Challenges And Interests Of The States In Social Mission / Hybrid Organizations

State Attorney General Regulation Of Charitable Hybrid Forms:
To Be Or Not To Be Charitable

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INTRODUCTION

One of the most significant challenges for state officials responsible for regulating charities in their state is how to approach their duties with regard to the growing trend of hybrid enterprises and business forms. More specifically, there are questions about whether these new forms are more like charitable trusts and should be treated as such, if they are more like profit-oriented tax paying enterprises and should be so treated, or if they are something so new and different that they require some combination of the two or wholly original approaches.

Of course, the uncertainty of charity officials and potential inconsistency in their approaches create corresponding problems for social enterprises, entrepreneurs who start and grow them, investors who support them, and various practitioners who advise them. Investors generally like to reduce or at least identify and control for uncertainty in order to maximize their financial or other returns. Creditors want to know and understand their lending environment as they seek to ensure that the money they lend will be put to productive and fruitful uses and, more importantly, that they will be able to get their money back with the predicted and agreed upon return so that they can re-circulate those funds and pay their own depositors and investors. Entrepreneurs and business managers need access to financial, human, and other capital to start and grow their enterprises. Degrees of predictability and consistency facilitate their ability to do so, even as entrepreneurs innovate and pursue new opportunities that may inherently disrupt the status quo – including by developing new forms and structures for doing so.

Such doubts and uncertainties are not bad in themselves; they are an important part of progress and innovation. New circumstances create new opportunities for any number of

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advances, mischief, or abuse. It is the response to those circumstances that will dictate whether society is allowed to advance while managing potential downside or if the threats are deemed so great that regulation must effectively obscure and prevent opportunities for advancement.

Thus, the key question is not whether hybrid forms whose purposes and activities include pursuing charitable outcomes should be regulated but rather how they should be regulated, particularly in the absence of direct guidance from the legislature. One approach would treat all charitable hybrid forms as charitable trusts, corporations, or associations. An alternative would regulate these entities as other for-profit, tax-paying organizations even though there may be differences in fiduciary duties and ultimate objectives. A critical related question is whether lawmakers should proactively bring charitable hybrid forms under the realm of charitable trust law by statute if such regimen would not otherwise apply.

Among hybrid forms, the questions most clearly apply to the low profit limited liability company, whose primary objectives must be to further charitable purposes. However, the question affects the flexible purpose and benefit corporation forms because, at a minimum, charitable purposes are a subset of the social good that these latter forms more broadly identify as permissible.

At a different level, the questions also affect the general public more broadly as it seeks to understand these forms and whether or how they might adopt them, including efforts to define what constitutes “charitable purposes” and what deserves special tax treatment. An essential concern for the general public is ensuring accurate understandings of how contributions to these various forms differ from contributions to charitable enterprises exempt from taxation under 501(c)(3). Nomenclature will not be enough, and there must be ways to hold fundraisers and operators of hybrid forms accountable for contributing to and/or abusing confusion that might exist.

Although understandable to want to regulate these forms as if charitable trusts or otherwise subjected to charitable oversight, it is not the only alternative and may not be the best for society. Other tools are available to protect the public and hold managers, officers, directors, and members/owners accountable. In addition, many of the reasons to impose charitable oversight on exempt organizations do not apply to these hybrid forms. Such oversight is not consistent with historical approaches to charitable activities pursued by non-hybrid, non-exempt forms. A charitable regulatory overlay could inhibit or even prevent charitable hybrids from achieving their charitable objectives, which ultimately should positively serve society and, as such, are desirable outcomes. Finally, legislatures in many states have declared a public policy that favors creation and adoption of these forms, and it is constitutionally incumbent on the executive branch to facilitate rather than impede that declaration, even arguably in those states that have not formally adopted the specific hybrid forms.

For these same reasons, legislatures also do not need to and should not surrender to the impulse to enact laws that affirmatively bring charitable hybrid forms under the rubric of charitable trust or charities law more generally.

I. STATEMENT OF THE PROBLEM

An essential first step in addressing concerns of regulators is to arrive at a reasoned understanding of what needs to be regulated. Without that understanding, there are very real
dangers of over or under regulating and attendant consequences. This section presents the core relevant characteristics of the new forms and addresses common misperceptions about the L3C, which is most likely to be caught in the charitable trust web. In this way, discussions about proper regulation of the charitable hybrid forms can focus on what is appropriate for each form generally rather than burdening every application of the forms with a broad regulatory regime that assumes only the worst and neglects their potential usefulness.

