ Steven Lawrence, *Doing Good with Foundation Assets: An Updated Look at Program-Related Investments*, in THE PRI DIRECTORY, at xiii, xiii (3d ed. 2010), available at http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf.

⁶ See, e.g., Ofer Lion & Douglas M. Mancino, *PRIs—New Proposed Regulations and the New Venture Capital*, 24 TAX'N EXEMPTS, Sept.–Oct. 2012, at 3, 3.

⁷ Prop. Treas. Reg. § 53.4944-3(b) exs. 11–19, 77 Fed. Reg. 23,430, 23,430–32 (Apr. 19, 2012).

⁸ Vermont was the first state to adopt L3C legislation in 2008. AMS. FOR CMTY. DEV., WHAT IS THE L3C? (2011), available at <http://americansforcommunitydevelopment.org/downloads/What%20is%20the%20L3C%20080711-1.pdf>. By 2010, seven more states had authorized L3Cs. *Id.* Then, in 2011, Rhode Island became the ninth state

L3C and deferred passing legislation.⁹ Many highly regarded scholars and practitioners adamantly oppose the L3C, even though those scholars and practitioners generally endorse PRIs.¹⁰ The ABA Business Law Section's Committee on Limited Liability Companies, Partnerships, and Unincorporated Entities and Committee on Nonprofit Organizations jointly oppose L3Cs.¹¹ Going even further, the North Carolina Bar is advocating repeal of its state's L3C statute.¹² This strong opposition and inconsistent pattern of adoption of L3C legislation contrasts sharply with the virtually uniform adoption of limited liability company ("LLC") and limited liability partnership legislation roughly twenty years ago.¹³ Moreover, despite a later start, legislation authorizing the formation of another type of "social enterprise"¹⁴ entity, the benefit corporation, has been enacted by twelve states and the District of Columbia¹⁵ and rapidly appears to be gaining traction in many other jurisdictions.¹⁶

to adopt L3C legislation. *Id.*; see also *Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, L3C (Jan. 18, 2013), http://www.intersectorl3c.com/l3c_tally.html (reporting the number of L3Cs organized in each state). As of the date of publication of this Article, no other states have adopted L3C legislation since Rhode Island in 2011. See *id.*

⁹ See Carter G. Bishop, *Fifty State Series: L3C & B Corporation Legislation Table 57* (Suffolk Univ. Law Sch. Legal Studies Research Paper Series, Research Paper No. 10-11, 2013), available at <http://ssrn.com/abstract=1561783>.

¹⁰ See, e.g., Bishop, *supra* note 4, at 244, 26; 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); Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 909 (2010).

¹¹ Letter from Linda J. Rusch, Chair, Am. Bar Ass'n Bus. Law Section, to Steve Simon, Assistant Minority Leader, Minn. House of Representatives (Apr. 19, 2012), available at <http://ssrn.com/abstract=2055823>.

¹² Email from Warren P. Kean, Chair, N.C. Bar Ass'n Joint Task Force on Ltd. Liab. Cos., to William J. Callison (Oct. 14, 2012, 1:16 PM) (on file with the Regent University Law Review).

¹³ Compare Letter from Linda J. Rusch, *supra* note 11 (arguing against the enactment of L3C legislation), with Robert W. Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065, 1065 (1995) (noting the rapid adoption of LLP statutes), and Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 1 (1995) (noting the rapid adoption of LLC legislation and the uniformity of the state statutes).

¹⁴ "Social enterprise" has no legally recognized definition, but it can loosely be described as "using traditional business methods to accomplish charitable or socially beneficial objectives." Cassady V. ("Cass") Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (a/k/a "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2012); see generally J. Haskell Murray, *Choose Your Own Master: Social Enterprise, Certifications, and Benefit Corporation Statutes*, 2 AM. U. BUS. L. REV. 1 (2012).

¹⁵ *State by State Legislative Status*, BENEFIT CORP INFO. CTR., <http://www.benefitcorp.net/state-by-state-legislative-status> (last visited Mar. 11, 2013).

¹⁶ See *id.* (noting other states have introduced benefit corporation legislation).

Why is L3C legislation languishing? Because the L3C suffers from the following fundamental defects: (1) except in name, the L3C is indistinguishable from a regular LLC; (2) without any type of statutory enforcement mechanism, the L3C lacks accountability and transparency; and (3) the L3C promises more than it can deliver absent new federal legislation, thus failing its essential purpose of encouraging PRIs. Under current law, the L3C is nothing more than a brand,¹⁷ and even that brand lacks any type of independent certification or approval process.¹⁸ Thus, the L3C lacks credibility, and, unless improvements to its statutory framework are made, the L3C is not likely to gain much acceptance or use.

Given its defects, opponents argue that the L3C should be abolished.¹⁹ These opponents rightly point out that regular LLCs are more than sufficient to accommodate PRIs.²⁰ Therefore, there is no need for the L3C, so the form is confusing at best and misleading and harmful at worst. Thus, the opponents maintain that the L3C is a well-intentioned but nonetheless failed experiment that should be abandoned.²¹

Even though the author generally agrees with the opponents' assessment of the L3C *in its current form*, the L3C should not be abandoned. The L3C is salvageable if the current statutory framework is strengthened and improved. To survive, the L3C must become substantively distinguishable from a regular LLC. Further, the L3C must become substantively distinguishable in a manner uniquely suited to its use by tax-exempt organizations, especially as a vehicle for PRIs. If the L3C becomes more than just a brand, then perhaps the L3C can fulfill its *raison d'être*.

With the foregoing premise in mind, this Article proposes seven relatively simple but impactful changes to the L3C statutory framework. These seven changes are designed to strengthen and improve the L3C

¹⁷ On the other hand, John Tyler has persuasively argued that the L3C does indeed change the law regarding fiduciary duties among managers and members of an LLC and that the L3C, therefore, is useful in this regard even if it may be no better than a regular LLC for accommodating PRIs. See John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 121–22, 146–53 (2010). The author agrees with Mr. Tyler, but, in the author's opinion, a carefully crafted operating agreement for a regular LLC likewise could modify fiduciary duties among managers and members, thus eliminating even this distinction.

¹⁸ See Callison & Vestal, *supra* note 10, at 291.

¹⁹ See Kleinberger, *supra* note 10, at 893–910.

