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## L3CS: An Innovative Choice for Urban Entrepreneurs and Urban Revitalization

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# L3CS: AN INNOVATIVE CHOICE FOR URBAN ENTREPRENEURS AND URBAN REVITALIZATION

BY DANA THOMPSON\*

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## INTRODUCTION

Social enterprises offer fresh ways of addressing seemingly intractable social problems, such as high levels of unemployment and poverty in economically distressed urban areas in the United States. Indeed, although social enterprises have deep and longstanding roots, the recent iteration of the social enterprise movement is gaining momentum in the United States and globally.<sup>1</sup> Though there is not a singularly accepted legal definition of social enterprises, they are popularly known as businesses that use for-profit business practices, principles, and discipline to accomplish socially beneficial goals.<sup>2</sup> Social entrepreneurs, those who operate social enterprises, eschew a traditional notion of charity, which primarily relies on charitable donations to eliminate societal ills and instead employ market-oriented strategies to achieve social good.<sup>3</sup> Social entrepreneurs are not just focused on the bottom line and seeking financial returns but seek to obtain double-bottom line (financial and social) or triple-bottom line (financial, social, and environmental) objectives.<sup>4</sup> The Grameen Bank is an example of an early social enterprise. The bank was established in 1976 by Muhammad Yunus to combat poverty in rural villages in Bangladesh by extending small loans to rural village women to allow them to establish businesses and provide them with self-employment opportunities.<sup>5</sup>

Social enterprises blur the lines among the nonprofit, for-profit, and government sectors, and given their innovative and distinct characteristics,

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1. See Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 TUL. L. REV. 337, 338 (2009); Matthew F. Doeringer, Note, *Fostering Social Enterprise: A Historical and International Analysis*, 20 DUKE J. COMP. & INT'L L. 291, 292 (2010); Cassady V. Brewer, *A Novel Approach to Using LLCs for Quasi-Charitable Endeavors (A/K/A "Social Enterprise")*, 38 WM. MITCHELL L. REV. 678, 679 (2012).

2. See MARC LANE, SOCIAL ENTERPRISE: EMPOWERING MISSION-DRIVEN ENTREPRENEURS 1 (2011); Robert A. Katz & Antony Page, *The Role of Social Enterprise*, 35 VT. L. REV. 59, 59 (2010); Rosemary Fei, *A Guide to Social Enterprise Vehicles*, TAX'N OF EXEMPTS, Jan.-Feb. 2011, at 37; Janelle A. Kerlin, *Social Enterprise in the United States and Europe: Understanding and Learning from the Differences*, VOLUNTAS, Sept. 28, 2006, at 248; J. Gregory Dees, *The Meaning of "Social Entrepreneurship"* 1 (Ctr. for the Advancement of Soc. Entrepreneurship, 2001), available at [http://www.caseatduke.org/documents/dees\\_sedef.pdf](http://www.caseatduke.org/documents/dees_sedef.pdf); *The Case for Social Enterprise Alliance*, SOCIAL ENTERPRISE ALLIANCE, <https://www.se-alliance.org/why#whatsasocialenterprise> (last visited Sept. 16, 2012) (describing the Social Enterprise Alliance as the membership organization for social enterprises in North America that defines social enterprises as businesses whose primary purpose is the common good and that "use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas").

3. See Kelley, *supra* note 1, at 339.

4. *Id.*

5. See *A Short History of Grameen Bank*, GRAMEEN BANK, [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=19&Itemid=114](http://www.grameen-info.org/index.php?option=com_content&task=view&id=19&Itemid=114) (last visited Sept. 1, 2012) (providing a short history of how Grameen Bank was established).

require new legal entities to meet their needs.<sup>6</sup> New legal entity forms, such as the low-profit limited liability company (“L3C”), the benefit corporation, and the flexible purpose corporation, were created in response to the needs of social entrepreneurs for new legal entities, other than traditional for-profit and nonprofit entities, that can attract the necessary funding for their ventures while also achieving their social missions.<sup>7</sup> Many social entrepreneurs, their lawyers, and others, who work with and support social entrepreneurs, support the creation of new hybrid legal entities, which better reflect the socially beneficial pursuits and financial concerns of social entrepreneurs.<sup>8</sup>

As with other social entrepreneurs, minority urban entrepreneurs determined to use their businesses to make a profit and provide positive social outcomes in economically distressed urban areas also need innovative legal entities to attract funding and fulfill their social missions. The L3C, though needing changes to enhance its effectiveness, holds promise for minority-owned small businesses in urban areas with socially beneficial goals that are in need of capital to establish and operate their businesses.

It is important to establish viable minority-owned social enterprises in urban areas because many urban areas in the United States face substantial challenges, such as high levels of poverty and unemployment.<sup>9</sup> Despite

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6. See Kelley, *supra* note 1, at 341 (discussing both the problems with existing complex legal entities that practitioners create for hybrid ventures and demands by social entrepreneurs for lawyers and lawmakers to develop new laws and new legal entities to facilitate double- and triple-bottom line goals); J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising, and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. MIAMI L. REV. 1, 6–8 (2011) (discussing social entrepreneurship as being a part of the Fourth Sector, an entirely new organizational sector that blends social purposes with business methods and is distinct from the three traditional sectors of private, public, and nonprofit organizations); see also Heerad Sabeti et al., *FOURTH SECTOR NETWORK ET AL., THE EMERGING FOURTH SECTOR: A NEW SECTOR OF ORGANIZATIONS AT THE INTERSECTION OF THE PUBLIC, PRIVATE, AND SOCIAL SECTORS 4–6*, available at [http://www.fourthsector.net/attachments/39/original/The\\_Emerging\\_Fourth\\_Sector\\_-\\_Exec\\_Summary.pdf?1253667714](http://www.fourthsector.net/attachments/39/original/The_Emerging_Fourth_Sector_-_Exec_Summary.pdf?1253667714) (describing how most Fourth Sector organizations are structured as hybrids of nonprofit and for-profit forms and asserting that new legal forms may need to be created to facilitate the creation of Fourth Sector enterprises).

7. See Katz & Page, *supra* note 2, at 62–63. See generally Susan H. Mac Cormac, *The Emergence of New Corporate Forms: The Need for Alternative Corporate Designs Integrating Financial and Social Missions*, in *SUMMIT ON THE FUTURE OF THE CORPORATION*, PAPER SERIES ON CORPORATE DESIGN (Allen White & Marjorie Kelly eds., 2007), available at <http://www.jussemp.org/Resources/corp2020SummitPapers.pdf> (discussing the need to develop new entities to facilitate the work of social enterprises, including a discussion of L3Cs, the B corporation, and the Minnesota Socially Responsible Corporation).

8. See Kelley, *supra* note 1, at 341. See generally LANE, *supra* note 2, at 31–52 (discussing the hybrid organizations developed for social enterprises).

9. See Christiana McFarland, *State of America's Cities Survey on Jobs and the Economy*, NAT'L LEAGUE OF CITIES RES. BRIEF ON AM.'S CITIES, May 2010, at 1–2, available at <http://www.nlc.org/Documents/Find%20City%20Solutions/>

these problems, urban areas in the United States are significant to the national economy and are valuable underutilized resources that need innovative and strategic solutions<sup>10</sup> to address their problems and help the United States become even more competitive in the global market. Social enterprises in these areas, particularly those owned by people of color, could play a role in revitalizing these financially troubled urban areas by providing much needed jobs to residents and much needed revenues, products, and services to these areas. Organizations, such as Greyston Bakery in New York and Sweet Beginnings, LLC in Chicago, provide compelling examples of for-profit urban social enterprises that have developed successful businesses while also providing jobs in their respective urban areas to individuals with considerable barriers to employment.<sup>11</sup> But many minority-owned small businesses in urban areas, including social enterprises, confront a number of challenges that hinder their development and growth, including lack of access to capital. Current entity forms available to these businesses are inadequate in allowing them to accomplish their socially beneficial goals and attract the necessary

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Research%20Innovation/Economic%20Development/state-of-americas-cities-survey-jobs-economy-rpt-may10.pdf; see also Teresa Lynch & Lois Rho, *Capital Availability in Inner Cities: What Role for Federal Policy?* 2 (Initiative for a Competitive Inner City, 2011), available at [http://www.icic.org/ee\\_uploads/publications/Capital\\_Policy\\_Paper\\_November\\_2011.pdf](http://www.icic.org/ee_uploads/publications/Capital_Policy_Paper_November_2011.pdf).

10. See, e.g., Michael E. Porter, *The Competitive Advantage of the Inner City*, HARV. BUS. REV., May–June 1995, at 55–62 (explaining the need to move from social models to economic models to revitalize inner cities and asserting that the competitive advantages of the inner city are: 1) its strategic location; 2) the local market demand; 3) its integration with regional clusters; and 4) the access to human resources); see also Jay Williams, Ric Geyer, and Peter Benkendorf, *Rumors of Our Death Have Been Greatly Exaggerated*, FORBES (Sept. 3, 2009, 8:42 PM), <http://www.forbes.com/2009/09/03/dying-cities-youngstown-ohio-opinions-contributors-21-century-cities-09-williams-geyer-benkendorf.html> (“[C]ities and urban counties represent 80 percent of the American population. They hold a concentration of wealth and the intellectual resources associated with technology, higher education, and research institutions. Cities are convenient, making a reduction in fuel consumption and green living within reach. And lastly, urban living provides access to arts and culture as well as other amenities and reflects a growing trend in this country.”); Gregory B. Fairchild, *In Your Own Backyard: Investment Opportunities in Emerging Domestic Markets* 3–4 (Batten Inst. Res. Paper No. 1440486, 2004), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1440486](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1440486).

11. See *The Greyston Bakery's Guiding Principles*, <http://www.greystonbakery.com/wp-content/uploads/pdf/greyston-bakery-guiding-principles.pdf> (last visited Dec. 20, 2012) (describing Greyston Bakery's double-bottom line mission to strive to be a model for inner-city business development by providing jobs and fair wages to inner-city residents and making a profit by creating a sustainable organization); see also *Greyston Bakery Our Story*, <http://www.greystonbakery.com/the-bakery/our-story/> (last visited Dec. 20, 2012) (discussing Greyston Bakery's innovative social mission, its high quality baked goods and brownies, and how it is the producer of brownies for Ben & Jerry's products); *About Us*, <http://www.sweetbeginningsllc.com/about-us> (last visited Dec. 20, 2012) (explaining that Sweet Beginnings, LLC offers full-time employment to formerly incarcerated individuals and others with extreme challenges to employment, while producing all natural urban honey skin care products).

financing to successfully establish viable ventures.

Consider the following example:

The city of Metropolis is a large, industrial metropolitan city suffering from high levels of poverty and unemployment due, in part, to the decline of its major manufacturing industry, the loss of a great number of manufacturing jobs, a lack of diverse business industries, and a massive decline in its middle class population. Recognizing the need for establishments to provide fresh, organic home-style meals in a casual yet elegant setting and for jobs for residents in Metropolis, Ann and Carl, both people of color and residents of Metropolis, decide to open a restaurant called the Good People, Good Food Company (“GPGFC”). They would also like the company to offer a delivery service to distribute their meals to different neighborhoods in Metropolis with limited access to fresh foods.

Metropolis has a burgeoning urban farming movement. There are large swaths of vacant land in Metropolis as a result of large numbers of people leaving the city in search of jobs and better housing in the suburban areas surrounding the city and outside of the state. People interested in repurposing these vacant urban lands are creating urban farms, which produce a wide variety of food items, including fruits, vegetables, honey, and even small farm animals, such as chickens. GPGFC will offer fresh, quality meals by obtaining as much food as possible from these Metropolis urban farms. Ann and Carl are committed to operating a high quality restaurant and delivery service with delicious and healthy locally-sourced foods and excellent customer service. They are also committed to paying fair wages and hiring a large percentage of the workers from a Metropolis nonprofit program that mentors and trains at-risk young people, most of whom are unemployed or underemployed people of color from low-income Metropolis neighborhoods, who are looking for opportunities to better their lives. Ann and Carl intend to make a profit and a living from the establishment and hope that if GPGFC is successful, they will be able to expand to other locations around the city and to other urban areas in the state and throughout the country. They would like to earn a salary and share in the potential upside of GPGFC’s financial returns. They also hope that by being able to make a profit, they will be able to attract a wide range of financing sources to invest in their enterprise, including socially conscious investors and small business lenders, which will allow them to establish a more sustainable business.