Throughout, this discussion demonstrates that none of these forms satisfy the conditions for imposing charitable trust law by virtue of their generic structure as distinguished from specific applications of any given form. Rob Wexler’s paper that is part of these proceedings and my recent article in the NYU Journal of Law and Business more deeply analyze those conditions, which in essence require an intent that assets be dedicated exclusively to charitable purposes – an intent that cannot be unilaterally inferred by virtue of these statutory forms, including the L3C.

A. Key Elements of the Primary New Forms

The most commonly discussed of the new hybrid forms are the benefit corporation, 1 flexible purpose corporation, and low-profit limited liability company (“L3C”). They are “hybrids” because they combine core elements of the for-profit and exempt, charitable realms that make these new forms both similar to but distinct from traditional forms.

All three forms share several characteristics that distinguish them from entities that the Internal Revenue Service recognizes as exempt charities: (1) hybrids can accumulate and distribute net profits and realize appreciated value; (2) contributions to or investments in hybrids are not treated as charitable deductions from income and estate; and (3) hybrids presumably are responsible for paying income, sales, property, and other taxes (as is discussed later, there are some who believe that charitable hybrids should be tax exempt by virtue of their form).

These forms are distinguishable from the for-profit sector in that each allows, or in the case of the L3C requires, subjugation of profits to prioritization of charitable purposes or other potentially conflicting demands. How each goes about this activity is one area in which there are material differences between the forms and among the reasons to consider regulating them as charitable trusts.

Benefit corporations are a subset of the corporate structure. As a threshold matter, they must pursue “general public benefit,” which the statutes define as “a material positive impact on society and the environment taken as a whole.” 2 As a corollary, the statutes also require directors to consider the impact of their decisions on shareholders; employees of the entity, its subsidiaries, and suppliers; customers; community and society; local and global environment; short and long term purposes; and its ability to accomplish its general and specific public benefits. 3 There is nothing inherently charitable under the Code about these general public benefits or the amalgamation of various constituents.

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1 The benefit corporation form is distinguished from the “B corporation” or “B corp” which is a private certification provided by B Labs based on the enterprise having met a certain number of criteria by which the enterprise demonstrates its commitment to social and/or public purposes, which may or may not be charitable under the Internal Revenue Code. The B corp certification is agnostic as to the business form because it is available to corporations, benefit corporations, flexible purpose corporations, partnerships, limited liability companies, and even L3Cs.

2See Britt at 13; Clark at 838; Lacovara at 825; Minnigh at 476; Model Act § 102.

3See Britt at 14; Clark at 839-40; and Model Act at § 201(c).
In addition, benefit corporations may, but are not required to, designate “specific public benefits” among their corporate purposes. These specific benefits may include purposes recognized as “charitable” under the Code but the litany of what qualifies is broader and not constrained by traditional notions of “charitability” under the law.\(^4\)

Consequently, benefit corporations must pursue general benefit purposes that do not satisfy legal definitions of “charitability,” and they may add more specific public benefits that may be but are not required to be charitable under the law. As such, no benefit corporation can pursue exclusively charitable purposes, and no one who contributes to a benefit corporation should be presumed to intend the pursuit of such purposes absent an explicit statement of such intent that is independent of the underlying form. In this way, benefit corporations are much less like exempt charities than profit-oriented enterprises that prioritize profits but may agree with an investor to use their resources for charitable activities.

The flexible purpose corporation requires that incorporators identify “special purpose(s)” that the directors may consider in their decision-making in addition to or even at the expense of the interests of owners.\(^5\) These “special purposes” may qualify as charitable under the Code or state law, but they are not so limited because they more broadly include promoting or minimizing effects of decisions on employees, suppliers, customers, creditors, community, society, or environment.\(^6\)

Thus, the flexible purpose corporation’s purposes may, but are not required to, be those that the law recognizes as charitable. Although charitable purposes may even be the exclusive mandate of the enterprise if the incorporators or subsequent shareholders and directors so elect, there is nothing innate about the form that would declare charitable purposes as the sole or exclusive province of entities that organize under it. As with the benefit corporation and absent discrete adoption of exclusively charitable special purposes, there is nothing about the flexible purpose form that implies intent by an investor to dedicate assets exclusively to charitable purposes. Like the benefit corporation and for-profit forms generally, an independent, affirmative declaration of such an intent should be required, and its absence should suggest the lack of such an intent.