²⁰ See, e.g., David S. Chernoff, *L3Cs: Less There than Meets the Eye*, TAX'N EXEMPTS, May–June 2010, at 3, 4–5.

²¹ See Bishop, *supra* note 4, at 243–46; Callison & Vestal, *supra* note 10, at 291–92; Kleinberger, *supra* note 10, at 881.

with respect to its use by tax-exempt organizations, including but not limited to its use for PRIs. If the changes proposed herein are adopted in future L3C legislation, then the L3C potentially could become *both* a brand and a valued tool for tax-exempt organizations and PRIs.

SEVEN PROPOSED CHANGES FOR L3CS

The seven proposed changes to the L3C statutory framework are as follows:

1. First and foremost, require every L3C to have at least one bona fide economic member that is a qualified tax-exempt charitable or educational organization within the meaning of I.R.C. § 501(c)(3).
2. Related to the first change, make a technical but important correction to the L3C statutes to clarify that only “one or more limited liability company interests” must be charitable in nature, not the entire company as currently stated in the existing L3C-enabling legislation.²²
3. Similar to reporting obligations imposed by federal law upon I.R.C. § 501(c)(3) organizations,²³ require L3Cs to report their PRIs (including detailed financial information) on an I.R.S.-approved information return that must be made public.
4. Similar to requirements imposed by state law upon many nonprofits, require L3Cs to register under state charitable solicitation acts.²⁴
5. Similar to requirements imposed by state law upon many nonprofits, require L3Cs with certain minimum revenues or assets (for example, one million dollars) to obtain annual, audited financial statements and provide those statements to the state agency responsible for regulating nonprofits.²⁵
6. Provide a “free transferability” default rule for L3Cs so that a tax-exempt member may assign its membership interest at any time, with the exempt member’s transferee being automatically admitted as a substitute member with full economic and membership participation rights in the L3C.
7. Provide a default rule so that at any time and for any reason a tax-exempt member unilaterally may withdraw from an L3C, whereupon the L3C must repay the exempt member’s unreturned capital contribution (unless the L3C is

²² See, e.g., VT. STAT. ANN. tit. 11, § 3001(27)(B) (2010).

²³ See I.R.C. § 6033(a)–(b) (2006 & Supp. IV 2010).

²⁴ See, e.g., GA. CODE ANN. § 43-17-5(b) (2011).

²⁵ See, e.g., *id.* § 43-17-5(b)(4).

simultaneously liquidated, in which case the exempt member would participate in the liquidating proceeds).

The foregoing seven proposed changes are explained in greater detail below.

1. Require Every L3C to Have at Least One Tax-Exempt Member

The Vermont L3C statute, which is typical of statutes in other adopting states,²⁶ imposes the following special requirements in order for a regular LLC to be formed and qualify as an L3C:

- *Charitable or Educational Purpose:* The L3C must further the accomplishment of a charitable or educational purpose within the meaning of I.R.C. § 170(c)(2)(B).
- *“But For” Relationship to Charitable or Educational Purpose:* But for its relationship to the accomplishment of a charitable or educational purpose, the L3C would not be formed.
- *Production of Income or Appreciation of Property Not a Significant Purpose:* The production of income or the appreciation of property must not be a significant purpose of the L3C.
- *No Political Campaign Activity and No Lobbying:* The L3C must not engage in political or lobbying activity within the meaning of I.R.C. § 170(c)(2)(D).²⁷

²⁶ See, e.g., ME. REV. STAT. ANN. tit. 31, § 1611 (2011); R.I. GEN. LAWS § 7-16-76 (Supp. 2012).

²⁷ VT. STAT. ANN. tit. 11, § 3001(27). Specifically, the Vermont statute defines a “low-profit limited liability company” as follows:

(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 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.

(C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the Internal Revenue Code of 1986, 26 U.S.C. § 170(c)(2)(D).

(D) If a company that met the definition of this subdivision (27) 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 name of the company must be changed to be in conformance with subsection 3005(a) of this title.

The foregoing state-law requirements for L3Cs are intended to dovetail with the unique federal income tax rules defining a valid PRI. As mentioned above, PRIs²⁸ are special types of charitable, yet potentially profitable, investments made by I.R.C. § 501(c)(3) tax-exempt private foundations.²⁹ The purpose of the federal income tax rules defining and limiting PRIs is to ensure that private foundation dollars are used consistently with their tax-exempt status.³⁰ In other words, even though a PRI is an *investment* by a private foundation, the primary motive behind the investment must be charitable or educational, not the potential for profit. Moreover, the invested funds must not be used for political or lobbying activities because private foundations essentially are prohibited from engaging in such activity directly.³¹

Id.

²⁸ See generally Lion & Mancino, *supra* note 6, at 3 (explaining the usefulness of PRIs for private foundations under new proposed regulations).

²⁹ Organizations that are organized and operated exclusively for charitable, religious, educational, or other specified purposes are generally exempt from federal income tax under I.R.C. § 501(a) as organizations described in I.R.C. § 501(c)(3). I.R.C. § 501(a) (2006). I.R.C. § 509(a) divides I.R.C. § 501(c)(3) organizations into two subcategories: private foundations and organizations that are not private foundations, which are commonly known as public charities. See *id.* § 509(a). To be categorized as a public charity, and not a private foundation, an organization must be described in I.R.C. § 509(a). *Id.* To be described in I.R.C. § 509(a)(1) or (2), an organization must receive a substantial amount of broad-based public support to fund its operations. I.R.C. § 509(a)(1) and (2) contain certain rules that test whether an organization's support is broad-based and, therefore, "public." *Id.* § 509(a)(1)–(2). To be described in I.R.C. § 509(a)(3), an organization must have a particular type of structural relationship with a publicly supported § 501(c)(3), (4), (5) or (6) organization. See *id.* § 509(a).

³⁰ See Treas. Reg. § 53.4944-3 (1973).

