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## **Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder**

**Elizabeth Schmidt**

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Elizabeth Schmidt  
Associate Professor  
Vermont Law School  
164 Chelsea Street, PO Box 96  
South Royalton, VT 05068  
802-831-1103  
bschmidt@vermontlaw.edu

## Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder

--Elizabeth Schmidt\*

### INTRODUCTION

On April 30, 2008, Vermont recognized a new business entity, the low-profit limited liability company, also known as the L3C.<sup>1</sup> An L3C is a for-profit organization, designed to retain the flexibility of a limited liability company (LLC), but with a primary motivation to achieve a charitable goal.<sup>2</sup> It is also expected to facilitate social investing from private foundations through program related investments (PRIs), which are investments private foundations can make in social enterprises without jeopardizing their tax-exempt status.<sup>3</sup> In the two plus years since Vermont adopted the L3C, six other states and two tribal nations have recognized this new social hybrid.<sup>4</sup> During that time, 101 entrepreneurs also registered their L3Cs with Vermont's Secretary of State.<sup>5</sup>

This article examines the experiences of the early adopters of the L3C business form. Through surveys, phone conversations, and examinations of web sites, I explored the reasons these social hybrid pioneers chose the L3C over alternatives such as a traditional LLC or a § 501(c)(3) tax-exempt organization. I found a group of entrepreneurs who embraced the unofficial slogan of the L3C,

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<sup>1</sup> 2007-2008 Vermont Legislative Session H.0775 (signed by the governor, April 30, 2008), codified at 11 Vt. Stat. Ann., tit. 11, § 3001(27) (2010)

<sup>2</sup> Much has been written on the L3C. See notes 32, 29, 41-46 accompanying text. Americans for Community Development maintains the most comprehensive website about the L3C, <http://www.americansforcommunitydevelopment.org/laws.php> (accessed July 18, 2010) [hereinafter Americans for Community Development].

<sup>3</sup> I.R.C. § 4944(c) (2009); Treas. Reg. § 53.4944-3(a)(2009)

<sup>4</sup> The L3C is called a hybrid because it has elements of both a for profit and nonprofit enterprise. Besides Vermont, four other states, Illinois, Utah, Wyoming, and Michigan, have passed the legislation. 805 Ill. Comp. Stat. 180/1-26 (2009); Utah Code Ann. § 48-2c-412 ((2009), Wyo. Stat. Ann § 17-15-102 (2010), Mich. Comp. Laws § 450.4102 (2009). Maine and North Carolina have passed, but not yet enacted, L3C legislation. Maine H. 819 (2010) and N.C. H769/SB308 (2010). Two tribal nations, the Crow Indian Nation of Montana and the Oglala Sioux Indian Tribe, have also authorized the creation of L3Cs. Americans for Community Development, *supra* note 2.

<sup>5</sup> The Vermont Secretary of State maintains a database of businesses registered in the state. A search of "L3C" in the Corporations Database Keyword Search on July 18, 2010 revealed 101 L3Cs. <http://www.sec.state.vt.us/seek/keysrch.htm>, (accessed July 18, 2010).

“the for profit with a nonprofit soul.”<sup>6</sup> The flexibility and simplicity of the L3C form also appealed to them. The possibility of attracting program related investments intrigued some, but certainly not all, of these entrepreneurs, and it was not the prime motivator for any of them. Given a choice between creating a traditional LLC or a § 501(c)(3) tax exempt organization, every entrepreneur I interviewed would choose the LLC.<sup>7</sup>

These findings suggest that the priorities of the entrepreneurs who adopted this business form were somewhat different from those who invented it. Nevertheless, the L3C gives voice to these entrepreneurs’ business values in a way that no other current business form does. These findings can inform policy decisions about the future of the L3C and provide substance to discussions about the L3C and other forms of social enterprise.<sup>8</sup>

Part I of this article examines the legal and theoretical basis for the L3C. It describes the genesis of the idea, the typical statute, the strategy behind its adoption, and the criticisms that have been raised. Both the strategy behind the L3C and the critical response depend on assumptions about the behavior of social entrepreneurs that are worth testing.<sup>9</sup> Part II introduces the study I undertook to test some of these assumptions. It sets forth the methodology of the study and describes the organizations that responded to a letter asking L3C pioneers to participate in the study. Part III describes the experiences of the L3Cs that responded – why they chose this business form and their reactions once they

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<sup>6</sup> Carol Coren and Robert Lang, *The L3C: The For-Profit with the Nonprofit Soul*, Bridges (Winter 2009-2010), available at <http://stlouisfed.org/publications/br/articles/?id=1848> (accessed July 18, 2010).

<sup>7</sup> See notes 111-129 *infra* and accompanying text.

<sup>8</sup> A second hybrid enterprise in the United States is the Benefit Corporation, a new corporate entity that requires directors to take into account social and environmental considerations when making corporate decisions. Legislation recognizing Benefit Corporations passed the Maryland and Vermont state legislatures in May 2010. The laws will go into effect in October 2010 and July 2011 respectively. Md. SB 690 (2010); Vt. SB 263 (2010). A private certification system also exists through an organization called B-Labs. For information on this system, see <http://www.benefitcorporation.net>. Hybrid enterprise forms also exist abroad. Steven Lloyd, who participated in the symposium on this topic, was the creator of the Community Interest Company in the United Kingdom. For comparisons of these forms, see Dana Brakman-Reiser, *Governing and Financing Blended Enterprise*, 85 Chi.-Kent L. Rev. 619 (2010); Matthew F. Doeringer, *Note: Fostering Social Enterprise: A Historical and International Analysis*, 20 Duke J. Comp. & Int’l L. 291, 295-305 (2010); Thomas Kelley, *Law and Choice of Entity on the Social Enterprise Frontier*, 84 Tul. L. Rev. 337 (2009); 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 (2009-10).

<sup>9</sup> They also depend on assumptions about the behavior of private foundations. Private foundations are not subjects of this study, except to the extent that the L3C pioneers discussed their interactions with foundations. In 2009 three students at the Tuck School of Business at Dartmouth College undertook a small study of foundations’ reactions to the L3C and found very little interest in the concept. Jason Bradfield, Moses Vejil & Will Vincent, *The Low Profit Limited Liability Company (L3C)* (unpublished ms. 2009) (copy on file with the Vermont Law Review).

began to use it—in order to begin to test the assumptions and make early observations. Part IV draws on those observations and suggests questions for further discussion among policy makers, academics and social entrepreneurs.

## I. THE LEGAL AND THEORETICAL FRAMEWORK FOR THE L3C

The impetus for the L3C stemmed from an observation that a little-used tool in the private foundation toolbox, the program related investment, could be used to help capitalize social enterprises.<sup>10</sup> A program related investment (PRI) is an investment made for the purpose of furthering a foundation's exempt purpose. It can take the form of a loan, an equity position, a loan guarantee, or any other transaction in which the foundation has an economic interest, so long as it has the following characteristics: 1) its primary purpose is the accomplishment of a charitable purpose that is enumerated in IRC § 170(c)(2)(B); 2) neither the production of income nor the appreciation of property is a significant purpose of the investment; and 3) it does not have any prohibited purpose such as lobbying or intervention in a political campaign.<sup>11</sup>

Section 170(c)(2)(B) defines the word "charitable" as being "organized and operated exclusively for 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."<sup>12</sup> An organization will ordinarily satisfy this charitable purpose test with regard to program related investments if it significantly furthers the accomplishment of the private foundation's exempt activities, and it was only made because of the

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<sup>10</sup> Robert Lang, the chief executive officer of the Mary Elizabeth & Gordon B. Mannweiler Foundation Inc. Lang presented his idea about the L3C at a meeting sponsored by the Aspen Institute's Nonprofit Sector and Philanthropy Program in 2006, the contents of which are presented in Thomas J. Billitteri, *Mixing Mission and Business: Does Social Enterprise Need A New Legal Approach?* (Aspen Institute 2007). After that meeting, Lang teamed up with two of the other participants, Marcus Owens, a partner at Caplin, Drysdale and a former Director of the IRS' Exempt Organizations Division, and Arthur Wood, then Director of Social Financial Services at Ashoka, to develop the idea further. Steve Davis and Sue Woodrow, *The L3C: A New Business Model for Socially Responsible Investing*, Community Development (Federal Reserve, Nov. 2009), [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=4305](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305). Lang continues in the forefront of promoting the L3C idea, along with a team of working groups committed to studying and promoting the L3C. See Americans for Community Development, *supra* n. 2.

<sup>11</sup> I.R.C. § 4944(c) (2009); Treas. Reg. § 53.4944-3 (a)(1) (2009). This exception to the jeopardizing investment rule has been in effect since the Tax Reform Act of 1969, Pub. L. No. 91-172, § 4942(g)(2), 83 Stat. 487, 505 (1969).

<sup>12</sup> IRC § 170(c)(2)(B) (2009). This language tracks closely the purposes set forth in § 501(c)(3). In this article, I use the terms "charitable and educational" or "socially beneficial" to mean the purposes listed in IRC § 170(c)(2)(B).

relationship between the investment and the foundation's exempt activities.<sup>13</sup> In other words, the foundation must determine that foundation's exempt purposes match the activities of the organization in which it invests in order for the investment to qualify as a PRI.

The income-production test, which requires that no significant purpose of the investment may be the production of income or the appreciation of property, actually means that the investment must be a risky one, one that would not ordinarily attract market rate investment because of the charitable purposes.<sup>14</sup> If the investment is one that would not attract most investors, and the foundation makes a program related investment, the possibility exists that the investment will eventually produce significant income or asset appreciation. In such a case, this occurrence is not conclusive evidence that the foundation has failed this income production test.<sup>15</sup>

The third requirement, that no purpose can be for the furtherance of lobbying or political campaign activity, appears in the regulations rather than the statute. It helps to ensure that the charitable funds used in a program related investment are used for charitable rather than political purposes.<sup>16</sup>

PRIs are exceptions to the jeopardizing investment rule, which imposes a substantial excise tax on foundations that make risky investments as well as the managers who knowingly authorize them.<sup>17</sup> PRIs also count toward the five percent qualifying distribution requirement—the rule that requires private non-operating foundations to spend at least five percent of an average market value of their previous year's assets each year on charitable purposes.<sup>18</sup> Foundations traditionally meet this qualifying distribution requirement through grants, for which they receive no return on investment. Because program related investments have the potential to make a return on the investment, they also have the potential to increase the amount of money they can eventually distribute for charitable purposes.

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<sup>13</sup> Treas. Reg. § 53.4944-3(a)(2)(i)

<sup>14</sup> Treas. Reg. § 53.4944-3(a)(2)(iii)

<sup>15</sup> *Id.* See also Treas. Reg. § 53.4944-3(b) (Ex. 1) (A below market rate loan to a small business owned by members of an economically disadvantaged minority group in a deteriorated urban area that meets all the requirements of a PRI "is a program related investment even though [a private foundation] may earn income from the investment in an amount comparable to or higher than earnings from conventional portfolio investments.")

<sup>16</sup> Treas. Reg. § 53.4944-3(a)(1)(iii).

<sup>17</sup> Sections 4944(a) and (b) impose an excise tax on private foundations that engage in high-risk investments unless they meet the definition of a program related investment. I.R.C. § 4944 (2009).