Ann has years of experience working in the restaurant industry, and she previously owned a small catering company. At Ann’s previous catering company, she hired Carl as a chef. Carl is committed to the socially beneficial mission of the restaurant and believes there is a demand for a restaurant and delivery service offering fresh and tasty food. They have a

small amount of money saved to invest in the business but need to attract additional investors and financing to meet the numerous costs necessary to start up and operate a restaurant. They have family and friends who think the restaurant is a great idea but do not have more than a nominal amount of money to invest in the company. Ann and Carl both own homes in Metropolis, but due to the economic downturn, the large number of foreclosures in Metropolis, and the overall poor economic state of the metropolitan area surrounding Metropolis, they owe more on their homes than the value of the homes. Consequently, they are unable to tap into the equity of their homes to finance the company.

As they explore the legal options they have to form their business, they determine they can establish the business as a for-profit entity, such as a limited liability company or a corporation, a nonprofit Internal Revenue Code (“IRC”) Section 501(c)(3) tax exempt organization, or the recently established L3C entity form for social enterprises. So what are the advantages and disadvantages of each of these entities given Ann and Carl’s social mission and their desire to make a profit and finance their establishment? In addition, why may a L3C provide an advantage over a for-profit entity and a nonprofit organization?

This Article answers these questions by examining the for-profit, nonprofit, and L3C entities available to establish GPGFC and the advantages and disadvantages of each of these entities. This Article focuses on the L3C entity, rather than exploring other hybrid entities, such as the benefit corporation, because the L3C was specifically created to address social entrepreneurs’ capital needs. This Article further considers whether the L3C should be another tool used to develop GPGFC and other socially motivated small businesses owned by people of color living in financially challenged urban areas. Part I examines minority small business owners in financially distressed urban areas and why these businesses play an important role in urban revitalization. It addresses their challenges and unique difficulties accessing capital and briefly discusses the various programs created to support minority urban entrepreneurs and their need for additional funding sources. Part II discusses the for-profit and nonprofit entities available to Ann and Carl and other urban minority-owned social enterprises and the advantages and disadvantages of using these entities for social entrepreneurial efforts. Part III discusses the development of the L3C and its advantages and disadvantages, including a discussion of the concerns with the L3C’s ability to attract private foundation funding. Part IV offers recommendations on how to improve the L3C structure. This Article concludes by asserting that the L3C could be another tool used to support urban minority-owned small businesses with social missions if certain measures are implemented to improve the L3C legislation.

## I. MINORITY-OWNED SMALL BUSINESSES IN URBAN AREAS

Small businesses are a critical part of a healthy economy.<sup>12</sup> They play a vital role in the United States' economic system by creating the most net new jobs, by bringing innovative products and services to the market, and by providing much needed tax revenues to local and state municipalities.<sup>13</sup> In the United States, small businesses, defined by the U.S. Small Business Administration as businesses with fewer than 500 employees, create 60–80% of net new jobs annually<sup>14</sup> and they represent approximately 43% of private payroll.<sup>15</sup> As these small businesses become successful and transition into larger businesses, they create more jobs and drive economic growth.<sup>16</sup> As with the national economy, small businesses play an important role in the economic development of inner cities.<sup>17</sup> Ninety-nine percent of all businesses in inner cities are small businesses and 80% of total inner-city employment comes from small businesses.<sup>18</sup>

For decades, urban areas in the United States have been plagued by high levels of unemployment and poverty. While the national unemployment rate fluctuated between 7.8% and 8.3%<sup>19</sup> in 2012, the unemployment rates of African Americans and Hispanics were well above the national rate.<sup>20</sup>

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12. See JAMES R. BARTH ET AL., BARRIERS TO ENTREPRENEURSHIP IN EMERGING DOMESTIC MARKETS: ANALYSIS AND RECOMMENDATIONS 1–2 (Milken Inst. 2006), available at <http://www.milkeninstitute.org/pdf/entrepreneurship.pdf>.

13. See U.S. SMALL BUS. ADMIN., THE SMALL BUSINESS ECONOMY: A REPORT TO THE PRESIDENT 1 (2010), available at [http://www.sba.gov/sites/default/files/sb\\_econ2010.pdf](http://www.sba.gov/sites/default/files/sb_econ2010.pdf); see also Tim Lohrentz, *Inclusive Business Practices*, in BUILDING HEALTHY COMMUNITIES: A GUIDE TO COMMUNITY ECONOMIC DEVELOPMENT FOR ADVOCATES, LAWYERS AND POLICYMAKERS 358–59 (Roger A. Clay, Jr. & Susan R. Jones eds., 2009) [hereinafter BUILDING HEALTHY COMMUNITIES].

14. BARTH ET AL., *supra* note 12, at 1.

15. U.S. SMALL BUS. ADMIN., OFFICE OF ADVOCACY, FREQUENTLY ASKED QUESTIONS ABOUT SMALL BUSINESS 1 (Sept. 2012), <http://www.sba.gov/sites/default/files/FINAL%20FAQ%202012%20Sept%202012%20web.pdf>.

16. See BARTH ET AL., *supra* note 12, at 1.

17. See INITIATIVE FOR A COMPETITIVE INNER CITY BOSTON, MA., STATE OF THE INNER CITY ECONOMIES: SMALL BUSINESSES IN THE INNER CITY 1 (2005) [hereinafter ICIC], available at <http://www.sba.gov/advo/research/rs260tot.pdf>. The ICIC defines inner cities as “core urban areas that are economically distressed.” *Id.* at 3.

18. *Id.* at 1.

19. See *Unemployment in the United States*, GOOGLE PUBLIC DATA, [http://www.google.com/publicdata/explore?ds=z1ebjgk2654c1\\_&met\\_y=unemployment\\_rate&idim=country:US&fdim\\_y=seasonality:S&dl=en&hl=en&q=unemployment+rate](http://www.google.com/publicdata/explore?ds=z1ebjgk2654c1_&met_y=unemployment_rate&idim=country:US&fdim_y=seasonality:S&dl=en&hl=en&q=unemployment+rate) (last visited Nov. 13, 2012); BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, <http://www.bls.gov/> (last visited Nov. 13, 2012).

20. See *Economic News Release: Employment Situation Summary*, BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR (Nov. 2, 2012) (stating that the unemployment rate for African Americans in October 2012 was 14.3% and for Hispanics was 10%, while the rate for Whites in October 2012 was 7%); Algernon Austin, *Uneven Pain: Unemployment by Metropolitan Area and Race*, ECON. POL'Y INST. ISSUE BRIEF, No. 278 (June 8, 2010), available at <http://www.epi.org/page/-/ib278/ib278.pdf> (examining the unemployment rates across the fifty largest metropolitan areas in the United States and the higher rates of unemployment among



Since an estimated 82% of the inner-city population are people of color,<sup>21</sup> these high levels of unemployment among African Americans and other people of color have an adverse impact on the growth and development of inner cities. Yet, inner cities hold great potential and are valuable, untapped domestic markets that, if developed, could contribute to the success and health of the national economy and produce businesses that “spur the next growth engine of the U.S. economy.”<sup>22</sup>

A strategy to revitalize economically distressed urban areas and decrease their high levels of unemployment is to create and grow viable small businesses in these areas.<sup>23</sup> Although it is important to establish viable small businesses owned by people of any race in urban areas to drive economic development, it is particularly important to establish viable small businesses owned by minority urban entrepreneurs in these areas.<sup>24</sup>

It is essential to develop urban small businesses owned by people of color for several reasons. First, small businesses owned by people of color operating in economically depressed urban areas tend to employ more people of color and residents living in these areas than White-owned

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people of color in these areas); see also *Unemployment Rates by Race and Ethnicity, 2010*, BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR (Oct. 5, 2011), [http://www.bls.gov/opub/ted/2011/ted\\_20111005.htm](http://www.bls.gov/opub/ted/2011/ted_20111005.htm).

21. Fairchild, *supra* note 10, at 3.

22. See *id.* at 2–4 (discussing the encouraging social and economic indicators of emerging domestic markets (defined either by ethnic minorities or inner-city neighborhoods), which include decreasing inner-city poverty, raising educational attainment of racial and ethnic minorities, growing minority purchasing power, and migrating back into previously unattractive urban neighborhoods in all major U.S. cities by young, single, college-educated professionals).

23. See Alicia M. Robb & Robert W. Fairlie, *Access to Financial Capital Among U.S. Businesses: The Case of African American Firms*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 47, 48–49 (2007) (“Stimulating minority business creation in sectors with high growth potential (e.g., construction, wholesale trade, and business services) may also represent an effective public policy for promoting economic development and job creation in poor neighborhoods.”); see also Lohrentz, *supra* note 13, at 358.

24. I use minority small business owner, small business owner of color, minority entrepreneur, and urban entrepreneur interchangeably in this Article. There is no common definition of urban entrepreneur, but when I use it in this Article, I use it to mean minority small business owners, small business owners of color, entrepreneurs of color, or minority entrepreneurs. See Susan Jones, *Current Issues in Community Economic Development: Supporting Urban Entrepreneurs: Law, Policy, and the Role of Lawyers in Small Business Development*, 30 W. NEW ENG. L. REV. 71, 72–73 (2007) (defining urban entrepreneurs as not having one definition but sometimes meaning minority entrepreneurship and other times meaning small businesses established in or serving economically depressed areas). Although not specifically discussing urban entrepreneurs, the legal scholar W. Sherman Rogers offers a compelling historical study on African American entrepreneurship and asserts the need for African Americans to become entrepreneurs. He states that “[t]he statistics suggest that the families of entrepreneurial African Americans fare better than those who assimilate into the job structure of the dominant culture. Additionally, persons who experience difficulty finding jobs have the option of establishing a business.” W. SHERMAN ROGERS, *THE AFRICAN AMERICAN ENTREPRENEUR THEN AND NOW* 20 (2010).

businesses.<sup>25</sup> A recent study of the urban development potential of Black-owned businesses found that due to social networks, small White-owned firms in urban areas most often employ Whites, while small Black-owned firms hire more minority workers.<sup>26</sup> Given this dynamic, more Black-owned small businesses and small businesses owned by people of color must be established in urban areas.

In addition, there are growing numbers of people of color in the United States and in urban areas. For example, between now and 2050, more than eighty-five percent of the estimated population growth will come from minority groups.<sup>27</sup> This means that in the near future, people of color will no longer be the minority population in the United States but will be a plurality of the population. This increasing ethnic population should play an important role in the economic growth of the United States and could fulfill this role, in part, by establishing viable entrepreneurial ventures in urban areas.

Furthermore, urban small businesses owned by people of color may bring wealth to the business owners and income to people of color living in these areas.<sup>28</sup> Also, these business owners often help to improve the social capital and civic engagement in urban neighborhoods.<sup>29</sup> Establishing successful minority-owned small businesses in economically distressed urban areas is essential to urban community economic development, in part, because these businesses help to stabilize neighborhoods.<sup>30</sup> Moreover, small businesses owned by urban entrepreneurs living in economically distressed urban areas have a unique understanding of the local issues of the area, which enhances the survival prospects of the businesses.<sup>31</sup> Finally, these owners often use their businesses to make a living and to provide social benefits to their communities.<sup>32</sup>

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25. Timothy Bates, *The Urban Development Potential of Black-Owned Businesses*, J. AM. PLAN. ASS'N, Spring 2006, at 227; Robb & Fairlie, *supra* note 23, at 49.

26. See Bates, *supra* note 25, at 229 (“Even among the businesses physically located within minority communities, the majority of the workers in the nonminority small firms are White. Black-owned businesses, in contrast, rely largely on minority workers, even when their firms are located outside of minority neighborhoods.”) (internal citation omitted).