Unlike both corporate hybrid forms, the L3C statutes impose a preference in decision making for significantly furthering charitable purposes as defined by the Code, including that the entity would not have been formed “but for” its relationship to those charitable purposes.\(^7\) The statutes further order business priorities by mandating that “no significant purpose” of entities organized as L3Cs can be the production of income or appreciation of property value.\(^8\)

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\(^4\) See Britt at 18 n. 15; Clark at 838; Brakman Reiser Benefit Corporations, at 594, n.22.; Minnigh at 476; Model Act § 102.

\(^5\) See Britt at 4; Minnigh at 476; Cal. Corp. Code § 2602(b)(2).

\(^6\) See Britt at 5.

\(^7\) See 805 ILCS 180/1-26; La. R.S. §12:1302(C); Me. Rev. Stat. Ch. 21, §1611.2; Mich. Comp. Laws §450.4102; R.I. Gen. Laws §7-16-76; Utah Code §48-02c-412; Vt. Stat. Tit. 11, Ch. 21, §§ 3001(23); Wyo. Stat. §17-15-102(ix); Oglala Sioux Tribal Council Ordinance 09-23; Crow Law and Order Code §18-5-102. See also Minnigh at 475, 481, nn. 86-96; Tyler, 2010, Negating at 123-24; Murray and Hwang at 623.

\(^8\) See 805 ILCS 180/1-26; La. R.S. §12:1302(C); Me. Rev. Stat. Ch. 21, §1611.2; Mich. Comp. Laws §450.4102; R.I. Gen. Laws §7-16-76; Utah Code §48-02c-412; Vt. Stat. Tit. 11, Ch. 21, §§ 3001(23); Wyo. Stat. §17-15-102(ix);
Also unique among hybrid forms is that the L3C is a subset of the limited liability company regime and as such generally benefits from its flexibility and is hampered by its limitations. Among the restrictions on the L3C’s flexibility that materially differentiate it from LLCs more generally are the parameters that the statutes place on the ability to modify or define fiduciary duties, which for the L3C must adhere to the priorities and purposes that genetically predispose the form.\(^9\)

Although the L3C must prioritize significantly furthering charitable purposes, it cannot and should not be presumed that such purposes are exclusive. Indeed, unless the originators or subsequent owners affirmatively and explicitly agree to forgo distribution of income or realization of appreciated property value, the L3C form explicitly recognizes the legitimacy – but properly placed priority – of these purposes. In addition, the L3C can elect to pursue other purposes – including those that are among the general public benefits, special public benefits, and special purposes of the benefit and flexible purpose corporate forms – as long as the do not supplant the statutorily ordered placement of charitable purposes.

Thus and like its hybrid cousins in the corporate form, there is nothing about the L3C as a structure that renders its purposes exclusively charitable under the law, and investors should not be said to have manifest an intent to conscript assets solely for such purposes unless there is independent, affirmative evidence of such intent separate and apart from the nature of the L3C form itself.

Both the flexible purpose corporation and L3C could have applications of their forms that are dedicated exclusively to charitable purposes as defined by law, and it would be appropriate in those instances to imply a manifestation of intent to impose charitable trust duties on investments in them under those discrete circumstances. It is conceivable that entities that deploy such applications of the forms might even pursue and receive recognition from the IRS and state authorities as exempt from taxation and able to permit donors to deduct contributions as charitable.\(^10\) Mere possibilities for such uses, however, do not warrant treating all applications of the forms as if exempt, charitable entities entitled to the benefits and subject to the limitations; instead, determinations should be unique.

Consequently, absent a specific declaration in a state’s enabling law, none of these hybrid forms should be treated as charitable trusts simply because of their form under state law. They do not innately suggest exclusivity of charitable purposes and cannot support an implied manifestation of intent to dedicate assets solely to such purposes.

The Illinois legislature has made such a declaration. At the behest of the then State Attorney General, Illinois has explicitly made all L3Cs that operate in the State subject to its

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\(^9\) See Tyler, 2010, Negating; Tyler, 2013, NYUJL&B.