<sup>18</sup> IRC § 4942 (2009)

Although some foundations make good use of this tool,<sup>19</sup> fewer than 200 of the more than 72,000 foundations in existence in 2006 actually made program related investments that year.<sup>20</sup> These investments totaled \$365 million, less than one percent of the total qualifying distributions foundations made in 2006.<sup>21</sup>

Several reasons exist for the relative dearth of PRIs. Foundations typically give grants instead of making loans or investments, and they may not have expertise or interest in managing these investments. They also typically seek reassurance that such investments actually qualify as PRIs, given the onerous excise taxes they face if they make an incorrect determination. Thus, foundations tend to forego the process entirely, seek a private letter ruling from the IRS or an opinion letter from an attorney before investing in a PRI, or engage in an expensive and time-consuming internal due diligence process.<sup>22</sup>

The architects of the L3C concept reasoned that private foundations would be more likely to use the PRI tool if a legally recognized entity could signal to the foundations that the PRI requirements were met. Presumably, this designation would give private foundations the same confidence the § 501(c)(3) designation gives to grantmaking foundations.<sup>23</sup>

The idea was to create a variation of the limited liability company (LLC) business form as the signaling device. The LLC is a relatively simple business form that provides both limited liability protection and pass-through tax treatment for its members.<sup>24</sup> It is the most widely used business form for small

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<sup>19</sup> The PRI Makers Network includes more than ninety foundations that invest in PRIs. See <http://www.primakers.org> (accessed July 18, 2010). More for Mission also helps foundations align their financial investments with the mission of the organization. <http://www.moreformission.org> (accessed July 18, 2010). For a description of some interesting PRIs, see Georgia Keohane, The Center for Effective Philanthropy Blog, *Foundation Philanthropy and the Power of PRIs*, <http://www.effectivephilanthropy.org/blog/author/georgialk/> (Feb. 3, 2010).

<sup>20</sup> Steven Lawrence, *Doing Good With Foundation Assets: An Updated Look At Program-Related Investments*, excerpted from *The PRI Directory*, 3<sup>rd</sup> Ed. (The Foundation Center, 2010) (accessed at [http://foundationcenter.org/gainknowledge/research/pdf/pri\\_directory\\_excerpt.pdf](http://foundationcenter.org/gainknowledge/research/pdf/pri_directory_excerpt.pdf), on July 18, 2010.)

<sup>21</sup> The Foundation Center, *Aggregate Data by Private Foundation Type*, 2006; (2008).

<sup>22</sup> Carter G. Bishop, *The Low-Profit LLC (L3C): Program Related Investment by Proxy or Perversion?* 63 *Ark. L. Rev.* 243 (2010); Luther M. Ragin, Jr., *The Evolution of PRIs*, Program-Related Investments Conference, Stanford University (Jan. 19, 2006).

<sup>23</sup> A determination letter from the IRS in response to an application that an organization is recognized as a § 501(c)(3) tax-exempt organization provides foundations and other donors advance assurance of deductibility of contributions. They can rely on this determination unless and until the IRS revokes the determination letter. Rev. Proc. 82-39, 1982-1, C.B.759.

<sup>24</sup> Daniel Kleinberger, *A Myth Deconstructed: The "Emperor's New Clothes" on the Low Profit Limited Liability Company*, p. 9, William and Mitchell Legal Studies Paper, available at <http://ssrn.com/abstract=1554045>, citing Carter G. Bishop and Daniel S. Kleinberger, *Limited Liability Companies: Tax and Business Law* ¶ 1.01[1] (1994, Supp. 09-2).

businesses in the United States.<sup>25</sup> It also allows a great deal of flexibility through the members' operating agreements.<sup>26</sup>

The creators of the L3C adapted the LLC by drafting legislation that incorporates the PRI provisions from the Internal Revenue Code into a state's law for LLCs.<sup>27</sup> The Vermont L3C statute, for example, amended the existing limited liability statute by adding the definition of "L3C" or "low profit limited liability company" to the definitions section.<sup>28</sup> That definition requires each L3C to satisfy the following requirements: 1) It must significantly further the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the Internal Revenue Code, and be formed solely as a result of its relationship to the accomplishment of charitable or educational purposes; 2) it cannot have the production of income or the appreciation of property as a significant purpose, although the actual production of significant income or property appreciation is not conclusive evidence of an inappropriate purpose; and 3) its purpose is not to influence any legislation or political campaign. The language tracks the language in the Internal Revenue Code and the Treasury Regulations that relate to program related investments.<sup>29</sup> The Vermont L3C statute also provides that, if any of these requirements are no longer met, the organization will cease being an L3C, but will remain an LLC as long as it meets the LLC requirements.<sup>30</sup>

Like traditional LLCs, the L3C is a pass-through entity for tax purposes. The L3C itself is not subject to taxation on its income, but its members pay all applicable taxes. Thus, the income is not exempt from taxation unless all its members are tax-exempt entities,<sup>31</sup> and those making investments in the L3C are not entitled to a charitable tax deduction. Unlike traditional LLCs, however, L3Cs must have a primary charitable purpose and steer clear of lobbying and political activity. The L3C is therefore a type of limited liability company that satisfies the requirements of the program related investment rules as long as the foundation making the investment also determines that its charitable objectives match the L3C's objectives.

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<sup>25</sup> *Id.*

<sup>26</sup> The members (owners) generally create an "operating agreement," which defines their relationship by contract. *Id.* at 11.

<sup>27</sup> Letter from Marcus Owens, attorney, Caplin & Drysdale, Chartered, to Elizabeth Grant, Charitable Activities Section, Oregon Department of Justice, July 2, 2009, on behalf of the Mary Elizabeth and Gordon Manweiler Foundation.

<sup>28</sup> Vermont's Limited Liability Statute is 11 Vt. Stat. Ann., tit. 11, § 3001-3184 (2010)). The L3C provision, 11 Vt. Stat. Ann., tit. 11, § 3001(27) (2010), is a definition. The remaining LLC provisions apply to L3Cs, which are a sub-set of the LLC.

<sup>29</sup> See notes 11-12 and accompanying text for a synopsis of the language in the IRC and Treasury Regulations relating to PRIs.

<sup>30</sup> 11 Vt. Stat. Ann., tit. 11, § 3001(27) (D) (2010)

<sup>31</sup> Brakman Reiser, *supra* n. 8 at 623.

The L3C is also able to take advantage of the membership flexibility that an LLC offers in order to create a multiple-tiered investment strategy, often called a tranche mechanism. The L3C creators reasoned that a private foundation would make the initial investment in an L3C through a PRI. That investment would be the investment with the highest risk and the lowest rate of return. It would provide the initial equity capital to the L3C, which would then give the L3C sufficient capital to attract investors who would otherwise have found the investment too risky. Such investors would then become a part of a separate membership class (or tranche) in the L3C, a class that could expect a higher rate of return than the foundation did. This class might become a middle tranche of investors, those who still accept a below market rate of return in order to encourage a social return. Ultimately, a class of investors who expect a market rate of return could emerge. Thus, the program related investment would not only provide capital; it would also leverage additional investment.<sup>32</sup>

The L3C is often touted as a business solution for the newspaper industry.<sup>33</sup> An L3C newspaper would promote community services by providing news, opinion pieces and cultural reviews, without considering profit as the primary concern. Foundation funds, which expect a high social return and a low monetary return, could serve as the top tier investment, thus making the economic risk more palatable for those investors that seek a higher return.<sup>34</sup> Similarly, an L3C designed to save jobs in an economically depressed area could buy factories, modernize them, and then lease them back to manufacturers at a low rate—steps that could help the manufacturers become more competitive and save jobs.<sup>35</sup>

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<sup>32</sup> The most helpful discussion of this concept, which includes a chart that helps the reader visualize the concept, is Davis and Woodrow, *supra* n. 10. Others who discuss this aspect of the L3C include Brakman-Reiser, *supra* n. 8 at 628-29 (2010); Bishop, *supra* n. 22 at 263-265; and Kelley, *supra* n. 8 at 373-74.

<sup>33</sup> See, e.g. Sally Duros, *How to Save Newspapers*, Huffington Post (Feb. 9. 2009); Richard Schmalbeck, symposium article in *Vt. L. Rev.* (2010). *But see* Marion R. Fremont-Smith, *Can Nonprofits Save Journalism? Legal Constraints and Opportunities*, 65 *Exempt Org. Tac Rev.* 463 (2010)., David Schwister, *L3cs: The Next Big Wave In Socially Responsible Investing Or Just Simply Too Good To Be True?* 3 *J. Bus. Entrepreneurship & L.* 1(2009).

<sup>34</sup> In May 2010 the first L3C newspaper was created. Peter Fimrite, *Pulizer-Prize Winning Marin Newspaper Sold*, *San Francisco Chronicle* (May 27, 2010). The proposed Philanthropic Facilitation Act of 2010, discussed in n. 35 *infra* and accompanying text, includes *Section III. An Industry in Need: News Organizations*, a four-page discussion of the ways in which the L3C could help the news industry. It also proposes that Treas. Reg. § 1.501(c)(3)-1 be amended “to provide that the dissemination of news furthers educational and literary purposes, including without limitation the inclusion of an example under Reg. § 1.501(c)(3)-1(d)(3)(ii).” The text of this Act can be found on the Legislative Watch page of Americans for Community Development, *supra* n. 2.

<sup>35</sup> Examples include the automobile industry, the furniture manufacturing industry, and a canning factory. The proposed Philanthropic Facilitation Act includes *Section IV: An Industry in Need: the Automobile Industry*, which describes how L3Cs could help the automobile industry. The L3C legislation that passed the North Carolina legislature in July 2010 was called “The

As of July 17, 2010, L3C legislation has been introduced in twenty states.<sup>36</sup> Seven states, Michigan, Utah, Illinois, Wyoming, North Carolina and Maine, and two Indian nations, the Og;ala Sioux Tribe of Montana and the Crow Indian Nation have passed the legislation, and the legislation has been enacted into law in all but two of those states, Maine and North Carolina.<sup>37</sup>

The L3C promoters have also drafted federal legislation, the Philanthropic Facilitation Act of 2010, which would amend §4944(c) of the Internal Revenue Code to provide a rebuttable presumption that investments in L3Cs qualify as PRIs. The legislation and accompanying regulations would set up a voluntary procedure, similar to that now in existence for recognition of a § 501(c)(3) tax exempt organization, that would allow entities to receive an IRS determination that an investment in a specific company qualifies as a PRI for any private foundation with a common purpose. Private foundations could then rely on this determination unless and until the Secretary of the Treasury published a notice of revocation. The proposed legislation also requires all for-profit organizations receiving PRIs to disclose a considerable amount of financial information, the disbursements made for the exempt purposes, a description of the results obtained from the use of those assets for charitable purposes, and the names and addresses of all private foundations holding PRIs in the organization.<sup>38</sup>

The creators of the L3C assume such legislation will give additional confidence to foundations that are wary of program related investments.<sup>39</sup> As of July 15, 2010, such legislation had been drafted but not yet introduced in Congress.<sup>40</sup>

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Endangered Manufacturing and Jobs Act.” It was designed, in part, to help the ailing furniture manufacturing industry in North Carolina. Steve Weiker, *Legislator Hopes his Law Will Bring Back Jobs from China*, The News Herald (July 13, 2010). Additionally, Davis and Woodrow, *supra* n.10. provide an example of a factory that uses prison labor to can local produce, thus providing job creation and promoting local agriculture.

<sup>36</sup> Americans for Community Development, *supra* n. 2 at Legislative Watch. See also Carter Bishop, *Fifty State Series: L3C & B Corporation Legislation Table*, (2010). Suffolk University Law School Research Paper No. 10-11. Available at SSRN: <http://ssrn.com/abstract=1561783>.

<sup>37</sup> The state statutes are cited in n. 4 *supra*.

<sup>38</sup> A final draft of the Philanthropic Facilitation Act of 2010 can be found at Americans for Community Development, *supra* n. 2, at Legislative Watch.

<sup>39</sup> Elizabeth Carrott Minigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations*, Tax Management, Estates, Gifts and Trusts Journal (Aug. 2009); Marcus Owens, *Response to NASCO’s letter dated March 19, 2009*, on file with Vermont Law Review, discussing an earlier version of the proposed federal legislation.

