THE CYCLE OF INNOVATION AND REGULATION: THE DEVELOPMENT OF A STATE CHARITY REGULATORY DIALECTIC FOR CHARITABLE INVESTMENT IN SOCIAL ENTERPRISE ACTIVITY THROUGH A LIMITED LIABILITY COMPANY STRUCTURE

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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.*

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I.
INTRODUCTION

The limited liability company (LLC) is a fairly recent innovation.[1] Legislative authorization of a variation on the LLC framework allowing the creation of a so-called low-profit limited liability company framework via one specific form, an L3C, is even more recent.[2] Whatever the claims that may surround the L3C framework at present, its principal purpose as manifest in the language of its design is to facilitate program-related investment, a specific type of high-risk investment permissible for a private foundation under the Internal Revenue Code (IRC).[3]

Thus, the L3C creates a specific mechanism for aggregating charitable investment with non-charitable investment.[4] As a charitable hybrid, the L3C can allow a charitable mission to exist alongside financial margin in the same enterprise. Nonetheless, through the IRC as well as the corresponding Treasury Regulations, there are significant restrictions applicable for such an arrangement, and there are penalties for a breach of the IRC or the Treasury Regulations with regard to investment in such an enterprise.

Vermont was the first state to enact legislation creating an L3C platform. Rather than each remaining state neatly falling in line behind Vermont, there have been variations on the Vermont theme. As Mr. Tyler notes in his article, Illinois "seems to have eliminated the ambiguity in its L3C statute by expressly subjecting L3C's in Illinois and their managers to the

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1. For background see The National Conference of Commissioners on Uniform State Laws' Limited Liability Company (Revised) Summary. http://www.uniformlaws.org/ActSummary.aspx?title=Limited%20Liability%20Company%20(Revised) (visited on 18 February 2013)

2. For background see the Vermont Secretary of State website regarding the Low-Profit Limited Liability Company. http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (visited on 18 February 2013)

3. For a discussion by Americans for Community Development concerning program-related investment and the L3C model, see http://www.americansforcommunitydevelopment.org/faqs/faqs-fedregulationnecessary.html (visited on 18 February 2013).

4. It is possible to aggregate charitable and non-charitable capital in a limited liability company other than an L3C. For this discussion of charitable hybrids, an examination of the L3C framework is sufficient.

[Illinois] charitable trust regime . . . ."[5] Therefore, at least one state legislature has chosen to signal that the creation of an L3C or the operation of an L3C within the borders of its jurisdiction carries with it an additional level of supervision for the purpose of protecting the jurisdiction's interests in assets dedicated to a charitable or public purpose.[6]

While the indication of additional supervision by state charity officials may not be a particularly favorable result for L3C advocates, it was predictable. As importantly, it is entirely necessary. In terms of the regulatory cycle, whenever there is innovation regulation will follow. Likewise, when there is regulation there will be innovation. As described by Edward J. Kane, "Introducing political power into economic affairs initiates a dialectical process of adjustments and counteradjustments."[7] The use of charitable assets in a venture or the claim of a charitable purpose for a venture will, unremarkably enough, trigger the interest of the state charity official. The creation of a new framework for aggregating capital that can include the investment or contribution of charitable capital will result in a regulatory counteradjustment. Thus, with regard to the use of charitable assets for social enterprise activity, the regulatory dialectic between L3C advocates and state charity officials is underway.

There is a very strong argument that L3C advocates will best serve their own cause by assisting in the development of tailored, reasonable regulation of charitable assets in charitable hybrid enterprises rather than by denying the need for incremental regulation of the enterprise through state charity official supervision. The first step that advocates could take is through establishing a duty of care for the proper use of the charitable assets that applies to each non-charitable participant having the ability to manage or control a charitable hybrid enterprise.

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5. 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. at 535, at 541 (2013).

6. *See id.* ("As such, Illinois L3Cs effectively are charitable trusts under Illinois law by virtue of their chosen form.").

7. Edward J. Kane, *Good Intentions and Unintended Evil: The Case Against Selective Credit Allocation,"* J. MONEY, CREDIT, AND BANKING 55 (1977).

II.
STATE CHARITY REGULATION AND THE FOR-PROFIT CORPORATION

A for-profit corporation may, in a manner consistent with the fiduciary duties of its directors, make a charitable contribution or support a charitable cause. For example, a for-profit corporation may provide a donation to an arts event. Charitable contributions seem a logical and necessary part of being a good corporate citizen or participant in the community. "Giving back to the community" is a phrase that can describe the transaction, and transaction is the correct term. A charitable contribution can frequently create a social benefit; however, some amount of care is in order with regard to the motivations behind the donation.

