2013 Columbia Law School Charities Regulation and Oversight Project Policy Conference on "The Future of State Charities Regulation"

Challenges and Interests of the States in Social Mission / Hybrid Organizations

Attorney General Regulation of Hybrid Entities as Charitable Trusts

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In which situations must, should or may state Attorneys General regulate the affairs of for- profit hybrid legal entities on the theory that they hold some or all of their assets in charitable trust?

I. INTRODUCTION

Consider the somewhat hypothetical reactions of four highly stereotyped individuals to this fundamental question that now confronts us:

> **The Practicing Lawyer:** Really? Why in the world would assets of a for-profit corporation or an LLC be subject to a charitable trust? If they were, how could investors receive profits or distributions from these entities or increase the value of their investment? How could the entity operate a business? Are there not other sufficient areas of law that already regulate for-profit corporations against consumer fraud and securities fraud? For example, if these entities are actually engaged in commercial fundraising or commercial co-venture work, they are already going to be regulated by the Attorneys General of most states. If these entities sell products under false pretenses, consumer fraud statutes would apply.
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> **The Regulator:** The L3C statutes seem to say that the L3C has to be set up to significantly further charitable or educational purposes. How could that entity not hold assets in a charitable trust? A Benefit Corporation or a Flexible Purpose Corporation is allowed to state specific charitable purposes. Depending upon how the purposes are framed and how products and services are marketed, a hybrid corporation might very well hold some or all of its assets in a charitable trust.
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> **The Nonprofit Executive Director:** I am concerned that these hybrids are just gimmicks that will be taking funding away from nonprofit organizations and using their "hybrid" status to fool investors and consumers into investing money and buying products and services by holding themselves out as "good guys."

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Regardless of what the law says, we need the Attorneys General to step up and find a way to regulate these entities, even if it means changing the law.

The Scholar: Well, we need to think carefully about the underpinnings of the charitable trust doctrine, the legislative intent of these hybrids, and the language of the hybrid statutes as well as the statutes that define charitable purposes and provide the regulators with authority.

Taking into account these hypothetical voices, this Article will examine whether current law obligates or empowers state Attorneys General to regulate the assets of hybrid entities under the charitable trust doctrine. To the extent it does not already do so, should it be modified to do so?

This Article is divided into four sections:

I. A summary of the currently existing types of hybrid legal entities.

II. A discussion of the charitable trust doctrine in the United States, with an emphasis on California.

III. An analysis of whether current charitable trust law applies to hybrid legal entities. This section concludes that only rarely will the doctrine apply to hybrid legal entities.

IV. A discussion of why the charitable trust laws should not be amended to apply to hybrid legal entities in most situations.

I. HYBRID LEGAL ENTITIES

There is a movement afoot in the United States and around the globe – the social enterprise movement. Social enterprises are, generally speaking, organizations that generate revenues and also seek to benefit society in some way. According to the Social Enterprise Alliance, "[s]ocial enterprises are businesses whose primary purpose is the common good. They use the methods and disciplines of business and the power of the marketplace to advance their social, environmental and human justice agendas."[1] Some social enterprises are set up within the framework of a nonprofit corporation, but more and more for-profit corporations are being established to mix mission and profit.[2]

[1] *See* www.se-alliance.org. S*ee also* www.socialent.org, website of The Institute for Social Entrepreneurs, which defines social enterprise as "any entity that uses earned revenue to pursue a double or triple bottom line either alone (in a private sector or nonprofit business) or as significant part of a nonprofit's mixed revenue stream that also includes philanthropic and government subsidies.

[2] The application of the charitable trust doctrine and the role of the Attorney General, with respect to nonprofit corporations, are beyond the scope of this Article.

Traditionally for-profit organizations have been formed and operated primarily to generate profits. While many businesses generate wonderful goods and services, create jobs, and add importantly to the economy and to the tax base, they are not generally established or operated for social welfare purposes or specifically to benefit the community. Any community benefits tend to be byproducts of a business' efforts to generate profits. Even today with increased emphasis on corporate social responsibility programs and enhanced corporate philanthropy, it is still unclear, under the law, how much of a for-profit corporation's operations can be devoted to anything other than making money for shareholder. As the Delaware Chancery Court said as recently as 2010:

> I cannot accept as valid ... a corporate policy that specifically, clearly, and admittedly seeks not to maximize the economic value of a for-profit Delaware Corporation for the benefit of its stockholders ...[3]

One response to what is at least perceived as the bright line between nonprofit and for-profit entities, between doing good and doing well, has been to create new corporate forms to change the rules. The new forms of emerging hybrid entities are for-profit in form and yet differ from traditional for-profit entities because they allow the entity to pursue a dual mission of making money for the owners of the entity while also pursuing a social mission. In several articles I have discussed the issues involved in selecting a for-profit or nonprofit entity for a social enterprise.[4]

Scholars and practitioners are still debating whether hybrids are needed, whether hybrids are more beneficial than burdensome, which type of hybrid is best and worst, and whether hybrids ought to qualify for any procurement preferences or federal, state, or local tax benefits. Although these are interesting questions, they are not the focus of this Article. The single topic of this Article is whether these new for-profit hybrid forms are and/or should be deemed to hold assets in a charitable trust and therefore be subject to state Attorney General charitable trust enforcement.

The first task is to define what is meant by the term "hybrid." The term "hybrid" is used in two different ways. It is used, by some, to describe tandem relationships in which a nonprofit entity and a for-profit entity work together and share resources and usually intellectual property. This tandem structure is not the topic of this Article.[5] The second use of the term hybrid, and the focus of this Article, involves a single for-profit legal entity that

[3] eBay Domestic Holdings, Inc. v. Newmark 16 A.3d 1, at 35 (Del. Ch. 2010); *See also, Dodge v. Ford*, 170 N.W. 668 (Mich. 1919) (holding that "a business corporation is organized and carried on primarily for the profit of the stockholders.").

[4] Robert A. Wexler and David A. Levitt, Using New Hybrid Legal Forms: Three Case Studies, Four Important Questions, and a Bunch of Analysis, *Exempt Organizations Tax Review* January, 2012; Wexler, Effective Social Enterprise – A Menu of Legal Structures, *Exempt Organizations Tax Review*, June 2009; and Wexler Social Enterprise – a Legal Context, *Exempt Organizations Tax Review*, December 2006.

[5] *See* Mittermaier and Neugart, Operating in Two Worlds: Tandem Structures in Social Enterprise, *The Practical Lawyer*, Fall 2011; *see also* Allen R. Bromberger, A New Type of Hybrid, *Stanford Social Innovation Review* (Spring, 2011).

serves both a business and a social or charitable mission.

Most legal entities are either formed as a trust, a corporation, an unincorporated association, a partnership, or a limited liability company. Of these forms, states have created so-called hybrid forms of limited liability companies and corporations. The hybrid form of the LLC is known as the low-profit limited liability company or the L3C, and the hybrid forms of corporations include the Benefit Corporation (many states), the Flexible Purpose Corporation (only California so far), and the Social Purpose Corporation (only Washington state so far).[6]

Some confuse the "B Corporation" with the Benefit Corporation. B Corporation is a certification mark, similar to the Green Business mark, and it is monitored and issued by B Lab, a 501(c)(3) entity. It is available to L3Cs, Flexible Purpose Corporations, and Benefit Corporations, as well as other "non-hybrid" corporations that satisfy certain tests showing that they are socially responsible. I often advise my clients to consider B Corporation status, but it is not a form of legal entity, and therefore not discussed further in this Article.[7] I turn, then, to the L3C, Benefit Corporation, Flexible Purpose Corporation, and the Social Purpose Corporation.