<sup>40</sup> Americans for Community Development, *supra* n. 2, at Legislative Watch.

The L3C concept has received a good deal of praise from commentators, most of whom tout the benefits described above.<sup>41</sup> Critics and skeptics have also come out of the woodwork, however. They have raised questions about whether the L3C will actually attract program related investments,<sup>42</sup> how to define and enforce the “charitable” and “low profit” requirements of the legislation,<sup>43</sup> whether the for-profit part of the organization will undermine its charitable mission,<sup>44</sup> whether the L3C will deprive the nonprofit sector of much needed funds,<sup>45</sup> and whether the new business form is necessary or even helpful.<sup>46</sup>

Although some of the disagreement between the promoters and detractors of the L3C is a matter of language, misunderstanding or policy, other points of the disagreement rest on assumptions about the way various actors will behave once they have adopted this new business form. Only by examining the operational experiences of actual L3Cs will we be able ultimately to determine whether a new business form is necessary for entrepreneurs, whether foundations will actually free up funds for these new organizations, or whether

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<sup>41</sup> See Kelley, *supra* n. 8; Robert R. Keatinge, *LLCs and Nonprofit Organizations-For-Profits, Nonprofits, and Hybrids*, 42 Suffolk U. L. Rev. 553 (2009); Community Wealth Ventures, *The L3C: Low Profit Limited Liability*, Company Research Brief (July 2008), Elizabeth Carrott Minnigh, *Low-Profit Limited Liability Companies: An Unlikely Marriage of For-Profit Entities and Private Foundations*, *Tax Management, Estates, Gifts and Trusts Journal* (Aug. 2009). Triple pundit, *The L3C: A More Creative Capitalism*, Jan. 15, 2009, <http://www.triplepundit.com/pages/the-l3c-a-more-creative-capitalism.php>; Community Dividend; *The L3C: A New Business Model For Socially Responsible Investing*,

[http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=4305](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4305); Davis and Woodrow, *supra* n. 10; John E. Tyler and Marcus Owens, *The L3C: A Potentially Useful Tool for Promoting Charitable Purposes* (Federal Reserve Bank of Minneapolis, June 16, 2010), available at SSRN: <http://ssrn.com/abstract=1628311>. Two articles that compare the L3C with other business entities in a neutral manner are, Robert Wexler, *Effective Social Enterprise – A Menu of Legal Structures* 63 Exempt Org. Tax Rev. 565 (2009) and Brakman Reiser, *supra* note 8.

<sup>42</sup> See Allison Evans, Christine Petrovits, and Glenn Walberg, *L3C: Will New Business Entity Attract Foundation Investment?* 63 Exempt Org. Tax Rev. 457 (2009); Bradfield, Vejl, Vincent, *The Low Profit Limited Liability Company (L3C)*, Dartmouth School of Business (2009) (unpublished paper on file with author); David Edward Spenard, *Panacea or Problem: A State Regulator’s Perspective on the L3C Model*, 65 Exempt Org. Tax Rev. 131, 133 (2010).

<sup>43</sup> Rick Cohen, *L3C: Pot of Gold or Space Invader*, Washington Nonprofit Insight (Oct. 2, 2009)

<sup>44</sup> *Id.*

<sup>45</sup> This argument has two distinct manifestations. One is the fear that the charitable gifts made to the private foundations, will find their way into private, profit making hands. See David Spenard, *supra* note 42 and J. William Callison & Daniel S. Kleinberger, *When the Law Is Understood: L3C No, Community Dividend* (Federal Reserve Bank Nov. 2009). The other argument is that L3Cs are in direct competition with the nonprofit sector for funds. Laura Otten, Nonprofit University Blog, *A Tough Hybrid to Swallow – the L3C* (Nov. 19, 2009), <http://www.nonprofituniversityblog.org/2009/11/a-tough-hybrid-to-swallow-the-l3c3/comment-page-1/>; Cohen, *supra* n. 43.

<sup>46</sup> William Callison, *L3Cs: Useless Gadgets?* Business Law Today 55 (Nov/Dec. 2009); Ian Wilhelm, *Do 'L3C' Businesses Really Offer New Benefits?* Chronicle of Philanthropy (Aug. 12, 2009). Kleinberger has an entire section entitled, *The L3C is Unnecessary*, Kleinberger, *supra* note 24 at 22-23.

L3C entrepreneurs will be able to balance the competing goals of charitable purpose and profit. In this respect, the behavior of the actors during the first two years of the L3C era is instructive.

## II. THE SURVEYS AND THE RESPONDENTS

### *Methodology*

Given that Vermont was the first state to adopt the L3C business form, I decided to contact the early adopters of the L3C there to determine why they chose this business form and whether it was proving a satisfactory choice of entity for their purposes. I was interested in whether they formed the L3Cs to gain access to PRI funds or if they had other reasons for adopting this new business form. I also wondered whether any of their motivations or actions had proved the naysayers correct. Finally, I hoped to explore whether their answers suggested areas for further exploration.

The L3C is, of course, still in its infancy, and its early adopters may not be representative of the types of people and organizations that will appear later. Moreover, L3Cs in Vermont may not be representative of L3Cs in other parts of the country. Nevertheless, the experiences of its early adopters can be informative as policy makers determine whether to adopt the L3C nationally and in other states or whether to modify it in the states that have already adopted it.

In order to learn about their experiences, I sent letters to the contact person listed for every L3C that had registered with Vermont's Secretary of State between April 30, 2008, and January 15, 2010.<sup>47</sup> Of the eighty-four letters mailed, thirteen were returned as undeliverable and twenty-eight L3Cs responded to the survey, a 39% response rate. I later spoke by telephone to nineteen entrepreneurs who had responded to the initial survey and had an email exchange with another respondent. The initial surveys and conversations took place in the fall and winter 2009. During the summer 2010 I sent a second survey to those who had responded initially, asking for a follow-up response. I heard from fourteen.<sup>48</sup>

I promised anonymity to each respondent. Therefore, anyone who is named in this article either gave permission for the attribution or has made a similar statement publically. Most of the observations and quotations in this article are made without attribution. I assigned numbers to each respondent,

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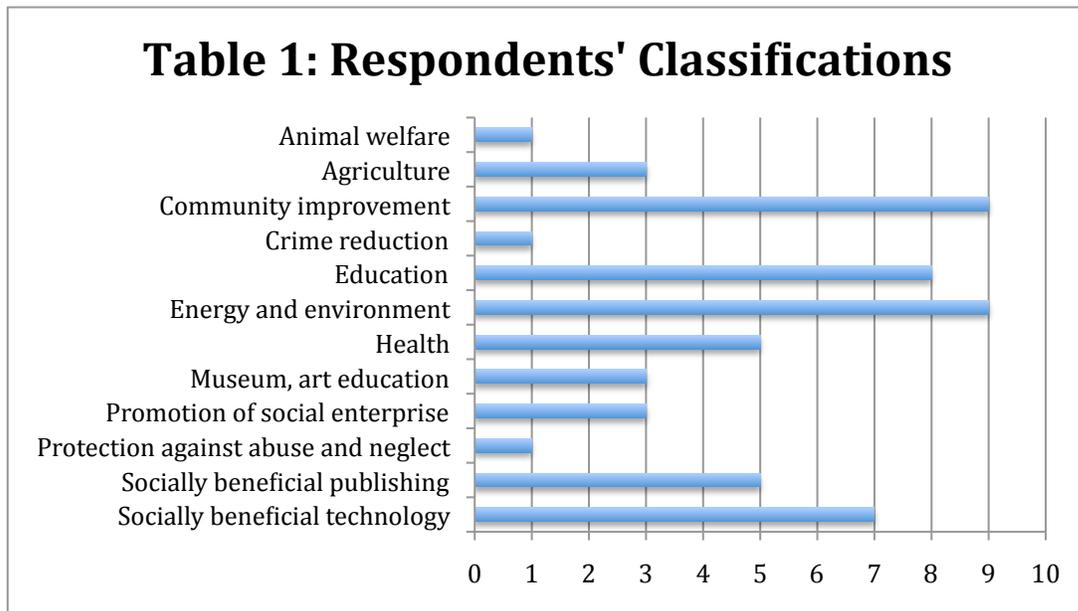
<sup>47</sup> The Vermont Secretary of State maintains a database of all business entities, including all L3Cs. <http://www.sec.state.vt.us/seek/keysrch.htm>.

<sup>48</sup> Nine responded to the second survey. The others corresponded either by email or phone. A copy of both written surveys and a list of the questions asked by telephone can be found in Appendix B.

however, and the footnotes reflect those numbers. Appendix A lists the participating L3Cs in. The actual responses to the surveys and the notes from interviews are on file with the Vermont Law Review.

*The L3C Pioneer Response:*

Leaders of organizations ranging from a motorcycle safety school to the technology arm of an online museum responded. Several organizations promote renewable energy and energy efficiency. Others hope to improve economic conditions in the community by promoting social enterprise, encouraging civic engagement, or saving agricultural jobs. Still others are in the healthcare field – developing innovative medical technologies, promoting healthy lifestyles, and serving the uninsured. One organization hopes to reduce crime through restorative justice. The remaining organizations have educational or literary objectives. Table 1 depicts the population of respondent organizations, according to their own self-classifications.<sup>49</sup>



The respondents represent small businesses. Most are start-ups.<sup>50</sup> In fact, four were not yet operational when the entrepreneurs responded to the initial

<sup>49</sup> Several respondents checked more than one classification. Hence, the number of responses is greater than the number of L3Cs. A list of the L3Cs represented by Table 1 and a short description of each can be found in Appendix A.

<sup>50</sup> Technically, of course, they are all start-ups, but several built upon existing businesses. The L3Cs I have labeled 3, 4, 5, 6, 7, 8, 10, 11, 13, 15, 16, 18, 19, 20, 22, 23, 24, 26, 27, and 28 are new businesses. The rest are affiliated with or derived from other businesses.

survey,<sup>51</sup> and one had already closed up shop by the time I sent the second survey.<sup>52</sup> Many of the entrepreneurs either had other full-time jobs or were retired from full time jobs,<sup>53</sup> an indication that these L3Cs were not yet sufficiently profitable to provide their founders with a living.

Of those organizations that had been in existence before they became L3Cs, one turned an existing for profit enterprises into an L3C,<sup>54</sup> three are closely affiliated with LLCs or corporations,<sup>55</sup> and eight are owned by or closely affiliated with existing § 501(c)(3) organizations.<sup>56</sup> One respondent runs two related L3Cs.<sup>57</sup>

As small businesses, many of the organizations described in the survey are owned and managed by a single individual or couple. When asked how the memberships worked in their organizations, eight answered that they are single member organizations,<sup>58</sup> another eight responded they had two or more members with a single classification,<sup>59</sup> and four organizations explained they had more than one classification of members.<sup>60</sup> The other eight respondents did not answer this question.<sup>61</sup>

Governance and ownership of the L3C would ordinarily be covered by an operating agreement.<sup>62</sup> Only eleven of the twenty-eight organizations confirmed

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<sup>51</sup> The L3Cs labeled 4, 8, 18, 19 and 22 responded that they were not yet operational. Those labeled 3 and 5 reported that their L3Cs were in a pilot stage.

<sup>52</sup> See <http://www.rbods.com>, accessed July 12, 2010. It is not entirely clear from the website whether the L3C has closed down entirely or if the founders continue to operate it in their spare time. I understood the announcement to say they would continue to support the mission of encouraging a healthy lifestyle but no longer as an enterprise. A second L3C, The Farm at South Village, switched from a L3C to an S-Corporation, but that decision was not because the business failed. Rather, they found they would not be eligible for a grant or for certain tax privileges as an L3C that they could receive as an S-Corporation. See n. 148 *infra* and accompanying text. A third, the L3C labeled 15, is still in existence, but is not active at this time.