\(^10\) In the current environment, an L3C could be recognized as exempt only if it has only one member and that member is itself tax exempt.
charitable trust regimen and its requirements and restrictions. The duties are extensive and comprehensive; they are not limited to registering as fundraisers and otherwise complying with charitable fundraising obligations. The consequences, which are discussed in a later section, are significant and negate the ability of L3Cs to operate legitimately in the State other than as equivalent to exempt, charitable trusts. It has been suggested that the Attorney General’s intent was less restrictive in only wanting L3Cs to comply with charitable fundraising statutes, but that is certainly not the law of the State and absent modification by the legislature cannot be safely presumed.

Of course, one of the ways to clarify a state attorney general’s regulatory authority and responsibility is by legislative pronouncement, such as that in Illinois. However, there is a question about whether the approach in Illinois was appropriate given the inability to presume exclusively charitable intent; it is also questionable whether the approach was necessary given other alternatives for oversight. Although not going as far as Illinois, the California legislature made clear that nothing about its adoption of the flexible purpose corporate form interferes with charitable trust requirements and enforcement that is otherwise applicable. The California approach seemed less of a reaction to misperceptions or unique applications of the form than was that of Illinois such that it is reasonable to wonder if Illinois would have acted as it did if more accurate information was available to it.

B. Common Misperceptions of the L3C

The L3C was originally inspired by a desire to make it easier for private foundations to make program related investments (“PRIs”) and to increase attention to PRIs as a legitimate tool for private foundations to achieve programmatic objectives. But the L3C has a depth that transcends private foundations or PRIs. The L3C is the only entity form that, by virtue of its elemental structure, inverts priorities inherent in our traditional forms by requiring primary focus on charitable purposes (like an exempt charity but unlike a for-profit entity) but permitting distribution of profits and realized appreciation of value (like a for-profit but unlike an exempt charity). Unfortunately, so much attention has been devoted to the surface applications of the L3C that the merits of its deeper innovation has been threatened by regulatory approaches that presume private foundation involvement, which has proven to be a misnomer.

The L3C does not require the involvement of private foundations, as is demonstrated by the fact that very few, if any, of the L3Cs formed so far have PRI or private foundation money attached to them yet. Instead, investors, entrepreneurs, and managers are seeing different merit in organizing as L3Cs – often branding benefits. But as Michael Moreland a founder and principle in SEEDR L3C has said, there is value in operating in a form that dictates desired priorities for

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11 805 Ill. Comp. Stat. Ann. 180/1-26(d) (2011) (“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”). See also Brakman Reiser Benefit Corporations at 616 n.132.

12 Arguably, the authority could be construed as having been given by underlying charitable trust statutes and common law. Also, the flexible purpose corporation legislation specifically disclaims undermining charitable trust principles or negating the attorney general’s authority to enforce charitable trust law. See Minnigh at 478, n. 47 (citing Cal. Corp. Code § 2700(e)). Notably, the legislature made no assertions about whether enterprises that deploy this form in fact are charitable trusts or otherwise subject to such regulation or oversight.
decision-making when competing interests collide, which they inevitably do.13

Because most of the criticisms of and concerns about the L3C are based on its grounding in the PRI regimen, they in many ways are setting up a straw man or red herring for unduly attacking the form and, thus, addressing how it should be regulated. Moreover, many of the critiques of the PRI-oriented L3C are actually criticisms of PRIs rather than the new form, even though PRIs have been permitted since 1969, and they have been deployed successfully in numerous circumstances to achieve charitable objectives without evidence of material abuse or misuse, including PRIs that have been part of tranched investments.14 As such, many criticisms are misdirected.

That being said, the criticisms are important in having encouraged greater awareness of the potential for abuse and misuse whether intentionally or by accident. PRIs and L3Cs must be structured and documented appropriately in order to ensure priority of charitable purposes and protect against impermissible private benefit, among other things. A clear benefit has been to bring awareness to the fact that an L3C does not and cannot automatically qualify an entity as a legitimate repository for PRIs; private foundations must still satisfy the statutory requirements for making PRIs.15 Noticeably missing from those requirements is any obligation to get prior permission from the IRS for making the PRI. As such, it is also a misperception to assert that recognition of the L3C by the IRS is a prerequisite for validity or usefulness for PRIs or other foundation funds.

Another frequent misstatement about L3Cs is that they must provide “public” benefits or serve “social” good as distinguished from “significantly furthering charitable purposes” as defined by the Internal Revenue Code. Certainly, the latter is a subset of the former but they are not synonymous. As currently constructed, it is not appropriate to set up or operate an L3C without its focus being on significantly furthering charitable purposes as defined by law. Failure to be so constrained, whether intentionally or unintentionally, can lead to problems. Some of this confusion may arise because the other hybrid forms do permit consideration of broader public/social purposes rather than focusing solely on narrower charitable purposes.