A. The Low-Profit Limited Liability Company

An L3C is a form of limited liability company. As "LLC" stands for limited liability company, L3C stands for low-profit, limited, liability company. The additional "L" is for low-profit. L3Cs are currently authorized under the laws of nine states – Illinois,[8] Louisiana,[9] Maine,[10] Michigan,[11] North Carolina,[12] Rhode Island,[13] Utah,[14] Vermont,[15] Wyoming,[16] and as well as two Indian Nations – the Oglala Sioux Tribe[17] and the Crow Indian Nation of Montana,[18] with laws pending in several other jurisdictions.[19] Typically, L3C statutes

[6] Maryland has also adopted a form of Benefit LLC, which I do not address in this Article. See, Md. Corp. & Ass'ns §§4A–1101 through 4A–1108.

[7] See www.bcorporation.net for more information about this certification mark

[8] 805 ILCS 180/1-5, 805 ILCS 180/1-10, 805 ILCS 180/1-26, 805 ILCS 180/5-5.

[9] La. R.S. §§12:1301(A)(21), 1302(C), 1305(B)(3), 12:1306(A)(1), 1309(A).

[10] Me. Rev. Stat. Ch. 21, §§1502, 1508, 1559, 1611.

[11] Mich. Comp. Laws §450.4102.

[12] N.C. Gen. Stat. §§57C-2-01, 57C-2-21, 55D-20(a).

[13] R.I. Gen. Laws §§7-16-2, 7-16-9, 7-16-49, 7-16-76.

[14] Utah Code §§48-02c-412 and 48-02c-1411.

[15] Vt. Stat. Tit. 11, Ch. 21, §§ 3001(23), 3005(a) and 3023(a).

[16] Wyo. Stat. §17-15-102(a)(ix), *et seq.*

[17] Oglala Sioux Tribal Council Ordinance 09-23.

[18] Crow Law and Order Code §§18-5-102, 18-5-108, 18-5-705.

[19] For specific citations and legislative updates, see Carter G. Bishop *Fifty State Series: L3C and B Corporation*

refer and defer to the state's regular LLC statute, but add language along the following lines (this is from Vermont):

> "L3C" or "Low-profit limited liability company" means a person organized under this chapter that is organized for a business purpose that satisfies and is at all times operated to satisfy each of the following requirements.
>
> > (A) The Company: (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes.
> >
> > (B) No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.
> >
> > (C) No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D).

Note the somewhat awkwardly crafted language in (A) through (C) above and also extensive cross reference to the Internal Revenue Code. In order to understand this language, one must understand that these L3C provisions are drawn directly from Section 4944 of the Internal Revenue Code for program-related investments by private foundations. The presence of this language is no coincidence since the L3C was initially set up in order to attract program-related investments. A private foundation, which is one type of tax-exempt 501(c)(3) entity, may incur an excise tax if it makes investments that are considering jeopardizing. Investments that qualify as program-related investments are an exception to this rule – they are not jeopardizing investments.

Consider the following comparison of the Vermont statutory requirements for the L3C with the language from the Department of Treasury regulations on program-related investments:

Legislation Table (Legal Studies Research paper Series, Research Paper, 10-11, May 26, 2011), available at http://ssrn.com/abstract=1561783; *See also* Americans for Community Development, Legislative Watch, http//www.americansforcommunitydevelopment.org/legislativewatch.php (providing updates).

Concept	Vermont L3C	Internal Revenue Code
Promoting Charity	The Company: (i) significantly furthers the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170 (c)(2)(B); and (ii) would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes	The primary purpose of the investment is to accomplish one or more of the purposes described in Section 170(c)(2)(B).… An investment shall be considered as made primarily to accomplish one or more of the purposes described in Section 170(c)(2)(B) if it significantly furthers the accomplishment of the private foundation's exempt activities and if the investment would not have been made but for such relationship between the investment and the accomplishment of the foundation's exempt activities.
Imprudent Investment	No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.	No significant purpose of the investment is the production of income or the appreciation of property. However, the fact that an investment produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

Concept	Vermont L3C	Internal Revenue Code
No Politics	No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D)	No purpose of the investment is to accomplish one or more of the purposes described in Section 170(c)(2)(D).

Program-related investments can be made in the form of loans to for-profit or nonprofit entities or in the form of equity investments in for-profit entities, including LLCs. The creators of the L3C were searching, in part, for a way to make it easier for a private foundation to make a program-related investment into an LLC, hence the language in the authorizing statutes that is closely tied to the Internal Revenue Code requirements for program-related investments.

The L3C is, therefore, the for-profit vehicle into which a private foundation makes a program-related investment. The private foundation is a charitable entity that holds all of its assets for exempt purposes. The L3C is a business entity that can serve as a vehicle to further the private foundation's exempt purposes. Consider the following example of a classic program-related investment in a for-profit entity:

> Foundation A makes a program-related investment loan to a grocery store that is being established in a very poor neighborhood in a city. Clearly operating a grocery store is not a charitable activity, and the entity operating the store could not qualify either as a nonprofit corporation under state law or as tax-exempt. But the entity is furthering the charitable purpose of combating community deterioration and promoting public health, by operating a store in an urban area where the residents do not have access to healthy food and where jobs will be created. This language in the statute is confusing unless one is intimately familiar with program-related investments and private foundation law.

At the same time, there is nothing in the L3C laws that would prohibit an L3C from adopting exclusively charitable purposes that read exactly like the purposes of a 501(c)(3) entity. There is no actual requirement that an L3C have any for-profit business purpose at all, and therein lies the complexity of applying or not applying the charitable trust doctrine to the L3C. The corporate forms that are discussed below all require some type of prevailing business purpose.

Illinois is the only state that requires L3Cs to register with the Attorney General and takes the position that L3C assets are held in charitable trust.[20]

B. Benefit Corporations

The Benefit Corporations currently authorized in at least eleven states, with laws pending in several others.[21] The eleven states as of this writing are: California,[22] Hawaii,[23] Illinois,[24] Louisiana,[25] Maryland,[26] Massachusetts,[27] New Jersey,[28] New York,[29] South Carolina,[30] Vermont,[31] and Virginia,[32] with laws pending in Colorado,[33] Pennsylvania,[34] and the District of Columbia.

Although the various states have different variations on the Benefit Corporation, generally speaking, Benefit Corporations must have:

> *a. Purpose:* a business purpose and a corporate purpose to create a material positive impact on society and the environment;
>
> *b. Accountability:* an expanded fiduciary duty to require consideration of the interests of workers, community and the environment; and
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> *c. Transparency:* publicly report annually on overall social and environmental performance against a comprehensive, credible, independent, and transparent third party standard. (www.bcorporation.net)

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[20] S.B. 0239, 2009, 96th Gen. Assemb. (Ill. 2009-2010).

