MUCH ADO ABOUT NOTHING: A COMMENT ON TYLER'S PAPER ON REGULATING CHARITABLE HYBRIDS* **

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This piece is a comment offered in conjunction with John Tyler's article, Analyzing Effects and Implications of Regulating Charitable Hybrid Forms as Charitable Trusts: Round Peg and a Square Hole?, *which can be found at 9 N.Y.U. J.L. & BUS. 535. An earlier version of the comment was presented on November 9, 2012 at the N.Y.U. Journal of Law & Business Fall Conference on the Law and Finance of Social Enterprise.*

I. INTRODUCTION

Low-profit, limited liability companies, commonly known as "L3Cs," are recent creatures of state legislatures. The form of entity demonstrates a "hybrid" purpose combining hallmarks of both for-profit and nonprofit entities: profit distribution and social mission. They were inspired and marketed with a primary goal of attracting program-related investments from private foundations,[1] a goal that remains unreal-

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* Professor Jill S. Manny, New York University School of Law. I would like to thank the students on the Journal of Law & Business, particularly Jesse Gero, for putting together this symposium on a timely and fascinating topic and for inviting me to comment on John Tyler's paper. I would also like to thank David Holmberg for his invaluable research assistance.

** I would also like to thank John Tyler for a terrific paper. It is a tremendous contribution to the field. John is one of the leading thinkers on this topic and it is an honor to have an opportunity to read and discuss his paper.

1. *See infra* Part II.

ized and unlikely to be accomplished without some change to the Internal Revenue Code. L3Cs are treated, for purposes of Federal tax law, as for-profit and taxable, indistinguishable from LLCs.[2]

John Tyler's insightful paper, *Analyzing Effects and Implications of Regulating Charitable Hybrid Forms as Charitable Trusts: Round Peg and a Square Hole?*,[3] focuses on the treatment of L3Cs and, to a lesser extent, other "hybrid" forms of entity, at the state level, by state attorneys general. The paper's primary concern is that L3Cs may be subject to charitable trust laws and regulated as charitable trusts, subject to the nondistribution constraint which distinguishes nonprofit from for-profit entities and makes distribution of profits unlawful.[4] Regulation of L3Cs under state charitable trust law would, in effect, confiscate half of the hybrid purpose by forbidding profit distribution, leaving the L3C form with a primary burden of charitable status (i.e., the nondistribution constraint) but with none of the benefits of charitable status (e.g., right to receive tax-deductible contributions[5]).

This comment will briefly provide background on the L3C form, its history, and its challenges, both at the state level and the Federal tax level. It will then review Mr. Tyler's concerns regarding the crippling impact of the application of state charitable trust law to L3Cs and argue that some of these concerns may be unfounded because charitable trust law is unlikely to be applied to regulate L3Cs. Finally, the paper will conclude that the L3C form does not and cannot accomplish its intended purposes and should be avoided in favor of other types of entities more suited to the dual mission.

2. An LLC, or "Limited Liability Company," combines the benefits of limited liability for its members with the flexibility and pass-through tax treatment of a partnership. *See, e.g.*, N.Y. LTD. LIAB. CO. LAW (McKinney 2012) (limited liability and partnership-style flexibility); Treas. Reg. § 301.7701-3 (can elect pass-through tax treatment).

3. John Tyler, *Analyzing Effects and Implications of Regulating Charitable Hybrid Forms as Charitable Trusts: Round Peg and a Square Hole?*, 9 N.Y.U. J.L. & BUS. 535.

4. *See* Henry Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 838 (1980); JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS 3 (4th ed. 2010); RESTATEMENT (THIRD) OF TRUSTS §§ 2, 76 (1991) (imposing nondistributional constraint on charitable trusts).