Of course, this has potential to create its own problems for regulators because the general public does not normally make this distinction; even those in the charitable sector itself talk in ways that might lead listeners to be confused. After all, charitable purposes do provide public benefits and social good, so it is certainly not incorrect to use those terms.16 Consequently, owners and managers of non-charitable hybrid entities should be more intentional and careful in their fundraising and operations or they risk being identified by the public and/or regulators as

13 SEEDR L3C is an Atlanta based entity that has worked with Georgia Tech, the Centers for Disease Control, the Gates Foundation and others to design, develop, test, and deploy new container technology for the consistent and safe transportation of vaccines and specimens regardless of temperatures, terrain, and over a longer period of time. Mr. Moreland made his observation at a meeting hosted by the Lumina Foundation in fall 2012 to explore how L3Cs can contribute to how colleges and universities achieve their diverse missions. See also Tyler, 2010, Negating; and Tyler, 2013, NYUJL&B.

14 See the recent example in New York of combining PRIs with social impact bonds.

15 These are essentially to conduct due diligence, document commitment of the funds to designated charitable purposes, get reports from the entity and make reports to the IRS on use of the funds, and ensure that the PRI is consistent with that specific foundation’s charitable purposes.

16 See generally, Tyler, 2013, Transparency.
dedicated to charitable pursuits and possibly subject to regulation accordingly or to consequences discussed below for their lack of discipline.

II. GETTING IT WRONG: WHAT IF CHARITABLE HYBRIDS ARE TREATED AS CHARITABLE TRUSTS.

The law of charities has developed over more than 400 years. It has been influenced by numerous factors:

- decisions of kings and presidents, parliaments and legislatures, and courts;
- policies of communities, states, and nations; and
- evolution of how formal charity is understood and organized, whether as trusts, unincorporated associations, corporations, or limited liability companies.

A consistent, guiding theme seems to have been ensuring that charitable purposes are preserved and prioritized and that those who donate to such entities can be assured that their contributions of assets and time are furthering those purposes. At a more practical level, there also was recognition that the system lacked an inherent mechanism for overseeing charitable enterprises such as there is with profit-oriented businesses whose owners have vested interests in paying attention to activities or as with non-charitable trusts who have beneficiaries with incentives to ensure compliance.

Two primary arrangements emerged. First, most states have vested regulatory authority and judicial standing in state attorneys general or another chief charity official. Degrees of this authority and jurisdiction are supplemented at the federal level by oversight from the Internal Revenue Service by virtue of tax treatment. Second, very strict, more detailed mechanisms and procedures evolved that restrict the freedom of trustees, directors, and managers to make certain decisions or undertake certain actions. Among these are the following:

- inability to distribute profits or permit private realization of appreciated value;
- limitations on the ability to compensate those who work for these enterprises, including use of equity and certain other forms of incentive compensation strategies;
- prohibitions on transactions in which an insider might actually receive a benefit or be perceived as having done so;
- restrictions on deviating from specified charitable purposes even to pursue other recognized charitable purposes; and
- constraints on merging, transferring assets, or terminating/dissolving.

Many of these apply to recognized charities whether corporations, associations, or otherwise. One exception is for insider transactions for which the trust regime has retained absolute, unforgiving prohibitions, even if the benefit is minimal or accidental. Charities structured as corporations, however, have gravitated toward the business model by which such transactions can be legally managed by ensuring that decisions are made by uninvolved persons with full information and provided that the transaction is ultimately not unfair to the charity. Of course, ensuring that such a transaction is managed legally may or may not address perceptions that could undermine an entity’s credibility and reputation.

Under this standard, then, a director of a corporate charity could lease office space to the charity for $1 per year but the trustee of a charitable trust could not. In fact, the trustee may not be
able to donate the space to the trust if benefits, financial or otherwise, might devolve to the trustee.

This, then, is the crux of the problem for charitable hybrid forms: should they be regulated as charities? Whether regulated under either corporate or trust doctrines, then enterprises that adopt charitable hybrid forms will be subject to the above restrictions to some debilitating degree. Most importantly, if they are charitable trusts or corporations, they cannot distribute profits or permit private realization of appreciated value. Essentially, they cannot be hybrids at all. After all, investors (even if private foundations or other charities) will not be inclined to invest in organizations that cannot return their equity or permit appreciation, especially when there is no tax benefit available for doing so.