[21] For a current list see www.benefitcorp.net/state-by-state-legislative-status.

[22] Cal. Corp. Code §14600 *et seq*.

[23] Haw. Rev. Stat. §§420D-1–420D-1.3.

[24] 805 ILCS 40, effective as of Jan. 1, 2013.

[25] La. Rev. Stat. §§1801–1832.

[26] Md. Code, Corps. & Ass'ns §§5-6C-01 to -08.

[27] Mass. Gen. Law. Ch. 156E.

[28] N.J. Stat. §§14A:18-1 to :18-11.

[29] N.Y. Bus. Corp. Law §§1701–1709.

[30] S.C. Code §33-38-110 *et seq*.

[31] Vt. Stat. tit. 11A, §§21.01–08.

[32] Va. Code §§ 13.1-782–791.

[33] Colo. SB 12-182, Colo. SB 12-003.

[34] Pa. HB 1616, reg. sess. 2011-2012.

More specifically, in most states the Benefit Corporation may engage in any lawful business purpose PLUS must provide a general public benefit, which means having a material positive impact on society and the environment, taken as a whole, as measured by a third-party standard.

In addition, it can have one or more specific public benefit purposes, which does not limit its obligation to create a general public benefit. Specific public benefits include: (a) providing low income or underserved individuals or communities with beneficial products or services; (b) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business; (c) preserving or improving the environment; (d) improving human health; (e) promoting the arts or sciences or the advancement of knowledge; (f) increasing the flow of capital to entities with a public benefit purpose; and (g) the accomplishment of any other identifiable benefit for society or the environment.

Accordingly, one could form a Benefit Corporation with only the broad purpose of creating a general public benefit or with a significantly narrower purpose.

C. Flexible Purpose Corporation

A Flexible Purpose Corporation, which only exists in California at this time, is both similar to, and different from, a Benefit Corporation. Like the Benefit Corporation, it is designed to allow a corporation to take into account alternative purposes that do not involve pure profit making. Unlike the Benefit Corporation, which requires the corporation to consider the general public benefit (in addition to any specific public benefit that might be articulated), the Flexible Purpose Corporation requires the corporation to only consider the specific alternate purposes that are articulated in the corporation's Articles of Incorporation, rather than general public benefit, including the impact of decisions on purposes that may not be listed in the Articles, such as the environment, the community, creditors, and suppliers.

A Flexible Purpose Corporation may engage in any lawful business purpose PLUS one or more enumerated charitable or public purpose activities that could be carried out by a nonprofit public benefit corporation and / or the purpose of promoting positive short-term or long-term effects or minimizing adverse short-term or long-term effects upon any of the following: employees, suppliers, customers, creditors, the community, or the environment.[35]

D. Social Purpose Corporation

A Social Purpose Corporation is Washington State's version of the Flexible Purpose Corporation. It permits a corporation to articulate an alternative social mission in addition to a business purpose.[36] Similarly to Flexible Purpose Corporations, Social

[35] Corporate Flexibility Act of 2011, California Corporations Code Sections 2500 et. seq.; see *Everything You Ever Wanted to Know About the Flexible Purpose Corporation (And Then Some)*, businessforgood.org (March 7, 2011), http://businessforgood.blogspot.com/2011/03/frequently-asked-questions-proposed.html.

Purpose Corporations need only consider one or more social purposes that are articulated in its Articles of Incorporation, rather than an overall public benefit.[37] The social purposes must include promoting positive short-term or long-term effects or minimizing adverse short-term or long- term effects upon any one or more of the following: (a) its employees, suppliers, or customers; (b) the local, state, national, or world community; and/or (c) the environment. The Social Benefit Corporation may also specify additional special social purposes.[38]

The specific social purposes must be stated in the Articles of Incorporation.[39] The Articles of Incorporation of a Social Purpose Corporation must also include the following statement: "The mission of this social purpose corporation is not necessarily compatible with and may be contrary to maximizing profits and earnings for shareholders, or maximizing shareholder value in any sale, merger, acquisition, or other similar action of the corporation."[40]

This is the current landscape of hybrid legal entities. These are early days in the evolution of these entities, and there are no cases interpreting any of their provisions.

II. CHARITABLE TRUST LAW

The law of charitable trusts is regulated at the state level by state Attorneys General. Some of the law is statutory and some is common law. The United States Supreme Court has long recognized that charitable trusts are enforceable under common law, even absent a specific state statute.[41] Indeed, historically, Attorney General authority to uphold the terms of a charitable trust even pre-dates the Statute of Charitable Uses (1601 England).[42]

According to the commentary accompanying the Model Protection of Charitable Assets Act ("Model Act"), thirty-seven states have statutes related to the Attorney General's duty to monitor charitable assets, and five of those states have very limited authority. In the states that best regulate charitable assets some version of the 1954 Uniform Supervision of Trustees for Charitable Purposes Act ("Uniform Act") is the law.[43]

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[36] Section 23B et. seq. of the Washington Business Corporation Act.

[37] Was. Rev. Code §23B.25.040(1)(c).

[38] Was. Rev. Code §23B.25.020.

[39] Was. Rev. Code §23B.25.030

[40] Was. Rev. Code §23B.25.040(1)(e).

[41] Vidal v. Girard's Executors, 43 U.S. (2 How.) 127 (1844).

[42] Abbott and Kornblum, The Jurisdiction of the Attorney General Over Corporate Fiduciaries Under the New California Nonprofit Corporation Law, 13 U.S.F Law Rev. 753, 755 (1979).

[43] Arkansas, California, Illinois, Massachusetts, Michigan, Minnesota, New Hampshire, New York, Ohio, Oregon, Pennsylvania, Rhode Island, and Washington all have registration statutes separate from solicitation statutes. *See* Ark.Code Ann. 4-28-401 (2011); Cal. Govt Code 2580 et seq. (West 2011) (no threshold amount; exempts religious organizations, educational institutions, hospitals, health care service plans, and cemetery corporations); 760 Il. Comp. Stat. 55/1 et seq. (2011) (more than $4,000 in assets); Mass.Gen.

It is not possible in the scope of this Article to do a complete review of how every state addresses the charitable trust doctrine, through statute and common law. Accordingly, this Article focuses on California law. California is one of the states that most carefully and thoughtfully enforces charitable trust law, and therefore, if the new hybrid forms are not subject to charitable trust law in California, they should not be subject to it in most other states. In California, the charitable trust doctrine is not merely theoretical. Every time a nonprofit corporation seeks to dissolve, merge, modify its Articles of Incorporation to change its purposes, accept a gift restricted as to purpose, or sell assets, the organization must address the charitable trust issues involved.

A. California Law

The statutory framework in California is based on the 1954 Uniform Act, as updated and tailored to California, the Nonprofit Corporations Law, specifically the Nonprofit Public Benefit Law, dating from 1979, and in California's version of Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). When considering the charitable trust doctrine in California, it is helpful to consider four questions:

1.) What is the substance of the doctrine?
2.) To whom does the doctrine apply?
3.) Who can enforce the doctrine?
4.) Why do we have this doctrine?