5. I.R.C. § 170(a), (c) (2006).

II. BACKGROUND

Although the law varies slightly among the various state statutes, in all cases the entity must: (1) significantly further one or more charitable purposes described in the Internal Revenue Code ("Code") section 170(c)(2)(B), which includes religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals and (2) not have as a "significant" purpose the production of income or the appreciation of property.[6] Other than the use of the term "significantly" in the L3C statutes as opposed to the term "exclusively" (which we know means "primarily"[7]) in Code section 501(c)(3), it is hard to distinguish the statutory description of L3Cs from the statutory description of charities. Thus far the world has no guidance on the proper measurement of either "significantly" or "primarily," leaving us with two equally indeterminate concepts. Another distinction between charities and L3Cs is that L3Cs are not statutorily subject to the nondistribution constraint[8] that constricts charities and distinguishes charities from for-profit entities. So, L3Cs are a strange type of hybrid—described to look like charities but ultimately looking more like noncharities because of the absence of the single attribute that distinguishes charities from for-profit entities.

In reality, L3Cs were designed with a specific purpose in mind—namely to attract program-related investments[9] (PRIs) from private foundations. PRIs are investments "the primary

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6. In addition, L3Cs are subject to the same limitations on legislative and political campaign activities that apply to charities. *See, e.g.*, 5 ILL. COMP. STAT. 180/1-26(b)(2) (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.).

7. Treas. Reg. § 1.501(c)(3)-1(c)(1) (2008).

8. *See* Hansmann, *supra* note 4, at 838; FISHMAN & SCHWARZ, *supra* note 4, at 3; *see also* RESTATEMENT (THIRD) OF TRUSTS, *supra* note 4, §§ 2, 76 (imposing nondistributional constraint on charitable trusts); I.R.C. § 501(c)(3) (2006) (conditioning federal tax exemption on, *inter alia*, "no part of [an organization's] net earnings inur[ing] to the benefit of any private shareholder or individual."). This is true at a Federal tax level, but perhaps in question at the state level, at least in Illinois.

9. I.R.C. § 4944(c) (2006).

purpose of which is to accomplish one or more of the [charitable] purposes defined in [Code] section 170(c)(2)(B),[10] and no significant purpose of which is the production of income or the appreciation of property. . . ."[11] Program-related investments may be made in the form of grants or loans and are not limited to grants or loans to organizations that are exempt under Code section 501(c)(3).[12] In other words, a grant or loan to a for-profit entity, including a public company, can qualify as a PRI if it is made to further the private foundation's charitable purposes.[13] As a result of the design genesis, the statutes describing L3Cs closely track the language defining PRIs in Code section 4944 and the relevant Treasury regulations. Unfortunately for the future of the entity form, the PRI is a federal tax law concept, governed by the Internal Revenue Service and the Internal Revenue Code rather than by the state legislatures that created L3Cs, and Congress seems to have no interest in recognizing L3Cs for this or any other purpose. Thus, L3Cs are tightly constricted by a tax statute that does not apply to them.

The dilemma for proponents of the L3C form is that L3Cs do not attract PRIs because the IRS does not recognize L3Cs as a vehicle similar to a public charity for purposes of permissible program-related investing.[14] Accordingly, investments in and loans to L3Cs are considered as made to a for-profit entity for purposes of the private foundation rules.[15] PRIs to L3Cs are permissible, as private foundations can lend to and invest in commercial enterprises as long as the loan or investment furthers a charitable purpose,[16] but PRIs to for-profit businesses involve significant processes and apparatuses that make the transactions less appealing than simpler PRIs to charities. So for example, unless the foundation exercises "expenditure re-

10. The purposes defined in Code section 170(c)(2)(B) are "religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals . . . ." I.R.C. § 4944(c) (2006).

11. I.R.C. § 4944(c) (2006); Treas. Reg. § 53.4944-(3)(a).

12. Treas. Reg. § 53.4944-3(a)(2)(i).

13. Treas. Reg. § 53.4944-3(b), exs.4-6.

14. The reason for the IRS failure to recognize L3Cs as charities is likely the absence of the distinguishing characteristic of charities—the nondistribution constraint requirement.