27. BARTH ET AL., *supra* note 12, at 2.

28. Lohrentz, *supra* note 13, at 359; Robb & Fairlie, *supra* note 23, at 48–49.

29. Lohrentz, *supra* note 13, at 359; see Dana Thompson, *The Role of Nonprofits in CED*, in BUILDING HEALTHY COMMUNITIES 74–75 (noting that social capital is an important concept in the community economic development field and has been defined as the “networks, norms and trust . . . that enable participants to act together more effectively to pursue shared objectives”).

30. *Id.* at 358.

31. See Jeffrey Robinson, *Current Urban Entrepreneurship: Patterns and Policy*, 30 W. NEW ENG. L. REV. 103, 107 (2007).

32. See Candida Brush et al., *Building Ventures Through Civic Capitalism*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 155, 168 (2007) (discussing a research study

Minority small business owners operating in various industries in inner cities confront many of the same challenges that other small business owners face, including the lack of access to capital and the increased market share of large, publicly-held corporations, which makes it difficult for small businesses to attain profit margins similar to those attained by large, publicly-held corporations.<sup>33</sup> But the access to capital issues minority entrepreneurs face are more extreme for a number of reasons. One reason is because certain businesses that start in urban areas, such as small grocery stores, bakeries, clothing stores, and retail businesses that provide necessary products and services to their communities, may not be as attractive to investors and are not high growth businesses; therefore, these businesses are not likely to attract venture capital funding.<sup>34</sup>

Venture capital financing is a significant source of revenue for emerging businesses that has spawned the development of innovative industries in the United States.<sup>35</sup> Venture capitalists typically invest in companies with technologies “that have the potential to disrupt product markets and generate enormous returns.”<sup>36</sup> Venture capitalists typically seek to invest in businesses that are able to grow in size quickly and generate large rates of return in four to six years.<sup>37</sup> These large rates of return are necessary so that the venture capitalists may realize certain rates of returns expected by their investors.

There are an increasing number of minority-owned urban businesses started by well-educated and experienced individuals, who are establishing businesses in higher growth industries, such as finance, business, and professional services.<sup>38</sup> Although they may be attractive to certain minority venture capitalists, many of these businesses are not attractive to traditional venture capital firms because they are not in the high-tech or other sectors that offer the potential for great returns.<sup>39</sup>

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evaluating the growth of smaller urban and minority businesses, asserting that many of these businesses blended business and community improvement goals in creative ways, and labeling these entrepreneurs as “civic capitalists” and their ventures as “civic enterprises”).

33. See Lohrentz, *supra* note 13, at 360; Robb & Fairlie, *supra* note 23, at 67.

34. Victor Fleisher, *Urban Entrepreneurship and the Promise of For-Profit Philanthropy*, 30 W. NEW ENG. L. REV. 93, 95 (2007).

35. Mike Green, *Venture Capitalists Aren't Investing in Black Entrepreneurs*, HUFFINGTON POST (Apr. 5, 2011, 9:20 PM), [http://www.huffingtonpost.com/mike-green/uplifting-black-america-v\\_b\\_844738.html](http://www.huffingtonpost.com/mike-green/uplifting-black-america-v_b_844738.html).

36. *Id.*

37. ROGERS, *supra* note 24, at 241.

38. See Bates, *supra* note 25, at 230 (discussing the nature of the modern Black business community and its focus on offering skill-intensive services as opposed to traditional Black businesses in the twentieth century that typically consisted of “mom-and-pop food stores, small restaurants, barbershops, and beauty parlors”).

39. Timothy Bates & William Bradford, *Traits and Performance of the Minority Venture-Capital Industry*, 613 ANNALS AM. ACAD. POL. & SOC. SCI. 95, 101 (2007)

Another reason access to capital issues are more extreme for minority entrepreneurs is that equity investors other than venture capital firms, such as private equity investors, tend not to invest in viable, minority-owned businesses located in urban areas because of, among other reasons, their unfamiliarity with these businesses and their perceptions that these businesses are small, undercapitalized, and subsistence in nature.<sup>40</sup> Moreover, many of these businesses face discrimination from both equity investors and lenders.<sup>41</sup> Research studies show that African American businesses are more likely than White-owned businesses to be denied credit, pay higher interest rates, and avoid borrowing from banks because they believe they will not be approved for financing.<sup>42</sup> Finally, African Americans have lower levels of wealth than Whites.<sup>43</sup> Given these lower levels of wealth, African Americans tend to invest less start-up capital in their businesses, which restricts the ability of these businesses to develop and prosper.<sup>44</sup> Thus, minority-owned businesses have access to fewer capital resources than other small businesses. A minority-owned urban social enterprise confronts greater obstacles accessing capital because of its blended profit and socially beneficial purposes and the traditional investor's reluctance to invest in these types of ventures.

In addition to financing issues, a higher percentage of inner-city minority small business owners face problems not experienced by other small business owners.<sup>45</sup> Due, in part, to these challenges and inaccurate perceptions of minority-owned businesses, many investors view urban minority-owned small businesses as riskier ventures than other kinds of

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(discussing how mainstream venture capital firms primarily invest in high-tech sectors while minority venture capitalists invest in high-tech fields, like communications, as well as low-tech fields, like wholesale and retail trade).

40. See Fairchild, *supra* note 10, at 13.

41. See Bates & Bradford, *supra* note 39, at 106–07 (“[T]he existence of discrimination . . . can result in distaste for minority persons, spilling into distaste for investing in minority businesses. To the extent that general partners prefer not to work with ethnic minorities and are willing to forego economic profits in order to avoid transacting with minority owners, then fund entrance will be (self-) restricted.”).

42. See Robb & Fairlie, *supra* note 23, at 66–67 (asserting the existence of lending discrimination against Black-owned businesses and claiming that lending discrimination directly effects the success of these businesses because it restricts access to loans that help the businesses sustain themselves through challenging times or limits their ability to offer new products or expand into new markets); see also BARTH ET AL., *supra* note 12, at 5 (noting studies that find lending discrimination against African American small businesses).

43. See Robb & Fairlie, *supra* note 23, at 67.

44. *Id.*

45. See Lohrentz, *supra* note 13, at 361 (citing problems that minority small business owners encounter, including lack of education, experience, and access to the growth sectors of the economy, and numerous regulatory and licensing burdens); Jones, *supra* note 24, at 78–79 (addressing inaccessibility to social, financial, and human capital as one of the many issues faced by urban entrepreneurs).

businesses and avoid making investments into these businesses because of the perceived risks.<sup>46</sup> Consequently, minority small business owners in urban areas need supplementary support and resources to ensure their success.

Gains have been made in the development of minority entrepreneurship, partially owing to numerous federal, state, and local programs designed to revitalize urban areas and spur entrepreneurship.<sup>47</sup> Despite the existence of these programs and advances made by urban entrepreneurs of color, additional resources, particularly financial resources, are needed to establish and develop these entrepreneurs. Urban areas continue to be plagued by high levels of unemployment and poverty, and viable urban small businesses may help combat these issues.<sup>48</sup> Indeed, social enterprises owned by minority urban entrepreneurs that are committed to using their businesses to make a positive impact on their urban communities are also likely to confront the same challenges faced by urban minority small business owners and also need additional sources of financing and technical support to establish viable businesses and accomplish their social missions.

## II. FOR-PROFIT AND NONPROFIT FORMS AVAILABLE TO ANN AND CARL

The social enterprise movement could play a larger role in positively impacting economically distressed urban areas, though the traditional for-profit and nonprofit legal structures available to minority urban social entrepreneurs, like Ann and Carl, do not adequately complement their goals and financing needs.<sup>49</sup> This Part revisits the charitable restaurant and

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46. See Fairchild, *supra* note 10, at 13 (contending that many investors are not interested in making investments in Emerging Domestic Market firms (firms either owned by ethnic minorities or operated in inner-city neighborhoods) for the following five reasons: "1) limited experience with investments in this asset class; 2) the perception that these investments are for social purposes rather than economic opportunities; 3) the mixed past performance of government-sponsored programs; 4) an outdated perception of minority-owned businesses; and 5) a public policy agenda that has been focused outside of business development").

47. See ROGERS, *supra* note 24, at 112–14 (describing federal programs assisting small businesses and minority-owned small businesses, including the Small Business Administration Programs (which include the 8(a) Program, Section 7(a) Loan Guaranty Program, Microloan Program and the Section 504 Certified Development Company Program, Economic Opportunity Loans, and Specialized Small Business Investment Company Loans), Empowerment Zones and Enterprise Community Programs, HUD's Renewal Communities Program and Community Development Block Grant Program, the New Markets Tax Credit Program, and the Community Reinvestment Act); see also Robinson, *supra* note 31, at 110–12 (discussing the various government programs designed to develop minority-owned businesses).

48. See McFarland, *supra* note 9, at 1; Lynch & Rho, *supra* note 9, at 2.

49. See Kelley, *supra* note 1, at 340. See generally Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233, 236–44 (discussing how for-profit and nonprofit legal structures are unable to meet the goals of social

delivery service Ann and Carl would like to establish and explores the for-profit corporation, the limited liability company, and the nonprofit, Section 501(c)(3) tax-exempt organization, entities traditionally available to Ann and Carl to establish GPGFC, and the advantages and disadvantages of these entities.

### A. For-Profit Entities

The for-profit entities Ann and Carl could consider for their business that have typically been used for social enterprises are the corporation and the limited liability company.<sup>50</sup> These entities are designed to attract capital from outside investors and limit the liability of the owners, but the for-profit corporation is primarily focused on maximizing profits for its owners.

#### 1. Corporation

The for-profit corporation is one of the most commonly used business entities in the United States. The corporation is formed principally to generate a profit for its owners.<sup>51</sup> It is a preferred entity for raising capital from investors because investors are familiar with the corporate form, the interests in the corporation are freely transferable, and the investors' liability in the entity is limited.<sup>52</sup> The corporation is an entity formed under state law and is legally separate from its owners, who are known as shareholders or stockholders.<sup>53</sup> Due to this separate identity, the shareholders of a corporation enjoy limited liability, subject to certain limitations.<sup>54</sup> Limited liability means that the shareholders are generally not liable for the debts and obligations of the corporation beyond the assets

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entrepreneurs).

50. There are other for-profit entities available to Ann and Carl, including the general and limited partnerships and the business trust. Those entities are not often used for social enterprises and will not be discussed further in this Article.

51. Indeed, the influential twentieth century economist Milton Friedman contended that the sole purpose of the corporation is to make a profit, and he stated that "there is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits." Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAG., Sept. 13, 1970, at 133. However, there is a debate among legal scholars concerning the claim of the primacy of shareholder profit maximization as opposed to the corporation having a responsibility to other stakeholders, including its employees and consumers. See generally Antony Page & Robert A. Katz, *Is Social Enterprise the New Corporate Social Responsibility?*, 34 SEATTLE U. L. REV. 1351, 1351 (2011).

52. See F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S CLOSE CORPORATIONS AND LLCs, LAW AND PRACTICE § 2.4, at 2-24 (3d ed. 2004).

53. *Id.* § 1.10, at 1-42.

54. Owners are subject to personal liability if they personally guarantee a debt or obligation of the corporation, and if they negligently perform their responsibilities. Richard A. Mann et al., *Starting From Scratch: A Lawyer's Guide To Representing A Start-Up Company*, 56 ARK. L. REV. 773, 791 (2003–2004).

they have contributed to the corporation.<sup>55</sup> For example, if the corporation is sued by a third-party for breach of contract, subject to certain exceptions, the third-party will only be able to reach the assets of the corporation to remedy the breach of contract claim and is not legally permitted to access the personal assets of the individual shareholders that are not invested in the corporation. Thus, the shareholder's sole assets at risk are the assets the shareholder has actually invested into the corporation.

