

July 13, 2011

Via Email

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With a copy to:

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Ladies and Gentlemen:

We, the undersigned, are writing in our individual capacities to respond to the letter and attachment that you have circulated in opposition to the low-profit, limited liability company or "L3C". We understand that you intend, on behalf of Nonprofit Organizations Committee and the Limited Liability Companies, Partnerships and Unincorporated Entities Committee of the Business Law Section of the American Bar Association, to lobby state legislators in opposition to any new L3C authorizing legislation.

We believe that your Committees' opposition to L3C is misguided and that your discussion of the tax-law rules as they relate to L3C is not entirely accurate. We are quite surprised that the ABA Business Law Section would take such a strong position against the

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adoption of a new legal form based primarily on tax-law considerations. Neither the Exempt Organizations Committee nor the Tax Section as a whole is opposing L3C; nor, to our knowledge, are any of the major organizations that represent private-foundation interests, including: the Council on Foundations, the Association of Small Foundations, or the PRI Makers Network.

In our view, L3C represents a progressive attempt to utilize the LLC legal form to (1) make program-related investments easier for private foundations (although not automatic) and (2) provide an investment vehicle for mixed-motive investors who want to promote a charitable purpose while still having the potential to make a return on their investment.

Specifically, we offer the following preliminary comments to your letter and attachment, in hopes that you will reconsider your opinion:

1. Your letter indicates that “The L3C is no better than any other business form for receiving program related investment[s]” In our view, an L3C is a better vehicle for accepting program-related investments than a standard LLC. The state-law L3C restrictions will make it easier for private foundation investors to conduct the due diligence necessary in order to complete a program-related investment and comply with expenditure responsibility. A charitable purpose would necessarily be articulated in the L3C’s operating agreement, helping to ensure that the L3C’s purposes and operations are aligned with PRI requirements. Persons who form L3Cs are likely to be better informed about the requirements applicable to private foundations for PRIs and for expenditure responsibility and so draft their operating agreements accordingly. The L3C designation automatically sets the entity apart from ordinary LLCs that may or may not be structured in a way compatible with PRI requirements.

We agree, and understand that, L3C is not necessary for an LLC to serve as the vehicle for a program-related investment, and we have represented many foundations that have made PRIs into LLCs, but we believe that in many cases L3C will make it easier for foundation investors to make the findings that they need to make for a proper PRI and for compliance with expenditure responsibility.

2. Your letter indicates that “tranching investing purposefully uses foundation funds to subsidize (and thereby attract) private, profit-seeking investors” so

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that such a PRI “almost inevitably results in private benefit.” Tranched financing does not lead to per-se private benefit, as you suggest. Private benefit depends on all of the facts and circumstances in a given situation. In fact, a PRI (other than one made to a charity) always involves some level of private benefit, but rather than a disqualifying private benefit, it is deemed incidental to the accomplishment of charitable purposes. One example in the Treasury regulations involves a foundation making a below-market-rate loan to a “business enterprise which is financially secure and the stock of which is listed and traded on a national exchange,” in order to encourage the enterprise to establish a factory in a depressed urban area.¹ In this example, there is clearly private benefit, since the corporation receives a below-market-rate loan from charity – but the private benefit is incidental. In any PRI investment in a for-profit entity there is private benefit, but the private-benefit doctrine involves a weighing of public good against private benefit.

In any case, there is *nothing* in the L3C statutes that requires or even addresses tranched financing anymore than there is in the LLC statutes. L3C is now a creature of the states and American Indian nations that have adopted it, not of some promoters. Just because some promoters of L3C have talked about tranches does not mean that tranched financing is an inherent part of L3C. It is simply not in the L3C legislation.

3. Your letter also points to a purported “technical error” in the L3C legislation, suggesting that there is some contradiction between the requirement that “no significant purpose of the company is the production of income or the appreciation of property” on the one hand and the label “low-profit” and the involvement of for-profit investors on the other. But there is no such contradiction.

L3C requires that the primary purpose of the organization must be charitable, but permits the production of income to be a secondary purpose. As with a tax-exempt charity that must have a charitable purpose by law, yet also must, from an economic standpoint, have sufficient revenue to conduct operations, institutional decisions must be made with the L3C’s overarching charitable purpose in mind, but profit may certainly be the result. The fact that an investment produces significant income or appreciation is not, in the absence of other factors, conclusive evidence of a significant purpose involving the

¹ Treas. Reg. § 53.4944-3(b), Ex. 5.

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production of income or the appreciation of property.² In fact, an example in the Treasury regulations, in analyzing an investment by foundation “Y,” states that the investment “is a program-related investment even though Y may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.”³

When assessing whether a “significant purpose” of a foundation’s proposed investment is the production of income for purposes of the PRI rules, the IRS finds it “relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.”⁴ Such an investment is less likely to be a PRI to the extent that for-profit investors would enter it on the same terms as a foundation. The clear corollary is that for-profit investors may enter such investments on terms more favorable to them than those under which a foundation is willing to invest. Thus, L3C can bring together foundations’ PRIs and investments on more favorable terms by for-profit investors to accomplish the L3C’s primary charitable purpose through a business that, because of its inherent risk and low likelihood of profit, simply would not be attractive solely to for-profit investors.

4. There is increased interest in the U.S. and the United Kingdom, as well as in other countries, regarding new types of business entities and financing structures, be it an L3C, a benefit corporation, a flexible purpose corporation, a community interest corporation (UK), a social enterprise LLP (UK) or a social impact bond (UK and MA). States have always been responsible for adopting new legal forms. In the interests of transparency and general access to information, it is perfectly appropriate for states to adopt new legal forms that signify a certain brand or purpose to the public. Certainly, such alternative structures are not “necessary” in the sense that businesses that pursue socially useful goals will cease to exist if the structures are not adopted, but there are benefits from having a standard structure and a means of more easily identifying the options. The example of Delaware proves that a separate nonprofit corporation law is not necessary to enable charities to flourish, but most other states find it useful. Why not the same dichotomy for the LLC structure?

² *Id.* § 53.4944-3(b), Ex. 1.

³ *Id.*

⁴ *Id.* § 53.4944-3(a)(2)(iii).

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In our view, the L3C designation identifies the entities to the public and to regulators, providing an element of transparency of purpose that is lacking in LLCs and corporations, whether non-profit or for-profit. It is a form that should be embraced rather than condemned.

Very truly yours,

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