15. I.R.C. §§ 4942, 4944-45; Treas. Reg. §§ 53.4942(a)-3, 53.4944-45.

16. As defined in I.R.C. § 170(c)(2)(B).

sponsibility,"[17] a PRI to an L3C is a taxable expenditure subject to excise taxes under Code section 4945.[18] Continued taxable expenditures will eventually give rise to the ultimate sanction of loss of tax-exempt status. PRIs to public charities, on the other hand, generally do not require the same apparatus or red tape.[19] For this reason, foundations tend to prefer to bestow their generosity in the form of grants and loans to domestic public charities. Private foundation investments in and loans to L3Cs are subject to favorable PRI treatment for purposes of the minimum payout rules[20] and the jeopardizing investment rules[21] only to the same extent and using the same process required for loans and grants to other for-profit entities. In other words, L3Cs are in no way uniquely attractive to private foundations. Without IRS buy-in, private foundations are no more likely to invest in an L3C than in any other for-profit company, so L3Cs do not perform the function they were created to perform. As a result, the L3C promoters have created a form of hybrid with all of the burdens of charitable,

17. I.R.C. § 4945(d), (h); Treas. Reg. § 53.4945-6. Expenditure responsibility requires the PRI-making foundation to (1) see that the grant is spent solely for the charitable purposes for which it is made, (2) obtain reports from the grantee on how the funds are spent, and (3) make annual detailed reports to the IRS with respect to the expenditures. See also Treas. Reg. § 53.4945-5(b).

18. I.R.C. § 4945.

19. I.R.C. § 4945(d); Treas. Regs. § 53.4945-5(a).

20. A private foundation's yearly charitable distributions must equal or exceed a statutorily defined amount or else the foundation and its managers will be exposed to excise tax liability. I.R.C. § 4942. Distributions to for profits count toward this amount but only if the distributions accomplish one or more § 170(c)(2)(B) purposes. I.R.C. § 4942(g).

21. To discourage risky portfolio strategies, the Code subjects to excise taxes private foundation investments made "in such a manner as to jeopardize the carrying out of [the foundation's] exempt purposes." IRC § 4944(a); Treas. Regs. § 53.49441(a)(2)(i). However, it provides a safe harbor for PRIs, defined as investments "the primary purpose of which is to accomplish one or more § 170(c)(2)(B) purposes, and no significant purpose of which is the production of income or the appreciation of property." I.R.C. § 4944(c).

tax-exempt status,[22] with the likely exception of the nondistribution constraint, and none of the benefits.[23]

III.
REGULATION UNDER CHARITABLE TRUST LAW

As is reflected in John Tyler's paper,[24] genuine concern has arisen as to potential oversight of L3Cs by state attorneys general under charitable trust rules. Mr. Tyler's paper is very clear and convincing in elucidating what the negative impact of common law charitable trust standards would be on those who govern and invest in charitable hybrids, particularly L3Cs.[25] The increased duties of care and loyalty that prohibit any activity that benefits the trustee would bind the hands of an investor trustee. Compensation schemes will be limited by charitable trust standards. Changes in purposes would be limited by the need for almost impossible to obtain court approval with a motion for trust standard *cy pres*,[26] removing the option of the statutorily permitted conversion to LLC form.[27] Attorneys general, on the other hand, point to an obvious concern, namely, that L3Cs, by statutory definition, promise "significant" charitable purposes and activities.[28]

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22. Including the restriction on "substantial" lobbying activities and the prohibition against political campaign activities imposed on charities under Federal tax law. I.R.C. § 501(c)(3); *see* 5 Ill. Comp. Stat. 180/1-26(b)(2) (West).

23. For example, a L3C is not an eligible donee for purposes of §§ 170, 2055, and 2522; it is not able to issue tax-exempt bonds. I.R.C. § 145.

24. Tyler, *supra* note 3.

25. *Id.*

26. The doctrine of *cy pres* requires charities to gain court approval when a charitable purpose becomes impossible, inexpedient or impracticable of fulfillment or is already accomplished (or wasteful) in order to substitute another charitable purpose which approaches the designated purpose as closely as possible. *Cy pres* is a saving device that permits courts to direct the application of charitable trust property to a charitable purpose other than that designated in the trust instrument. Courts tend to be conservative in granting motions of *cy pres* making it difficult to change charitable purposes even when complying with original charitable purposes is quite difficult. JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS: CASES AND MATERIALS (2006) at 91.

27. *Id.*

28. *See, e.g.*, 805 ILL. COMP. STAT. 180/1-26 (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.)