1. What is the charitable trust doctrine?

The essence of the doctrine derives from the rich history of California case law. The

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Laws ch. 12, 8E (2011) (no threshold amount); Mich. Comp. Laws 14.251 et seq. (2011) (no threshold amount; exempts religious organizations, educational institutions, and hospitals); Minn. Stat. 501B.33 et seq. (2011) (assets of $25,000 or more; exempts religious associations, split-interest trusts); N.H. Rev. Stat. Ann. 7:19 (2011) (no threshold amount); N.Y. [Est. Powers & Trusts] Law 8-1.4 (2011) (total receipts or total assets more than $25,000); Ohio Rev. Code Ann. 109.26 (West 2011) (no threshold amount; exempts charitable remainder trusts and agricultural societies); Or. Rev. Stat. Ann. 128.610 et seq. (2011) (no threshold amount; exempts religious organizations, cemeteries, and certain child care agencies); 10 Pa. Cons. Stat. Ann. 379 (2011) ($25,000 or more of contributions a year or program service revenue equal to or exceeding $5 million; exempts religious institutions and organizations forming an integral part of a religious institution); R.I. Gen. Laws 18-9-6 (2010 (no threshold amount); Wash. Rev. Code Ann. 11.1110.51 (2011) (no threshold amount; exempts religious organizations and educational institutions with programs of instruction comparable to Washington public schools and universities).

Although Idaho does not require registration, it provides by statute that the Attorney General has the duty to supervise any person holding property subject to a charitable or public trust and to enforce the purpose of the trust. Idaho Code Ann. 67-1401 (2011). Idaho also provides that each person holding charitable assets is subject to examination by the Attorney General to ascertain the condition of its affairs and to what extent, if at all, said trustee or trustees may have failed to comply with trusts said trustee or trustees have assumed or may have departed from the general purpose for which it was formed. I*d. See also* Nev. Rev. Stat. Ann. 82.536 (West 2010); N.H. Rev. Stat. Ann. 7:24 (2011); S.D. Codified Laws 55- 9-5 (2010); Tex. Govt. Code Ann. 402.021 (Vernon 2011) (*See Hill v. Lower Colo. River Auth.*, 568 S.W.2d 473 (Tex. Civ. App. 1978) for case law that affords the Texas Attorney General authority to protect public charity trusts); Vt. Stat. Ann. tit. 9, 2479(b) (2011); Wyo. Stat. Ann. 17-19-170 (2010).

California Attorney General's Office takes the position, and case law supports this position, that the common law rules around the charitable trust were not supplanted by the statutory authority contained in the California Nonprofit Public Benefit Law[44] or in California's version of UPMIFA.[45]

In *Pacific Home v. County of Los Angeles*,[46] the California Supreme Court announced the application of the charitable trust doctrine to nonprofit corporations, regardless of specific donor expression:

> All the assets of a corporation organized solely for charitable purposes must be deemed to be impressed with a charitable trust by virtue of the express declaration of the corporation's purposes, and <u>notwithstanding the absence of any express declaration by those who contribute such assets as to the purpose for which the contributions are made</u>. In other words, the acceptance of such assets under these circumstances establishes a charitable trust for the declared corporate purposes as effectively as though the assets had been accepted from a donor who had expressly provided in the instrument evidencing the gift that it was to be held in trust solely for such charitable purposes. (Emphasis added.)

As initially formulated in *Pacific Home*, the charitable trust doctrine looked to language in Articles of Incorporation and other formal manifestations of declared corporate purposes. The court reasoned that donor intent and donor restrictions need not be express but could be inferred from donee representations that are written and formal.

Eleven years later, the California Supreme Court took the next step in expanding the charitable trust doctrine when it dropped the requirement that donee representations be written and formal and accepted them as equivalent to express donor restrictions even where they were oral and informal. Thus, a college of osteopathic medicine could not change to become a college of allopathic medicine when it had "held out to the public" that it was a college of osteopathic medicine and "solicited and received donations for use in teaching . . . osteopathy." *Holt v. College of Osteopathic Physicians and Surgeons*.[47]

Then, in *Queen of Angels Hospital v. Younger*,[48] the court broadened the application of the charitable trust doctrine to encompass a wide array of donee acts and representations. The court considered the language of the Articles of Incorporation, which included the name "Queen of Angels Hospital" and a hospital purpose clause. The court also noted that Queen had operated a hospital since 1927 and stated:

> Queen also represented to the public that it was a hospital. In its statement to the

[44] *See generally*, Abbott and Kornblum, at 754.

[45] *See* California Probate Code Sections 18501 *et. seq.*

[46] 41 Cal.2d 844, 852 (1953).

[47] 61 Cal. 2d 750 (1964).

[48] 66 Cal. App. 359, 368 (1977).

> Franchise Tax Board, it stated that it was in the "business of running a hospital." Similar statements were made to the Internal Revenue Service and Los Angeles county tax authorities. Funds were solicited from the public for the hospital or hospital purposes. Such acts further bind Queen to its primary purpose of operating a hospital.[49]

The result, in *Queen of Angels*, was that a charitable organization that operated a hospital and raised funds based on its representations as a hospital, was prevented from abandoning the operation of a hospital and operating a medical clinic instead.[50]

The California cases are quite fascinating, but for purposes of the balance of this article, a summary of their findings should suffice:

- A donor's charitable contributions to a nonprofit corporation are subject to any valid legal restriction imposed by the donor at the time of contribution. These restrictions impose a charitable trust on the assets, binding on the charitable recipient.[51] Most states accept this principle.

- Even where a donor imposes no express restriction, assets accepted by a nonprofit corporation are restricted by operation of law and may only be used for the charitable purposes. Most states would agree with this principle.

- Even where a donor imposes no express restriction, assets accepted by a nonprofit corporation are restricted by operation of law and may only be used for **specific** charitable purposes, if any, set forth in the corporation's Articles of Incorporation.[52] Not all states have adopted this principle.

- These restrictions apply not only to contributions and donations received and accepted by a nonprofit corporation but also to revenues generated by it from the performance of its charitable activities. Revenues, like contributions, are impressed with a charitable trust and may only be used for the charitable purposes set forth in the Articles of Incorporation at the time the revenues are received.[53] Most states agree that revenues are limited to use for general charitable purposes; only some states limit use to purposes stated in the Articles.

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[49] *Id.*

[50] See also *In Re Metropolitan Baptist Church of Richmond, Inc.*, 48 Cal. App. 3d 850 (1975) (representing itself as a fundamentalist Baptist church located in Richmond, California, the church was prohibited from distributing its assets on dissolution to distant Baptist churches and required to distribute them to fundamentalist Baptist churches nearest geographically to Richmond).

[51] *See* In Re L. A. County Pioneer Society, 40 Cal.2d 852, 864-865 (1953).

[52] In re Metropolitan Baptist Church of Richmond, Inc., 48 Cal. App. 3d 850, 857 (1975), *citing* Lynch v. Spilman, 67 Cal. 2d 251, 260; In re L.A. County Pioneer Society, 40 Cal. 2d. 852, 860; and *Estate of Clippinger*, 75 Cal. App. 2d 426, 433).

[53] *See* Queen of Angels Hospital v. Younger, 66 Cal. App. 3d. 359 (1977).