<sup>53</sup> The founders of the L3Cs labeled 3, 4, 5, 11, 13, 18, 23, and 25 specifically stated they had other jobs. Those labeled 7 and 17 mentioned they had retired from other jobs. This list does not include those L3Cs that are affiliated with other LLCs or § 501(c)(3) organizations if the person who spoke to me was working for both organizations. See note 56 for a list of L3Cs affiliated with another organization.

<sup>54</sup> L3C labeled 25.

<sup>55</sup> L3Cs labeled 8, 15 and 20.

<sup>56</sup> L3Cs labeled 1, 2, 9, 12, 14, 16, 20, 28.

<sup>57</sup> CF Operations LLC and CF Real Estate Holding L3C.

<sup>58</sup> L3Cs labeled 6, 8, 10, 15, 17, 20, 22, 25

<sup>59</sup> L3Cs labeled 4, 7, 12, 14, 19, 21, 24, 26

<sup>60</sup> L3Cs labeled 3, 11, 13, 23

<sup>61</sup> L3Cs labeled 1, 2, 5, 9, 16, 18, 27, 28

<sup>62</sup> See n. 26 *supra* and accompanying text.

that they have written agreements, however.<sup>63</sup> All the organizations with different classifications of members had written operating agreements, but the less complex organizations were less likely to have them. As one entrepreneur explained, “When I get other people involved, I will finish the operating agreement.”<sup>64</sup>

As for management arrangements, eight L3Cs answered that they were member managed<sup>65</sup> and seven reported that managers filled the management role.<sup>66</sup> The rest did not respond to the question about management.

Eighteen organizations represented in the survey operate in Vermont, two in Massachusetts, two in New York, and one each in California, Colorado, Maine, New Jersey, Pennsylvania, and Texas.<sup>67</sup>

Eight women and nineteen men responded to the survey. Four respondents revealed they founded the organization as part of a husband/wife or life partner team.<sup>68</sup>

### III. EARLY OBSERVATIONS

The major purpose of the questionnaires was to ask the L3C pioneers about their motivations for choosing this business form. Both written surveys requested the entrepreneurs to list every reason for pursuing this business form. The second survey also asked the respondents to state their top priority, and the telephone interviews explored their motivations and priorities in further detail.

The social entrepreneurs who created L3Cs in Vermont within the first year and a half of its existence had almost as many reasons for choosing the L3C business form as they had business purposes. When asked to list all reasons for choosing the L3C business form, the most common response was the desire for PRI funding. The entrepreneurs also recognized that this form fit their mission and that profits were not their primary motive. Their desire for flexibility, control, and to be cutting edge also played prominent roles in this decision. The results from the surveys, in which the respondents mentioned every reason they chose the L3C business form, are summarized in Table 2 below.

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<sup>63</sup> L3Cs labeled 3, 7, 8, 9, 11, 13, 17, 21, 23, 27, 28

<sup>64</sup> L3C labeled 5. Those numbered 3 and 6 expressed similar thoughts. Number 3 adopted an operating agreement between the time its founder completed the first and second surveys.

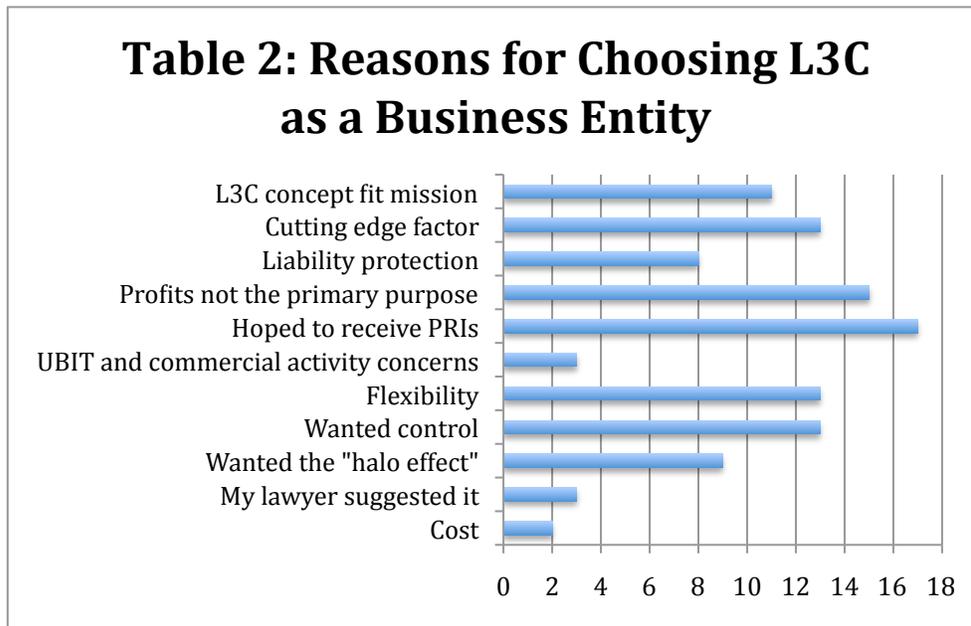
<sup>65</sup> L3Cs labeled 4, 5, 7, 13, 16, 17, 22, 23

<sup>66</sup> L3Cs labeled 8, 9, 11, 18, 19, 24, 25

<sup>67</sup> All 28 L3Cs are registered in Vermont, but several operate in other states. Appendix A lists the L3Cs and their states of operation.

<sup>68</sup> Women responded for the L3Cs labeled 1, 2, 5, 10, 14, 16, 21, 25; men responded to the rest. Those labeled 1, 2, 21, and 24 are operated by couples.

**Table 2: Reasons for Choosing L3C as a Business Entity**



Once the entrepreneurs’ priorities are taken into account, a slightly different picture emerges. For example, the possibility of receiving PRI funding, while intriguing, was not the most important factor in the entrepreneurs’ decisions to form L3Cs. Instead, Vermont’s social hybrid pioneers saw the need for a hybrid business form, a “for profit with a nonprofit soul.” They also responded to the simplicity and flexibility of the L3C, as well as its branding potential. Interestingly, if the L3C had not been an option, these social hybrid pioneers would have chosen to forego the option of setting up a §501(c)(3) organization. In their minds, a sole proprietorship, LLC, or corporation would be preferable to the public charity form, which they saw as too complicated, too restrictive, and over which they would have little or no control. Finally, for the most part, the L3C pioneers remain pleased with their decision to adopt this new business form several months to two years after they formed their businesses. They hold this favorable impression even though PRI funds have not materialized and the L3C business form has actually confused some their funders and customers. These observations are spelled out in more detail below, along with quotations and anecdotes that help clarify the findings.

Following is a description of the observations I made as I conducted this study, along with quotations and anecdotes from the L3C pioneers who participated in the study, which should clarify my findings.

1. *The possibility of receiving PRI funding, while intriguing, was not the most important factor in the entrepreneurs’ decisions to form L3Cs*

As established in Part I, the L3C is designed to facilitate foundations' use of program related investments,<sup>69</sup> and the publicity surrounding this form stresses this purpose. The Vermont Secretary of State's site, for example, says, "The basic purpose of the L3C is to signal to foundations and donor directed funds that entities formed under this provision intend to conduct their activities in a way that would qualify as program related investments."<sup>70</sup> One would expect, then, that the early adopters would choose this business form to take advantage of the PRI possibility.

To some extent, these expectations proved true. All the entrepreneurs who answered the survey or spoke on the phone were aware that the L3C was designed to attract PRIs, and most, but not all, were intrigued by the prospect of PRI funding.<sup>71</sup> Only two of these adopters said the PRI funding was a major factor in their decision to adopt the L3C, however.<sup>72</sup> Most of the respondents acknowledged that the possibility of PRI funding was either unimportant or not a major reason they chose the L3C business form.<sup>73</sup> Several claimed they would have started their social enterprises even if the PRI possibility did not exist.<sup>74</sup>

The founders of ISC Enterprises L3C, for example, never considered the possibility of obtaining a PRI when they began this business. ISC Enterprises L3C solved a problem its parent nonprofit organization faced in China, where the government agreed to work with a socially oriented for-profit organization, but not with a nonprofit.<sup>75</sup> Two other entrepreneurs explained that they did not

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<sup>69</sup> See notes 10-20 *supra* and accompanying text. The creators of the L3C were interested in more than program related investments, of course. They understood and hoped to retain the simplicity and flexibility of the LLC form, and they appreciated the branding possibilities of the L3C. See Americans for Community Development, *supra* note 2. Nevertheless, if these motivations had been their only concern, the L3C itself would be much simpler, as it would not track the language from IRC § 4944. The L3C critics have also focused on the program related investment language to a large extent. See note 2 *supra*.

<sup>70</sup> Vermont Secretary of State, Corporations Division, *Low Profit Limited Liability Company*, [http://www.sec.state.vt.us/corps/dobiz/llc/llc\\_l3c.htm](http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm) (accessed July 20, 2010).

<sup>71</sup> The L3Cs labeled 3, 4, 5, 6, 7, 8, 10, 11, 13, 14, 18, 20, 23, 26, and 28 checked the box that they were interested in PRIs when they chose their business entity form. The founder of the L3C labeled 8 specifically stated he was not interested in PRIs, as did Brendan Keleher, the agent for ISC Enterprises L3C, which was formed for unique reasons described in note 75 *infra* and accompanying text. Telephone interview with Brendan Keleher, Agent, ISC Enterprises, L3C, Nov. 3, 2009. Confirmed via email from Brendan Keleher to Elizabeth Schmidt, Re: Follow-up on Article About L3Cs in Vermont, July 15, 2010, 11:13 a.m.

<sup>72</sup> L3Cs labeled 3 and 16.

<sup>73</sup> L3Cs labeled 5, 6, 8, 9, 11, 13, 14, 15, 17, 18, 19, 21, 23, 25, 27.

<sup>74</sup> L3Cs labeled 4 and 6.

<sup>75</sup> Telephone interview with Brendan Keleher, agent, ISC Enterprises, L3C, Nov. 3, 2009. Confirmed by email from Brendan Keleher to Elizabeth Schmidt, Follow-up on Article on L3C Pioneers in Vermont, July 15, 2010, 11:13 a.m.

understand PRIs and would not consider that fundraising angle unless and until they did.<sup>76</sup>

Several early adopters had not yet had time to seek a PRI or did not need investment at this time in their organizations' life.<sup>77</sup> Some sought funds from governmental units, angel investors, or other non-foundation institutions instead of foundations.<sup>78</sup> They might have thought the L3C could leverage additional funds, but they were not focused on receiving these funds from foundations.<sup>79</sup>

Many wanted to keep open the possibility of receiving a PRI. They either realized that foundations were not yet prepared to make these investments in L3Cs or they themselves were not prepared to ask for funds from foundations.<sup>80</sup> Nevertheless, the major reason the L3C came into existence—to facilitate PRI funding for social enterprises, was not the major reason these early adopters chose this business form.

2. *The L3C fit the entrepreneurs' business needs for a legal entity that bridged the for profit and nonprofit worlds.*

Far more important than the PRI to most of the L3C entrepreneurs was the idea that a business form had appeared that fit the type of business they were trying to create. Repeatedly, the respondents told me that their concept was neither a for-profit nor a nonprofit concept. Rather, they truly hoped to form a "for profit with a nonprofit soul."<sup>81</sup>

For some, the L3C is a statement of values. I heard phrases like "aligned with my values," "aligned with our mission," and "there could not be a better business form for us."<sup>82</sup> The entrepreneurs were delighted to find a business entity that allowed them to pursue their dual values of improving the community and operating a sustainable market-responsive enterprise. As Michael Harp, the CEO of H20, L3C, said, "Seeing a business entity type that is a hybrid with a double bottom line, with social impact and creation of social value foremost, fits me. ... [The L3C] brings 'venture philanthropy' to life."<sup>83</sup> Will Raap of The Farm at South Village offered a more philosophical perspective with

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<sup>76</sup> L3Cs labeled 5 and 17.