Without suggesting that every for-profit corporation donation or dedication of resources is a hollow act, it bears remembering that the standard for-profit entity exists to advance the interests of its investors principally through return on the investment through growth in share price and dividends.[8] Well-advised directors of a for-profit entity do not lose sight of this fact.[9] Neither does the typical or standard state charity official.

At the moment that the directors of a for-profit corporation authorize a donation to a local arts council, the typical state charity official does not rush into the boardroom or the courtroom declaring that the for-profit entity is now a charity and its directors are now charitable trustees.[10] The reason is simple. The investment in the for-profit corporation is private property. The focus of the state charity official is upon property held and administered consequent to a formal, binding dedication to a charitable or public purpose. This is precisely why the interests of state charity regulation attach to any structure or arrangement that exists for the purpose of holding or administering charitable assets.

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8. *See* Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders.")

9. *Id.* ("It is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others.")

10. For a critique of exercises of power by attorneys general in state charity law enforcement, see Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937 (2004).

III.
WHY THE DISTINCTION BETWEEN "SOCIAL" AND "CHARITABLE" MATTERS TO THE STATE CHARITY OFFICIAL

The L3C is principally designed for furthering charitable purposes. Its regulation will include a state charity official response addressing its charitable dimension. The state has an interest in protecting charitable assets from conversion to private use, misapplication, waste, or mismanagement. There is, with the adoption of an L3C framework or model, an adjustment with regard to the ability to deploy charitable assets; there is now a counteradjustment advancing the interest of state charity officials. Again, the fact of a regulatory dialectic may not be welcomed by L3C advocates, but it is in every regard a natural and logical consequence of the pursuit of this innovation for using charitable assets.

Revisiting the terms "social" and "charitable," the typical state charity official does not run into the boardroom or courtroom declaring that for-profit entities that make charitable donations become charities at the moment of authorization of a charitable donation. There should be no expectation for a state charity official to do so in scenarios in which directors of for-profit corporations do no more than declare the intent to engage in activity that is social in nature but does not fall within the definition of being charitable. If a for-profit corporation, under no obligation to do so, decides to fill its walls with paintings done by local school children, then it may pursue that goal. The investment in the for-profit corporation remains private property, and the investors in the for-profit are quite capable of supervising the decision by the directors.

If investors of a for-profit corporation want to band together with the intent to authorize the directors of the for-profit corporation (the agents of the investors) to consider goals other than the maximization of investors' financial wealth, then so be it. It is their money. To this end, an organizational structure such as the flexible purpose corporation or benefit corporation seems well-suited for allowing these investors to aggregate their capital. Still, in the absence of any charitable assets or declaration of charitable purpose, these corporations are not charitable ventures. An example can provide some contrast.

It is not difficult to find individuals who find societal threats consequent to decisions to eat fruits and vegetables out-of-season or that are not grown locally. For many members of this movement, there is belief in a true, material benefit to society through supporting "local" agriculture. This type of benefit, though, does not necessarily constitute charity.

If an otherwise for-profit restaurant makes a decision to purchase farm produce from farm operations with a location within a 100-mile radius of the restaurant (thereby supporting local or community farmers), then an argument can be made that the restaurant is generating a social return (which presumably benefits the community, non-investors) rather than simply generating a financial return for its investors. There are, nonetheless, two important points to emphasize regarding the assumptions for this hypothetical.

First, the investment in the restaurant is all private capital. The decision to invest in a restaurant that supports local farmers, of itself, is no more charitable than the decision by a person to shop at a farmers' market. In fact, it is no more charitable than the decision to buy fresh produce at a regular for-profit grocery store rather than produce in a can or freezer bag. True enough, supporting local farmers and restaurants that support local farmers may be of a somewhat selfless nature that, at least arguably, provides the community with benefit, thereby falling under the umbrella of social return; however, the activity is simply not charitable in the context of state charity regulation.

Second, if the otherwise for-profit restaurant makes the decision to purchase some produce from outside the 100-mile radius under the claim that it cannot obtain satisfactory quantities of the produce from within the zone, then there may be a state regulatory interest in protecting consumers stemming from the marketing of the restaurant. However, the state regulatory interest finds its foundation in preventing or remedying consumer fraud rather than the misapplication of charitable assets. Not all decisions regarding social objectives, however noble, implicate charity. Remove the state's interest in protecting the consumer, and the decision is a matter for the directors and the investors of private capital to address and resolve. The decision to seek a social return in the absence of an actual charitable asset is, basically, a private matter.