³¹ Regarding the general requirements for PRIs, see I.R.C. § 4944(c) and Treas. Reg. § 53.4944-3(a). Regarding the limitations upon and excise taxes imposed with respect to political and lobbying expenditures by private foundations, see I.R.C. §§ 501(c)(3), 4945(d). Paradoxically, if a private foundation makes an investment that expressly is not a PRI but instead is an investment intended to make a profit as part of the foundation's regular endowment, there is no prohibition on the issuer's use of all or a portion of the invested funds to engage in lobbying or political campaign activity. (As would almost always be the case, the immediately preceding sentence assumes that the private foundation's invested funds are to be used for general corporate purposes and are not earmarked for political or lobbying expenditures.) Thus, a private foundation could purchase newly issued IBM preferred stock as a part of the private foundation's regular endowment, yet IBM would not be prohibited from using all or part of the investment proceeds to engage in lobbying or political campaign activity. This is true even though the private foundation itself would face a heavy excise tax and possible loss of exempt status if it used the same dollars to engage in lobbying or political campaign activity. In the author's view, this odd result is illustrative of a fundamental disconnect within all of the excise tax rules applicable to private foundations. That is, the excise tax rules are based upon the assumption that, from a financial standpoint, every private foundation does and should operate paradoxically. In other words, the excise tax rules presume that a private foundation's endowment funds will be invested exclusively and entirely to make a profit by any legitimate means necessary,

Neither federal law nor state L3C statutes, however, require an L3C to have an I.R.C. § 501(c)(3) tax-exempt organization as a member,³² even though the L3C should not have been formed “but for” its relationship to the accomplishment of a federally defined charitable or educational purpose.³³ Further, except perhaps in Illinois where L3Cs are subject to the Illinois Charitable Trust Act and Attorney General supervision,³⁴ there is no governmental or other enforcement mechanism in place to hold L3Cs accountable against a stated charitable or educational purpose.³⁵ Thus, unscrupulous founders could form an L3C to masquerade as charitable or educational even though their true purpose is purely profit-taking for their own private benefit. This lack of an enforcement mechanism and potential for abuse has led many state regulators and leaders of some nonprofit organizations to oppose the L3C.³⁶

On the other hand, if an L3C were required to have an I.R.C. § 501(c)(3) tax-exempt organization as an economic member, then an

but then the private foundation annually must give away (that is, grant) at least five percent of those assets to charitable organizations and pursuits. Private foundations do indeed operate financially in this schizophrenic manner. Their endowment assets typically are invested with a myopic focus upon profit only so that they can give away a portion of the assets in their charitable mission. Federal tax law encourages this arguably nonsensical behavior. For example, nothing in federal tax law prohibits a private foundation with a mission of promoting healthcare from investing in publicly traded tobacco companies, so long as that investment is sound from a purely investment management standpoint. If, however, the same private foundation desires to invest in a risky, privately held start-up company developing a safe cigarette, the foundation could be hit with an excise tax and possibly even lose its exempt status unless the investment qualifies as a PRI. *See id.* § 4944(c). Again, this odd tax regime that encourages conflicting uses of a private foundation’s assets does not make sense, but it clearly is the law.

³² *See* I.R.C. § 4944(c); Treas. Reg. § 53.4944-3(a); *see also, e.g.*, VT. STAT. ANN. tit. 11, § 3001(27) (2010).

³³ *See, e.g.*, R.I. GEN. LAWS § 7-16-76(a) (Supp. 2012); VT. STAT. ANN. tit. 11, § 3001(27)(A)(ii).

³⁴ *See* 805 ILL. COMP. STAT. 180/1-26(d) (2010). The Illinois statute goes too far by imposing trustee-like fiduciary duties on managers and officers of an L3C. *See id.* That approach might be appropriate if an L3C was itself intended to be a charitable organization, but that is not the intended purpose of an L3C. Instead, the L3C is intended to be an *instrument* through which charitable purposes indirectly may be accomplished, not a charitable organization directly engaged in charitable activities.

³⁵ *Compare, e.g., id.* (requiring officers, managers, and directors to have trustee duties to pursue the charitable or educational purpose), *with* VT. STAT. ANN. tit. 11, § 3001(27) (lacking an enforcement mechanism to ensure that the L3C pursues a charitable or educational purpose).

³⁶ *See, e.g.*, Chernoff, *supra* note 20; Letter from Chris Cash, President, Nat’l Ass’n of State Charity Officials, to Senator Max Baucus & Senator Charles Grassley (Mar. 19, 2009), *available at* <http://data.opi.mt.gov/legbills/2009/Minutes/Senate/Exhibits/jus65b04.pdf>.

evolving body of federal tax law would force the exempt member to exercise some degree of control over the L3C, thereby safeguarding the L3C's charitable or educational purpose. This evolving body of law consists of a number of cases and several published I.R.S. rulings defining and constraining the use of LLCs by exempt organizations in joint ventures and so-called "ancillary" joint ventures.³⁷

As a preliminary matter, note that the joint venture and ancillary joint venture rules presumably apply only if the tax-exempt organization is an *economic* member of an L3C (or LLC).³⁸ An L3C, like an LLC, generally permits members to have at least two distinct bundles of rights with respect to their membership interest. Members have an economic interest—the right to allocations and distributions of cash or other property from the L3C—and members have a participation interest—the right to information and to consent or object to certain actions.³⁹ Most often, members of an LLC or L3C have both an economic interest and a participation interest, but it is possible to have one type of interest without the other. If a tax-exempt member only had a participation interest in an LLC or L3C without having an economic interest, then theoretically the joint venture and ancillary joint venture rules would not be implicated. The joint venture rules presumably would not be implicated because the tax-exempt organization would have no charitable assets or property rights at risk via the LLC or L3C. The author is not aware of any I.R.S. guidance regarding a tax-exempt organization holding only participation rights in an LLC, but it is certainly true that the joint venture and ancillary joint venture rules were developed to protect a tax-exempt organization's charitable assets, property rights, and activities from improperly benefiting private interests.⁴⁰ Thus, it generally should be necessary for a tax-exempt organization to have an *economic* interest in an LLC or L3C in order to bring into play the rules developed by the cases and I.R.S. rulings regarding joint ventures with tax-exempt organizations.

A full discussion of tax-exempt joint venture cases and I.R.S. rulings is beyond the scope of this Article, but in general they establish the

³⁷ See CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.09 [2][b]–[c] (2012) (discussing the use of LLC by exempt organizations for joint ventures and ancillary joint ventures).

³⁸ See *id.* ¶ 1.09, 1.09[2][d].

³⁹ *Id.* ¶ 8.06[1][a] (2012).