<sup>77</sup> L3Cs labeled 5, 6, 14, 19, 21.

<sup>78</sup> L3Cs labeled 6, 14, 15, 17, 19, and 25.

<sup>79</sup> The founder of the L3C labeled 17 believes, for example, that the L3C helped #17 obtain funds from an angel investor.

<sup>80</sup> L3Cs labeled 15 and 23 specifically stated that they were uninterested in PRIs at this point, but that they were set up to receive them if the opportunity arose later.

<sup>81</sup> See note 6 *supra* for the origin of the phrase.

<sup>82</sup> L3Cs labeled 5, 19, 24 are quoted. L3Cs 8 and 24 expressed similar sentiments.

<sup>83</sup> Telephone interview with Michael Harp, CEO, H20 L3C, Oct. 30, 2009. Confirmed via email to Elizabeth Schmidt, July 13, 2:45 p.m.

a similar theme: “It is central to hold an idea that might find long term expression, not from a return on investment but as an ultimate steward or champion of the effort.”<sup>84</sup>

Whether the mission was saving children’s lives or the environment, encouraging social enterprise or storytelling, improving physical fitness or energy efficiency, the social commitment was palpable. Mark Benz, founder of Safer Pediatric Imaging L3C noted that “anyone who is moved to do an L3C is carrying something on their soul—they feel something is not right.”<sup>85</sup> They are also called to action. Michael Harp undoubtedly spoke for many when he declared, “I’m going to leave this world leaving a mark.”<sup>86</sup>

Making a large return on investment was not the major focus for any of these entrepreneurs. Fully 60% of the respondents to the initial survey checked the box that said, “Realized that profits alone were not the motivation for this enterprise.”<sup>87</sup> As Robert Lang said in his capacity as founder of L3C Advisors L3C, “We have lost the concept that you can make money even if you don’t make a nifty return and [still] make people happy. As long as folks have jobs and can buy dinner, it’s a good thing. Who cares if you do not meet the return on investment that Wall Street expects?”<sup>88</sup> Other L3C pioneers echoed this thought. I heard, “We aren’t in this to make a profit. ... We want to help others with [a] problem;” “We didn’t want [our] future dictated by profits over social good;” and “You don’t have to squeeze every nickel out of every stone.”<sup>89</sup>

Not all the entrepreneurs were completely idealistic. Several realized they could not make a profit anyway. As Matthew Rudikoff, Executive Director of Institute for Public Financial Incentives L3C, said, “I never made any money to speak of in any of my other business formations so the L3C was perfect for me!”<sup>90</sup> One entrepreneur hoped to be paid back, although he did not care if he made a profit.<sup>91</sup> Others hoped to make a good return on their investment

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<sup>84</sup> Telephone interview with Will Raap, founder Vermont Solar Farms L3C, Nov. 3, 2009. Confirmed via email to Elizabeth Schmidt, July 16, 2010 11:15 a.m.

<sup>85</sup> Telephone interview with Mark Benz, Oct. 30, 2009. Confirmed via email, July 16, 2010 8:22 a.m.

<sup>86</sup> Telephone interview with Michael Harp, Oct. 30, 2009. Confirmed via email, July 15, 2010, 5:48 p.m.

<sup>87</sup> See Table 2.

<sup>88</sup> Telephone interview with Robert Lang, founder, L3C Advisors L3C, Oct. 30, 2010.

<sup>89</sup> L3Cs labeled 13, 26 and 8, respectively

<sup>90</sup> The L3Cs labeled 8, 15, and 23 spoke of the low profit nature of their business. The Rudikoff statement was made during a telephone interview with Matthew Rudikoff, Executive Director of Institute for Public Financial Incentives, L3C on Oct. 29 2009. Confirmed via email from Matthew Rudikoff to Elizabeth Schmidt, Re: Follow-up on Article about L3C Pioneers in Vermont, July 26, 2010, 2:47 p.m.

<sup>91</sup> L3C labeled 28.

eventually, but realized it would take a long time, if ever, to achieve that goal.<sup>92</sup> Nonetheless, they all planned, as the legislation requires, to have the charitable mission trump any profit motive.

Several of the L3C pioneers had economic reasons, beyond the branding potential of the L3C that is discussed below,<sup>93</sup> for choosing this business form. Some wanted to hedge their bets by choosing a form that could accept grants as well as investments, a structure that would work particularly well if the L3C were associated with a §501(c)(3).<sup>94</sup> Others found that their business models fit well with the L3C structure.<sup>95</sup>

Sustainable Timber Investment Exchange L3C, for example, is a timber harvesting company that uses sustainable and ecological harvesting techniques. Timber harvesting equipment is so expensive that harvesters use poor forestry techniques in order to earn enough money make timely payments on their loans. Only if a lender were willing to offer a lower interest rate or a longer-term loan, actions that will inevitably lead to a lower rate of economic return and a higher rate of social return, would a harvester be able to afford to use more ecological and sustainable harvesting techniques.<sup>96</sup>

Safer Pediatric Imaging L3C, a research organization devoted to improving CT scan safety through better x-ray technology, provides another example. Its founder, Mark Benz, was haunted by the statistic that 3,000 of the six million children who receive CT scans each year will develop cancer later in life as a result of their scans. Benz developed a theory about a way to make CT scan technology safer, but funding to test his hypothesis proved elusive. Investors who expect a quick return on investment will not invest at the hypothesis stage, because the investment is too risky. Even foundations, Benz found, require some experimental evidence of promise before being willing to provide a grant. Benz eventually found a group of individuals willing to provide funding for the initial experiment without receiving a return on investment. Ultimately, Benz expects this organization to be self-sustaining.<sup>97</sup>

Almost all the other L3C founders had similar stories. For one reason or another, a purely for-profit model did not work well. For different, but equally

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<sup>92</sup> L3Cs labeled 11, 23

<sup>93</sup> See notes 1-7-110 *infra* and accompanying text.

<sup>94</sup> L3Cs labeled 7, 14, 25

<sup>95</sup> The second survey asked whether “the business form itself fit with the mission of the organization.” Seven of the eight respondents to the survey said “yes.”

<sup>96</sup> Telephone interview with Eli Gould, founder, Sustainable Timber Investment Exchange, Oct. 29, 2009.

<sup>97</sup> Telephone interview with Mark Benz, founder, Safer Pediatric Imaging L3C, Oct. 30, 2009. Confirmed via email, July 16, 2010 8:22 a.m.

compelling reasons, a nonprofit did not fit, either.<sup>98</sup> As Robert Hart of Rbods.com L3C explained on his website,

[W]e started attending Venture Capital conferences in search of partners to get started. ... Unfortunately, the extreme emphasis on profits didn't fit our plan for creating a social network with a primary focus on creating ... a healthier, happier society with less debt. ... So then we looked at the non-profit model. That didn't fit either. As a businessman I just couldn't see myself asking for donations every year to sustain a business that I knew was capable of carrying itself within a few years. ... I can't tell you how delighted Cat and I were when we discovered the L3C business form! It fits our company to a T!<sup>99</sup>

According to several L3C pioneers, a social hybrid business form is both a perfect fit for their organizations and a perfect fit for our times. "The L3C was created for organizations that want to operate at the intersection of mission and profit," said Rick Zwetsch of Intersector Partners L3C. "We had been trying for 10+ years to figure out how to weave together 50+ years of for-profit, nonprofit and government agency experience. In our minds, there is no better way to do that than with the L3C."<sup>100</sup>

3. *The simplicity and flexibility of the L3C were important considerations in choosing a business form, as was its branding potential.*

However appealing the hybrid nature of the L3C, its early adopters also welcomed its simplicity, flexibility, and branding potential. "It was a very simple process. That's my prime reason [for choosing the L3C]," explained Jon Kidde, founder of Green Omega L3C, an organization that brings restorative justice to Vermont's institutions. He was not alone. Several others credited the L3C's flexibility as the main factor in their decision to use the L3C business form.<sup>101</sup>

Even those who did not consider flexibility the primary reason for choosing the L3C business form appreciated that factor.<sup>102</sup> Several respondents

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<sup>98</sup> Besides the L3Cs described in notes 96-98 *infra*, the L3Cs labeled 3, 4, 11, and 24 specifically mentioned that their ideas were "on the fence" between existing business forms.

<sup>99</sup> Robert Hart, founder of Rbods.com. Quoted at <http://www.rbods.com>. Echoed by Bill Eldridge, of Maine's MOO Milk, who commented on how the L3C fits their mission, structure and purpose perfectly and allows them to focus their fund raising on socially responsible investors. Telephone interview with Bill Eldridge, CEO and Chairman, Maine's Own Organic Milk Company L3C, Oct. 30, 2009. Confirmed via email to Elizabeth Schmidt, Follow-up on Article About L3C Pioneers in Vermont, July 15, 2010, 4:24 p.m.

<sup>100</sup> Rick Zwetsch, Survey Response, June 30, 2010. His thoughts were echoed by L3Cs labeled 13 and 15.

<sup>101</sup> L3Cs labeled 9 and 20.

<sup>102</sup> L3Cs labeled 5, 6, 9, 11, 13, 13, 15, 17, 18, 20, 26

were pleased they could pilot their idea without investing the time and money that a more complex business form would take.<sup>103</sup> Others did not want complex legal issues to complicate their ability to start addressing their social goals.<sup>104</sup> Still others could not spare the time. Maine's Own Organic Milk Company L3C, for example, began when a group of organic dairy farmers realized that they could set up their own distributorship in order to prevent the loss of agricultural jobs once their original distributor ceased operations. MOO Milks CEO and Chairman, Bill Eldridge, found the speed with which they could begin operations to be crucial. A more complicated process, such as starting a nonprofit coop, would have failed because "you can't herd farmers."<sup>105</sup>

Not only did this new business form offer flexibility, but it also gave the entrepreneurs an opportunity to project their business values to customers and investors. Approximately 1/3 responded to the written survey that they had chosen the L3C business form for its "halo" effect, and the same percentage stated that they wanted to be on the cutting edge of a social movement.<sup>106</sup> In the telephone interviews, several commented that the L3C had a branding advantage. "There are millions of LLCs out there. How can you tell, just from their name, that they have a social mission?" asked Rick Zwetsch of Intersector Partners L3C.<sup>107</sup> Michael Harp of H2O L3C had a similar response. "To go through normal channels of grant making reduces us to another pretty face at the dance."<sup>108</sup> They and others recognize, of course, that L3Cs need substance as well as a name, but they also see an opportunity to be recognized as socially motivated innovators.<sup>109</sup>

4. *Had the L3C not been available as a business form, the L3C pioneers would have chosen a for profit entity over a § 501(c)(3).*

Despite their emphasis on social mission and their plan to proclaim this mission publically, none of these entrepreneurs would have chosen to create §501(c)(3) organizations. Some faced insurmountable obstacles that precluded this option, but for most, the complexity and accompanying loss of control were simply too daunting. Some also had philosophical reasons for shying away from

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<sup>103</sup> L3Cs labeled 5 and 6.

<sup>104</sup> L3C 17

<sup>105</sup> Telephone interview with Bill Eldridge, CEO and Chariman, Maine's Own Organic Milk Company L3C, Oct. 30, 2010. Confirmed via email to Elizabeth Schmidt, July 15, 2010, 4:24 p.m.