The corporation has a very well-developed and accepted body of law established by each state. It is subject to certain statutory requirements, such as having a board of directors who manages the affairs of the company, having certain officers, such as a president, secretary, and treasurer, who carry out the day-to-day responsibilities of the corporation, and having regular meetings.<sup>56</sup> The corporation's directors, officers, and other managers have heightened legal duties, known as fiduciary duties, when acting on behalf of the corporation and its shareholders.<sup>57</sup> Furthermore, the directors are legally required to maximize the profits of the owners, although they may consider other issues, such as the impact of the company's activities on employees and the environment when making decisions.<sup>58</sup> If the directors fail to fulfill these fiduciary duties, they may be subject to personal liability to the corporation and its shareholders.<sup>59</sup>

For federal income tax purposes, a corporation may be taxed as a C corporation or an S corporation.<sup>60</sup> A corporation taxed under Subchapter C of the IRC is subject to double taxation.<sup>61</sup> The C corporation is first taxed on its business income, and if the corporation distributes the business income to the shareholders in the form of dividends, the shareholders pay

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55. O'NEAL & THOMPSON, *supra* note 52, § 1.10, at 1-43.

56. Mann et al., *supra* note 54, at 799.

57. See MODEL BUS. CORP. ACT § 8.30 (2011).

58. See Celia R. Taylor, *Carpe Crisis: Capitalizing on the Breakdown of Capitalism to Consider the Creation of Social Businesses*, 54 N.Y.L. SCH. L. REV. 743, 747-48 (2009-2010) (comparing the "canonical account," which requires directors to further shareholder interests and maximize profits, with the "corporate social responsibility" model); see also Janet E. Kerr, *Sustainability Meets Profitability: The Convenient Truth of How the Business Judgment Rule Protects a Board's Decision to Engage in Social Entrepreneurship*, 29 CARDOZO L. REV. 623, 636-37 (2007-2008) (discussing how the business judgment rule protects a manager's decision to consider other stakeholder's interests and issues other than maximizing profits).

59. See Robert Rosenberg, *Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations*, ILL GLOBAL, 2 (June 2003), <http://www.iiiglobal.org/component/jdownloads/viewdownload/393/1422.html>; Charles M. Nathan, *Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations*, AMERICAN BAR ASSOCIATION THE SECTION OF BUSINESS LAW ERESOURCE (Aug. 2002), available at <http://www.abanet.org/buslaw/newsletter/0003/materials/tip3.pdf>.

60. O'NEAL & THOMPSON, *supra* note 52, § 1.5, at 1-17.

61. LEE R. PETILLON, ROBERT JOE HULL & MARK T. HIRAIDE, REPRESENTING START-UP COMPANIES § 2.6, at 2-13 (2011).

tax on the dividends.<sup>62</sup> A corporation that elects to be taxed under Subchapter S of the IRC is a pass-through entity.<sup>63</sup> This means that a Subchapter S corporation is not subject to tax on its income. Instead, the corporation's income and losses are passed through to the shareholders and are considered their income and losses.<sup>64</sup>

*a. Advantages of the Corporation*

There are a number of advantages of the corporation that may make it a useful form for Ann and Carl to operate their restaurant and delivery service as a social enterprise. One advantage is the ability to attract equity and debt investments from a number of different sources. Because Ann and Carl need capital to establish the restaurant, have limited money to invest in the company, and are unlikely to be able to obtain capital from family and friends, the corporation allows them to seek funding from socially conscious angel and venture capital investors, private foundations, and other investors who will get a return on their investment. In addition, Ann and Carl want to earn a profit from the company, and the corporation allows them to distribute income earned from the corporation to themselves and other investors. Furthermore, since the corporation has a well-developed governance structure, they can set up the entity with relative ease.

*b. Disadvantages of the Corporation*

A significant disadvantage of forming Ann and Carl's socially beneficial restaurant and delivery service as a corporation is the corporation's profit-driven focus. This focus conflicts with a fundamental aspect of Ann and Carl's vision of GPGFC, which is to use the restaurant and delivery service as a means to employ and provide job training to the unemployed and underemployed of Metropolis and to provide fresh food to the underserved in this community, in addition to making a profit. As mentioned earlier, a corporation is a vehicle primarily used to make profits for its shareholders; however, as will be discussed further below, for-profit corporations are increasingly taking into account and engaging in socially beneficial pursuits.

One of the key roles of the corporation's directors is to ensure that the corporation increases shareholder value and maximizes the corporate returns for the shareholders.<sup>65</sup> Directors owe fiduciary duties to the

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62. *Id.*

63. *See generally* O'NEAL & THOMPSON, *supra* note 52, § 2.6, at 2-44.

64. *Id.*

65. GREGORY V. VARALLO ET AL., *FUNDAMENTALS OF CORPORATE GOVERNANCE: A GUIDE FOR DIRECTORS AND CORPORATE COUNSEL* 7 (2d ed. 2009) (citing to *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986)) (explaining



corporation and its shareholders.<sup>66</sup> These duties are known as the duty of loyalty and the duty of care.<sup>67</sup> The duty of loyalty imposes on the directors, and those who manage the corporation, an undivided duty of loyalty to the corporation and its shareholders, and they must act in a way they reasonably believe is in the best interests of both the corporation and the shareholders.<sup>68</sup> This generally means that the directors, officers, and managers may not use corporate property to further their interests to the detriment of the corporation. The duty of care requires directors and officers to use care when making decisions on behalf of the corporation.<sup>69</sup> This means that when the directors and officers act on behalf of the corporation, they must do so on an informed basis.<sup>70</sup> If they are relying on information from employees, consultants, or other third parties, the reliance must be reasonable and in good faith.<sup>71</sup>

Related to these fiduciary duties, the courts have developed the business judgment rule, which creates a rebuttable presumption that recognizes that when the directors, officers, and managers are making business decisions, they are doing so in good faith and on an informed basis.<sup>72</sup> This presumption may be rebutted if one can prove the directors', officers', or managers' actions did not have a rational business purpose, or they were acting fraudulently, illegally, or in conflict of interest with the corporation.<sup>73</sup> This rule encourages individuals to serve on corporate boards, make corporate decisions without unnecessary judicial interference, and take an appropriate level of risk.<sup>74</sup> It is well-settled that the business judgment rule allows directors to take account of other issues and interests, such as impacts on the environment and employees, in addition to maximizing the profits of the owners.<sup>75</sup>

### *c. Constituency Statutes and Corporate Social Responsibility*

Constituency statutes and the corporate social responsibility movement

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that the board's discharging of its responsibilities must have rationally related benefits to stockholders).

66. *Id.* at 2.

67. *Id.* at 2.

68. See MODEL BUS. CORP. ACT § 8.30.

69. VARALLO ET AL., *supra* note 65, at 2.

70. *Id.*

71. MODEL BUS. CORP. ACT. § 8.30.

72. VARALLO ET AL., *supra* note 65, at 61.

73. *Id.*

74. Kerr, *supra* note 58, at 636–37.

75. See *id.* at 637 (discussing the court's opinion in *Shlensky v. Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968), in which the court ruled that the directors' decisions were covered by the business judgment rule and held that "the effect on the surrounding neighborhood might well be considered by a director").

offer examples of the increasing acceptance of for-profit corporations considering non-shareholder stakeholder interests as well as shareholder interests. Since the 1980s, many state legislatures in the United States have passed constituency statutes that allow corporate managers to consider the interests of non-shareholders, such as customers, employees, suppliers, communities, and others, when making corporate decisions and satisfying their fiduciary duties.<sup>76</sup> Constituency statutes further solidify the business judgment rule protections of corporate managers' decisions that take into account non-shareholder stakeholder interests that may conflict with maximizing shareholder profits.<sup>77</sup> Some commentators argue that these constituency statutes allow corporate managers to give preference to non-shareholder stakeholder interests over shareholders' interests.<sup>78</sup> Yet, the prevailing understanding of most constituency statutes is that, while they allow managers to consider non-shareholder interests, they are not legally mandated to consider these interests.<sup>79</sup> Furthermore, in most jurisdictions with constituency statutes, even if managers are permitted to consider non-shareholder interests, legal scholars assert that there are legal and practical arguments that any decisions managers make that involve non-shareholder interests must be tied to enhancing shareholder value.<sup>80</sup>

There is also a growing movement among the general public, consumers, social investors, corporate critics, and activists known as "corporate social responsibility" ("CSR"), which asserts that corporations should consider a set of constituencies broader than shareholders and profit maximization, including employees, governments, communities affected by corporate activities, and organizations promoting environmental and social interests.<sup>81</sup> Supporters of CSR argue that, given the power and influence of corporations, these organizations have a responsibility to do more than serve their owners' interests; they have a responsibility to also serve interests that benefit society as a whole.<sup>82</sup> Various jurisdictions in the United States have acknowledged the ability of corporations to consider

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76. *Id.*; John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 132 (2010).

77. *Id.*

78. *Id.* at 134.

79. *Id.*

80. Only three states, Iowa, Indiana, and Pennsylvania, may allow directors in these states to give preference to non-shareholders' interests over shareholders' interests. *Id.* at 136.

81. Kelley, *supra* note 1, at 349 (discussing the CSR trend); see Page & Katz, *supra* note 51, at 1353 (providing a historical analysis of the CSR movement and arguing that social enterprise provides an alternative to CSR); Taylor, *supra* note 58, at 747–48.

82. Kelley, *supra* note 1, at 349.

these wider constituencies.<sup>83</sup> In addition to state constituency statutes and the CSR trend, there are for-profit companies, such as Google.org that are engaging in for-profit philanthropy and successfully using the for-profit corporation for socially beneficial purposes.<sup>84</sup>

Despite the development of state constituency statutes, CSR, and corporations, such as Google.org, many scholars and corporate law commentators still contend that for-profit corporations are established and operated chiefly to generate revenues for their shareholders.<sup>85</sup> There are debates among scholars about the dominance of this theory, but the predominate view is that corporate managers must primarily focus on maximizing shareholder profits and may consider other interests as long as they are tied to maximizing shareholder profits.<sup>86</sup> Although state constituency statutes permit managers to consider interests other than shareholders and their financial maximization, most of these statutes still do not require them to consider non-shareholder interests.<sup>87</sup> If a for-profit corporation's managers ultimately decide they do not want to pursue socially beneficial activities or consider non-shareholder interests in favor of generating shareholder profits, they are legally able to do so.<sup>88</sup> Those corporations who engage in CSR may consider and be aware of larger societal and environmental interests while engaging in their business operations but are not legally required to incorporate these interests into their decision-making processes. In fact, some advocates of CSR maintain that a reason to engage in more socially responsible practices is because it increases the bottom line.<sup>89</sup> Again, this illustrates the linkage between CSR and using good corporate practices to increase shareholder value.

Given that Ann and Carl's restaurant and delivery service is committed not only to making a profit but also to paying fair wages, employing and training unemployed and underemployed residents of Metropolis, and providing underserved community members with access to fresh and

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83. *Id.* at 350.

84. *Id.* at 344; Dana Brakman Reiser, *For-Profit Philanthropy*, 77 *FORDHAM L. REV.* 2437, 2438 (2009) (discussing Google.org and how the for-profit company purposely chose the for-profit corporation rather than a nonprofit, tax-exempt corporation to further its philanthropic goals).

85. Tyler, *supra* note 76, at 126–27.

86. *Id.* at 127–28.

87. Of the thirty-one states that have enacted constituency statutes only Connecticut requires consideration of non-shareholder interests and then only for publicly traded corporations when there is a change of control. *Id.* at 132–33.

88. *Id.* at 135; see Allen R. Bromberger, *Social Enterprise: A Lawyer's Perspective*, (Perlman & Perlman (2008)), available at <http://www.perlmanandperlman.com/publications/articles/2008/socialenterprise.pdf>.

89. Christopher Flavelle, *Responsibility is Still Good For Business*, *WASH. POST*, Feb. 15, 2009, at F1 (discussing a study of sustainable companies that outperformed the market and asserting that proponents of CSR claim that “good behavior is also good for the bottom line”).

healthy food, the for-profit corporation would not be an ideal fit for their purposes. If Ann and Carl created the GPGFC as a for-profit corporation, various constituency statutes and CSR would allow their corporate managers to consider the interests of the workers and the community benefitted by their services. Yet, these corporate managers may subsequently decide that employing and training unemployed and underemployed residents of Metropolis may not be the most cost effective way to operate the business. If these managers decide to change who they employ in the company to maximize profits, they will legally be permitted to do so, and subsequent investors may argue that they are legally required to do so. Therefore, in order for Ann and Carl to fulfill their goals of creating a sustainable business that would allow them to make a profit and employ unemployed and underemployed citizens of Metropolis, the for-profit corporation is not likely to suit their needs.