⁴⁰ See, e.g., Rev. Rul. 2004-51, 2004-1 C.B. 975, 975–76 (attributing "insubstantial" activities of an ancillary LLC joint venture to an exempt member to determine the effect on the tax-exempt status of a member); Rev. Rul. 98-15, 1998-1 C.B. 718, 719–20 (attributing "substantial" activities of a whole hospital LLC joint venture to exempt a member to determine the effect on the tax-exempt status of the member).

following guidelines⁴¹: If a “substantial” part of an I.R.C. § 501(c)(3) tax-exempt organization’s⁴² activities and assets are held through an LLC, then the LLC must further an exempt purpose *and* the exempt member must retain control over the LLC.⁴³ Otherwise, the tax-exempt member seriously risks losing its I.R.C. § 501(c)(3) status.⁴⁴ In fact, for “substantial” activities and assets held through an LLC, the exempt member must possess control even if the assets contributed to the LLC by the exempt member are proportionately less than assets contributed by non-exempt members.⁴⁵

On the other hand, if an “insubstantial” part of an I.R.C. § 501(c)(3) tax-exempt organization’s activities and assets are held through an LLC, then the organization generally can maintain its exempt status without retaining control over the LLC.⁴⁶ Upon a finding of an “insubstantial” interest in an LLC, a secondary analysis then applies. If the “insubstantial” activity conducted through the LLC is related to the member’s exempt purpose, then the income generated by the LLC typically will not be taxable as unrelated business income.⁴⁷ If the “insubstantial” activity conducted through the LLC is unrelated to the member’s exempt purpose, then the income may be taxable as unrelated business income depending upon the nature of the income and the application of numerous other technical rules.⁴⁸

Caveat: Even in connection with an “insubstantial” activity conducted through an LLC, if the value of the assets contributed to the LLC by the exempt organization member is proportionately greater than the value of the assets contributed by non-exempt members, to safeguard I.R.C. § 501(c)(3) status, the exempt member should retain control over the LLC.⁴⁹ If the exempt member contributes proportionately greater value than other non-exempt members but does not retain control over the LLC, the I.R.S. may challenge the arrangement as constituting

⁴¹ See generally BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09. The use of the word “guidelines” here is intentional. There are no hard and fast rules in this area, and, as noted by the commentators, the I.R.S. historically has taken inconsistent positions. *Id.* ¶ 1.09[2].

⁴² This summary excludes discussion of private foundations because they are subject to separate rules—the excess business holdings rules—that severely limit a private foundation’s ability to invest in an arrangement that even remotely resembles a “joint venture” or even an “ancillary joint venture.” See I.R.C. § 4943 (2006).

⁴³ See Rev. Rul. 2004-51, 2004-1 C.B. 975; Rev. Rul. 98-15, 1998-12 C.B. 718.

⁴⁴ Rev. Rul. 2004-51, 2004-1 C.B. 975.

⁴⁵ See Rev. Rul. 98-15, 1998-12 C.B. 718, 721.

⁴⁶ See *id.*

⁴⁷ See Treas. Reg. § 1.501(c)(3)-1(b)(1)(iii) (as amended in 2008).

⁴⁸ *Id.* § 1.501(c)(3)-1(e).

⁴⁹ See BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[2][c][iii].

impermissible private benefit even when the LLC's activity is "insubstantial" with respect to the exempt member.⁵⁰

The preceding paragraph describes the I.R.S.'s position with respect to "insubstantial" activities conducted through an LLC, but the law is not settled. An exempt member could take a more aggressive but supportable position that, even where it contributes a proportionately greater share of the LLC's assets, the exempt member is not required to retain control for an "insubstantial" activity conducted through an LLC.⁵¹ This is a potentially dangerous position to take, however, because, as noted above, the I.R.S. may challenge the member's tax-exempt status.⁵²

To complicate matters more, for purposes of the above general guidelines, there is no clear definition of when an exempt organization's activities and assets held through an LLC are considered "substantial" versus "insubstantial."⁵³ If the question is litigated, the "substantial" versus "insubstantial" dividing line apparently is open to interpretation and hindsight by the I.R.S. and the courts. Thus, the uncertainty both as to whether an exempt member of an LLC must have control and whether its activities and assets held through an LLC are "substantial" or "insubstantial" makes tax-exempt joint ventures and ancillary joint ventures extremely delicate undertakings.⁵⁴

Moreover, just to muddy the waters further, it is well established that, as part of its regular endowment management, an exempt organization may hold passive investments in an LLC similar to passively holding corporate stock.⁵⁵ Such passive investment, certainly if it is only a small fraction of an exempt organization's assets, apparently is not considered by the I.R.S. to be subject to the joint venture or ancillary joint venture rules.⁵⁶ Presumably such passive investment in

⁵⁰ See *St. David's Health Care Sys. v. United States*, 349 F.3d 232, 239 (5th Cir. 2003) ("[W]hen a non-profit organization forms a partnership with a for-profit entity, the non-profit should lose its tax-exempt status if it cedes control to the for-profit entity."); *Redlands Surgical Servs. v. Comm'r*, 113 T.C. 47, 92-93 (1999) (holding a non-profit organization under I.R.C. § 501(c)(3) did not operate "exclusively for exempt purposes . . . by ceding effective control over its operations to for-profit parties" because it "impermissibly serve[d] private interests").

⁵¹ BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[2][c][iii].

⁵² See *id.* (providing a thorough discussion of the guidelines for tax-exempt members of LLC joint ventures).

⁵³ *Id.* ¶ 1.09[2][d].

⁵⁴ See *id.*

⁵⁵ See *Trinidad v. Sagrada Orden*, 263 U.S. 578, 582 (1924); BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[1][c][i]-[ii].

⁵⁶ See I.R.C. § 512(b)(13) (2006); BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[1][d][v].

an LLC is not a “joint venture” even though the LLC generally would be treated as a partnership for tax purposes.⁵⁷ Put differently, as far as the author is aware, there is no clear rule as to when a passive investment in an LLC either is so large or borders so closely on being “active” that the joint venture rules are implicated.⁵⁸

Given all of this uncertainty in the law and given the potential threat to exempt status, any I.R.C. § 501(c)(3) organization with an economic interest in an L3C would insist upon exerting substantial influence over the L3C to safeguard the organization’s exempt status. Arguably, this influence by any I.R.C. § 501(c)(3) member would result in L3Cs truly behaving differently in commerce, rather than just pretending to be charitable or educational as a marketing ploy. In effect, requiring at least one I.R.C. § 501(c)(3) member of any L3C would result in indirect regulation of the L3C due to the I.R.S.’s direct regulation of the tax-exempt member of the L3C. This indirect regulation would bring credibility to the L3C.