<sup>106</sup> See Table 2. This interest was both personal, because they were proud of their mission, and professional, because they hoped to get extra attention. L3Cs 6, 17 and 24 specifically mentioned that they hoped the newness of their business form would help attract investors and business.

<sup>107</sup> Telephone interview with Rick Zwetsch, Founder, Intersector Partners L3C, July 1, 2010.

<sup>108</sup> Telephone interview with Michael Harp, CEO H2O L3C, Oct. 30, 2010. Confirmed via email July 13, 2010, 12:15 p.m.

<sup>109</sup> The opportunity to be on the cutting edge of a social movement and/or receive a "halo effect" from the L3C was mentioned by 3, 5, 6, 7, 8, 9, 22, 14, 16, 19, 20, 21, 23, 24, 27, 28.

the nonprofit model.<sup>110</sup> They held these beliefs despite, or perhaps because of, widespread familiarity with the nonprofit sector.<sup>111</sup>

Two of the L3Cs represented in this study could not be organized as nonprofit organizations. ISC Enterprises L3C came into being once it became obvious the Chinese government would not approve the environmental initiative that its parent, the Institute for Sustainable Communities, had proposed unless it was organized in a for-profit business form.<sup>112</sup> Community Health Development Resources, an organization that brings health facilities to uninsured and underinsured areas, found that combining the regulatory hurdles of a medical provider in this market with those of a § 501(c)(3) would be like “trying to thread a needle with a rope.”<sup>113</sup> In other words, it was so impracticable as to be impossible.

For the other entrepreneurs, however, a § 501(c)(3) could have been a viable option. After all, these organizations must have a charitable or educational purpose equivalent to that which would be recognized under § 501(c)(3) in order to qualify as an L3C.<sup>114</sup> Nevertheless, these entrepreneurs did not want to jump through the hoops necessary to obtain and maintain recognition as a § 501(c)(3). A § 501(c)(3) requires considerable state and federal paperwork. The Form 1023 alone, without schedules and attachments, is twenty-nine pages long. The IRS estimates that a novice would need more than one hundred hours to prepare this form. It also estimates that even the simplest, most complete Form 1023 takes about ninety days to process; complicated ones take much longer.<sup>115</sup>

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<sup>110</sup> Intersector Partners L3C interviewed people associated with twenty L3Cs, none of which participated in this study, and drew the same conclusion: “They do not want to be a traditional, § 501(c)(3) nonprofit because they do not want to be constrained by the strict compliance of the § 501(c)(3) world. While most of their businesses and business ideas have a very nonprofit slant in terms of mission, these entrepreneurs do believe they can turn a fair profit—enough that if a foundation took on some of the risk, private investors would be able to see a near market-rate return. Quite a few have background in the nonprofit sector and see the vulnerability and challenges facing that sector—particularly the constraints facing social enterprises under that model.” Caryn Capriccioso, Rick Zwetsch, and Erin Shaver, *Who Is the L3C Entrepreneur?* (May 10, 2010), available at <http://www.intersectorl3c.com>, accessed July 16, 2010.

Intersector Partners PDF, p. 9

<sup>111</sup> The founders of L3Cs labeled 5, 9, 15, 18, 21, and 24 mentioned their nonprofit backgrounds. Ironically, several of these founders remain associated with 501(c)(3)s, and one, the L3C labeled 20, eventually did create a 501(c)(3) to be affiliated with the L3C in response to difficulty in obtaining funding as an L3C. See note 145 *infra* and accompanying text.

<sup>112</sup> Telephone interview with Brendan Keleher, Agent, ISC Enterprises L3C, Nov. 3, 2009. Confirmed via email from Brendan Keleher to Elizabeth Schmidt, July 15, 2010, 11:13 a.m.

<sup>113</sup> Telephone interview with James Reeb, Founder, Community Health Development Resources, Feb. 12, 2010.

<sup>114</sup> See notes 28 and 29 *supra* and accompanying text.

<sup>115</sup> <http://www.irs.gov/charities/article/0,,id=156733,00.html>, accessed July 3, 2010. Fees are currently \$400 for orgs with expected revenues of less than \$10k and \$850 for organizations with

The L3C, on the other hand, is quite simple to form. The entrepreneur simply finds the one page document online, checks the box that states it meets the L3C requirements, and pays a fee. It is then legally in business.<sup>116</sup> Moreover, once in business, those operating the L3C need not worry about private inurement, the unrelated business income tax, excess benefit transactions, or any of the other myriad rules and regulations that § 501(c)(3) organizations must follow.<sup>117</sup>

The loss of control over enterprises set up as § 501(c)(3) organizations was another concern for many of these entrepreneurs. The CEO of one organization, which would have a better chance at funding if affiliated with a university, was worried about the bureaucracy and lack of control that such an affiliation would entail.<sup>118</sup> Two others had a significant amount of intellectual property that they wanted to own, even as that intellectual property was being used for charitable and educational purposes.<sup>119</sup> One worried that she would never recoup her investment if she switched to a for-profit business entity.<sup>120</sup> Several others knew that nonprofits were run by a board of directors who held the reins of power, and that they would have no legal control if they became a § 501(c)(3).<sup>121</sup> Many of them had experience with the nonprofit sector and did not want to replicate what they had seen.<sup>122</sup>

Several respondents hoped to make money and saw nothing wrong with that desire. The idea that one must lose ownership of ideas, plans, and all potential profit in order to make a social difference was anathema to them. Michael Harp spoke for many when he said, "Ownership is nice."<sup>123</sup>

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expected revenues greater than \$10k.

<http://www.irs.gov/charities/article/0,,id=121515,00.html>

<sup>116</sup> See <http://www.sec.state.vt.us/corps/>. The form is available at <http://www.sec.state.vt.us/corps/forms/llcarts.htm>.

<sup>117</sup> If they receive funding from a 501(c)(3) private foundation, that foundation must still be aware of all the legal rules governing it and its expenditures and the L3C may find life somewhat more complicated as it deals with the foundation's concern about following the tax rules. The L3C itself, however, is not a tax-exempt entity and does not have these concerns.

<sup>118</sup> L3C labeled 17.

<sup>119</sup> L3Cs labeled 14, 21. The one labeled 17 also had intellectual property concerns.

<sup>120</sup> L3C labeled 25. As an attorney, I am aware that some of the L3C's founders could be addressed in a 501(c)(3), but their perceptions led them to their decision. In any case, dealing with these concerns as a 501(c)(3) would have been more legally difficult than using a for-profit vehicle.

<sup>121</sup> L3Cs labeled 3, 5, 15, 21, and 24 mentioned this loss of control. The founder of the L3C labeled 6 was not concerned about this factor. He believed that someone with real vision and direction can work well with a board that will provide resources and perspectives so that the vision can be advanced in a more thoughtful way. Despite this defense of 501(c)(3) governance, he did not want to start a 501(c)(3) organization.

<sup>122</sup> Note 112, *supra*.

<sup>123</sup> Telephone interview with Michael Harp, founder H2O L3C, Oct. 30, 2010.

Finally, the nonprofit option contradicted strongly held beliefs of some entrepreneurs. Two L3C adopters questioned the § 501(c)(3) option because believed that even social ventures should respond to market forces.<sup>124</sup> Another worried that employees of § 501(c)(3) organizations tended to burn out because they are not paid well. He wanted to treat his employees better than that.<sup>125</sup> A third thought it immoral to ask for donations to sustain a business that could be self-supporting within a few years.<sup>126</sup>

This unwillingness to start a nonprofit organization was something of a paradox, both because so many of the entrepreneurs had experience in the sector and because so many of the L3Cs are affiliated with 501(c)(3)s.<sup>127</sup> The sample in this study is not unusual, however. Intersector Partners L3C also conducted a study of L3C entrepreneurs, none of whom overlapped with this study, and also that the 501(c)(3) was an unacceptable alternative.<sup>128</sup>

5. *For the most part, the L3C business form has not provided a branding or fundraising advantage to these entrepreneurs.*

The novelty of the L3C has proven to be double-edged for these entrepreneurs. It has led to some press coverage<sup>129</sup> and the occasional customer. One L3C, for example, attracted a customer who assumed that an entity organized as an L3C would be more innovative than a similar organization.<sup>130</sup> Another L3C, however, was unable to purchase liability insurance because the insurance company had no code for “L3C.”<sup>131</sup> A third faced a higher than expected rent payment because the organization did not qualify for nonprofit rates,<sup>132</sup> and a fourth lost a potential individual donor to its affiliated 501(c)(3) because the donor did not trust the L3C.<sup>133</sup>

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<sup>124</sup> L3Cs labeled 7, 25.

<sup>125</sup> L3C labeled 3.

<sup>126</sup> Robert Hart, *What's special about rBods.com? It's an L3C!*

<http://rbods.com/blogs/115-whats-special-about-rbodscom-its-an-l3c> Sept. 17, 2010.

<sup>127</sup> It is also ironic, given how many have found the need to establish a 501(c)(3) or create a fiscal agency relationship with another charity in order to receive funding from foundations. See notes 145 and 146 *infra* and accompanying text.

<sup>128</sup> Intersector Partners, *Who Is the L3C Entrepreneur?*, *supra* n. 111.

<sup>129</sup> See e.g. Sharon Kiley Mack, *True Yankee Ingenuity Launches MOOMilk, Maine Organic Milk Producers Form Company to Save Farms*, Bangor Daily News, Oct. 10, 2009; Grant Williams, *Dozens of Companies Are Sprouting With the Intention of Doing Good*, Chronicle of Philanthropy, Nov. 12, 2009; Steve Weiker, *Legislator Hopes His Law Will Bring Back Jobs from China*, The News Herald (July 13, 2010).

<sup>130</sup> L3C labeled 24.

<sup>131</sup> L3C labeled 6.

<sup>132</sup> L3C labeled 25.

<sup>133</sup> L3C labeled 21.

Almost all the entrepreneurs recognized that the newness of the L3C had failed to bring the caché they had hoped. Only three entrepreneurs suggested the L3C status had been helpful in any respect.<sup>134</sup> The others noted that the L3C was a “confusing” and “untested concept,” and “people have no clue what it is.” One entrepreneur, who had originally thought the L3C would signal to investors that profit was not the main motive, found such confusion among potential investors that he has temporarily shelved the L3C he founded.<sup>135</sup>

Although the general public may not understand L3Cs, many of the entrepreneurs expected foundations to be up to speed on this concept, given that the L3C was designed to facilitate foundations’ use of program related investments. These expectations proved wrong. When asked how their ideas about L3Cs had changed since they started their businesses, I heard several variations of the following: “It turns out foundations do not recognize our ‘in between’ status at all and won't fund us.”<sup>136</sup> Some early adopters realized that the L3C was an untested concept, and had lowered expectations.<sup>137</sup> These expectations were more realistic. None of the responding L3Cs has received a program related investment.

The financial experiences of these organizations have been varied. Some L3Cs are struggling. At least one has apparently shut down, and a second is close to closing. A few exist on a shoe string budget, and one sent one half of the husband-wife management team back to full-time work.<sup>138</sup> Nevertheless, several L3Cs have succeeded in attracting investment, much of it from outside the foundation world. Three L3Cs received funding from their own members,<sup>139</sup> two from angel investors,<sup>140</sup> and a third received a Small Business Administration loan.<sup>141</sup> The rest did not share how they funded their operations except to state that they had not received a program related investment from a foundation.

The experiences with foundations have not been entirely negative. One L3C entrepreneur recounted that even though two foundations “looked at us as if we were crazy,” he remained hopeful that the third would provide funding.<sup>142</sup> Three others were also hopeful at the time of the interview. Of those three, one

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<sup>134</sup> L3Cs labeled 11, 17, and 24.