## 2. *Limited Liability Company*

Since its inception in 1977 in Wyoming, the limited liability company (“LLC”) has become the preferred business entity form used by for-profit organizations to conduct business.<sup>90</sup> In fact, the number of new LLCs formed in the United States in 2007 surpassed the number of new corporations by a margin of nearly two to one.<sup>91</sup> The LLC has become a popular business entity due, in part, to its limited liability characteristic, its flexible management and governance structure, its tax structure, and its respect for the LLC parties and their agreements, including agreements limiting or waiving fiduciary duties.<sup>92</sup> The LLC is a limited liability entity similar to a for-profit corporation but has some of the characteristics of a general partnership, such as the ability to be managed by the owners, who are known as members, and to be taxed by default as a partnership.<sup>93</sup> As discussed above, limited liability means that subject to certain exceptions, the LLC’s owners’ personal assets are not available to be used to pay the liabilities of the entity, and the owners are not personally liable for the debts and obligations of the entity.<sup>94</sup>

The LLC also possesses other features that make it an attractive business entity for numerous types of businesses.<sup>95</sup> For example, the LLC may be

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90. See LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES 1 (2d ed. 2012).

91. Rodney D. Chrisman, *LLCs are the New King of the Hill*, 15 FORDHAM J. CORP. & FIN. L. 459, 460 (2010).

92. *Id.* at 485.

93. PETILLON ET AL., *supra* note 61, § 2.8, at 2-16.

94. *Id.* § 2.3, at 2-9.

95. *Id.* § 2.8, at 2-16 to 2-17 (discussing other favorable aspects of the LLC, including: 1) few statutorily required administrative requirements, such as holding regular meetings and keeping meeting minutes; 2) no restrictions on the number of

owned by individuals or any type of business entity, such as a for-profit corporation, a nonprofit corporation, a trust, and a partnership.<sup>96</sup> This feature makes the LLC attractive to a wide variety of investors.<sup>97</sup> Unless it elects to be taxed as a corporation, a multi-member LLC is taxed as a partnership under the federal tax laws and is a pass-through entity.<sup>98</sup> As a pass-through entity, the LLC itself is not subject to taxation, but the individual owners must pay tax on the LLC's income at their individual tax rates.<sup>99</sup>

*a. Advantages of the LLC*

As with the corporation, the LLC structure offers Ann and Carl the ability to attract both equity and debt financing for GPGFC. Ann and Carl could offer angel investors, corporations, and individuals membership interests in the company. They could also seek program-related investments ("PRI") from private foundations to finance the company. Further, as a startup company, they are not likely to qualify for traditional bank financing, but could seek other debt financing, such as convertible debt financing, microfinance loans, and Small Business Administration guaranteed loans. It is highly unlikely that they would attract venture financing for two reasons. First, they are not the type of high growth company with the potential for high returns in which venture capitalists typically invest. Second, venture capitalists tend not to invest in pass-through entities, such as LLCs, because of unfavorable tax treatment on their investments. Venture capital firms receive investments from a variety of entities, including charitable organizations, educational endowments, government and corporate pension funds, large corporations, banks, professional institutional investors, funds of funds, high-net-worth individuals, and insurance companies.<sup>100</sup> The tax-exempt entities investing in venture firms prefer to invest in entities that minimize or eliminate unrelated business taxable income ("UBTI").<sup>101</sup> Generally, a tax-exempt entity does not pay any unrelated business income tax ("UBIT") on dividends from corporations.<sup>102</sup> However, if the tax-exempt investor is a

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shareholders; and 3) the ability to divide profits and losses of the entity among the members in any manner upon which they agree as long as the substantial economic effect rules are satisfied).

96. EMERGING COMPANIES GUIDE: A RESOURCE FOR PROFESSIONALS AND ENTREPRENEURS 72 (Robert L. Brown & Alan S. Gutterman eds., 2011).

97. *Id.*

98. PETILLON ET AL., *supra* note 61, § 2.8, at 2-16 to 2-18.

99. Mann et al., *supra* note 54, at 800.

100. BRAD FELD & JASON MENDELSON, VENTURE DEALS: BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST 101 (2011).

101. UBTI and UBIT will be discussed in greater detail *infra* Part II.A.3.

102. BRUCE HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 696 (10th ed.

member of an LLC taxed as a partnership and the LLC's business is an unrelated trade or business with respect to the tax-exempt investor's organization, the tax-exempt investor must pay unrelated business income tax on its share of the gross income of the LLC.<sup>103</sup>

Other advantages of the LLC are that the LLC may be established easily and can give Ann and Carl a limited liability vehicle that allows them to manage the establishment or hire other individuals to manage it. In addition, if GPGFC initially generates losses, which is likely for this type of business, then subject to certain limitations, the LLC taxed as a partnership allows Ann and Carl and other investors to deduct these losses from their personal taxable incomes.<sup>104</sup> Moreover, if they establish the LLC in a jurisdiction that permits an LLC to be formed for any purpose, given the LLC's freedom of contract feature, they could restrict the purposes of the LLC in the articles of organization and the operating agreement to include only providing fair wages, employing the unemployed and underemployed, and providing fresh food to the underserved. They could also contractually impose fiduciary duties on the GPGFC's managers to ensure that the managers take LLC actions consistent with the company's charitable purposes as well as for profit-making purposes.

*b. Disadvantages of the LLC*

The inherent flexibility of the LLC is both one of the greatest benefits and liabilities for Ann and Carl and others considering the LLC for social enterprises.<sup>105</sup> Though Ann and Carl could form the LLC for their charitable purposes in a jurisdiction that enables an LLC to be formed for any purpose, creating an operating agreement, the document that dictates how the LLC is governed and managed, would be time consuming and could potentially overlook crucial provisions, impacting their ability to accomplish their social goals.<sup>106</sup> As mentioned above, the operating agreement could be drafted to provide for Ann and Carl's charitable and profit-making purposes and to impose fiduciary duties on the managers,

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2011).

103. *Id.* at 718.

104. RIBSTEIN & KEATINGE, *supra* note 90, at 48–49.

105. See Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 586 (2009) (“[T]he flexibility of LLCs is both a blessing and curse. Like a very sharp knife, properly used, an LLC is an effective tool to accomplish exactly what the craftsman using it wishes. On the other hand, used carelessly, it can cause severe and unanticipated damage.”).

106. See *id.* (asserting that it is not clear whether the LLC's flexibility is a good or bad thing for nonprofits and claiming that “careless organization or inappropriate actions by the LLC or its constituents can defeat the nonprofit purposes of the LLC, result in adverse tax consequences, and possibly lead to acrimonious litigation or regulatory action”).

mandating their fidelity to the charitable mission while also making a profit. In addition to these provisions, they would need to state in their operating agreement the authority that would enforce the charitable purposes of the organization.<sup>107</sup> In the nonprofit corporation context, the enforcement body is typically a jurisdiction's attorney general's office.<sup>108</sup> Ann and Carl would need to decide whether it makes sense to include an outside enforcement agency to enforce GPGFC's charitable mission or to instill in the members or some other third-party the rights to enforce the charitable purpose.<sup>109</sup> They should also consider adding a provision that limits the personal liability of LLC managers, except in the case of self-dealing.<sup>110</sup> They should also provide a mechanism for dealing with disputes concerning the legitimacy of the LLC's actions.<sup>111</sup> In order to ensure that these provisions are not easily modified, they need to address how the operating agreement can be amended and make it difficult to amend the operating agreement and subvert the charitable purpose of the LLC.<sup>112</sup>

There is also a compelling legal argument that given the LLC's flexibility and the ability for the parties to the LLC agreement to waive their fiduciary duties, the LLC form is not best suited to accomplish hybrid charitable and profit purposes because it is easier for the parties to the LLC to freely change their purpose without notice to the public or other public consequences.<sup>113</sup> Indeed, although the parties may contractually agree to a charitable and profit making purpose, if Ann, Carl, or some of their other investors eventually decide they would rather not pursue charitable purposes, they may amend their agreement accordingly without informing the public.<sup>114</sup>

In addition to the uncertainty of locking in the charitable purpose of an entity organized as an LLC, it could be more difficult for Ann and Carl to effectively brand GPGFC as a social enterprise if operating a limited liability company that has no obvious social enterprise, charitable, or social purpose designation, such as an L3C or a nonprofit organization. Creating a brand as a social enterprise has the potential for attracting socially conscious investors and consumers interested in investing in social enterprises. Socially conscious investors and consumers may be opposed

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107. *See id.* at 583–85 (discussing the provisions that should be addressed when establishing a nonprofit or hybrid LLC).

108. Murray & Hwang, *supra* note 6, at 38.

109. Keatinge, *supra* note 105, at 584.

110. *Id.*

111. *See id.* at 585.

112. *See id.*

113. *See* Tyler, *supra* note 76, at 146.

114. *Id.*

to a for-profit entity engaging in socially responsible practices that they perceive are ultimately designed to increase the entity's profits.<sup>115</sup> In light of these disadvantages, a limited liability company is not the ideal entity to operate GPGFC.

### 3. *Nonprofit, Tax-Exempt Organization*

A nonprofit, tax-exempt organization is an entity governed by both state and federal law<sup>116</sup> and is typically formed as a corporation under a state's nonprofit corporation statute. In order for a nonprofit to be recognized as being exempt from federal income taxation under the IRC, it must submit an application to the Internal Revenue Service ("IRS").<sup>117</sup> A nonprofit, tax-exempt organization may earn profits.<sup>118</sup> In fact, in order for most nonprofit organizations to be sustainable and effectively carry out their missions, they must make more earnings than their expenses and earn profits. However, a nonprofit, tax-exempt organization may not distribute its profits to its directors, officers, or other individuals, except in the form of reasonable compensation.<sup>119</sup>

The type of nonprofit, tax-exempt organization Ann and Carl would most likely consider creating is a charitable organization. A charitable organization is a nonprofit, tax-exempt organization formed for charitable, educational, or some exempt purposes set forth in Section 501(c)(3) of the IRC.<sup>120</sup> For an organization to qualify as a tax-exempt charity, it must be organized and operated exclusively for IRC Section 501(c)(3) purposes; the organization will not qualify as charitable if it is not operated exclusively for these purposes.<sup>121</sup> To satisfy the "organized" requirement in IRC

115. See Kelley, *supra* note 1, at 361 (discussing the importance of branding for social enterprises to attract investors and customers).

116. See HOPKINS, *supra* note 102, at 3 (discussing the large number of federal laws, including tax exemption, charitable giving, antitrust, education and labor, and state laws, including formation of corporations, trusts, and charitable solicitation laws, applicable to nonprofit, tax-exempt organizations).

117. See *id.* at 46 (describing how Congress, and not the IRS, grants tax-exemption, how certain organizations, such as religious organizations, are automatically exempt from federal income taxes, and how other organizations must by law submit an application to the IRS to be recognized by the IRS as a business that qualifies for tax-exemption).

118. Tyler, *supra* note 76, at 160.

119. HOPKINS, *supra* note 102, at 508.

120. The IRC states that the following organizations qualify as charitable organizations: "Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals . . . ." See Treas. Reg. § 1.501(c)(3) (2012).