- Charitable trust restrictions, once imposed, continue to apply to assets impressed with a charitable trust even if a corporation later changes its purposes, dissolves and distributes its assets, or transfers its assets to another charity without receiving full consideration. Charitable restrictions, once imposed, also continue to apply to the proceeds from the sale or lease of any charitable assets.[54]

- A nonprofit corporation is free to change its charitable purpose by amending its Articles of Incorporation, but such a change applies only to later-acquired funds, not to existing assets.[55] The Revised Model Nonprofit Act does not appear to accept the notion that assets acquired by a nonprofit corporation at a time when its Articles contain a specific charitable purposes (without a donor restriction) remain subject to that specific purpose even if the Articles are later amended.[56]

The charitable use of existing assets can be changed only where there is a general charitable purpose and the specific charitable use has become illegal, impossible, or impracticable. In that case, the doctrine of *cy pres* requires the assets to be used for a charitable purpose that is as near as possible to the original charitable purpose.[57] In certain circumstances, the donor may include in the initial gift a variance power, empowering the donee charity to alter the specific purposes of the gift if the governing body of the charity determines that such later alteration is warranted by changed circumstances.

2. To whom does the doctrine apply?

In California, the Uniform Act applies to "all charitable corporations, unincorporated associations, trustees, and other legal entities holding property for charitable purposes, commercial fundraisers for charitable purposes, fundraising counsel for charitable purposes, and commercial co-venturers, over which the state or the Attorney General has enforcement or supervisory powers."[58] The term "Charitable Corporation" means any nonprofit corporation organized under the laws of California for charitable or eleemosynary purposes and any similar foreign corporation doing business or holding property in California for such purposes.[59] Accordingly, as we routinely advise clients, Delaware corporations with charitable assets in California are still subject to the Attorney General's jurisdiction.

Nothing in this language, therefore, precludes a for-profit entity, including a hybrid, from holding assets in charitable trust.

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54 *See, e.g.*, Pacific Home v. County of Los Angeles, 41 Cal.2d 844, 854 (1953).

55 *See* In Re Veterans Industries, Inc., 8 Cal. App. 3d. 902

56 *See* Revised Model Nonprofit Corp. Act. 11.01 (1987).

57 *See* In re Los Angeles County Pioneer Soc. 40 Cal.2d 852, 865-866 (1953).

58 Government Code Section 12581

59 Government Code Section 12582.1.

3. Who can enforce the doctrine?

California Government Code Sections 12588 and 12591 are the centerpiece of the Attorney General's authority over charitable assets. They provides as follows:

> The Attorney General may investigate transactions and relationships of corporations and trustees subject to this article for the purpose of ascertaining whether or not the purposes of the corporation or trust are being carried out in accordance with the terms and provisions of the articles of incorporation or other instrument. He may require any agent, trustee, fiduciary, beneficiary, institution, association, or corporation, or other person to appear, at a named time and place, in the county designated by the Attorney General, where the person resides or is found, to give information under oath and to produce books, memoranda, papers, documents of title, and evidence of assets, liabilities, receipts, or disbursements in the possession or control of the person ordered to appear.[60]
>
> The Attorney General may institute appropriate proceedings to secure compliance with this article and to invoke the jurisdiction of the court. The powers and duties of the Attorney General provided in this article are in addition to his existing powers and duties. Nothing in this article shall impair or restrict the jurisdiction of any court with respect to any of the matters covered by it, except that no court shall have jurisdiction to modify or terminate any trust of property for charitable purposes unless the Attorney General is a party to the proceedings.[61]

The California Nonprofit Public Benefit Law ("CNPBL"), which is part of the California Corporations Code, provides additional specific authority for the Attorney General to enforce the charitable trust in connection with California Nonprofit Public Benefit Corporations. Section 5250 provides as follows:

> A corporation is subject at all times to the examination by the Attorney General, on behalf of the state, to ascertain the condition of its affairs and to what extent, if at all, it fails to comply with trusts which it has assumed or had departed form the purposes for which it was formed. In the case of any such failure or departure the Attorney General may institute, in the name of the state, the proceeding necessary to correct the noncompliance or departure.

In addition, CNPBL Section 5142 provides that the Attorney General, the corporation itself, the members (if any), the directors and the officers, and persons with reversionary or contractual rights, may also bring actions for the breach of the charitable trust. In an action not otherwise involving the Attorney General, the Attorney General must be notified and given the opportunity to intervene.

A number of other provisions in the CNPBL provide the Attorney General with either

[60] Government Code Section 12588

[61] Government Code Section 12591

notice or approval rights over significant corporate changes, in part to ensure that corporations do not circumvent their charitable trust obligations by amending their Articles, merging, dissolving, or transferring substantially all of their assets.

4. Why do we have this doctrine?

We have the charitable trust doctrine, and we give the Attorney General the authority to enforce it, quite simply to protect donors who donate money to a charity, to protect "customers" who purchase or receive goods or services from a charity, and to protect the charities themselves, from the misuse, whether intentional or not, of charitable assets. Charities, whether organized as trusts or as corporations do not have owners with a personal financial interest in the charity, who will look out for their own interests, and therefore, the Attorney General steps in as the protector of the assets. "The placement of these [enforcement] powers with a public official grew out of necessity since by definition the beneficiaries of the charitable trusts are indefinite and are therefore unable to enforce the trusts on their own behalf."[62] More often than not, the charitable trust doctrine comes into play when a charity has a "life changing" event, such as a dissolution, merger, or transfer or sale of substantially all of its assets, but it can also, at times, be relevant in day to day operations.

The Prefatory Note to the Model Act also notes that it is, indeed, in the charitable sector's best interest to be so regulated:

> Public confidence in charities will help maintain the vibrancy of the charitable sector. If potential donors worry that charities will misuse contributed funds, donors are unlikely to contribute. The good work charities do will suffer if reports of abuse, fraud, or other types of misbehavior reduce public confidence in the sector.[63]

III. APPLICABILITY TO HYBRID ENTITIES

This section of the Article examines the question of whether the charitable trust law, as it currently exists, even in the most rigorous enforcement states, like California, applies to some or all of the assets held by for-profit hybrid entities. This section examines first what the Model Act, which came about at a time when hybrids already existed, says about this issue. Next it applies the charitable trust law analysis to specific hybrid legal entities.

A. Model Protection of Charitable Assets Act

In July 2011, the National Conference of Commissioners on Uniform State Laws proposed the Model Protection of Charitable Assets Act. The Commissioners encourage states, especially states without laws enabling the regulation of charitable assets, to adopt this law. For our purposes the most interesting question is how the Commissioners, viewing the drafting of a new law in 2011, view its application to new hybrid forms.

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[62] Abbott and Kornblum, at 755, *citing*, *Holt v. College of Osteo. Phys. & Surg.*, 61 Cal. 2d. 750 (1964).

[63] Prefatory Note to the Model Act, page 2.