Again, because the fact does not seem to get adequate discussion, one major problem in discussions regarding social enterprise is that many of the participants fail to distinguish between furthering a social mission and furthering a charitable mission. The decision to buy corn grown from seeds that are not genetically modified may have social benefit, but the purchase, in itself, does not further a charitable mission. Comparatively, the decision of a farmer to donate corn to a local food bank or shelter accomplishes both a social benefit and a charitable benefit.[11]

The social benefit vehicle, whether a flexible purpose corporation, a benefit corporation, or another variation, is not, in itself, a charitable hybrid. Thus, while there are individuals who talk in terms of housing "mission" and margin in a hybrid or mixed-purpose corporation or entity, if the arrangement is for housing social mission it can be markedly different from a discussion of housing charitable mission and margin in a charitable hybrid. The housing of social margin alongside mission, with nothing else, in, say, a flexible purpose entity pertains to how much the investors of corporation want to give back to the community. It is a decision to forego some amount of financial return through pursuit of non-financial objectives, which are not by definition always charitable.

IV.
THE ACTIVATION OF SUPERVISION OF A STATE CHARITY OFFICIAL FOR A SOCIAL ENTERPRISE ARRANGEMENT

A slight variation of our local agriculture scenario demonstrates the activation of the state charity official's interest. If a nonprofit is formed for the purpose of purchasing and holding a parcel of real property that will serve as a marketplace for farmers with operations within a 100-mile radius of the parcel, and if the articles of incorporation of the nonprofit include

11. While feeding the hungry clearly fits within a traditional notion of charity, it is not clear that such actions always result in a net gain in social welfare. In growing the corn later donated, the farmer may have imposed substantial costs on society through his land management and labor practices, or his reliance on harmful products, like chemical fertilizers, pesticides, and genetically modified seeds. Likewise, even if a tobacco company made a sizeable charitable donation and voluntarily agreed to eliminate the use of certain pesticides, many people would hesitate before characterizing that activity as social enterprise.

the requisite language through which the nonprofit qualifies as a charity (including restraints against an investor equity position, distribution of profits, private inurement, etc.), then the nonprofit is a charitable venture. The state has an interest in the assets and operation of the charitable nonprofit. If one puts this arrangement into a low-profit limited liability company via the L3C model, the state still has an interest in the charitable assets and the operation of the enterprise.

As explained, a charitable venture may simultaneously serve a social enterprise role and generate a social return. But, the fact that charitable return may constitute social return does not run in tandem with the premise that where there is social return, there is charitable return. As shown above, social return, however worthy, does not necessarily constitute charitable return. Meanwhile, a state interest in protecting charitable assets will follow the charitable assets into any arrangement.

An L3C is a tool for aggregating capital in a hybrid arrangement. When an L3C combines for-profit investment into a venture or enterprise alongside of charitable investment, there is necessarily a need to consider the protection of the charitable assets. Because state charity regulators represent the interest of the public in protecting charitable assets, it is rather difficult to understand why promoters and advocates of charitable hybrids, and most notably the L3C, are surprised that state charity regulation is following the charitable assets into these ventures. The premise has been, and will continue to be, if you utilize charitable assets for your venture, you should necessarily expect some level of regulation by the state charity official. The key is not whether there will be regulation. The key is the proper or legitimate extent of state supervision.

As per Kane, regulation is the continuing operation of force and counterforce, adjustments and counteradjustments.[12] When the regulation is consequent to a need to remedy an abuse (when the use of a device or a practice has "gone too far" thereby creating a scandal or crisis or failure or other adverse consequence), then there is a likelihood that the counteradjustment may "go too far" toward the other direc-

12. Edward J. Kane, *Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Banking Regulation*, 36 J. OF FIN. 355 (May 1981).

tion. Thus, if we want to properly tailor regulation, placing adequate safeguards and measures before there is a scandal or crisis or failure may offer the best means to prevent regulatory overreaction. We cannot eliminate risk through regulation; however, we can properly assign it to the parties to an arrangement. The variations in L3C legislative frameworks and the present uncertainty regarding the extent of state charity regulation manifest the fact that the regulation is not yet tailored, there is not yet a proper assignment of risks.