121. See *generally id.* § 1.501(c)(3)-1 (describing the organizational and the operational tests).



Section 501(c)(3), also known as the organizational test, an organization must be organized as a corporation, trust, unincorporated association, or an LLC. It must also include language in its organizing or creating document, usually the articles of incorporation for a nonprofit corporation, which sets forth the purpose or purposes of the organization that must be aligned with IRC Section 501(c)(3) purposes. The articles must also state that the organization will not engage in private inurement nor will it be used to impermissibly benefit the interests of the organization's founders, insiders, or other third parties.<sup>122</sup> The articles must also limit the organization's lobbying activities and forbid the organization's involvement in any political campaign on behalf of any candidate for public office.<sup>123</sup> Finally, the articles must state that the assets of the organization will be permanently dedicated to charitable purposes, and if the organization is dissolved, the organization's assets will either be distributed for a charitable purpose, distributed to a government to be used for public purposes, or provided to a court to distribute in accordance with the exempt purposes of the organization.<sup>124</sup> The organization must also have bylaws or other governance documents that are consistent with the articles, which set forth the governance structure of the organization.<sup>125</sup>

To satisfy the "operated" language in the IRC and the operational test, an organization must establish that its activities are "operated exclusively" for exempt purposes.<sup>126</sup> The Treasury Regulations interpret "operate exclusively" to mean that the organization must engage "primarily" in activities that accomplish one or more exempt purposes, and if more than an insubstantial part of the activities are not in furtherance of the exempt purposes, the organization will not qualify for the exemption.<sup>127</sup> An organization will not meet the operational test if "its net earnings inure in whole or in part to the benefit of private shareholders or individuals."<sup>128</sup>

A nonprofit, tax-exempt organization may operate a trade or a business as a substantial part of its activities as long as such activities further its tax-exempt purposes.<sup>129</sup> If the trade or business does not further its tax-exempt purposes, the income from the trade or business is considered UBTI and the tax-exempt organization will pay unrelated business income tax on the

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122. Section 501(c)(3) forbids charitable organizations from engaging in private interests and states in relevant part that "no part of the net earnings which inures to the benefit of any private shareholder or individual." *Id.*

123. *See id.* § 1.501(c)(3)-1, 3(i)-(iii).

124. *See* Treas. Reg. § 1.501(c)(3)-1(4) (as amended in 2008).

125. *See* HOPKINS, *supra* note 102, at 64.

126. *Id.* at 77.

127. *See* Treas. Reg. § 1.501(c)(3)-1(c)(1) (as amended in 2008).

128. *See id.* § 1.501(c)(3)-1(c)(2).

129. *See* HOPKINS, *supra* note 102, at 78.

income at normal corporate tax rates.<sup>130</sup> If the trade or business is a substantial part of the organization's activities and does not further an IRC Section 501(c)(3) purpose, then the organization may not obtain tax-exemption or may even have its tax-exemption revoked.<sup>131</sup> The central focus is on the actual purpose of the organization and not the nature of the organization's activities.<sup>132</sup> If the organization's primary purpose is to revitalize an economically distressed community by providing fair wages and jobs to the community's unemployed or underemployed and fresh food to underserved neighborhoods, and if the organization accomplishes this purpose by operating a for-profit business, the activity of operating the business does not violate the operational test. If a tax-exempt organization is operating a commercial business to accomplish primarily an exempt purpose under IRC Section 501(c)(3), the IRS and courts will examine a number of factors to determine whether the primary purpose is nonexempt. Those factors include: 1) the particular manner that the organization's activities are conducted; 2) the commercial hue of the activities; and 3) the existence and amount of annual or accumulated profits of the organization.<sup>133</sup>

*a. Advantages of Nonprofit, Tax-Exempt Organizations*

If Ann and Carl formed the GPGFC as a nonprofit, IRC Section 501(c)(3) tax-exempt organization, the organization would enjoy a number of advantages. First, assuming the organization satisfies both the organizational and operational tests, it would not be required to pay federal income tax on the income it earns from the business. The organization could also be exempt from state taxes and may be able to get exemption from property, sales, and use taxes. Second, as a charitable organization, Ann and Carl could attract charitable donations from individuals and the general public by offering a charitable contribution deduction for federal and state income taxes. Third, the organization could obtain government, private foundation, and other grants available only to IRC Section 501(c)(3) organizations. Other advantages include: 1) the organization would not have to pay certain employment taxes; 2) volunteers of the organization would not have to comply with the Fair Labor Standards Act; 3) the organization could qualify for an exemption from federal and state securities laws; 4) the organization and any volunteers would be immune from certain types of tort liability arising out of the organization's charitable activities; and 5) the organization could get preferential postage

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130. *Id.*

131. *See id.*

132. *Id.*

133. *Id.* at 79.

rates.<sup>134</sup>

*b. Disadvantages of Nonprofit, Tax-Exempt Organizations*

Ann and Carl would not be able to qualify for IRC Section 501(c)(3) tax-exemption because they want to be able to receive profits from the establishment. Although an essential part of their mission is to revitalize Metropolis by providing fair wages and jobs to the unemployed and underemployed and to provide fresh food to the underserved citizens of Metropolis, the fact that they want to distribute profits to themselves and their investors violates the operational test. Even if GPGFC fulfilled the operational test, it could not raise money from private investors because of its inability to distribute its earnings to investors, also referred to as the nondistribution constraint.<sup>135</sup> A significant disadvantage of the nondistribution constraint is that it limits a nonprofit corporation's ability to raise capital from outside investors who are seeking a return on their investment in the form of a financial profit.<sup>136</sup> Furthermore, many nonprofit organizations trying to obtain a loan to finance their organizations find that loans are more costly and less flexible than equity, and traditional lenders may not be as likely to make competitive loans to them because of concerns about the nonprofits' ability to repay the loan.<sup>137</sup> Other disadvantages include: the time-consuming administrative requirements with which the organization must comply to obtain recognition of and maintain its tax-exempt status, the restrictions on lobbying and prohibitions on engaging in political campaigns, and the need to comply with each state's attorney general and fundraising rules.<sup>138</sup>

A possible solution to the private inurement prohibition for Ann and Carl is that they could establish the restaurant as a for-profit subsidiary of a nonprofit, tax-exempt organization. However, this structure is not likely to work because while Ann and Carl will offer fair wages and jobs to the unemployed and underemployed of Metropolis and fresh food to the underserved, they will not offer specific job training programs or other charitable programs separate from the restaurant and delivery service. The primary function of the nonprofit organization would be to operate the for-profit subsidiary. Moreover, a nonprofit, tax-exempt organization with a for-profit subsidiary requires greater administrative effort and expense to establish and operate because it is necessary to create and maintain two

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134. *Id.* at 48–50; *see* Brewer, *supra* note 1, at 692–93.

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

136. *See* Kelley, *supra* note 1, at 353.

137. *Id.* at 354.

138. HOPKINS, *supra* note 102, at 55–56; Brewer, *supra* note 1, at 694–95.

entities. A nonprofit, tax-exempt organization that creates a for-profit subsidiary must carefully comply with IRS rules when operating the subsidiary.<sup>139</sup> For these reasons, the nonprofit, tax-exempt organization is not the ideal entity to serve Ann and Carl's purposes.

The analysis of the for-profit corporation, the LLC, and the nonprofit, tax-exempt organization illustrates that these entities are inadequate to meet Ann and Carl's financing and mission-driven purposes. This Article now turns to the L3C to evaluate its development, advantages, disadvantages and whether it could serve Ann and Carl's capital and charitable purposes.

### III. L3Cs

The L3C is one of a number of hybrid legal entities recently established to satisfy the social entrepreneur's need for a business entity more legally suitable to operate a social enterprise.<sup>140</sup> The architects of the L3C created the entity to address the social entrepreneur's capital concerns, and it was originally envisioned as a vehicle to attract PRIs from private foundations, as well as other forms of private investment, as further discussed below.<sup>141</sup>

The L3C is a type of LLC that consists of both for-profit and nonprofit characteristics.<sup>142</sup> It is designed to enable its owners to accomplish charitable or educational goals while earning and distributing profits to its owners.<sup>143</sup> The L3C is gaining momentum as an accepted hybrid organization,<sup>144</sup> as evidenced by the increasing number of jurisdictions

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139. Bromberger, *supra* note 88, at 7 (discussing the rules with which charitable organizations must comply to operate joint ventures).

140. A complete discussion of the other entities recently created to facilitate social enterprises is beyond the scope of this Article, but these other entities include the benefit corporation, flexible purpose corporation, and the United Kingdom's Community Interest Company. There is also the nonprofit corporation, B Lab, which certifies various business entities as "B Corporations" if these entities meet B Lab's certification standards. See generally Katz & Page, *supra* note 2, at 62–63; Fei, *supra* note 2, at 37–42; Thomas J. Billitteri, MIXING MISSION AND BUSINESS: DOES SOCIAL ENTERPRISE NEED A NEW LEGAL APPROACH?, [http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New\\_Legal\\_Forms\\_Report\\_FINAL.pdf](http://www.aspeninstitute.org/sites/default/files/content/docs/pubs/New_Legal_Forms_Report_FINAL.pdf) (last visited Aug. 20, 2012).

141. ROBERT M. LANG, JR., THE L3C: THE NEW WAY TO ORGANIZE SOCIALLY RESPONSIBLE AND MISSION DRIVEN ORGANIZATIONS, ALL-ABA COURSE OF STUDY MATERIALS: TAX-EXEMPT CHARITABLE ORGANIZATIONS 2 (2007).

142. Robert Lang & Elizabeth Carrott Minnigh, *Corporate Creativity: The Vermont L3C & Other Developments in Social Entrepreneurship: The L3C, History, Basic Construct & Legal Framework*, 35 VT. L. REV. 15, 17 (2010); Doeringer, *supra* note 1, at 315 (discussing the development of social enterprise in the United States and Europe and the development of the L3C).

143. Lang & Minnigh, *supra* note 142, at 17.

144. See Kelley, *supra* note 1, at 341 (discussing hybrid ventures); see also Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 620 (2010) (discussing various hybrid forms including the L3C).

adopting L3C legislation<sup>145</sup> and the growing number of social enterprises forming as L3Cs.<sup>146</sup>

The L3C is a type of LLC, which means that it is a for-profit entity that offers the limited liability and flexible ownership and management structure of the LLC. As with the LLC, the L3C offers its owners: 1) fewer administrative requirements than a corporation and the ability to freely structure the LLC; 2) pass-through taxation; 3) the flexibility to allocate its profits and losses; and 4) the opportunity to attract a variety of investors, among other characteristics of the LLC. The primary difference between the LLC and the L3C is the purpose of the L3C. As mentioned earlier, some jurisdictions require the LLC to be formed for business purposes, but some allow the LLC to be formed for any purpose, including a nonprofit purpose. Conversely, the L3C is required to “significantly further the accomplishment of one or more charitable or educational purposes.”<sup>147</sup> Additionally, no “significant purpose of the company is the production of income or the appreciation of property . . . .”<sup>148</sup> These purpose requirements mandate that the L3C be guided chiefly by its charitable aims and secondarily by making a profit.

#### A. *Advantages of the L3C*

A key advantage of the L3C is that it offers Ann and Carl and other urban social entrepreneurs the opportunity to pursue their social missions while also attracting investment from a variety of investors, including private foundations, socially conscious angel investors and other private investors, and crowdfunding investors, as well as attracting debt financing. The L3C facilitates private investment because of its ability to distribute profits to investors.

The ability to attract investors is an advantage the L3C has over the nonprofit, tax-exempt organization, which cannot obtain investor capital because the nonprofit cannot distribute its excess profits to any individual,

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145. Currently, nine states and two federal jurisdictions have adopted L3C legislation, and the L3C is currently being considered in some form in twenty-six jurisdictions and has been introduced in fourteen states. See *Laws*, AMS. FOR CMTY. DEV., <http://www.americansforcommunitydevelopment.org/laws.html> (last visited Oct. 31, 2012); see also *Considering Legislation in Your State?*, AMS. FOR CMTY. DEV., <http://www.americansforcommunitydevelopment.org/considering.html> (last visited Oct. 31, 2012).

146. As of December 13, 2012, there were 696 L3Cs organized in various jurisdictions in the United States. See *Here's the Latest L3C Tally*, INTERSECTOR PARTNERS, L3C, [http://www.intersectorl3c.com/l3c\\_tally.html](http://www.intersectorl3c.com/l3c_tally.html) (last visited Dec. 13, 2012).