In fairness, the Model Act is very well constructed, and consideration of whether to apply the charitable trust doctrine to for-profit corporations was not its primary mission. With respect to for-profit entities holding assets for charitable purposes, the commentary to the Act contains three somewhat inconsistent provisions:

> 1.) The commentary to the Model indicates that "[t]he Act does not cover private businesses except to the extent that those entities hold charitable assets."[64]
>
> 2.) Later the commentary indicates that the Attorney General authority does not depend on "organizational form of the person holding the assets." It can even extend to a for-profit corporation, citing *Lifespan Corp. v. New England Medical Center* (2010).[65]
>
> 3.) But the commentary also indicates that "the definition of charitable purpose does not include property held in benefit corporations or in low profit, limited liability companies (L3Cs) unless the L3C has a purpose that is primarily charitable."[66]

Looking at the actual language in the Model Act, only charitable assets are subject to Attorney General supervision. Section 2 of the Act defines "charitable asset" as "property that is given, received, or held for a charitable purpose. The term does not include property acquired or held for a for-profit purpose." This begs the question as to when a for-profit can hold assets that are not for profit purposes. In addition, the commentary to Section 2 makes it clear that to constitute a charitable asset, property must be irrevocably dedicated to a charitable purpose. This suggests that property that may be used for a charitable purpose, but is not required to be used for a charitable purpose, is not a charitable asset. Consider the following commentary:

> The property need not be held in perpetuity for a charitable purpose but must be irrevocably committed to a charitable purpose. The term "charitable asset" means that property will be used, whenever it is used, for charitable purposes and cannot be diverted from the charitable stream. The remainder interest in a charitable remainder trust is property held for a charitable purpose, as is the current interest in a charitable lead trust, property held for ten years in a building fund, and property given to a charity subject to a restriction on its use. Property held in a revocable trust that provides a remainder interest for a charitable purpose is not a charitable asset because the settlor can revoke or change the interest.[67]

The Act defines "charitable purpose" as "the relief of poverty, the advancement of education or religion, the promotion of health, the promotion of a governmental purpose, or any other purpose the achievement of which is beneficial to the community." According to the

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[64] See June 2, 2011 final discussion draft, Text and Comments, Preface, page 6.

[65] See June 2, 2011 final discussion draft, Text and Comments, Comment to Section 3, page 5.

[66] See June 2, 2011 final discussion draft, Text and Comments, Comment to Section 2, page 3.

[67] See June 2, 2011 final discussion draft, Text and Comments, Comment to Section 2, page 2.

drafters, "beneficial to the community" is not as broad as it sounds. The concept really is intended to include activities that are "considered charitable and not merely beneficial," which, in the context of the question at hand, is a bit of a circular definition. It does not appear to be the intent of the Commissioners, however, to provide that any activity that is beneficial establishes a charitable trust.

While the Commissioners made an attempt to discuss how the charitable trust rules might apply to new hybrid forms, in the end, they did not provide a definitive answer.

B. Application of Charitable Trust Law

First of all, legal entities can be subject to the jurisdiction of a particular state's Attorney General under a variety of statutes or common law principles, including consumer protection statutes, commercial fundraising statutes, charitable solicitation statutes, commercial co-venture statutes, and many others. These other laws are not addressed. Indeed, one of the compelling arguments for why the charitable trust rules need not apply to for-profit hybrids is precisely because all of these other statutes continue to apply regardless. For example, if a Benefit Corporation sells a product on the promise of giving a portion of the proceeds to a charity, then it is a commercial co-venturer, already regulated by most states and deemed to hold the assets that it promises to give to charity in charitable trust.

How does one determine whether the charitable trust doctrine applies to assets held by hybrid legal entities? It seems to me that even in states that stridently enforce charitable trust laws, the assets of a for-profit entity, however, are only impressed with a charitable trust, and therefore subject to Attorney General regulation under the charitable trust doctrine, where:

1.) There is specific statutory authority so that the statute under which the entity is formed specifically provides that the entity's assets are subject to a charitable trust, and presumably requires some type of filing with the Attorney General; or

2.) Another statute, typically the one authorizing Attorney General supervision over charitable assets (such as the Uniform Act or the Model Act), or in the absence of a statute well-established case law, provides that assets held for charitable purposes are subject to a charitable trust AND there is in fact some evidence that the entity actually holds assets for charitable purposes, either because:

a. The entity represents to its contributors/donors, at the time it seeks contributions, that their contributions are for one or more charitable purposes; or

b. Even if the entity says nothing, its organizing documents contain provisions limiting the use of its assets for charitable purposes at the time when a donation is made or when revenue is earned (and the entity operates in a state, like California, that looks both at donor intent and at the language in the organizing documents).

1. Specific Statutory Authority Creating a Charitable Trust and Enforcement

Aside from Illinois' regulation of the L3C, none of the states specifically provided the Attorney General with statutory authority over hybrid legal entities on the basis of charitable trust. The Illinois L3C statute provides as follows:

> 1-26(d) Any company operating or holding itself out as a low-profit limited liability company in Illinois, any company formed as a low-profit limited liability company under this Act, and any chief operating officer, director, or manager of any such company is a "trustee" as defined in Section 3 of the Charitable Trust Act.

Accordingly, Illinois does treat an L3C as holding assets in charitable trust. It is the only state to date that has this requirement.

For states other than Illinois, is there anything in the **statutory language** that definitively establishes a charitable trust (regardless of what the organizing documents say and regardless of what is said to donors and consumers)? If we compare the articulation of purposes in the typical L3C, Benefit Corporation, and Flexible Purpose Corporation statutes, we find the following:

> **L3C:** The L3C must "significantly further the accomplishment of one or more charitable or educational purposes" and the L3C "would not have been formed but for the company's relationship to the accomplishment of charitable or educational purposes."
>
> **Benefit Corporation:** The Benefit Corporation can engage in any lawful business purpose. In addition, it must provide a general public benefit, which means a material positive impact on society and the environment, taken as a whole, as measured by a third-party standard. In addition, it can have one or more specific public benefit purposes, which does not limit the obligation to create a general public benefit. Specific public benefits include: (a) providing low income or underserved individuals or communities with beneficial products or services; (b) promoting economic opportunity for individuals or communities beyond the creation of jobs in the normal course of business; (c) preserving or improving the environment; (d) improving human health; (e) promoting the arts or sciences or the advancement of knowledge; (f) increasing the flow of capital to entities with a public benefit purpose; and (g) the accomplishment of any other identifiable benefit for society or the environment.
>
> **Flexible Purpose Corporation:** The Flexible Purpose Corporation can engage in any lawful business purpose. In addition it must have one or more enumerated

> charitable or public purpose activities that could be carried out by a nonprofit public benefit corporation **and / or** the purpose of promoting positive short-term or long-term effects or minimizing adverse short-term or long-term effects upon any of the following: employees, suppliers, customers, creditors, the community, or the environment.

Starting with these two corporate forms – Benefit Corporation and Flexible Purpose Corporation – there is absolutely nothing in the statutory language that **requires** these entities to have a charitable purpose, at all. Clearly a public benefit is not the same as a charitable purpose. Each has the option of listing one or more charitable purposes, but none is required. It would be a mistake, therefore, to assert that simply because of the statutory language, either or both of these corporate forms **necessarily** holds any assets in a charitable trust or should be subject to Attorney General jurisdiction with respect to charitable assets. In the next section, this Article explores situations in which either or both of these corporate forms might make themselves subject to a charitable trust based on what they actually write into their Articles of Incorporation or based on what they actually say to investors or donors, but, to be clear, unlike with a nonprofit public benefit corporation where all assets are and must be held for charitable purposes, nothing in these statutes requires that any assets be held for charitable purposes.

