MITCHELL | HAMLINE School of Law

Mitchell Hamline School of Law

Mitchell Hamline Open Access

Faculty Scholarship

2010

When the Law is Understood—L3C No

Daniel S. Kleinberger
Mitchell Hamline School of Law, daniel.kleinberger@mitchellhamline.edu

J. William Callison

Follow this and additional works at: https://open.mitchellhamline.edu/facsch

Part of the Business Organizations Law Commons

Publication Information
William Mitchell Legal Studies Research Paper No. 2010-07

Repository Citation
Kleinberger, Daniel S. and Callison, J. William, "When the Law is Understood—L3C No" (2010). *Faculty Scholarship*. 512.
https://open.mitchellhamline.edu/facsch/512

This Article is brought to you for free and open access by Mitchell Hamline Open Access. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Mitchell Hamline Open Access. For more information, please contact sean.felhofer@mitchellhamline.edu.

MH MITCHELL | HAMLINE School of Law OPEN ACCESS
mitchellhamline.edu

When the Law is Understood—L3C No

Abstract

The November, 2009 issue of Community Dividend, included an article entitled "The L3C: A new business model for socially responsible investing." The article spoke enthusiastically about "[t]he low-profit limited liability company, or L3C, …a newly developed form of business that blends attributes of nonprofit and for-profit organizations in order to promote investment in socially responsible objectives."

We understand the enthusiasm; proponents of the L3C have predicted dramatic benefits. However, after careful study of the relevant law, we have concluded that the enthusiasm is misplaced. The L3C concept is fundamentally flawed, potentially dangerous, and at best counterproductive.

We also understand that our skepticism may make us seem like a pair of Grinches. We want, therefore, to briefly describe our experience in this realm of law and to outline the legal issues we have considered. We have each been involved in the law and practice of limited liability companies for more than 20 years. One of us (Bill) has a full-time practice that includes substantial amounts of work with low-income housing and community development financing transactions and extensive work with nonprofit organizations. The other of us (Daniel) is a professor of law, who was the Reporter for the Uniform Limited Partnership Act (from the National Conference of Commissioners on Uniform State Laws) and Co-Reporter for the Revised Uniform Limited Liability Company Act. Each of us has taught and written extensively about LLCs. In our assessment of the L3C concept, we have considered the arguments and claims of the L3C's proponents (including statements made in state legislatures), and also the laws providing for limited liability companies, regulating charitable foundations, and governing the sale of securities.

The promoters of state L3C legislation describe three principal benefits from the L3C form: (1) the L3C complies or "dovetails" with IRS program-related investment ("PRI") rules, thereby enabling private foundation investment in qualifying business enterprises that operate according to for-profit metrics (but nonetheless for socially beneficial purposes); (2) the L3C permits "tranched investment" through which foundations can make high risk/low return investments to enable profit-seekers to make low risk/high return investments, thereby bringing market-rate capital into socially beneficial enterprises; and (3) the L3C creates a "brand" to enable easy comprehension and use of the PRI tool. Our research shows that none of these benefits exist.

Keywords

Limited liability companies, LLC, Low profit limited liability company, Program related investment, Tax exempt organizations, Socially beneficial investing

Disciplines

Business Organizations Law

This article is available at Mitchell Hamline Open Access: https://open.mitchellhamline.edu/facsch/512

When the law is understood – L3C No

© 2010 Daniel S. Kleinberger[1] and J. William Callison[2]
submitted for publication in
Community Dividend
"a community development periodical for
the Ninth Federal Reserve District"

The November, 2009 issue of Community Dividend, included an article entitled "The L3C: A new business model for socially responsible investing." The article spoke enthusiastically about "[t]he low-profit limited liability company, or L3C, …a newly developed form of business that blends attributes of nonprofit and for-profit organizations in order to promote investment in socially responsible objectives."

We understand the enthusiasm; proponents of the L3C have predicted dramatic benefits. However, after careful study of the relevant law, we have concluded that the enthusiasm is misplaced. The L3C concept is fundamentally flawed, potentially dangerous, and at best counterproductive.

We also understand that our skepticism may make us seem like a pair of Grinches. We want, therefore, to briefly describe our experience in this realm of law and to outline the legal issues we have considered. We have each been involved in the law and practice of limited liability companies for more than 20 years. One of us (Bill) has a full-time practice that includes substantial amounts of work with low-income housing and community development financing transactions and extensive work with nonprofit organizations. The other of us (Daniel) is a professor of law, who was the Reporter for the Uniform Limited Partnership Act (from the National Conference of Commissioners on Uniform State Laws) and Co-Reporter for the Revised Uniform Limited Liability Company Act. Each of us has taught and written extensively

[1] Professor of Law, William Mitchell College of Law, St. Paul, Minnesota.
[2] Partner, Faegre & Benson, LLP, Denver, Colorado.

about LLCs. In our assessment of the L3C concept, we have considered the arguments and claims of the L3C's proponents (including statements made in state legislatures), and also the laws providing for limited liability companies, regulating charitable foundations, and governing the sale of securities.