147. VT. STAT. ANN. tit. 11 § 3001(27)(a) (2012). Other state L3C statutes, such as Michigan and Illinois, reflect substantially similar language.

148. *Id.* § 3001(27)(b).

except in the form of reasonable compensation.<sup>149</sup> L3Cs maintain an advantage over LLCs because the L3C's charitable purpose may not be waived, and its managers are required to fulfill their fiduciary duties to pursue the organization's charitable purposes.<sup>150</sup> The language of the L3C statutory provisions expressly requires that the L3C significantly accomplish charitable or educational purposes.<sup>151</sup> Because of these stated purposes, as a matter of law (as opposed a contractual requirement for an LLC), the L3C must satisfy this requirement, and the L3C's managers have fiduciary duties to ensure the L3C pursues these purposes.<sup>152</sup> As a result, unlike the LLC, it is not possible to waive the charitable purpose of the L3C.<sup>153</sup>

The L3C's statutory language directs the L3C to operate first for charitable or educational purposes, and its managers must engage in actions on behalf of the L3C to fulfill its fiduciary duties and ensure the L3C's fundamental commitment to these purposes.<sup>154</sup> If the managers of GFGPC are presented with a choice between engaging in activities that permit them to revitalize their community by paying fair wages, employing the unemployed and underemployed, and delivering fresh food to the underserved, or pursuing a primarily profit-driven structure, the managers are required to favor the charitable pursuits. If the L3C no longer significantly furthers its charitable and educational purposes, the L3C will convert to an LLC.<sup>155</sup>

Due to the LLC's much touted flexibility, the parties to the LLC may initially decide to incorporate a charitable purpose into the LLC's structure and require the LLC's managers to maintain fiduciary duties that satisfy this purpose. Yet, if the parties to the LLC subsequently decide they no longer want to pursue charitable purposes, they may amend the operating agreement and remove these charitable purposes and fiduciary duties. Moreover, they do not have to provide public notice of these fundamental changes. Accordingly, due to the conversion feature in the L3C statute and the ability to more easily waive requirements in the LLC context, the L3C's managers, owners, investors, employees, and the general public can be more certain that the L3C will remain committed to its charitable purposes.

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149. HOPKINS, *supra* note 102, at 513.

150. Tyler, *supra* note 76, at 146–47.

151. VT. STAT. ANN. tit. 11, § 3001(27).

152. Tyler, *supra* note 76, at 146–47 (2010).

153. *Id.* at 146.

154. *Id.*

155. Murray & Hwang, *supra* note 6, at 31. Although the L3C converts to an LLC if it no longer significantly furthers a charitable or educational purpose, there is no adequate monitoring of the L3C by a third-party enforcement agency to ensure that the L3C will actually convert, if it is no longer primarily charitable. This issue will be discussed further in Part III.B below.

Another advantage of the L3C for Ann and Carl is the branding effect of the L3C designation on their venture. The L3C is developing a brand as a for-profit business that is committed to pursuing socially impactful goals. This brand enables investors interested in making investments in social enterprises to identify these types of companies more easily. There is a growing segment of investors evaluating opportunities to invest in businesses with a specifically stated social purpose that also offers financial returns.<sup>156</sup> The brand also signals to socially conscious consumers that the business is engaged in a charitable venture that uses its profits toward socially beneficial ends. This taps into the growing consumer sentiment for businesses to be engaged in pursuits with a broader positive community and environmental impact than the traditional for-profit corporation's bottom line focus.<sup>157</sup>

One of the benefits of the nonprofit, tax-exempt organization form over the for-profit form for those engaged in socially beneficial activities is the recognition of the nonprofit brand's dedication to the public good and helping the disadvantaged.<sup>158</sup> This brand facilitates the charitable donations the nonprofit receives from the general public, the government and foundations, and promotes the general support these organizations receive for their charitable programs. The L3C is developing a similar brand to that of the nonprofit, but is unique as a brand because the L3C blends a for-profit and nonprofit identity while using innovative practices to affect change that are unavailable to traditional for-profits and nonprofits.<sup>159</sup> This branding is important for urban social enterprises that need to attract investors and explicitly illustrate their commitment to social goals. Ann and Carl could use this brand to draw in a variety of customers to the establishment along with investors interested in revitalizing urban areas.

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156. JP Morgan recently published a report entitled *Impact Investments: An Emerging Asset Class* discussing the growing asset class of impact investment and stated in the report, "[W]e believe that impact investing will reveal itself to be one of the most powerful changes within the asset management industry in years to come." Nick O'Donohoe et al., *Impact Investments: An Emerging Asset Class*, J.P. MORGAN GLOBAL RESEARCH, Nov. 29, 2010, at 13, available at [http://www.jpmorgan.com/cm/BlobServer/impact\\_investments\\_nov2010.pdf?blobkey=id&blobwhere=1158611333228&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs](http://www.jpmorgan.com/cm/BlobServer/impact_investments_nov2010.pdf?blobkey=id&blobwhere=1158611333228&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs).

157. James Epstein-Reeves, *Consumers Overwhelmingly Want CSR*, FORBES: THE CSR BLOG (Dec. 15, 2010, 9:58 AM), <http://www.forbes.com/sites/csr/2010/12/15/new-study-consumers-demand-companies-implement-csr-programs/> (discussing the highlights of two public opinion surveys that reveal that eighty-eight percent of consumers want companies to achieve their business goals while improving society and the environment).

158. See Murray & Hwang, *supra* note 6, at 13 (contending that the public views nonprofits as more trustworthy because nonprofits "have less incentive to profit at the expense of consumers than do [for-profits]").

159. *Id.* at 23.

Other advantages of the L3C include the advantages offered by the LLC entity structure, including its limited liability feature and flexibility in governance and management. In addition, an advantage of the L3C over the nonprofit, tax-exempt organization is that the L3C does not have to engage in the time-consuming and expensive process of applying for recognition as a tax-exempt organization.

### B. Disadvantages of the L3C

Although the L3C offers advantages to Ann and Carl, there are a number of issues with the L3C that must be addressed before it can most effectively serve their purposes.<sup>160</sup> First, although there are an increasing number of private foundations making PRIs, most private foundations, except for large organizations such as the Gates Foundation, still continue to favor making grants rather than PRIs.<sup>161</sup> Although L3Cs were established to attract more easily PRI dollars, private foundations continue to be reluctant about making PRI investments to L3Cs or any other for-profit or nonprofit entity.<sup>162</sup> The next Section will provide some background on private foundations and PRIs and explain why private foundations are hesitant to make PRIs.<sup>163</sup>

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160. There are a number of L3C critics who contend that L3Cs are unnecessary because LLCs can be used to accomplish the same purposes as L3Cs. Further, critics contend that L3Cs are dangerous because they may mislead private foundations to think it is easier to make PRIs to L3Cs due to the L3C form. See generally Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?*, 63 ARK. L. REV. 243, 244–45 (2010) (asserting that the L3C's utility depends on revising federal tax laws regarding PRIs to recognize that investments made to L3Cs are PRIs and not jeopardizing investments and that tranche investments advocated by L3C proponents require more federal tax oversight); David S. Chernoff, *L3Cs: Less Than Meets The Eye*, TAX'N EXEMPTS, May–June 2010 at 3, 4–5 (stating a number of myths asserted about PRIs, including those asserted by L3C proponents); 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) (contending that the L3C form has little or no value without revising federal PRI rules); Daniel S. Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low-Profit Limited Liability Company*, 35 DEL. J. CORP. L. 879, 881 (2010) (claiming that the L3C is "unwise" and "misleading," that "current L3C legislation is nonsensical and useless," and that giving L3C special status under the IRC contradicts the policies of its relevant Sections).

161. See Brewer, *supra* note 1, at 685; Luther M. Ragin, Jr., *Transcript: Program-Related Investments in Practice*, 35 VT. L. REV. 53, 57 (2010) (discussing the increasing number of PRIs being made).

162. See Brewer, *supra* note 1, at 685.

163. One of the criticisms of the L3C is that the L3C founders advocated using PRIs to engage in tranche investing, which could lead to impermissible private inurement. Founders of the L3C envisioned the entity having three different equity investment levels or tranches. The first tranche is intended for foundation investors making PRIs into the entity. The foundation would receive a below market rate of return but their investment in the entity would encourage socially conscious and market rate investments. The second tranche is designed to attract socially motivated investors who receive a higher rate of return than foundations but less than a market rate of



Private foundations are nonprofit, IRC Section 501(c)(3) tax-exempt organizations, usually funded from one source (such as an individual or a corporation), whose primary activity involves grant making to accomplish their exempt purposes.<sup>164</sup> Unlike public charities, private foundations are subject to a number of punitive excise taxes if they fail to follow the federal rules governing private foundations.<sup>165</sup> For example, private foundations are obligated to distribute at least five percent of their net asset value annually or they will be subject to a tax on their undistributed income.<sup>166</sup> Private foundations are able to satisfy this five percent payout rule by making grants and PRIs.<sup>167</sup> Under the Tax Reform Act of 1969, private foundations are prohibited from making jeopardizing investments.<sup>168</sup> Jeopardizing investments are investments in which private foundation managers fail to meet the prudent investment standard.<sup>169</sup> PRIs are not considered jeopardizing investments, but instead are investments by private foundations that further their exempt purposes and whose investments are made to nonprofit or for-profit organizations.<sup>170</sup>

The language of the L3C legislation in various jurisdictions tracks the Treasury Regulation's definition of a PRI. A PRI is an investment made by a private foundation to a nonprofit or for-profit entity that complies with the three following requirements: 1) the primary purpose of the investment

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return. The third tranche attracts market rate investors who take the lowest risk and receive a competitive market rate of return. This may be a problematic investing strategy for L3Cs and is not recommended. However, this investment strategy is not central to the existence of the L3C and without implementing it, the other advantages of the L3C outlined in this Article illustrate the importance of the L3C to social entrepreneurs, including those working to achieve urban revitalization. For a discussion of tranche investing, see Steve Davis and Sue Woodrow, *The L3C: A New Business Model for Socially Responsible Investing*, FED. RES. BANK OF MINNEAPOLIS (Nov. 1, 2009), [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=4305](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305); see also Bishop, *supra* note 160, at 245 (discussing the riskiness of the tranche investment plan).

164. See BRUCE R. HOPKINS & JODY BLAZEK, PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE, 6–14 (2d ed. 2003). Section 501(c)(3) organizations may be categorized as either public charities or private foundations. Public charities are more common than private foundations and generally receive funding from a wide variety of sources, including the general public, the government, and foundation grant funding sources. Private foundations typically receive funding from one or two sources, such as a corporation or a family, and are subject to numerous excise taxes and restrictions.

165. *Id.* at 1–5 (discussing excise taxes set forth in IRC §§ 4940–4948 imposed on private foundations for failure to adhere to the IRC).

166. I.R.C. § 4942 (2012).

167. *Id.* § 4942(g).

168. *Id.* § 4944(a)(1).

169. Treas. Reg. § 53.4944-1(a)(2)(i) (as amended in 1973).

170. I.R.C. § 4944(c); Treas. Reg. § 53.4944-3(a)(1) (1972). See generally David A. Levitt, *Investing in the Future: Mission-Related and Program-Related Investments for Private Foundations—When It Comes to Private Philanthropy, the Return on an Investment May Not Be Only Financial*, PRACTICAL TAX LAWYER, May 2011, at 33.

is to accomplish one or more charitable, educational, religious, or other exempt purposes under Section 170(c)(2)(B) of the IRC; 2) no significant purpose of the investment is the production of income or the appreciation of property; and 3) no purpose of the investment is to lobby, support or oppose candidates for public office, or to accomplish any other political purposes forbidden to private foundations by Section 170(c)(2)(D) of the IRC.<sup>171</sup> To satisfy the prudent investment standard and obtain more assurance that a PRI is not a jeopardizing investment, foundation managers often obtain, but are not required to obtain, legal opinions from tax counsel, private letter rulings from the IRS, or both, particularly for high dollar, complex, or unique PRIs.<sup>172</sup>

PRIs generally take the form of interest-free or below market rate loans, loan guarantees, equity investments in for-profit entities, purchases of promissory notes, and purchases of participation in loans.<sup>173</sup> If a private foundation makes a PRI to a for-profit entity, it is also required to comply with the expenditure responsibility rules of the Treasury Regulations.<sup>174</sup> Many private foundations, particularly small and medium sized foundations, avoid making PRIs in part because of the need to comply with the stringent requirements of the expenditure responsibility rules, their unfamiliarity with PRIs, and their unfamiliarity with the underwriting credit risk of PRIs.<sup>175</sup>

To facilitate the use of PRIs, L3C advocates drafted federal legislation that was recently introduced in the House. This legislation would allow entities seeking PRIs to receive IRS approval and voluntarily report on any PRI dollars they received.<sup>176</sup> Although this legislation may help to assist private foundations with satisfying their expenditure responsibility requirements and influence them to make PRIs, the bill has not moved beyond being introduced in the House Ways and Means Committee.