This is a problem regardless of the form adopted, whether corporate or limited liability company. At least under the corporate form, the fiduciary duties are more permissive with regard to insider transactions. L3Cs, however, are more likely to be treated as more constrained charitable trusts.

Other problems also follow, including with regard to compensation and ease of changing purposes (even within variations of charitable), merging, transferring assets, and terminating/dissolving.17

The problems are not limited to the new hybrid forms either. Consistency and predictability will require that contractual adaptations of traditional forms be similarly regulated. For instance, if the L3C must be treated as a charitable trust as a matter of form, then it seems that every limited liability company that chooses to prioritize furthering charitable purposes must be treated similarly. The logic also then applies to whole-entity joint ventures between an exempt charity and a for-profit entity (which the IRS suggests must prioritize the charity’s purposes18), which would restrict distribution of profits and ability to merge or transfer assets. Should ancillary joint ventures involving less than all of the charity’s assets be similarly restricted?

Arguments for applying charitable trust law to the L3C and other charitable hybrid forms should similarly subject any and every entity that receives a program related investment or expenditure responsibility grant from a private foundation to limitations on its use of the fruits of those assets. Conceivably, the rationale could prevent any recipient of such funds from retaining any profits from such PRI funds for the benefit of owners or making other decisions about the entity. They also might be prohibited from allowing the results obtained from deployment of those funds to contribute to increased value of the overall enterprise. Such applications and restrictions would be contrary to how PRIs have functioned over the decades consistent with the law.

What about a taxpaying entity like Newman’s Own, whose owners have agreed to dedicate all net profits to charity? Or Google, whose founders and key decision-making owners have documented and publicized commitment of 1% of its asset value and profits to charity? Although their operations are not charitable and they could not be recognized as tax exempt, their purposes certainly further charitable purposes. Should the owners of Newman’s Own and Google be permitted to change their mind on their own about how they distribute their respective profits?

17 See Tyler, 2013, NYUJL&L.
or must they first apply to the state attorney general and/or the courts for permission? Can they decide to merge or transfer assets without such permissions? If consistent with some of the arguments for applying charitable regulatory approaches to hybrid forms, then such changes must require consent of the State.

Should enterprises like the Omidyar Network and the Gary Community Investment Co. be regulated as charities with their combinations of exempt charity and taxpaying forms oriented toward accomplishing charitable objectives? If their taxpaying entities are not soliciting funds from the public, should principles of regulating charities prevent the subsequent transfer of underlying portfolio assets without approval of the attorney general or court? Even if their taxpaying entities solicit investment from members of the general public, are they required to comply with laws and regulations that apply to both securities registration and charitable solicitation?

Perhaps the above circumstances might be distinguished with an appeal to the distinction between corporate and limited liability company forms. Such a distinction, however, neglects the underlying principles that apply in the charitable context and overstates the differences between the forms as to matters of fiduciary duty.

Extending charitable trust law to adaptations of traditional forms could have extraordinary and unnecessary ramifications, many of which would inhibit public benefit, social good, and charitable outcomes. Doing so could intrude inappropriately on fundamentally private decision-making in contexts that are also either private or market-based. Such results seem extreme and undesirable.

Charitable hybrid forms – as a matter of their macro structure as distinct from unique micro applications – seem to have much more in common with adaptations of traditionally taxpaying forms than they do with conventional exempt charities. These similarities should support the availability of causes of action, remedies, and oversight regimes as alternatives to trust law that nonetheless can address the legitimate concerns of charity regulators. Even more so, at least for the L3C, there are at least arguments that additional, more compelling causes of action and remedies might exist for enforcement than relying on those available under contract or traditional limited liability company.

III. OTHER TOOLS ARE AVAILABLE TO ADDRESS LEGITIMATE CONCERNS OF ATTORNEYS GENERAL AND POLICY MAKERS

Specific applications of charitable hybrid forms might qualify as charitable trusts or charities, and they should be so treated when they do. Benefit and flexible corporations are least likely to be conscripted as charitable trusts or charities as a matter of their statutory forms. The L3C form is more likely to appear to meet the elements for being considered a charitable trust, although there are compelling arguments against doing so given the lack of exclusively charitable intent. Among other considerations is that alternative means of regulation and enforcement are available to address the legitimate concerns of attorneys general, policy makers, and others.