<sup>135</sup> L3Cs labeled 3, 5, 6, 8, 14, 15, 16, 23, 25 spoke of the confusion created because the L3C was not well-known. The L3C labeled 15 is the one that remains in existence but is not currently active.

<sup>136</sup> L3Cs labeled 6, 14, 16, 18 mentioned this difficulty.

<sup>137</sup> L3Cs labeled 3 and 15 mentioned they knew the L3C would be unknown to most investors.

<sup>138</sup> Rbods L3C has already been identified as the one that closed. *See n. 52 supra*. The others mentioned in this paragraph are L3Cs labeled 5, 13, 21, and 25.

<sup>139</sup> L3Cs labeled 3, 11, 28.

<sup>140</sup> L3Cs labeled 7, 15, 17

<sup>141</sup> L3C labeled 14. Some of the organization

<sup>142</sup> L3C labeled 11.

reported success in the second survey, one remained hopeful, and the third did not respond.<sup>143</sup>

Those entrepreneurs who shared how they received foundation funding all noted that they needed to go through complex legal hoops to do so. One found it necessary to set up an affiliated 501(c)(3) to receive foundation and governmental funding,<sup>144</sup> and two others created a fiscal sponsorship to receive grants from foundations.<sup>145</sup> Evidently, for some of the L3Cs their charitable missions were attractive to foundations. Nonetheless, the foundations were still too leery of program related investments to provide the funds through that vehicle.

Intersector Partners L3C's study made a similar finding. None of the entrepreneurs with whom they spoke had received PRI funds, but they reported on two L3Cs that had attracted foundation investments. In one case, the parent organization, a 501(c)(3), received a grant for the purpose of creating the L3C. The second was a direct grant from the Bill and Melinda Gates Foundation to redesign and re-engineer cold-chain containers used in vaccine and disease-monitoring programs. This grant was made under the tax code's expenditure responsibility provisions, which allow foundations to make grants to organizations that are not classified as public charities so long as the foundations provide assurances that the grants are used for charitable purposes.<sup>146</sup>

Thus, even those L3Cs that have attracted foundation funding did so through a mechanism other than a program related investment, most often by affiliating with a § 501(c)(3) organization. One L3C, however, found a need to go the other direction. The Farm at South Village, a community-based organic farm, changed to a Subchapter S corporation in July 2010, because the federal government did not recognize the L3C in two situations for which it needed such recognition. First, the government would not make a much needed solar energy REAP grant to an L3C. Second, it would only allow IRC §1042 capital gains treatment of ESOP stock proceeds in a corporation.<sup>147</sup>

6. *Vermont's social hybrid pioneers remain pleased with the L3C business form despite its relative obscurity and their inability to secure PRI funding.*

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<sup>143</sup> L3Cs labeled 7, 17, and 18,

<sup>144</sup> L3C labeled 20. The L3C may also have received a direct grant from a foundation that used expenditure responsibility. Its founder mentioned a grant from a legitimate foundation for which he completed several forms. He emphasized that it was a gift, not a loan or an investment.

<sup>145</sup> L3Cs labeled 17, 18. Number 17's legal fees for setting up the fiscal sponsorship equaled 10% of the grant.

<sup>146</sup> Intersector Partners, *supra* n. 111 at 14. The expenditure responsibility provisions are spelled out in IRC § 4945.

<sup>147</sup> Email from Will Raap, Founder, The Farm at South Village, to Elizabeth Schmidt, Follow-up on Article about L3Cs in Vermont, July 13, 2010, 10:11 p.m.

However difficult it has been for the L3C pioneers to obtain funding and begin operations, their frustrations have not translated into dissatisfaction with their L3C choice. All but two of the survey respondents answered the question, “Do you still believe the L3C is the best business form for your venture?” with “Yes.”<sup>148</sup>

This degree of enthusiasm for the concept seems surprising at first blush. The L3C pioneers recognize, however, that they are early adopters, and the L3C remains in its infancy. Further, most of them are fortunate to be weathering difficult economic conditions. Their enthusiasm also confirms my observation that the goal of obtaining program related investments was lower on their priority lists than the opportunity to build mission-driven businesses. As described above, they chose this business form because it reflected their values, and it continues to do so, even if it has not produced the funding or recognition initially anticipated. Although the architects of the L3C concept correctly identified capitalization as a concern for social entrepreneurs, their concept tapped even more strongly into a desire to find a relatively simple and flexible way to improve the human condition.

#### IV. QUESTIONS TO PONDER

These findings, while obviously still preliminary, can provide food for thought for both proponents and skeptics of the L3C. What significance should attach to the finding that the architects of the L3C concept have a different approach than the entrepreneurs who embrace it? Why has this disconnect occurred and why have the L3Cs not attracted PRI funds? Should policy makers take note or do these differences simply suggest a slight shift of emphasis and the young age of the L3C? What can, or should, policy makers learn from the L3C pioneers’ aversion to the 501(c)(3) or their enthusiasm for a business form that has yet to produce the promised benefits?

1. *Why are the L3C pioneers’ priorities different from those of the L3C architects, and why have they not yet attracted PRIs?*

In many respects, the differences in priorities could have been predicted. An L3C is basically an LLC that satisfies the requirements for a PRI. However symbiotic the LLC and PRI concepts may be as a matter of public policy, they are rather strange bedfellows in terms of their relative complexity. The strength of

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<sup>148</sup> See Appendix B for the list of questions. The respondents from the L3C that closed, Rbods.com, and the one that changed to an S Corp, the Farm at South Village, both remain enthusiastic about the L3C concept. [Http://www.rbods.com](http://www.rbods.com); Email from Will Raap, founder, The Farm at South Village, to Elizabeth Schmidt, Follow-up on Article about L3Cs in Vermont, July 11, 10:11 pm.

the LLC is its simplicity and flexibility.<sup>149</sup> Entrepreneurs can gain the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership by completing a few forms and paying a registration fee.<sup>150</sup> In contrast, the program related investment is anything but simple. Even sophisticated foundations with millions of dollars in assets find them too complex to undertake.<sup>151</sup> It is hardly surprising that entrepreneurs, who are often creating new organizations as single member entities, are more attracted to the simplicity of the L3C than the complexity of the PRI.

The lack of response from the foundation community is equally unsurprising. Social entrepreneurs, particularly those adventurous enough to start the first few L3Cs in the country, tend to be risk-takers. Foundations, on the other hand, have millions of dollars to protect, tax compliance issues to monitor, and lawyers advising them at every step to be cautious. If, as the creators of the L3C concept have recognized, foundations are leery of program related investments in general, they will, at least initially, be equally leery of making program related investments to enterprises that have adapted an untested business form. Passage of federal legislation that would provide a presumption that an organization meets the requirements of a PRI could help ease foundations' concerns, but that legislation has not yet been introduced, much less passed or enacted. Even if the legislation is passed, foundations will need to determine whether the L3C's charitable mission complements its own and will need to conduct expenditure responsibility (due diligence) over the course of the investment. As other commentators have noted, these steps in themselves may be so onerous that the federal legislation will not allay their fears.<sup>152</sup>

The tepid response is also unsurprising considering the Vermont L3C statute passed a few months before the United States began its worst economic downturn since the Great Depression.<sup>153</sup> Unlike some of the earlier recessions, this one has taken an especially hard toll on small businesses.<sup>154</sup> It has also taken quite a toll on foundations, which decreased their payouts significantly during

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<sup>149</sup> See notes 24-26 *supra* and accompanying text.

<sup>150</sup> See <http://www.sec.state.vt.us/tutor/dobiz/dobiz18.htm>. Deborah Markewitz, Vermont's Secretary of State emphasized when the L3C statute passed, that the state's role was a registration, not a regulation, role. McLean, *State to Host a New Type of Company*, Burlington Free Press C6 (April 20, 2008).

<sup>151</sup> See n. 22 *supra* and accompanying text

<sup>152</sup> Kleinberger, Spenard, etc. Bob Willis, *U.S. Recession Worst Since Great Depression, Revised Data Show* (Bloomberg News, Aug. 1, 2009).

<sup>153</sup> Bob Willis, *U.S. Recession Worst Since Great Depression, Revised Data Show*, Bloomberg News (Aug. 1, 2009); But see David Wessel, *Did the Great Recession Live Up to its Name?* W. St. J. (April 10, 2010);

<sup>154</sup> Christine Dugas, *Business Bankruptcies Up 240% Since 2006* (Gannett News Service, July 21, 2009); *Small Business Hit Worst by Recession* (July 27, 2009).

the past year as a result of their diminished endowments.<sup>155</sup> One could hardly imagine a worse time to start a small business, especially one that sought funding from a foundation.

Finally, Vermont's L3c statute will have been in effect for two and one-half years as this article is published. The winds of change may simply take longer to arrive than many had hoped.

2. *Is the L3C's emphasis on program related investments misplaced? Have its creators focused on the wrong issue?*

At first glance, it could appear that the inventors of the L3C missed the mark by focusing on the program related investment. The entrepreneurs are relatively uninterested in PRIs, and foundations appear unwilling to use them. The secondary message of the L3C, that it is a way to signal a charitable purpose through a flexible business form, is the one that resonates with the social hybrid pioneers. Legislators and policy makers may eventually consider separating these messages.

It would premature to declare the emphasis on PRIs misplaced, however. First, as mentioned above, the concept is in its infancy. It has had early legislative success in a few states, but it is untested in the vast majority of states and the federal government. If the L3C gains traction over the next few years and PRIs become more widely available, the entrepreneurs' and foundations' priorities will undoubtedly change.

Second, access to PRIs may not be the top priority of the L3C pioneers, but access to capital remains a concern. The L3C is flexible enough to allow for other types of investment, and the tranche mechanism available through the L3C is a creative way to allow for the different rates of return for different classes of members that may be necessary to capitalize these businesses.

Finally, the L3C concept has already had an effect. In its first two years, it has inspired almost 200 entrepreneurs to create social ventures in the states that have passed L3C legislation.<sup>156</sup> The concept has also spawned numerous newspaper, law review, and business journal articles.<sup>157</sup> The changes may be more inspirational than legal, for the opportunity to receive PRIs already exists with other business forms.<sup>158</sup> Nevertheless, the publicity alone can help raise

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<sup>155</sup> Foundation grantmaking fell by 8.9% between 2008 and 2009. Center on Philanthropy, Indiana University, *Giving USA* (2010).

<sup>156</sup> Intersector Partners, L3C maintains a tally of L3Cs in all the states that have passed L3C legislation, <http://www.intersectorl3c.com/l3ctally.html>, accessed July 20, 2010.

<sup>157</sup> See notes 32, 39, 41-46 *supra*.

<sup>158</sup> See note 11 *supra*.

foundations' consciousness about and comfort level with the PRI tool, which could in turn lead to a greater use of PRIs. Such a result would thus accomplish a major goal of the L3C legislation, even if the L3C never gains widespread acceptance.

3. *Is the L3C necessary or do existing business forms meet entrepreneurial needs?*

The differences in priorities point to other questions, however. First, one of the criticisms directed to the L3C concept is that this new business form is unnecessary. These critics maintain that private foundations have been authorized to make program related investments for over forty years, and LLCs already offer the tranching opportunity described above.<sup>159</sup> Given this argument, it follows that a new label is unlikely to change foundations' reluctance to offer PRIs, especially when the L3Cs are not particularly enthusiastic about receiving them. In fact, the entrepreneurs' relative disinterest in PRIs could add to the arguments that this new business form is unnecessary.