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171. Treas. Reg. § 53.4944-3(a)(1)(i)-(iii) (1972); see DAVID S. CHERNOFF, PROGRAM-RELATED INVESTMENTS: A USER-FRIENDLY GUIDE 2 (Community-Wealth 2005), [http://www.community-wealth.org/\\_pdfs/tools/pris/tool-macarthur-pri.pdf](http://www.community-wealth.org/_pdfs/tools/pris/tool-macarthur-pri.pdf) (generally discussing program-related investments).

172. See Chernoff, *supra* note 160, at 4.

173. See CHERNOFF, *supra* note 171, at 2–3.

174. See Treas. Reg. §53.4945-5; see also HOPKINS & BLAZEK, *supra* note 164, at 323 (explaining the expenditure responsibility rules make the private foundation responsible for using reasonable efforts and establishing adequate procedures to 1) ensure that the grant is spent solely for the purpose it was made; 2) obtain full and complete reports from the grant recipient on how the funds were spent; and 3) make full and detailed reports about how the funds were spent to the IRS).

175. See Ragin, *supra* note 161, at 56–57; see also Chernoff, *supra* note 160, at 4 (stating that private foundations are not required to obtain a private letter ruling from the IRS nor obtain a tax opinion letter from counsel prior to making a PRI). In certain circumstances when dealing with a high dollar or unusually complex PRI, private foundations may obtain a private letter ruling or a tax opinion letter.

176. Philanthropic Facilitation Act of 2011, H.R. 3420, 112th Cong. (2011).

There is guidance in the Treasury Regulations and from the IRS that should give certainty to private foundations that PRIs made to urban social enterprises are not jeopardizing investments. The Treasury Regulations pertaining to PRIs provide a number of examples of private foundation investments to for-profit entities that constitute valid PRIs.<sup>177</sup> The first three examples in these Treasury Regulations involve a private foundation that makes PRIs to small businesses owned by members of an economically disadvantaged minority group operating their businesses in a deteriorated urban area.<sup>178</sup> The first two examples are of a private foundation that made a below market interest rate loan to a business because the business was not able to find conventional financing on reasonable terms.<sup>179</sup> The third example is of a private foundation that made an equity investment in the business so the business could attract conventional financing on reasonable terms.<sup>180</sup>

In all three examples, the private foundation made the PRIs to encourage the economic development of the economically disadvantaged minority groups.<sup>181</sup> Based on the facts, the Treasury Regulations recognized the private foundation's investments as PRIs because they were not intended to produce income or appreciate property. Furthermore, the private foundation would not have made the PRIs unless there was a connection between making the PRI and the private foundation's exempt purposes.<sup>182</sup>

In a 2006 private letter ruling, the IRS found that a private foundation's investment in a private investment fund structured as an LLC was a valid PRI.<sup>183</sup> The private investment fund was established to "enhance social welfare, support community improvement, eliminate prejudice and discrimination and promote economic self-sufficiency by serving or providing investment capital for, low-income communities or low-income persons."<sup>184</sup> The fund's operating agreement specifically stated the foregoing purposes. The fund accomplished these purposes by serving as

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177. Treas. Reg. § 53.4944-(3)(b) (1972).

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

182. *Id.*

183. The IRS ruled that the capital contributions made to a fund by a private foundation with charitable programs helping individuals achieve economic independence by promoting educational achievement and entrepreneurial success qualified as a PRI. The fund invested in businesses in low-income communities owned or controlled by minorities or other disadvantaged groups unable to obtain conventional financing on reasonable terms. The foundation expected its capital contribution and its entrepreneurship initiatives to enhance investment in minority or disadvantaged businesses in low-income communities. I.R.S. Priv. Ltr. Rul. 200610020 (Mar. 10, 2006).

184. *Id.* at 2-3.

an angel investor and investing in certain types of minority-owned or otherwise disadvantaged businesses, providing these businesses with technical support and educating the other individual investors about angel investing and entrepreneurship.<sup>185</sup> The private foundation was the lead investor, and its mission was to help individuals achieve economic independence by advancing education and entrepreneurship.<sup>186</sup> The foundation's rate of return was predicted to be lower than similar investments and all of the LLC's members shared equally in the return and risk of the fund.<sup>187</sup> Other notable aspects of the ruling were that the operating agreement gave the foundation approval on the LLC investments, required reports and other oversight authority, and specifically prohibited the LLC from engaging in lobbying or political campaigning.<sup>188</sup> Given the foregoing facts, the IRS found that the foundation's investment was a PRI.<sup>189</sup>

The examples above illustrate that properly structured investments to for-profit entities in economically distressed urban areas are valid PRIs. If Ann and Carl are able to identify a private foundation with a purpose aligned with GFGPC's charitable purpose, show they are unable to obtain conventional financing, specifically provide the L3C statutory language that tracks the PRI language in their articles and operating agreement, and provide for oversight and control by the foundation in their operating agreement, an investment from the private foundation to GFGPC should be considered a PRI. Although the private foundation would still have to exercise expenditure responsibility over the PRI, the benefits of making a PRI, including making a more impactful direct investment to an organization and receiving a return on its investment and other tax benefits,<sup>190</sup> should make the PRI a more attractive option to the private foundation. If GFGPC is structured as an L3C, GFGPC's managers would be legally required to operate primarily for charitable purposes which should provide more assurance to private foundations with charitable purposes aligned with GFGPC that its investment would be a PRI. Despite this guidance, unless a critical mass of small- or medium-sized foundations take the lead on making PRIs to urban social enterprises (or to intermediary organizations that will fund these urban social enterprises), they will likely continue to be hesitant to make PRIs. So, Ann and Carl may not be able to obtain PRI funding for GFGPC.<sup>191</sup>

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185. *Id.* at 3–4.

186. *Id.* at 3.

187. *Id.* at 5.

188. *Id.* at 5–6.

189. *Id.* at 14.

190. See CHERNOFF, *supra* note 171, at 8–9.

191. Even if a social enterprise, such as Ann and Carl's, is able to find a private

The L3C entity may also deter other types of investors from investing in Ann and Carl's venture. The "low-profit" designation and the statutory language that states "no significant purpose of the company is the production of income or the appreciation of property" may discourage certain types of socially conscious investors who are seeking a certain level of return. Concerns about the low-profit margins of the L3C could practically limit Ann and Carl's ability to attract a broad range of investors.

Another disadvantage of the L3C for Ann and Carl, their investors, and customers is that there is no regular mechanism for determining whether an L3C continues to principally pursue its charitable and educational purposes. Although the L3C statutes require an L3C that no longer meets the requirements of an L3C to convert to an LLC, there is no way to adequately monitor the L3C to ensure that it either meets the statutory requirements or has converted to an LLC.

For example, the Vermont statute provides that an L3C that fails to satisfy the requirements of an L3C will immediately cease to be an L3C, but will continue to exist as an LLC as long as it meets the requirements of the statute. The statute also requires the L3C to change its name to indicate it is no longer an L3C.<sup>192</sup> Under this statute, if a manager of GFGPC decides to reduce the number of unemployed and underemployed Metropolis citizens hired in order to hire other individuals who may require less training and potentially increase the profits to GFGPC, this could cause the L3C to cease to be an L3C. If GFGPC's articles are not amended to indicate it no longer is an L3C, there is no authority to ensure that the reporting requirement has been met to inform the public that the establishment is no longer an L3C. This could mislead the L3C's investors, customers, and the general public who may not be aware of the conversion and therefore decide to continue to invest in or patronize GFGPC despite the fact that it is no longer a social enterprise.

#### IV. RECOMMENDATIONS FOR THE L3C

Although the L3C is still in its early stages of development and has certain disadvantages for urban social entrepreneurs, such as Ann and Carl, the entity should be further developed to address the capital concerns and hybrid purposes of social enterprises. First, the statutory language of the L3C, which states that "no significant purpose of the company shall be the production of income or appreciation of property," should be changed to allow the company to have as an important purpose the production of

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foundation interested in making a PRI to them, the private foundation would likely not make the PRI directly to the individual social enterprise but to an intermediary who would then distribute the PRI funds to the individual social enterprises.

192. See VT. STAT. ANN. tit. 11, §§ 3001(27), 3005(a), 3023(a).

income or appreciation of property, but should also not allow that purpose to outweigh the charitable or educational purpose of the company. Revising this provision should allay the fears of certain socially conscious investors who are concerned about not making a certain return on their investment.

Another recommendation is to amend the L3C provisions of the LLC statutes to require the L3C articles and operating agreement to specifically state the L3C's particular charitable or educational purposes, in addition to stating that the L3C will significantly further the accomplishment of those purposes. Similar to nonprofit, tax-exempt organizations, this will require L3Cs to clearly articulate their purposes and provides a prima facie case to foundations, investors, customers, and the general public that the L3C is organized to significantly further charitable or educational purposes. Another suggested revision to the L3C provisions in the LLC statutes is that L3Cs should be required to submit an annual report to the state that will be available to the public. The annual report should state that the L3C continues to significantly further the charitable or educational purpose set forth in its articles and operating agreement and provide a report discussing how its activities further that charitable or educational purpose. The L3C managers should also be required to issue a similar report to its investors every year. Although some L3Cs may have converted to LLCs in between the periods they are required to submit the annual report, the report should at least prompt those L3Cs that have converted during that period to change their names to indicate their current LLC status.

#### CONCLUSION

The L3C is a positive development for social enterprises, including for those minority-owned urban social enterprises working to improve conditions in economically deteriorated urban areas. Urban social enterprises owned by minority social entrepreneurs have a unique understanding of the issues impacting the urban areas in which they reside. These urban social enterprises are particularly poised to provide resources, such as jobs and entrepreneurship training to the disadvantaged citizens of these areas. Yet, these urban social entrepreneurs must be able to adequately finance their ventures to become sustainable, impactful companies. The L3C offers the possibility for minority-owned urban enterprises to gain access to a greater number of investors, but the L3C needs to be further developed to accomplish this goal. Indeed, although the LLC is currently the preferred entity form for businesses, the LLC was not widely accepted until there were changes in the federal income tax rules that provided significant tax advantages to operating as an LLC.<sup>193</sup>

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193. RIBSTEIN & KEATINGE, *supra* note 90, at 1.

Likewise, it is necessary to consider changes to the federal income tax rules pertaining to PRIs and to the L3C statutes to facilitate the use of L3Cs for urban social enterprises.

As more socially conscious investors interested in making impact investments in urban areas become aware of the L3C's potential and the entity's commitment to accomplishing charitable purposes as well as making a profit, the investors should find that the L3C form is an attractive investment vehicle that ensures a dedication to double- and triple-bottom line goals. Just as the C corporation is a brand that high-tech companies use to attract venture capital financing,<sup>194</sup> the L3C should continue to develop its brand for urban social entrepreneurs to use to attract urban impact investments. The L3C must be further refined as set forth in this Article to enable urban social enterprises to more effectively amass the financial resources they need to become viable entities. These entities can help urban areas become places of opportunity, innovation, and economic success in the United States.

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194. Mann et al., *supra* note 54, at 803–04.