V.
PROPER REGULATION OF A CHARITABLE HYBRID REQUIRES THE IMPOSITION OF A DUTY OF CARE UPON EACH PARTICIPANT IN A CHARITABLE ENTERPRISE

The perspective of this commentator is that social enterprise activity does not always require or activate the state's interest in protecting charitable assets. If the aggregation of capital is private capital and the arrangement does not hold charitable assets or dedicate any of its assets to a charitable purpose or create a charitable restriction, then the arrangement is not the concern of the state charity regulator.[13] If investors want to invest private capital into a for-profit retail store that, say, sells area rugs made out of recycled plastics, then they should be able to do so without any concern that state charity officials will intervene in their affairs regarding wholly non-charitable assets and activity.

However, the use of charitable assets in a charitable hybrid venture requires each participant with power to manage or control the venture to demonstrate fidelity to the proper use of the charitable assets. If a for-profit entity enters into an arrangement with a charitable entity and we create a structure for housing margin and mission, the for-profit entity should have some measure or assignment of responsibility to prevent the misapplication or waste of the charitable assets dedicated to the venture. To be clear, if a for-profit vendor simply sells proverbial widgets to a charitable nonprofit, then the for-profit does not become responsible for oversight of the char-

13. The arrangement may be the concern of another state regulatory authority such as a state securities agency. Further, nothing in this comment should be construed as suggesting that the state's interest in consumer protection and consumer safety should be diminished.

ity. In such an arrangement, margin is housed in the for-profit while mission is housed in the charity.[14] Nonetheless, when margin and mission share the same house, then margin must be loyal to the mission. With regard to mission, there is a duty of care that should extend to each participant in the enterprise.

In terms of its principal purpose, the L3C is designed to facilitate program-related investment (PRI) by private foundations. The primary problem with the L3C is that, with regard to its use to aggregate capital that includes charitable investment, it signals an inherently risky transaction by the charity in a framework that does not appear to incentivize diligence by all participants with regard to the risks. Participants in the enterprise pursuing margin do not appear sufficiently bound to protect the mission.

PRI is a lawful means though which a private foundation may make an investment that furthers the exempt purposes of the foundation.[15] Nonetheless, with regard to PRI, no significant purpose of the investment can be the production of income or the appreciation of property.[16] Given this prohibition, violation of which results in a tax on the jeopardizing investment, the private foundation that wants to house its PRI in an arrangement that includes both margin and charitable mission should exercise considerable caution to make sure that the production of income or the appreciation of property is not a significant purpose.

The imposition of an excise tax for a violation of the prohibition has its foundation in the Internal Revenue Code and is, therefore, a matter for enforcement by the Internal Revenue Service—a federal regulatory matter. For the state charity official, if there is an imposition of an excise tax, then it stands to result in charitable assets that are no longer available to serve that community. This is a negative outcome for any state, and charity officials at the state level have a legitimate interest in supervising a charitable hybrid to prevent or reduce the risk of such an outcome.

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14. A discussion of "cause-marketing" arrangements or ventures is beyond the scope of this article.

15. *Id.* at 37.

16. I.R.C. § 4944(c) (2006).

The paramount rule is obvious. If the aggregation of capital is through an arrangement in which a participant in the management of the venture is a charity, then the arrangement is a concern of the state charity regulator. This rule also applies to any arrangement that includes the use or investment of charitable assets or it is for the express purpose of furthering a charitable purpose as required by its governing documents.[17] The premise could not be any more simple or self-evident. Any participant with the power to manage or control the activity of a charitable venture or enterprise should expect oversight by state charity officials. Nonetheless, it is important to address the level of reasonable oversight for the non-charitable participant.

The observation of Mr. Tyler, that "it is not required that charitable hybrids be uniformly treated as charitable trusts," is true.[18] Further, as Mr. Tyler indicates, "driving the analysis is the extent to which assets are dedicated to charitable purposes and the corresponding degree or responsibility to an enterprise and its personnel have to pursue those purposes."[19]

It is fair for the state charity regulator to continue to insist that the primary responsibility for the proper use of charitable assets falls upon the charitable entity (the private foundation, charitable trust, etc.) with primary control over the charitable assets and responsibility for their proper use. There is a fiduciary duty that corresponds to holding and using charitable assets. Acting in good faith, on an informed basis, and in a manner reasonably believed to be in the best interest of the corporation is the standard duty for directors of the charitable nonprofit.[20] Combining a charitable nonprofit or its assets into a hybrid venture does not remove or reduce the fiduciary duty of the directors of the charitable nonprofit.