Concerns over attorney general oversight are particularly acute in Illinois, where the relevant state statute authorizing L3Cs[29] explicitly treats the new entities as charities for certain purposes, subject to the Illinois Charitable Trust Act (ICTA) which regulates charities and the oversight of the Charities Bureau of the Illinois Office of Attorney General. Illinois is, thus far, the only state explicitly to impose the fiduciary duties of charitable trustees on L3C managers.[30] Section 3 of the ICTA defines "trustee" as: "any person, individual, group of individuals, association, corporation, not-for-profit corporation, estate representative, or other legal entity holding property for or solicited for any charitable purpose; or any chief operating officer, director, executive director or owner of a corporation soliciting or holding property for a charitable purpose."[31] The ICTA also provides registration and filing requirements for entities subject to the ICTA and provides for jurisdiction and administrative subpoena power of the Illinois AG. These provisions seem appropriate for an entity holding itself out as significantly charitable and aimed at soliciting contributions from private charities. Finally, the ICTA sets forth various fiduciary duties of trustees, including L3C managers, which include (a) to avoid self-dealing and conflicts of interest, (b) to avoid wasting charitable assets, (c) to adhere and conform the charitable organization to its charitable purpose, (d) to utilize the trust in conformity with its purposes for the best interest of the beneficiaries, and (e) not to make non-program loans, gifts, or advances to any person, except as allowed by the Not-For-Profit Corporation Act of 1986, among others.[32]

The Illinois ICTA does not, however, specify common law trust standards in enforcing the fiduciary duties of its trustees.

(furtherance of significant charitable purposes requires significant charitable activities).

29. *Id.* 1-26.

30. Illinois law stipulates that any L3C formed or operating in the state or holding itself out as a operating in the state, as well as its chief executive officer, directors, and managers, is a trustee as defined in the Illinois Charitable Trust Act. *Id.* at 1-26(d).

31. 760 Ill. Comp. Stat. 55/3 (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.).

32. Other fiduciary duties include timely filing of registration and financial reports and general compliance with the ICTA. 760 Ill. Comp. Stat. 55/15 (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.).

Even before the advent of L3Cs, more than one fiduciary standard applied to charities. Because the ICTA applies to both charitable trusts and nonprofit corporations, and now to for-profit L3Cs as well, it is silent as to standards. One must look to common law and to enabling statutes to determine the fiduciary standards that apply to each defined trustee subject to the ICTA. So, for example, if the entity in question is a charitable trust, common law charitable trust standards will apply. Those standards are stringent, and, as Mr. Tyler indicates, would severely limit a charitable hybrid in its operations and growth and in its ability to distribute profit to investors. An L3C cannot exist under those standards. If the entity in question were a nonprofit corporation, the standards of fiduciary duties would be significantly relaxed and perhaps much closer to the standards that apply to for-profit entities, albeit with significantly more oversight and subject to the nondistribution constraint. For example, a conflict of interest under the common law of charitable trusts would have to be avoided at all costs to avoid self-dealing, but a conflict of interest under Illinois NFP corporation law can be sanitized by disclosure and a vote of an informed, disinterested board.[33] Similarly, the negligence standard that applies under common law to charitable trusts would be much more daunting to an L3C manager than the more flexible "gross negligence" standard that applies to not-for-profit corporate directors.[34] While it might be complicated to pay a trustee of a real charitable trust a percentage of gross revenues as compensation, a director could be paid a revenue stream for services rendered in an employee capacity.[35] While the *cy pres* standard for charitable trusts seems vir-

33. 805 ILL. COMP. STAT. 105/108.60 (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.).

34. The Illinois Not for Profit Corporation Act does not itself prescribe a duty of care but the modern trend is to adopt the gross negligence standard of corporate law in the nonprofit context. MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 208 (2004); *see also* Model Nonprofit Corporation Act § 8.30; Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003, 1013 (D.D.C. 1974).