Lastly, if an I.R.C. § 501(c)(3) tax-exempt member of an L3C is a private foundation, then unless the investment is merely part of the private foundation’s normal endowment assets—like an investment-grade real estate LLC or a bona fide hedge fund LLC—the restrictive PRI rules also would come into play. The PRI rules (at least insofar as the private foundation’s investment was intended to qualify as a PRI) would require the L3C to use the private foundation’s investment for charitable or educational purposes, to report annually on the expenditure of the investment, and to refrain from using the investment for political or lobbying activity. Again, this additional layer of indirect regulation would add credibility to a PRI-motivated L3C.

2. *Correct a Technical Flaw in the L3C Statutes*

As has been noted by the critics, if the L3C’s *raison d’être* is to facilitate PRIs, then the L3C legislation arguably contains a technical flaw.⁵⁹ Specifically, the L3C statutes uniformly provide that the “company” must “further[] the accomplishment of one or more charitable or educational purposes within the meaning of [I.R.C.] Section 170(c)(2)(B).”⁶⁰ The regulations defining PRIs, however, only require that the “investment[]”—not the company—have “the primary

⁵⁷ See *Thompson v. United States*, 87 Fed. Cl. 728, 738–39 (2009); Scott R. Anderson, *The Illinois Limited Liability Company: A Flexible Alternative for Business*, 25 *LOY. U. CHI. L.J.* 55, 62 n.38, 87–88 (1993).

⁵⁸ See BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.09[2][d].

⁵⁹ See, e.g., Kleinberger, *supra* note 10, at 908.

⁶⁰ See *id.* at 882–83.

purpose . . . to accomplish one or more of the [charitable or educational] purposes” within the meaning of I.R.C. § 170(c)(2)(B).⁶¹ If, as the enabling statutes seem to state, the entire L3C must fulfill a charitable or educational purpose, then that would run counter to the notion that the company as a whole may pursue a pure profit-making activity. It is absolutely clear, though, that a private foundation can make an investment into a pure profit-making enterprise—such as an established, publicly traded company that is “financially secure”—and that, under the right circumstances, such an investment may qualify as a PRI.⁶² Similarly, the entire L3C should not be required by statute to further a “charitable or educational” purpose. Rather, it would be more accurate to require only that one or more investments (that is, membership interests) in the L3C must further a “charitable or educational” purpose.

This technical glitch in the L3C statutes should be corrected, and the correction is an easy one. In particular, in each case where the L3C statutes provide that the “company” must further a charitable or educational purpose,⁶³ the language should be revised simply to state that “one or more low-profit limited liability company interests in the company” must further a charitable or educational purpose. This change in the statutory language would align the L3C more closely with its *raison d’être* of facilitating PRIs. Furthermore, because under most state statutes LLCs may pursue any “lawful purpose” (not just a “business purpose”), one could still form an L3C (or for that matter a regular LLC) that is 100% focused upon charitable or educational pursuits. Put differently, fixing the technical flaw in the statutes would more closely align the L3C with the requirements for PRIs without compromising the ability to use an L3C *entirely* for charitable or educational activities. Thus, a tax-exempt hospital or school might choose to use a wholly owned L3C or a joint venture L3C to conduct some of its charitable activities without regard to the L3C’s particular suitability for PRIs and without any particular membership interest qualifying as a PRI (because PRIs are endemic to private foundations only).

3. Require L3Cs to Report Their PRIs (if Any)

Another way to add credibility to the L3C, as well as to PRIs generally, would be to require any entity that receives PRI funds

⁶¹ I.R.C. § 4944(c) (2006); *see also id.* § 170(c)(2)(B).

⁶² *See* Treas. Reg. § 53.4944-3(b) ex. 5 (2012) (discussing the use of a below market-rate interest loan to induce a “financially secure” public company to establish a new plant in a deteriorated urban area).

⁶³ *See, e.g.,* VT. STAT. ANN. tit. 11, § 3001(27)(B) (2010).

(whether via equity, loan, or loan guaranty) to disclose and report annually to the I.R.S. the terms and conditions and financial performance of the PRI. Such I.R.S. information reporting, similar to reporting already done by entities taxed as partnerships and S corporations,⁶⁴ could be accomplished via a separate schedule required to be included with the PRI recipient's regularly filed income tax return. This schedule also could be required to be made available for public inspection, similar to the annual I.R.S. Form 990 filed by tax-exempt organizations.⁶⁵

Proposed federal legislation, introduced in Congress on November 14, 2011, by Representative Aaron Schock of Illinois, took just such an approach with respect to information-reporting for PRIs.⁶⁶ In particular, the Philanthropic Facilitation Act ("Act") proposed a process, similar to the process used for applying for and obtaining tax-exempt status, to pre-clear an entity to accept PRIs.⁶⁷ Under the procedure established by the Act, an intended PRI recipient would apply to the I.R.S. for approval to receive such investments.⁶⁸ Upon approval, the I.R.S. would issue an official determination that the applicant presumptively qualifies to receive PRIs.⁶⁹ A safe harbor, thereby, would be established so that an investing private foundation would have some assurance from the I.R.S. that the foundation's investment qualifies as a PRI.⁷⁰

The Act also would have created a new I.R.C. § 6033A that would require each recipient of a PRI to report the following information to the I.R.S. on a to-be-developed tax return: (1) the recipient's gross income for the year; (2) the recipient's expenses for the year; (3) the recipient's charitable, educational, or other similar disbursements for the year; (4) a balance sheet; (5) a list of each private foundation holding a PRI in the recipient; (6) the portion of the recipient's capital obtained via the PRI; (7) the amounts paid (such as interest, dividends, or distributions, if any) with respect to each PRI; and (8) any additional information (if any) required by the expenditure responsibility rules.⁷¹ This last requirement

⁶⁴ See I.R.C. §§ 6031, 6037.

⁶⁵ See *id.* § 6033.

⁶⁶ Philanthropic Facilitation Act, H.R. 3420, 112th Cong. §§ 4–5 (2011).