In addition, the fact that the Articles of Incorporation of a Benefit Corporation or Flexible Purpose Corporation permit the directors to consider both business purposes and, taking the most narrowly drafted Articles, a specific charitable purpose does not mean that the directors are required to engage in charitable activities or hold any particular assets for charitable purposes. If any assets can be used either for charitable or non-charitable purposes, with no obligation to use any specific assets or percentage or amount of assets for charity, how can they said to be held in charitable trust?

The L3C is more complicated because the statute uses the rather abstract language that indicates that the purposes of the L3C, and therefore, presumably its assets, must be applied to "significantly further the accomplishment of one or more charitable or educational purposes." Can an entity have assets that are used to accomplish a charitable purpose but that are not themselves held in charitable trust or dedicated to charitable purposes? YES. We know that this is true because charitable grantmaking foundations often make grants to for-profit entities because the grant will further the charitable purposes of the grantmaker, even though the grant itself is used by the for-profit grantee as part of a business. This principle is best illustrated by example:

> Foundation A makes a grant to a bank in a poor neighborhood in order to combat community deterioration in the neighborhood. The fact of having a bank in that neighborhood, (or a grocery store, or a doctor) helps the neighborhood and therefore is a charitable use of funds for the foundation. The business receiving the funds is simply running a business.

This is the typical scenario for a program-related investment, and the program-related investment is the main reason that L3Cs were established. In short, Illinois notwithstanding, there is a clear difference between using money and other assets to further a charitable purpose and actually using money and other assets as part of a charitable activity. It is this distinction that dictates why the L3C should not be deemed to automatically hold assets for charitable purposes and in charitable trust. Moreover, to say that assets are all held for charitable trust purposes would be entirely inconsistent with the statutes that permit profits and indeed the assets to be distributed back to the owner on dissolution.

In short, absent a statute that labels these assets as charitable trust assets, as in Illinois, I believe that none of the assets of a for-profit hybrid are automatically impressed with a charitable trust.

2. Charitable Trust Statutes Plus Language or Other Evidence

If we assume that a hybrid corporation or an L3C is established in, or holds assets in, a state with clear charitable trust enforcement, such as California, then the more subtle and interesting question is under what circumstances assets held by hybrid entities will be deemed to be held in charitable trust either because of what the entity's Articles of Incorporation say or because of what the entity says to its funders. The factual question then becomes whether the entity has actually done anything to establish a charitable trust that can now be imposed and enforced. As the case law discussion above indicates, in California, an entity – any entity – can establish a charitable trust by accepting money from a donor that is charitably restricted, by including language in its organizing documents that requires it to hold assets for general or specific charitable purposes, or by representing to consumers that their purchase of goods or services will result in funds going to charity.

Consider the following examples:

> **Example 1:** An L3C is established in Vermont, but does all of its business in California. It is established for the benefit of an existing nonprofit charitable corporation that is already subject to Attorney General jurisdiction in California, in order to hold title to some donated real property. The member corporation will conduct its operations on the real property, but title is held in the L3C. The L3C organizing documents articulate exclusively charitable purposes and irrevocably dedicate its assets for charitable purposes. The entity could qualify itself for tax-exempt status, but instead elects to be treated as a disregarded entity for tax purposes.
>
>> ***Analysis:*** Any such entity would certainly hold assets subject to a charitable trust and should be required to register with, and be monitored by, the Attorney General. More and more, tax-exempt 501(c)(3) entities are setting up wholly owned LLCs and L3Cs in order to hold real estate or other potentially high liability assets. These assets can be donated directly to the L3C or the LLC. In this situation, cases such as *Queen of Angels* would require that the assets of the L3C be held in charitable trust because of the express language in the L3C organizing documents that prohibits anything other than

> charitable uses, irrevocably.

Example 2: An L3C is formed to operate a social enterprise. It will operate restaurants for the primary purpose of training troubled teens how to gain important job skills. This activity could qualify for tax-exempt status if operated in a nonprofit corporation, but the L3C needs investors to fund the construction of the restaurants. The L3C seeks private investors and also private foundation program-related investments.

The L3C's organizing documents contain the following language:

> This organization is established to own and operate restaurants for the primary purpose of training troubled teens to have life skills and to find careers. It shall at all time engage in activities that would qualify as charitable under Section 501(c)(3) of the IRC.
>
> ***Analysis:*** This entity has created a contractual obligation with its investors and with those who purchase products and services from it to only engage in a job training program that could qualify under Section 501(c)(3). Does this language create a charitable trust that the Attorney General, not simply investors, could enforce against the organization? Without the irrevocable dedication of assets clause, it would be hard for an Attorney General to assert charitable trust jurisdiction here. The L3C statute permits investors to profit and permits the L3C to dissolve and return capital to investors. As the commentary to the Model Act provides, assets are only charitable assets if they are irrevocably dedicated to charitable purposes. This L3C, unless organized in Illinois, should not be deemed to hold assets subject to a charitable trust. During its existence, it is contractually obligated to operate in a manner that would qualify as charitable under Section 501(c)(3), but it is free at any time to dissolve or to distribute profits from its business to its members. None of the cited cases would work to impress these assets with a charitable trust.

Example 3: Happy Earth, a Benefit Corporation operates a clothing company. Its Articles of Incorporation contain the following language:

> This corporation is a California Benefit Corporation. The purpose of the corporation is to engage in any lawful act or activity for which a corporation may be organized under the General Corporation Law of California other than the banking business, the trust company business or the practice of a profession permitted to be incorporated by the California Corporations Code. The Specific public benefit purpose of this corporation is to defend and protect the environment in the United States and around the world.

Happy Earth now does the following:

> 1.) Happy Earth discloses to potential shareholders, at the time it offers shares for sale, that its mission is to operate a clothing store in an environmentally friendly way, even if this means less profits for shareholders and that it intends to make charitable contributions, from time to time, to environmental organizations, even if this cuts into dividends. If you buy shares, you do so understanding that this corporation is not set up to maximize profits and is dedicated to helping the earth. Shareholders are given a copy of the Articles of Incorporation.
>
> 2.) Happy Earth tells customers about its mission and encourages customers to buy from Happy Earth in order to benefit the environment. It markets itself as a Benefit Corporation that cares about the environment.
>
> 3.) Happy Earth tells customers that for every pair of jeans purchased in April 2013, it will donate $10 to the Environmental Organization X.
>
> 4.) In addition, in December 2013, the Board of Directors decides to donate 20% of the net profits of Happy Earth to Organizations Y and Z.

Happy Earth reports all of this activity to its shareholders in accordance with the Benefit Corporation reporting requirements.