35. Nonprofit director compensation is regulated by federal law, which determines whether pay is excessive under a "reasonableness" standard. *See* I.R.C. § 4958(c), (c)(4); Treas. Reg. 6 53.4958-4 (note that under §4958(c)(4) Secretary has authority to prescribe regulations governing revenue-based compensation but none forthcoming). A handful of states have also taken an interest in regulating nonprofit director compensation. *See*

tually impossible to overcome and might leave Mr. Tyler's successful electrical impulse processing company in the lurch, a more gentle *cy pres* standard often applied to not-for-profit corporations is more likely to permit a minor change in purposes.[36] In any event, in drafting a charter for an entity subject to any law, the founders should have been more careful in drafting broad purposes to avoid any need to change the documents. This issue, while real, may be more of a drafting issue than an insurmountable legal challenge resolvable only through charitable trust law. Finally, as the Act suggests, while a charitable trust subject to common law charitable trust standards could not make non-program loans, gifts, or advances to any person, some of these types of payments are permitted for not-for-profit corporations under the Illinois General NFP Corporation Act of 1986.

To advance this analysis one step further, L3Cs are neither charitable trusts nor nonprofit corporations. L3Cs are for-profit entities with a significant charitable purpose and a right to distribute funds. They are creatures of their own enabling statutes and similar in structure to LLCs, which have their own well-developed fiduciary standards for managers. Because Illinois' Charitable Trust Act neither specifies nor suggests fiduciary standards for entities subject to the Act, the fiduciary standards for any particular entity's managers must be found outside of the Act. The proper place to find these standards for L3Cs is in L3C enabling statutes which delineate the priorities and responsibilities to be followed by managers, and in the case and statutory law that sets standards for LLCs. The Illinois Charities Bureau has never attempted to impose common law charitable trust standards on fiduciaries of not-for-profit corporations, and there is no reason to believe they would choose to subject L3Cs to those unduly burdensome

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Ben Gose, *An Increasing Number of States Consider Steps to Limit Pay for Nonprofit Leaders,* THE CHRONICLE OF PHILANTHROPY, Sep. 16, 2012, *available at* http://philanthropy.com/article/States-Seek-to-Limit-CEO-Pay/134464/.

36. *Cf., e.g.*, 805 ILL. COMP. STAT. 105/112.16 (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.) (assets of dissolving nonprofit corporation may be distributed to organization engaged in activities "substantially similar to those of the dissolving corporation").

standards, either.[37] To apply those standards would be to nullify legislative intent, and the attorney general has no interest in doing that.[38] The Act merely empowers the attorney general to enforce appropriate standards for accountability. It does not set those standards. This analysis suggests that the Act might bring us to exactly where John wants us to be—L3C managers subject to the LLC fiduciary standards with an L3C charitable overlay[39] but with someone to enforce those standards, namely the attorney general.[40] Thus, the fiduciary duties outlined in the Act would have unique meaning with respect to L3Cs, just as those duties are interpreted differently when applied to charitable trustees vs. nonprofit directors. Appropriate distributions of profits would not represent self-dealing or a conflict of interest, nor would those distributions be prohibited by the ban on wasting or distributing charitable assets. These terms would reflect the distinct entity and its purposes laid out in its enabling statute, which mandates a significant charitable purpose but does not impose a nondistribution constraint. The L3C would be required to "adhere and conform" to its own charitable purpose mandate and could convert to LLC status if such a conversion furthered its own charitable purpose. The Act would likely require notice to and perhaps approval of the attorney general for the conversion, but that is not a negative.

In sum, Mr. Tyler is correct in his assessment that an application of the common law standards of charitable trusts would cripple L3Cs, but it is unlikely that those are the applicable standards for L3Cs. Many of the entities defined in the Act as "charitable trustees" for purposes of the Act are not defined as such for purposes of common law and are, in fact,

37. In fact, the Illinois Charities Bureau Chief indicates that the intention is not to subject L3Cs to the nondistribution constraint. Telephone Interviews with Therese Harris, Office of the Illinois Attorney General, Charitable Trust & Solicitations Bureau Chief (Oct. 4, 2012 and Nov. 8, 2012).

38. *Id.* The Illinois legislature, evidently intended to create a "hybrid" entity under Illinois law that could serve charitable purposes and distribute profits. Applying the nondistribution constraint to this type of entity would entirely disable its intended purposes by forcing it into non-hybrid, charitable status, crippling legislative intent.