The L3C is a vehicle that has as its most essential characteristics three features. It is an enterprise that must signifi-

17. The divide created through these two rules should incentivize greater care in the use of the terms "social return" and "charitable return," and decisions relating to choice of organizational structure.

18. Tyler, *supra* note 5, at 539.

19. *Id.*

20. *See* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS, FEDERAL AND STATE LAW AND REGULATION 207-11 (Harvard University Press 2004); JACK B. SIEGEL, A DESKTOP GUIDE FOR NONPROFIT DIRECTORS, OFFICERS, AND ADVISORS 80-87 (Wiley 2006).

cantly further charitable, otherwise exempt purposes within the meaning of the Internal Revenue Code. It is an arrangement that would not have been formed "but for" the relationship to such charitable purposes. Finally, it cannot have as a significant purpose of the enterprise the production of income or appreciation of property.[21] Given these three attributes of an L3C, each entity or investor with an ability to participate in the management or control of the enterprise should have a duty of care to use best efforts to see that the enterprise does significantly further charitable, otherwise exempt purposes. The duty of care should logically extend to a non-charitable participant in the enterprise.

Otherwise stated: While the primary duty for the proper application of charitable assets rests with the charitable entity, other participants in an enterprise involving the charitable assets should not be agnostic towards or disinterested in whether the essential characteristic of the enterprise operates "according to plan." It is not necessary to impose upon non-charitable participants the responsibilities or duties of a charitable trustee, with regard to the enterprise. Nonetheless, placing upon non-charitable participants a duty of care regarding the enterprise is necessary. With regard to the non-charitable participants, they should act in good faith, on an informed basis, and in a manner reasonably believed to be in furtherance of the essential characteristics of the enterprise.

The goal is not to render or convert all of the investment (charitable and non-charitable) in a charitable hybrid into charitable assets. To the contrary, the goal is to recognize that the vehicle is for the aggregation of significantly different types of investments. With regard to the distribution of profits or the appreciation of capital as well as the sale or conversion of the L3C, the same problems remains for the non-PRI facilitating L3C that is present in the PRI facilitating L3C that is present for PRI in general. Combining charitable assets into ventures with for-profit investment carries with it a risk that the charitable assets will be used for supporting or subsidizing for-

21. *See* John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117, 123 n. 28 (2010) (laying out the key features of an L3C) (quoting Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 581-82 (2009)).

profit ventures. State charity officials and the Internal Revenue Service will continue to insist that mission prevail over margin. Therefore, the L3C framework remains an inherently risky means of aggregating capital. PRI is not, in any real sense, simplified by the L3C. The use of the L3C for purpose other than pursuit of PRI (the principal design of the L3C) only makes the situation more vexing.

One other point regarding the L3C merits mention. The mere existence of an L3C as a creature of state law does little to effect an incremental increase in or facilitate program-related investment. In fact, in terms of the early adopters of this form, "[t]he possibility of attracting PRIs intrigued some, but certainly not all, of these entrepreneurs, and it was not the prime motivation for any them."[22] Thus, the L3C structure is being chosen as the vehicle for a reason or reasons other than its principal design, namely the attraction of PRI. While some may view this as a non-event, the fact that a structure for aggregating capital is being used in a manner other than that for which it was designed is a bit of a yellow flag if not a red one.

Thus, we circle back or cycle back to where we seemingly began. The interest of the state charity official is in preventing the conversion of charitable assets to a non-charitable or private purpose, preventing the misapplication of charitable assets, and preventing their waste and mismanagement. A new device has been created that adds complexity and risks in the regulation of charitable assets, and the process of counteradjustment is taking place. That the new device is not being utilized in a manner consistent with its principal design only adds to the counteradjustment process. That the early versions of the L3C model did not include adequate safeguards for the incremental risks seems the reason that the counteradjustment of the imposition of charitable trust law by at least one jurisdiction may seem so drastic. Nature abhors a vacuum, and charitable trust law serves as a logical default when adequate protections are not otherwise in place. The development and adoption of a duty of care to the charitable enter-

22. Elizabeth Schmidt, *Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder*, 35 VERMONT L. REV. 163, 164 (2010); *see also* 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 VERMONT L. REV. 1 (Fall 2010).

prise by the non-charitable participants in the L3C legislative framework could serve as a very effective protective measure to replace a charitable trust law approach.