⁶⁷ Compare *id.* (proposing that organizations provide a balance sheet and information necessary for public disclosure), with INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, NO. 17132z, INSTRUCTIONS FOR FORM 1023, at 5, 13 (rev. June 2006) (requiring organizations applying for charitable exempt status to provide a balance sheet and information necessary for public disclosure).

⁶⁸ H.R. 3420 § 2(3).

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ *Id.* § 4.

would allow the annual information return provided by the recipient to satisfy the obligation of each investing private foundation to report on the PRI under the expenditure responsibility rules of I.R.C. § 4945.⁷²

Unfortunately, this bill was referred to the Ways and Means Committee and never taken up again.⁷³ Perhaps asking the I.R.S. to pre-clear an entire enterprise to receive PRIs is overreaching. Under the regulations, every PRI requires a detailed facts and circumstances analysis with respect to the particulars of the investment itself, not the activities of the whole enterprise. On the other hand, in the author's opinion, there is at least some chance that a more rigorous PRI reporting and disclosure regime, such as that contained within the Act, would be practical and could be approved by the IRS and therefore enacted by Congress. This limited but practical reporting and disclosure regime would promote transparency and accountability not only for L3Cs, but for any entity that accepts PRI funds.

4. Require L3Cs to Register Under State Charitable Solicitation Acts

Most jurisdictions already require charities that solicit contributions in the state to register with a designated state agency.⁷⁴ For example, subject to certain exceptions, the Georgia Charitable Solicitations Act requires all individuals and organizations that solicit contributions from the public for charitable purposes to register with the Georgia Secretary of State.⁷⁵ Furthermore, as discussed in greater detail below, charities subject to the Georgia Charitable Solicitations Act are also required to make certain financial disclosures.⁷⁶ These charitable registration and disclosure laws typically are not limited to nonprofit organizations but may apply to private, for-profit fundraising entities as well.⁷⁷ Although the charitable solicitations rules may not automatically

⁷² See I.R.C. § 4945(h) (2006).

⁷³ 157 CONG. REC. H7578 (daily ed. Nov. 14, 2011) (showing the introduction of the bill); *H.R. 3420 (112th): Philanthropic Facilitation Act*, GOVTRACK.US, <http://www.govtrack.us/congress/bills/112/hr3420> (last visited Mar. 12, 2013) (noting the bill died).

⁷⁴ NAT'L ASS'N OF ATTORNEYS GEN. & NAT'L ASS'N OF STATE CHARITIES OFFICIALS, STANDARDIZED REGISTRATION FOR NONPROFIT ORGANIZATIONS: UNDER STATE CHARITABLE SOLICITATION LAWS 1 (version 4.01 2010), available at http://www.multistatefiling.org/urs_webv401.pdf.

⁷⁵ GA. CODE ANN. § 43-17-5(b)(1) (2011). Some charities, such as churches, schools, and emergency rescue departments, and political parties are exempt from registration. *Id.* § 43-17-9(a).

⁷⁶ *Id.* § 43-17-5(b)(4).

⁷⁷ Memorandum from the Office of the Sec'y of State of Ga. on Charitable Org. Registration Info. Pursuant to the Ga. Charitable Solicitations Act of 1988, as Amended

apply to every L3C operating within a state, in the proper circumstances, the laws conceivably could apply to an L3C. If so, then even under current law, the L3C would be required to register and disclose financial information just as any other charitable or fundraising organization.

Some states go even further to require registration of “commercial coventurers” with charities.⁷⁸ These laws were enacted in response to certain fundraising and marketing arrangements frequently used by charities and for-profit firms. These fundraising and marketing arrangements also are known as “cause marketing.”⁷⁹

For example, in 1999, General Mills advertised nationwide that it would donate \$0.50 to the Breast Cancer Research Foundation for every Yoplait Yogurt sold by and corresponding container lid returned to General Mills during the period of January through March.⁸⁰ The slogan for the ad campaign was “Save Lids to Save Lives.”⁸¹ This was a classic “cause marketing” campaign. Subsequently, though, the Georgia Secretary of State launched an investigation into the Yoplait Yogurt cause marketing campaign.⁸² As a result of that investigation, the Georgia Secretary of State concluded that the General Mills/Breast Cancer Research Foundation Promotion was misleading to consumers because it did not adequately disclose that General Mills’s total charitable commitment limit was \$100,000 during the relevant time period.⁸³ If General Mills’s obligation to the Breast Cancer Research Foundation had not been so limited, the Georgia Secretary of State’s investigation contended that General Mills would have been obligated to donate \$4.7 million to the Breast Cancer Research Foundation.⁸⁴ Accordingly, based upon the percentage of sales of Yoplait Yogurt in Georgia, the settlement with the Georgia Secretary of State required General Mills to donate an additional \$63,000 to the Breast Cancer Research Foundation.⁸⁵

(July 2003), available at http://sos.georgia.gov/acrobat/Securities/forms_2006/Charity%20Org%20Info%20Release.pdf.

⁷⁸ GA. CODE ANN. § 43-17-6(a).

⁷⁹ Scott M. Smith & David S. Alcorn, *Cause Marketing: A New Direction in the Marketing of Corporate Responsibility*, 5 J. SERVICES MARKETING 21, 21 (1991).

⁸⁰ Press Release, Cathy Cox, Ga. Sec’y of State, Secretary Cox: Agreement with General Mills to Conclude Investigation into Yoplait Charitable Promotion Results in Additional \$63,000 for Breast Cancer Research (Dec. 21, 1999), available at <http://sos.georgia.gov/pressrel/pr991221.htm>.

⁸¹ *Id.*

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.*

⁸⁵ *Id.*

The provision of the Georgia Charitable Solicitations Act pertaining to commercial coventurers, such as the General Mills/Breast Cancer Research Foundation Promotion, imposes certain rules upon such cause marketing arrangements.⁸⁶ In particular, the applicable statute: (1) requires a written agreement between the charity and the commercial coventurer; (2) sets minimum standards for such charitable cause marketing agreements; (3) imposes record-keeping requirements; and (4) permits the Georgia Secretary of State to examine such agreements and related records.⁸⁷ Like the registration and financial disclosure requirements mentioned above, the commercial coventure statute does not expressly apply to an L3C operating in Georgia, but it could depending upon the particular circumstances.

⁸⁶ See GA. CODE ANN. § 43-17-6 (2011).