39. *See* John E. Tyler, *Negating the Legal Problem of Having 'Two Masters': A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 138-49 (2010).

40. Tyler, *supra* note 3, at 563-65.

subject to less crippling standards. It is important not to confuse statutory definitions with common law standards.

IV.
ARGUMENTS FOR AND AGAINST REGULATING L3CS AS CHARITIES

With some of the sting perhaps removed from Attorney General oversight, it is still worthwhile to contemplate whether such oversight over L3Cs is appropriate, given that L3Cs are fully taxable entities not statutorily subject to the nondistribution constraint. Several meaningful arguments can be drawn against subjecting L3Cs to laws pertaining to charities. First, L3Cs have none of the benefits of charitable organizations so arguably should not suffer the burdens of charities, including increased disclosure and attorney general oversight and the nondistribution constraint. Second, L3Cs have investors, not donors. The investors may be publicly minded, but they have selected a vehicle that can repay them, hopefully with a profit. They have not demonstrated pure donative intent and have opted for a possible return over a charitable contribution deduction. LLC investors have protections under the LLC Act.[41] Accordingly, L3Cs should not be subject to regulations designed to protect donors. Third, L3Cs compete in the market for investors to fund their social enterprises. Heightened regulation would hamper the ability of L3Cs to compete with less regulated for-profit enterprises for funding, negating much of the alleged purpose of these unique entities.[42]

On the other hand, convincing arguments may be made in favor of the application of some charities laws and attorney general oversight to L3Cs. The L3C statute is drafted to require assets to be used for "charitable purposes," and the L3C form is entirely elective. The entity is essentially promising its investors to devote its assets "significantly" to charitable purposes. Shouldn't someone oversee and enforce that promise? Don't the directors have a right to exact this accountability that Mr. Tyler suggests is a major benefit of an L3C and that is not evident in other types of entities?[43] With respect to chari-

41. 805 ILL. COMP. STAT. 180/40-1 (West, Westlaw through P.A. 97-1113 of the 2012 Reg. Sess., and through P.A. 98-6 of the 2013 Reg. Sess.) (giving LLC members the right to bring derivative actions).

42. Tyler, *supra* note 3, at 536-42, 542-44.

43. *Id.* at 548.

ties there are two official enforcers of charitability—the IRS and the state attorneys general. For L3C oversight, the only possible overseers are the state attorneys general since the IRS does not recognize these entities as distinctive or accord them any particular benefits or burdens. With public charities, another overseer of charitability is present: the public polices the border, because public charities are dependent on the public and government. If a public charity missteps, its fundraising will suffer and the users of its services will dwindle.[44] Again, the public will not police L3Cs in the same way because L3Cs are not similarly dependent on and accountable to the public and government. The only available enforcer is the attorney general. Some person or agency is necessary to enforce accountability and perhaps obligations of successors, and the state attorney general is the right person, but the trust standards are the wrong standards to enforce, and there is no indication that the Illinois attorney general (or any other attorney general, for that matter) intends to enforce them.[45] Less rigid standards applicable to nonprofit corporations or, more likely, LLCs, should be the applicable standards for L3C directors, and, under Illinois law, the only law that explicitly raises the issue of attorney general regulation, those more appropriate standards are apt to apply. The strict self-dealing prohibition and increased standard of care would disappear. The role of attorneys general would be one of necessary oversight and enforcement of the purposes of the L3C.

V.
SOLUTIONS

Two possible solutions are available for the lack of clarity and regulatory authority in L3C oversight, and the social enterprise sector should aim for the implementation of at least one of them. First, because the Illinois Charitable Trust Act and other similar acts in other states do not set fiduciary stan-

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44. For a famous example, see Deborah Sontag, *Affiliates Feeling Pinch of United Way Scandal*, N.Y. TIMES, Apr. 22, 1992, http://www.nytimes.com/1992/04/22/nyregion/affiliates-feeling-pinch-of-united-way-scandal.html?pagewanted=all&src=pm.