A. State Interests are Best Served by Business-Like Oversight

States, communities, donors, charities, beneficiaries, and even the entire charitable sector itself depend most broadly on states’ attorneys general or other chief charity official to enforce
applicable laws, regulations and standards regarding charitable enterprises and assets. They are the first line for regulatory oversight of charitable hybrid forms as well.

At the federal level, the exempt organizations division ("EO") of the IRS is most concerned about organizations that have its imprimatur to justify tax exemptions and charitable deductions. The EO division wants to ensure that those entities further recognized charitable purposes, do not permit unauthorized private benefit, do not intervene in political campaigns or pursue impermissible lobbying, and make certain documents publicly available. As a purely legal matter, then, the EO division is most interested in individual organizations within its orbit at the micro level. However, the IRS also has important responsibilities and influence on the health and integrity of the charitable sector at the macro level as well, but the ability of the EO division to reach organizations and people not associated with tax treatment and its underlying elements is limited.¹⁹

For instance, the EO division could pursue an exempt organization that misused charitable donations but it is not the first line of defense to directly pursue a non-exempt entity that misrepresented its fundraising as if for charitable activities, much less protect a confused donor even in the absence of misrepresentations. The states attorneys general could pursue both and thus protect micro interests of donor intent and macro interests in charitability and the credibility of the charitable sector as a whole.

Consequently, regulatory interests in and oversight uncertainty about charitable hybrid forms understandably are most pronounced at the state level. As such, states attorneys general worry about tax treatment, charitable activities, and protecting against impermissible private benefit. They also worry most directly about fiduciary duty, charitable fundraising, and the “halo” affect and goodwill that attach to the sector and its members. These are the purview of the states much more directly than the IRS or the federal government, which means that these legitimate interests with regard to charitable hybrids must be resolved by the states.

States are a significant repository for enforcement of fiduciary, governance, and other aspects of business, particularly those numerous areas that have not been preempted by the federal government. These tools for regulating business are and should be available for overseeing activities of charitable hybrids and enforcing their requirements.

These tools at the state level offer at least two advantages to the mechanisms available under charitable trust and charity law. First, they most effectively balance legislative and policy objectives for formalizing charitable hybrid forms with ensuring against fundraising abuse and preserving the integrity of the charitable sector. Second, they provide greater consistency with historic practices with regard to contractual adaptations of traditional structures.

¹⁹ It has been suggested that viability of the L3C depends on the IRS issuing a ruling or other advice that specifically acknowledges the L3C and the legitimacy of it as a vehicle for receiving program related investments. However, no such ruling or guidance is needed or, for that matter, likely. It is not needed for at least two reasons: (1) PRIs do not require pre-approval from the IRS; and (2) most L3Cs do not have any ties to private foundations much less to PRIs. It is not likely for at least two reasons: (a) the IRS focuses on the required elements and has historically been agnostic as to the form of entity into which a private foundation makes a PRI, including to limited liability companies (see, e.g., PLR 200610020 (12/13/2005 and 3/10/2006)); and (b) in the eyes of the IRS, each PRI is unique by nature because of the customized fit with the specific foundation’s charitable purposes, in which case blanket rulings are not currently likely. Consequently, there is no legal link between the IRS and validation of the L3C form or its usefulness.
In other words, treating charitable hybrid forms generally as if charities or charitable trusts fundamentally interferes with or even destroys the ability of enterprises operating under such forms to function as intended, including restrictions on distributing profits, realizing appreciated property value, using equity in incentive compensation, or making decisions about mergers, transfers, or terminations. Treating them as businesses does not undermine that legislative/policy intent. It also does not require completely rewriting or redesigning how to regulate enterprises that receive program related investments, joint ventures among for profit and exempt charitable entities, taxable entities that pursue charitable purposes, or organizations like Newman’s Own, Google, Omidyar, and many others.

Finally, business tools for regulation and enforcement also aid attorneys general in protecting against fundraising fraud and in preserving the integrity of the charitable sector and the “halo” effect that is available to those who operate honorably within it. These tools expand available causes of action, corresponding remedies, and standing to enforce the requisite elements and priorities of the forms, such as they are.