⁸⁷ *Id.* Specifically, the statute provides:

(a) Every charitable organization which agrees to permit a charitable sales promotion to be conducted in its behalf shall obtain, prior to the commencement of the charitable sales promotion within this state, a written agreement from the commercial coventurer which shall be available to the Secretary of State upon request. The agreement shall be signed by an authorized representative of the charitable organization and the commercial coventurer and it shall include, at a minimum, the following:

- (1) The goods or services to be offered to the public;
- (2) The geographic area where, and the starting and final date when, the offering will be made;
- (3) The manner in which the charitable organization's name will be used, including the representation to be made to the public as to the actual or estimated dollar amount or percent per unit of goods or services purchased or used that will benefit the charitable organization;
- (4) If applicable, the maximum dollar amount that will benefit the charitable organization;
- (5) The estimated number of units of goods or services to be sold or used;
- (6) A provision for a final accounting on a per unit basis to be given by the commercial coventurer to the charitable organization and the date by which it will be made;
- (7) A statement that the charitable sales promotion is subject to the requirements of this chapter; and
- (8) The date by when, and the manner in which, the benefit will be conferred on the charitable organization.

(b) The final accounting for the charitable sales promotion shall be kept by the commercial coventurer for three years after the final accounting date.

(c) All records of charitable organizations and commercial coventurers pertaining to such sales promotion are subject to such reasonable periodic, special, or other examinations by representatives of the Secretary of State, within or outside this state, as the Secretary of State deems necessary or appropriate in the public interest or for the protection of the public, provided that the Secretary of State shall not disclose this information except to the extent necessary for investigative or law enforcement purposes.

Id.

Instead of hinging registration on circumstances such as fundraising or cause marketing, Georgia should require every L3C conducting any business whatsoever in the state to register under the Georgia Charitable Solicitations Act. Similar measures should also be passed in other states. Moreover, the governing documents of the L3C (such as the articles of organization and operating agreement) could be subject to comparable record-keeping and examination requirements mandated for commercial coventure arrangements across the fifty states. This would allow the secretary of state for each state (or other appropriate state agency) to inspect the governing documents of the L3C. Imposing such registration and record-keeping requirements on every L3C conducting business in a state would heighten the level of transparency and accountability that currently is lacking for L3Cs.

5. *Require Audited or Reviewed Financial Statements for L3Cs*

In addition to registration and record-keeping requirements, state charitable solicitation acts also generally require charities to disclose detailed financial information to an appropriate state agency.⁸⁸ The Georgia Charitable Solicitations Act, for instance, requires charitable organizations⁸⁹ that collect more than one million dollars in either of the organization's two preceding fiscal years to obtain and submit to the Georgia Secretary of State independently audited financial statements along with the organization's annual registration form.⁹⁰ Financial disclosure also is required for smaller organizations. Specifically, charitable organizations that collect between \$500,000 and \$1 million during the preceding two-year period must submit independently reviewed financial statements, while organizations collecting less than \$500,000 during the period need only submit non-reviewed financial statements.⁹¹ If no contributions have been collected by the organization during the preceding two-year period, then Georgia law requires an officer of the charity to confirm that fact in a signed statement submitted with the annual registration form.⁹²

It should be simple enough to require any L3C with similar revenue levels or assets to likewise submit audited, reviewed, or non-reviewed financial statements to a designated state agency along with their

⁸⁸ Typically, this involves a filing with the secretary of state. *See, e.g., id.* §§ 43-17-5(b)(4), -6.

⁸⁹ That is unless the organization is covered by a specific exemption. *See id.* §§ 43-17-9(a).

⁹⁰ *Id.* § 43-17-5(b)(4).

⁹¹ *Id.*

⁹² *See id.*

annual registrations (as proposed above). This would serve two worthwhile purposes. First, it would promote transparency and accountability to the state agency charged with monitoring and regulating charitable activity. Second, for those L3Cs reaching the \$500,000 and greater revenue or assets threshold, it would create an added cost associated with L3Cs—the cost of preparing a financial statement. This cost likely would deter those unscrupulous owners who would form an L3C in name only without actually planning to serve a charitable purpose. The added cost would be a deterrent because, in the author’s experience, average fees for reviewed financial statements range from \$5,000 to \$10,000 even for small organizations, while fees for audited financial statements typically range from \$12,000 to \$20,000 *or more* depending upon an organization’s size. Such added costs generally would be a deterrent to improper use of an L3C.

6. Permit Free Transferability for an Exempt Member’s Interest in an L3C

In general, most state LLC acts follow a familiar pattern: the LLC statute provides a number of “default rules” regarding rights and obligations that members have vis-à-vis each other and the LLC itself, but then the members have virtually unlimited flexibility to modify the default rules in the LLC’s operating agreement.⁹³ In most cases, the operating agreement will modify the default rules, but in the absence of agreement otherwise, the default rules govern.⁹⁴

One common default rule across the various LLC statutes restricts a member’s ability to freely transfer its membership interest in the LLC. The LLC default rule with respect to transferability usually provides that a member may freely transfer its *economic* rights in the LLC (that is, rights to allocations and distributions) but not membership participation rights (that is, rights to vote or consent, inspect books and records, etc.) without approval of the other members.⁹⁵ Thus, by default under most state LLC acts, an unapproved transferee of a membership interest does not become a full member of the LLC. Instead, such unapproved transferee becomes an un-admitted assignee of the former member’s economic rights only, with no right to vote or consent or right to information from the LLC.⁹⁶ This contrasts sharply with the default rule for corporations whereby corporate stock generally is freely transferable and the transferee obtains all rights of a shareholder absent

⁹³ See BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.08.

⁹⁴ See *id.*

⁹⁵ *Id.* ¶ 8.06[1][a].

⁹⁶ *Id.* ¶ 8.06[2][a].

a contrary provision in a shareholders' agreement or some other legally binding agreement.⁹⁷

The contrasting default rules for LLCs versus corporations stem from the LLC's partnership heritage. In particular, with regard to membership rights, LLCs more closely resemble partnerships than corporations.⁹⁸ Partnership law typically restricts transfers because holding a partnership interest is considered akin to a consensual, contractual relationship with a co-owner, whereas holding corporate stock is considered more like outright ownership of a distinct, intangible, and essentially fungible asset.⁹⁹ Put differently, the LLC/partnership paradigm values the relationship between and among the owners over the separate property rights of each owner, while the corporate paradigm values the separate property rights of each owner over any relationship with other owners.