> ***Analysis:*** Nothing in the Articles of Incorporation creates a charitable trust. Having the option or the right to use corporate funds to protect the environment does not create a charitable trust under any example of existing case or statutory law.
>
> Similarly, nothing about the way in which shares are offered for sale creates a charitable trust, and nothing about the way in which products are marketed or sold in number 2 creates any charitable trust over revenues earned from customers.
>
> In number 3, Happy Earth has now engaged in a commercial co-venture with Charity X. $10 per pair of jeans is clearly now held for the benefit of Charity X, and Happy Earth has a legal obligation to transmit that money to Charity X. In some states, of course, commercial co-venture laws would also require registration and / or reporting and / or use of a particular contract form. In some states a bond is even required. In California, and other states with solid commercial co-venture laws, we know that the Attorney General has the right to enforce this obligation, but this does not give the Attorney General supervisory rights over the entire corporation, only those assets that are specifically committed to charity under the co-

venture agreement.

In number 4, the 20% donation at the end of December, however, is optional and not something that is otherwise regulated.

In my view, this Example 3 is going to be the most typical way in which a Benefit Corporation is organized and used, and absent a specific fundraising effort, like the commercial co-venture in number 3, there would be no charitable trust created.

Example 4: It is now 2014, and Happy Earth is doing well and doing good work. The Board decides to step up its good works by locking in future boards. With the consent of the shareholders, the Board amends the last sentence of the purposes clause of the Articles, which now reads:

The specific public benefit purpose of this corporation is to defend and protect the environment in the United States and around the world, and each year no less than 25% of the net profits of this organization will be donated to environmental charities that are tax-exempt under IRC Section 501(c)(3).

Analysis: This example creates one of the most difficult fact patterns we are likely to face. Has Happy Earth taken an optional charitable activity and now converted it into a charitable trust obligation by indicating that at least 25% of the profits will go to charity? Is this promise akin to a commercial co-venture arrangement or is it akin to impressing a charitable trust on 25% of the profits of Happy Earth? My lawyerly advice to Happy Earth would be not to draft its Articles in a way that creates this potential mess. But if this were done, I would probably argue – if I were a state Attorney General – that Happy Earth has created a charitable trust because the Articles specifically allocate a portion of the assets for charitable purposes. I would argue that these specific assets, that is 25% of net profits must be donated to environmental charities.

Example 5: Let's Get Back to Work is a California Flexible Purpose Corporation ("FPC") that operates an auto repair shop and hires formerly homeless men and women who have already worked through two-year job training programs. It offers them permanent employment with good working conditions.

The FPC's Articles of Incorporation say that it is operated for any legal business purpose and also to provide a place for formerly homeless men and women to have permanent employment in a worker friendly atmosphere. Its repair shop is going to be built in a deteriorating part of town in order to provide local jobs and boost that area of the town.

The FPC is capitalized by five local businessmen and women. In addition, the FPC needs even more capital to build its new garage, and Private Foundation X makes a grant to the FPC of $300,000 because it believes that building a garage to provide employment for the homeless furthers the foundation's charitable mission, even though the garage will be operated as a for-profit.

> ***Analysis:*** I do not believe that anything in Example 5 establishes a charitable trust. The grant from Private Foundation X will likely contain some contractual obligations between the two entities so that if the FPC does not use the money for the stated purposes, Private Foundation X can sue it, but the fact of the grant does not create a charitable trust over those funds. The funds are used for business purposes that happen to also further Private Foundation X's charitable mission. This is a classic grant to a for-profit. If this were an equity investment in the form of program- related investment, the answer would be the same.

IV. WHAT SHOULD THE LAW BE?

It would be a huge mistake to take a position that hybrid legal entities hold assets in a charitable trust, absent some specific representation made to donors or consumers or absent specific language in the organizing documents. Hybrid entities should only be deemed to hold assets in a charitable trust in the following situations:

1. They request contributions or they fundraise for a specific charitable purpose, much like a mutual benefit trade association or social club could raise funds for such a purpose. In that case only those funds should be subject to a charitable trust. These hybrid entities are unlikely to fundraise, other than from foundation grantors, because they do not offer a charitable contribution deduction.

2. They deliberately or mistakenly draft their organizing documents in a manner that specifically restricts a portion of their funds for charitable purposes, as in example 4 above.

Other than in these two circumstances, then, why do we not want the charitable trust doctrine to apply to for-profit hybrids? Two reasons: **practicality and policy.**

A. Practicality

As a practical matter, Attorneys General do not have the people power or time to enforce existing problems in nonprofit organizations. As the preamble to the Model Act suggests, "… in 2007 attorneys staffing state offices (generally those of the Attorneys General) varied from 20.5 attorneys in New York, to 12 in California and Pennsylvania, to no attorneys assigned to this function in 17 states. Some 79% of the states had one or fewer full-time equivalent attorneys devoted to charitable oversight. [citation omitted] … These officials are dedicated professionals but the limited number of these officials and the limited information available in most states make it difficult, if not impossible, to focus on cases warranting attention, or even to respond to complaints." My personal experience is consistent with this statement. When an Attorney General's Office does investigate a charitable trust problem, it tends to do so thoroughly and capably. However, the lack of people power makes it impossible for these officials to investigate anything more than the most egregious cases, and then only when those cases are called to their attention via a complaint or news story.

B. Policy

As a matter of policy, we want to encourage businesses to be socially responsible, to help society, while making money. It may sound overly simplistic, but we simply do not want to send the message that if a business wants to do good and chooses to adopt an alternate corporate form, then it becomes subject to an additional regulatory regime that would not otherwise apply to a for-profit business. All of these statutes already have increased reporting to shareholders; that should be sufficient.

We also already have laws that regulate the conduct of for-profit businesses, including securities laws, consumer protection laws, commercial fundraiser laws, commercial co-venture laws, and the like. If we do not feel that these laws are working, then we need to strengthen these laws for all businesses, but not single out the few businesses that are trying to do good.

If the point of the charitable trust doctrine is to protect an indefinite and unorganized class of beneficiaries, then it does not apply where a corporation or L3C has shareholders or members.

V. CONCLUSION

In conclusion, I believe that we need to think about these new for-profit hybrid forms as for-profit entities, not as charitable entities. We should regulate them in the same way that we regulate all for-profit entities in a properly structured legal system.

Consider again the four voices from the Introduction, and how they may be swayed by the analysis in this Article:

> **The Practicing Lawyer:** I need to be careful about how I set up a hybrid entity. If the entity wants to raise money or sell products or services by promising to dedicate a fixed percentage of funds or a specific amount of money for charity then it may beimpressing those assets with a charitable trust. Otherwise, I need to advise my client that if it engages in any commercial co-venture activities or commercial fundraising activities, it needs to comply with statutes in the different states in which it operates. I still believe, however, that a hybrid that merely has the option, but not the requirement, to engage in more charitable or public activity than would be appropriate for a purely profit making entity should not be subject

to a charitable trust.

The Regulator: Hybrid corporations have shareholders, and L3Cs have members. These owners are allowed to profit from the hybrid, and they are present to make sure that the hybrid is fulfilling its dual mission of profit and good. Because there are owners with a stake, and not an undefined class of charitable beneficiaries, we do not need to regulate these entities unless they cross the line and commit fraud, violate securities laws, violate other consumer protection laws, or specifically designate certain assets as charitable.

The Nonprofit Executive Director: I am still worried about these entities, but I understand now that there are existing laws that will regulate them.

The Scholar: Everything the Author says makes perfect sense to me.