45. Telephone Interviews with Therese Harris, Office of the Illinois Attorney General, Charitable Trust & Solicitations Bureau Chief (Oct. 4, 2012 and Nov. 8, 2012).

dards, force a certainty that proper, noncharitable standards will be applied with respect to noncharitable entities deemed charitable trustees. John Tyler's paper is a terrific first step on that road. Second, redraft the model L3C enabling statute to take it out of the charities bureau, now that PRI eligibility is no longer a viable issue. The language that put L3Cs under the authority of charities officials is meant to serve a purpose it will never serve, and therefore is unnecessary. L3Cs need to evolve to the purposes they are now intended and likely to serve. Instead, redrafting should be aimed at moving the entity from the charities bureau to the consumer affairs bureau, where it belongs. But perhaps those who choose this restrictive form as currently formulated over other hybrids or for-profit LLCs implicitly choose the potential burdens, including attorney general oversight and charitable trust law. Ultimately, avoiding oversight by state charities officials is simple—avoid the L3C form in favor of forms free from attorney general charities bureau oversight, including for-profit entities, flexible purpose corporations, and benefit corporations.

VI.
Conclusion

The best thing about the L3C is its progeny.[46] The L3C form reflects a notion which has been refined and given rise to better entity forms without unnecessary problems and strictures, and the conversation energized by the L3C has just begun. It is unclear whether L3Cs are necessary in the lexicon of legal entities, or whether any sort of hybrid is required, on any level, to carry out social enterprise activities. At this point, a social entrepreneur has several entity choices other than L3C, including a for-profit, a charity, a flexible purpose corporation, and a benefit corporation. Charities can, and in fact must, operate primarily for charitable purposes. But charities, like for-profit entities, can make a profit and can attract funding from private foundations and public charities, donors, joint venturers (subject to certain requirements), and lenders. The downside of charity is the nondistribution constraint—a charity cannot pay out dividends or capital appreciation to investors. A for-profit, on the other hand, arguably can do any-

46. These are the Benefit Corporation, B Corp, and Flexible Purpose Corp. *See generally* Tyler, *supra* note 3, at 544-46.

thing that an L3C can do, without the complexity and unnecessary constraints of this nebulous duty "significantly to pursue charitable mission." The distinction is one of notice and disclosure, but a newly formed for-profit that properly discloses to potential investors its charitable intentions should be able to pursue charitable purposes to the extent of the disclosure.[47] Mr. Tyler and others discuss benefit and flexible purpose corporations,[48] and this paper will not endeavor to add to the dialogue, except to say that other types of hybrid entities can accomplish charitable purposes under more predictable standards and without the constraints and regulation imposed on L3Cs, and therefore are arguably better vehicles for social enterprise. If society needs a form of hybrid, flexibility and disclosure should be the hallmarks of that form. The other forms of hybrid are more flexible than L3Cs and deliver equivalent notice and disclosure to investors. Finally, although some have suggested that L3Cs are somehow more "accountable" than other entities and provide a guarantee of succession for charitable purposes, they can fall into LLC / for-profit form on a whim. That easy escape makes these claims of accountability and succession questionable at best.

It seems fairly obvious that L3Cs were created for a purpose that they cannot fulfill and subject to unnecessary regulation because of constraints imposed by drafting for a tax law that is irrelevant to their function. In a sense, the L3C form is a victim of the unintended consequences of its branding and the drafting of the statutes that establish it. L3Cs arrived in the charities bureau by drafting miscalculation. The statutory language that landed them in the charities bureau was intended to guarantee PRI eligibility without expenditure responsibility, and that did not happen. In a worse case scenario L3Cs may be tethered with the burdens of charity and none of

47. Although Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919), and more recent cases, *see, e.g.*, Katz v. Oak Indus, Inc., 508 A.2d 873 (Del. Ch. 1986); Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), conclude, loosely, that the purpose of a corporation is to increase shareholder value, none of those cases involved a corporation that was formed for purposes other than profit maximization and that gave notice to investors prior to investment of the non-profit maximization purposes.

48. Tyler, *supra* note 3, at 544-46 (discussing and citing articles on benefit and flexible purpose corporations).

the benefits. The simplest solution is to redraft the statutes to take L3Cs out of the charities bureaus now that PRI eligibility is no longer an issue.