Generally speaking, with respect to transferability, an exempt organization would prefer the corporate stock paradigm (that is, free transferability) over the LLC/partnership paradigm (that is, limited transferability). An exempt organization would prefer free transferability because, if the exempt member becomes concerned or dissatisfied with the financial performance or activities of the LLC, the exempt member unilaterally may divest itself of its membership interest at any time.¹⁰⁰ In the context of a joint venture LLC, for example, if at any time an LLC's activities pose a threat to an exempt member's tax status, free transferability would allow the exempt member to terminate its relationship with the LLC unilaterally by simply selling its membership interest. The viability of such a unilateral transfer by an exempt member, however, could only be facilitated if, as is the case in the corporate paradigm, the transferee obtains full economic *and* participation rights in the LLC as a result of the transfer.

If the corporate paradigm with respect to transfers is preferable for exempt organizations, then perhaps the L3C statutes in the various adopting states could reverse the normal LLC default rule on free transferability. In particular, the L3C acts could provide as a default rule that a tax-exempt member of an L3C is permitted to freely transfer its entire membership interest in the LLC, and that the transferee shall

⁹⁷ *Id.* ¶ 8.06[1][a].

⁹⁸ *See id.* ¶ 5.04[2][a][iv] (explaining that an LLC likely cannot admit members unless they have economic and governance rights).

⁹⁹ *See id.* ¶¶ 5.04[2][a], 8.06[1][a].

¹⁰⁰ Of course, the demand for an interest in the LLC may be severely limited or even nonexistent, but that is a consequence of the available market, not limited transferability at law. Closely held corporate stock suffers from the same, limited demand in the market. Rev. Rul. 59-60, 1959-1 C.B. 237.

be admitted as a full member unless the LLC's articles or operating agreement expressly provides otherwise. This free-transferability default rule for L3Cs would distinguish them dramatically from regular LLCs, which have a limited-transferability default rule. Due to the free-transferability default rule, exempt organizations likely would favor L3Cs over regular LLCs.

7. Provide an Exempt Member of an L3C with a Unilateral Right to Withdraw

By default, most LLC statutes restrict a member's right to withdraw from an LLC, or if the right to withdraw is not restricted, then the statutes provide that withdrawal has no significant legal or economic implications for the continuing operation of the LLC.¹⁰¹ Further, at least in the author's experience, most written operating agreements (as they are permitted to do under the LLC statutes) go further to either expressly prohibit withdrawal or to provide that if a member nonetheless unilaterally withdraws, then such member is in breach and loses all rights as a member. These operating agreements then further provide that a withdrawing member forfeits its membership interest (unless, due to the particular circumstances involved, the member's withdrawal is permitted by the express terms of the operating agreement). In slightly less extreme cases, the operating agreement provides that a withdrawing member loses all voting, inspection, and similar membership participation rights, but retains rights to allocations and distributions from the LLC (like an un-admitted assignee).¹⁰²

In this regard, the author proposes to reverse the default rule so that an exempt member of an L3C unilaterally may withdraw for any reason and at any time. Further, by default, such withdrawal by an exempt member should trigger a right to distribution of the exempt member's unreturned capital contributions. Like transferability, this reversal of the normal LLC default rule for withdrawal would favor the use of L3Cs by exempt organizations.

In addition, with respect to L3Cs being used for PRIs, a state-law default rule permitting unilateral withdrawal by an exempt member would align more closely with applicable federal law. Specifically, the regulations governing PRIs require that any funds not used for exempt purposes be repaid to the investing private foundation "to the extent permitted by applicable law concerning distributions to holders of equity

¹⁰¹ See BISHOP & KLEINBERGER, *supra* note 37, ¶ 1.08 tbl. 1.2.

¹⁰² See THOMAS A. HUMPHREYS, LIMITED LIABILITY COMPANIES § 3.01[1], at 3-4 (10th release 2004).

interests.”¹⁰³ A rule allowing unilateral withdrawal from an L3C by a private foundation would be a veritable “trump card” because the other members (by default) would not possess such right. Therefore, if the L3C misappropriated any PRI funds or otherwise misbehaved, the private foundation member could withdraw and demand repayment of the unreturned portion of its investment. This repayment right due to withdrawal would prioritize the private foundation member’s economic rights in the L3C over the other members’ economic rights.

If the non-exempt members object to allowing the private foundation such a powerful economic priority, then the operating agreement could soften the adverse economic consequences to those members by providing the L3C a choice: either repay the foundation member’s unreturned PRI capital or dissolve the L3C according to the terms of the operating agreement. In the case of dissolution, the private foundation and the non-exempt members would participate in liquidating proceeds according to the priorities originally set forth in the L3C’s operating agreement. Nevertheless, even though the adverse economic impact to the non-exempt members would be softened by such an approach, the private foundation’s ability via unilateral withdrawal to compel dissolution at any time and for any reason would be an extremely powerful right.

Providing a default rule that allows an exempt member at any time and for any reason to withdraw unilaterally and receive a distribution of its unreturned capital from an L3C would be a very meaningful, distinguishing feature from a regular LLC. A unilateral withdrawal right could safeguard an exempt member’s tax status, and, in the case of a private foundation member, it would dovetail with certain federal-law requirements for PRIs.

CONCLUSION

The L3C is languishing. In an effort to salvage the form, this Article proposes seven changes to the L3C’s statutory framework. The seven proposed changes are designed to promote accountability and transparency and to favor the use of the L3C by tax-exempt organizations. If L3Cs become the favored vehicle for tax-exempt organizations to use in circumstances in which a regular LLC otherwise would be appropriate, then the L3C might flourish alongside benefit corporations as part of the social enterprise movement. If L3Cs remain indistinguishable (except in name only) from regular LLCs, then, in the author’s opinion, L3Cs likely will not (and arguably should not) survive. Regardless of whether L3Cs survive, some of the proposals suggested by

¹⁰³ Treas. Reg. § 53.4945-5(b)(4)(i) (as amended in 2008).

the author in this Article (that is, free transferability and a unilateral right of withdrawal) also could be useful in an operating agreement for a regular LLC that has a tax-exempt member.