The problem with this argument, however, is that other aspects of the L3C have struck a chord with those entrepreneurs who wish to retain control over a relatively simple enterprise and still proclaim their social mission. In the entrepreneurs' minds, no other business form offers this possibility. A § 501(c)(3) organization signals its social mission through its charitable status, but the founder loses legal control of the organization. Founders of for-profit organizations retain control to the extent that investors and business partners allow, but they cannot announce their social intentions through the business form itself. The Benefit Corporation, a new business form that has been recognized in Vermont and Maryland, may ultimately provide an alternative for many of these entrepreneurs, but the underlying business model is a corporation, which lacks the L3C's simplicity and tax advantages.<sup>160</sup> The entrepreneurs could also create a combination of for-profit and nonprofit enterprises through joint ventures and subsidiaries, but these options seem too complex to undertake.<sup>161</sup>

The L3C, on the other hand, with its relative simplicity and its "for profit with the nonprofit soul" message, meets these entrepreneurs' business needs. The critics who claim the L3C legal form is unnecessary may have a valid legal argument, but the L3C entrepreneurs' response suggests that, as a practical matter, they are wrong. The L3C has definitely provided them with a business form that, at least in their perception, was not available before the advent of the L3C.

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<sup>159</sup> See n. 46 *supra* and accompanying text.

<sup>160</sup> See n. 39 *supra* for a discussion of the Benefit Corporation.

<sup>161</sup> See n. 39 *supra* at 2.

4. *Is the L3C the best business form for enterprises that are not interested in program related investments?*

The more relevant question may be whether the L3C is the best form for those entrepreneurs who are more interested in the “for profit with the nonprofit soul” message than the opportunity to receive program related investments. Common sense suggests that a business entity authorized by legislation that tracks the tax-code’s language permitting program related investments may not be the most appropriate vehicle for organizations that are uninterested in such investments. Perhaps the entrepreneurs who do not seek PRIs should register as LLCs and then obtain a B certificate instead of forming L3Cs. Or perhaps a new designation will appear that focuses more on the mission than on program related investments. A third possibility, of course, is that the L3C concept is broad enough to include both groups. If the proposed federal legislation is passed, those who are interested in PRIs will proceed through the voluntary process of receiving the IRS imprimatur, because foundations are less likely to offer PRIs without it. Those who are uninterested or not yet ready for PRIs will be able to decide for themselves whether to take the steps necessary to obtain IRS recognition. If they do not take those steps, they will remain state-designated L3Cs, much as nonprofit corporations that do not become 501(c)(3) organizations remain nonprofit corporations in their states of incorporation.<sup>162</sup> Again, it is too early to resolve this issue, but it is an issue that should be considered as the L3C concept and other forms of social enterprise evolve.

5. *Can this study inform the discussion about appropriate enforcement mechanisms for the L3C?*

This study also raises questions about the appropriate enforcement mechanisms for the L3C. Critics of the L3C maintain that unscrupulous actors will take advantage of the state statutes’ failure to establish a mechanism to monitor whether an L3C meets the required charitable and educational purposes or whether it continues to place its social purpose above the profit motive.<sup>163</sup>

As described in Part III, the L3Cs that participated in this study all have noble missions and probably meet the “charitable and educational” requirements of the statute. The list of purposes in § 170(c)(2)(B) is identical to those listed in § 501(c)(3),<sup>164</sup> and almost every organization that applies for recognition as a §

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<sup>162</sup> The enforcement mechanisms may ultimately be different for the L3Cs that receive PRIs than for those that do not, given the difference between state and federal jurisdictions. The enforcement criteria may also be different, because the states will not have the same concern about misuse of tax-deductible funds as the IRS will. Continuing the parallel between nonprofit corporations and 501(c)(3)s, the states may be more interested in governance and the low profit message of the L3Cs, while the IRS will ensure that foundations’ funds are used appropriately.

<sup>163</sup> Cohen, *supra* n. 43; Brakman Reiser, *supra* n. 8 at 250.

<sup>164</sup> See n. 12 *supra* and accompanying text.

501(c)(3) receives its letter of determination.<sup>165</sup> In all probability, the L3C organizations responding to the survey would be able to state their purposes in such a way that they would fulfill the § 170(c)(2)(B) requirements.

Nevertheless, no mechanism exists to determine whether they actually do fulfill these requirements. The Vermont Secretary of State allows any organization that checks a box on the Limited Liability Companies Articles of Organization form<sup>166</sup> stating that it is an L3C to become an L3C so long as the fee is included with the form. Nowhere on this form is there a list of the permissible purposes, and the founder of the L3C is not asked to include a statement that the organization meets the requirements of the statute. Although the proposed federal statute would create a system that vets the missions of these organizations and determines whether they are capable of accepting a program related investment, such a system has not been implemented.<sup>167</sup>

Two findings from the survey could raise additional concerns about whether the charitable and educational requirements are met. First, several of the L3C adopters did not use attorneys when they began their organizations.<sup>168</sup> Even if these entrepreneurs had read the Vermont statute, a layman's definition of "charitable" and "educational" could be different from a lawyer's. Second, only some of the organizations had written policies in place to help ensure that the mission would remain paramount.<sup>169</sup>

Other findings, however, are more reassuring. Even those who did not use an attorney when setting up their L3Cs reported a high degree of awareness of the statutory requirements.<sup>170</sup> Also, the more complex organizations, those that

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<sup>165</sup> Rob Reich, Lacey Dorn & Stephanie Sutton, *Anything Goes: Approval of Nonprofit Status by the IRS*, Center on Philanthropy and Civil Society, Stanford University (Oct. 2009) maintains 99% of all applications are approved.

<sup>166</sup> This form can be found at <http://www.sec.state.vt.us/corps/forms/llcarts.htm>, accessed July 20, 2010.

<sup>167</sup> See note 38 *supra* and accompanying text.

<sup>168</sup> L3Cs labeled 3, 6, 7, 8, 13, 24 and 25 mentioned that they had not used attorneys when starting the L3C, although #4 used one for the operating agreement. L3Cs labeled 1,2, 3, 11, 14, 17, 19, 27 and 28 said they did use attorneys. The others did not respond to this question.

<sup>169</sup> The lack of policies that require the mission to be paramount may not be as alarming as seems at first blush. Those organizations that are already affiliated with a Section 501(c)(3) tend to have both an operating agreement and a written policy protecting the mission. Without such an agreement, the 501(c)(3) could have its own tax problems. The organizations that receive angel investments are also likely to have something in writing about the mission, but it is less clear that the investors will enforce this part of the agreement without the tax incentive to do so. The remaining organizations are single member organizations, for whom the mission is more likely to stay paramount than if the organization were more complex. Nevertheless, policies are no substitute for an enforcement mechanism.

<sup>170</sup> The second survey asked the respondents to rank their understanding of the PRI requirements that are incorporated into Vermont's L3C statute. All nine respondents reported being very aware that the L3C's purpose must significantly further the accomplishment of one or more

might need a policy to protect their mission, are the ones most likely to have one. Those without policies protecting the mission tend to be the smaller, single member L3Cs for which a policy would only remind the founder of the mission.<sup>171</sup> No amount of lawyers or policies, however, can substitute for an enforcement mechanism.

The L3C architects and promoters have two answers to the concerns about defining and monitoring the purposes of the L3Cs. One is that the federal legislation will address many of these concerns, because the IRS will determine which organizations actually qualify as L3Cs.<sup>172</sup> The second is that, even without federal legislation, the private foundation investors will enforce the social mission.<sup>173</sup> Theoretically, the foundations will receive the lowest financial return but maintain a significant governance presence, which will give the foundations enough control over the company to enforce the mission. The foundations' incentive to maintain this mission is built-in, for the tax consequences to the private foundation of making a program related investment to an entity that has never had or has lost its charitable or educational mission are too large for it to do otherwise.<sup>174</sup>

These answers are only partially reassuring, however. The federal legislation has not been enacted, and there is no guarantee it ever will be. Even if it is enacted, the determination will be voluntary. Thus, L3Cs that do not seek the federal designation or receive PRIs will not be covered by either of the above-described enforcement mechanisms. Nevertheless, passage of the federal legislation should go a long way toward answering the concerns of those who fear that tax-exempt funds from foundations will be used to enrich entrepreneurs.<sup>175</sup>

Protecting the public fisc is not the only policy concern, however. Policy makers will want to protect investors, customers, and even the L3C brand itself from misuse. The first well-publicized abuse of these terms will harm the entire social enterprise movement along with its victims. The temptation to regulate

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charitable or educational purposes, as defined in § 170(c)(2)(B) of the Internal Revenue Code of 1986, and the L3C would not have formed except for its relationship to the accomplishment of this/these charitable or educational purpose(s). Eight of the nine were very aware that “no significant purpose can be the production of income or the appreciation of property, and 8 of the nine were also very aware that “there can be no political or legislative purposes within the meaning of Section 170(c)(2)(D).”

<sup>171</sup> See n. 63 *supra* and accompanying text.

<sup>172</sup> Note 38 *supra* and accompanying text. Brakman Reiser, *supra* n. 8 at 646-7.

<sup>173</sup> *Id.* at 651.

<sup>174</sup> Bishop, *supra* n.22 at 244.

<sup>175</sup> See n. 35 *supra* and accompanying text. The legislation should also go a long ways toward reassuring foundations.

will be strong, and the desire to prevent such abuse before it happens is understandable.

Legislators and government officials grappling with these issues should keep in mind the dangers of too much regulation, however. Every one of the social entrepreneurs in this study had an idea that fit within the 501(c)(3) model, and every one of them decided to forego tax exemption and tax-deductible contributions in order to avoid the complex rules and regulations that accompany the 501(c)(3).<sup>176</sup> As one respondent noted, “The whole sector is set up to discourage entrepreneurship.”<sup>177</sup> Too much regulation can stifle the social creativity we will need if we hope to encourage new approaches to solving problems.

Given that the statutory language authorizing the L3C parallels language in the federal tax code relating to private foundations, the danger that this new entity will quickly become as complicated as the 501(c)(3) is genuine. At that point, the L3C will no longer be useful to the entrepreneurs who seek a simple business form that proclaims a social mission. Policy makers who hope to see social enterprise help solve our society’s problems will need to keep these concerns in mind as they work to prevent abuse, for the wheels of social enterprise will undoubtedly run more smoothly if the brakes are not constantly engaged.

#### CONCLUSION:

The early adopters of the L3C have created enterprises that try to solve a wide range of problems. What they have in common is a seemingly genuine interest in improving the world through a business entity that provides them with simplicity, control, and the ability to signal their social mission through the L3C. In other words, they are looking for a “for profit with a nonprofit soul.” The early adopters are less interested in receiving program related investments, however, a finding that appears to contradict the expectations of the L3C’s creators.

These findings lead to several questions that policy makers should consider as they decide whether to adopt or revise L3C legislation and what regulations to impose. Is the emphasis on PRIs misplaced? Should entrepreneurs who are not interested in PRIs find another business entity through which to advance their mission? What level of regulation is necessary? These questions cannot be resolved at this early stage, because the L3C is a new and relatively untested idea, and much will change if the concept gains traction.

Whatever happens, however, an observation from Bill Dunnington, Managing Partner of Virginia Energy Project, will remain true. When asked his

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<sup>176</sup> See n. 111-116 *supra*

<sup>177</sup> See n. 15 *supra*

opinion of the L3C, he wrote, “A new type of organization is trying to be born because governments and businesses are both failing in critical institutional aspects. [I]t's fundamentally a values issue trying to surface in governance and structural ways.”<sup>178</sup> Whether the L3C concept takes off, evolves, or even disappears over the next few years, it has given these pioneers an institutional outlet for their values – a for profit with a nonprofit soul.

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<sup>178</sup> Email from Bill Dunnington, Managing Director, Virginia Energy Project to Elizabeth Schmidt, Re: Follow-up on Article about L3C Pioneers in Vermont, July 13, 2010, 6:42 a.m.