The promoters of state L3C legislation describe three principal benefits from the L3C form: (1) the L3C complies or "dovetails" with IRS program-related investment ("PRI") rules, thereby enabling private foundation investment in qualifying business enterprises that operate according to for-profit metrics (but nonetheless for socially beneficial purposes); (2) the L3C permits "tranched investment" through which foundations can make high risk/low return investments to enable profit-seekers to make low risk/high return investments, thereby bringing market-rate capital into socially beneficial enterprises; and (3) the L3C creates a "brand" to enable easy comprehension and use of the PRI tool. Our research shows that none of these benefits exist.

<u>First</u>, the Congress, Treasury Department and IRS have not created any special category of PRI treatment for the low profit limited liability company, and it is not likely that they will ever do so. Indeed, they could not do so without turning the PRI concept upside down. To be a Program Related Investment, a foundation's investment must fit the program of the <u>investing</u> foundation. Therefore, each time a foundation considers making a PRI, the foundation must make a situation-specific determination that takes carefully into account the foundation's mission, the purpose of the organization receiving the investment, the relationship of the receiving organization's purpose to the foundation's mission, and how the governance and

financial structure of the receiving organization insures that the receiving organization will operate within the PRI requirements.

Thus, contrary to the hopes and assertions of L3C proponents, private foundation investments in L3Cs will not have any PRI-related advantage over investment in ordinary LLCs. Moreover, due to the substantial excise taxes imposed on foundations (and in some circumstances their managers) for failing to distinguish correctly between PRIs and non-PRIs, foundations will continue to be conservative in these determinations. Thus, devising a PRI arrangement will continue to require careful and individualized investigation, deliberation, negotiation, and drafting, and foundations will continue to need to ensure, through rulings, legal opinions and other due diligence, that their investments meet the PRI rules

We submit that this result is just as Congress intended when it authorized PRIs – i.e., a narrow channel through which tax exempt, non-profit organizations might divert assets into the for-profit world. We therefore caution that it would be misleading – both to foundations and to people who might set up L3Cs in expectation of foundation investment – to promote the L3C as enabling PRIs.

Second, "tranched investment" raises very serious policy concerns and is dangerous as a tax matter. Foundations have the privileges of tax-exempt status and the ability to receive deductible contributions. Tranched investing runs the risk of exporting these privileges to benefit non-charitable businesses, managers, and investors. Tax law has a term for this sort of private benefit – private inurement – and transactions that create private inurement cause large and potentially debilitating problems for charitable organizations. Properly constructed, a tranched investment arrangement might well survive IRS scrutiny, but it is dangerous to

advocate tranched investing by foundations as a generic, easily-designed, and readily-available device for social progress.

Third, given our first two points, we question whether there is any branding value to the L3C label. Branding properly occurs when the market perceives substantive value behind the brand. As we have shown, the L3C's two principal "claims to fame" lack legal substance. Moreover, the very idea of a brand in this area is dangerous for foundations. Brand connotes simplicity, templates, even (as one proponent predicted in a recent presentation) "L3Cs for Dummies." But, if an L3C is to receive PRIs, simplicity and templates are dangerous impediments, not facilitators.

Finally, we note that the L3C legislation enacted to date contains a technical but nonetheless fundamental error in drafting. Extrapolating from language in the federal regulations on PRIs, the typical L3C statute provides that: "no significant purpose of *the company* [can be] the production of income or the appreciation of property." (Emphasis added). How could tranched investing possibly work under these constraints? (As a chart in the November article illustrated, the final tranch is for investors seeking "a competitive market rate of return.") More generally, how is it possible to have a low profit limited liability company when no significant purpose of the company is the production of income or the appreciation of property?

The PRI is an important tool for foundations willing to devote the thought, care, and time to look wisely for "social investment" opportunities. However, the existing forms of business

organizations (including the “regular” LLC) are perfectly suitable to for PRI arrangements. In our judgment, the L3C adds nothing and risks much.

For further reading we suggest:

- Carter G. Bishop, “The Low Profit Limited Liability Company (L3C): Program Related Investment Proxy or Perversion,” U. Ark. L. Rev. (forthcoming 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1552056 .
- J. William Callison, “L3Cs: Useless Gadgets?” Business Law Today, (Vol. 19, No. 2, Nov./Dec. 2009)
- Daniel S. Kleinberger, “A Myth Deconstructed: The “Emperor’s New Clothes” on the Low Profit Limited Liability Company (forthcoming 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1554045 .
- David Edward Spenard, “Panacea or Problem: A State Regulator’s Perspective on the L3C Model,” 65 Exempt Org. Tax Rev. 131(2010)

Mitchell Hamline Open Access

Mitchell Hamline Open Access is the digital archive of Mitchell Hamline School of Law. Its mission is to preserve and provide access to our scholarly activities, for the benefit of researchers and members of the legal community.

Mitchell Hamline Open Access is a service of the Warren E. Burger Library.
open.mitchellhamline.edu

MITCHELL | HAMLINE
School of Law

© Mitchell Hamline School of Law
875 Summit Avenue, Saint Paul, MN 55105
mitchellhamline.edu