B. Alternative Standards, Causes of Action and Remedies, and Expanded Standing

1. Standards, Causes of Action, and Remedies

Most hybrid adaptations of traditional forms and the PRI rely on contract principles to determine and enforce various rights and responsibilities for pursuing charitable purposes. Such dependence on contract can offer flexibility for customization (particularly in the limited liability context). Thus, agreements can be freely modified and/or purposes waived with impunity, which also is the case with the corporate hybrid forms if enough shareholders agree. People can, do and will change their minds about charitability, public benefits, and social good, and control of decision-making can, does, and will devolve to others whose priorities differ. Principles of contract will apply as will their limited remedies for breach.

Done right and done well, charitable hybrids will have fiduciary principles, causes of action, and remedies to supplement those of contract and thus better preserve charitable purposes, public benefits, and social good. Statutory and common law fiduciary duties that attach by virtue of a form’s genetic disposition are much more likely to provide clarity, certainty, and consistency when those qualities are desired. More than any other charitable hybrid form, the L3C statutes inject clear priorities and duties into the form. In this way, they may resemble trusts but without their uncompromising elements. Of course, these qualities only attach to the L3C to the extent that conversion to LLC status as allowed by statute requires a fiduciary overlay and is not potentially even more whimsical than other forms and arrangements.

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20 See Tyler, 2010, Negating; Tyler, 2013, NYUJL&B; Haskell et al.

21 For a discussion about why the limited liability company form fails to provide these qualities, see Tyler, 2010, Negating.

22 The possibility of converting L3C status is necessary and also is consistent with its PRI precursor. The Internal Revenue Code and accompanying regulations permit a private foundation to convert a PRI into an alternative status. However, the L3C conversion should occur in a context of the fiduciary priorities established by the statutes. Consequently, conversion should only be permitted if a fiduciary decision is made that either the charitable purposes have in fact been significantly furthered or achieved or that doing so through the L3C structure is no longer likely (or possible). Such decisions should be informed, debated, and
Fiduciary duties permit additional causes of action and remedies, including punitive damages, disgorgement of profits, removal, and others. Contractual remedies are limited to damages actually caused or as appropriate to put the parties in a position they would have been in had the obligations been performed; however, punitive damages, lost profits, and attorneys’ fees are not normally recoverable. A problem with charitable hybrids is that there may not be damages in a monetary sense because neglecting the charitable priority may actually increase profitability, in which case contract remedies are inadequate. Fiduciary remedies, on the other hand, can be useful and appropriate, which is part of the reason that fiduciary responsibilities must attach to the forms for them to be most worthwhile.

Other civil and criminal causes of action and remedies also become more likely resources, including those based on fraud and misrepresentation, consumer protection, and conspiracy to defraud. State and federal securities laws can also be invoked for civil and criminal relief. Depending on the nature of the underlying scheme, it may even be possible to prosecute for violations of the Racketeer Influence and Corrupt Organizations Act, which permits treble damages and pre-trial forfeiture. Administratively at the federal level, the Federal Trade Commission may take more of an interest in these new hybrid forms than they have traditionally taken in exempt charities and the deference due to IRS.23

Finally with regard to causes of action and remedies, it may be appropriate to resurrect the *ultra vires* doctrine and permit piercing of the veil of personal liability that otherwise covers the corporate and LLC forms, particularly if the circumstances support finding an intent to deceive using the hybrid forms. These may be particularly useful tools for attorneys general to enforce the sanctity of form.

2. Standing

With regard to standing, recall that the attorney general is the primary enforcer of charitable trust law with assistance from the EO division of the IRS for exempt charities. A donor may have limited standing in certain instances; beneficiaries almost never have standing. Unlike charitable trusts and charities, charitable hybrid forms actually do have owners who have interests to oversee and motivation to protect them and keep watch over the managers and operators of the business. Presumably, those owners or some material segment of them are (or at least one time were) motivated by the primacy of charitable purposes; they have the power to preserve and enforce that primacy.

Enforcement problems arise if the owners change their mind, if they change, or if they never had or acquired that motivation. But in a fiduciary situation, all of the owners may need to change their minds not just a majority or even super-majority of them, which then empowers only one owner—even of a very small interest—who remains dedicated to the
documented. There is much more work, study, and thinking to be done on the practical means for L3C conversions.

Conflicts of interest are inherent in such decisions because owners will likely make money from successful outcomes, in which case their motives may be impugned. Those conflicts will be impossible to avoid but may justify requiring notice of the conversion to the state attorney general, or at least secretary of state, and to potentially affected parties (*e.g.* owners/members, directors, managers, employees, customers, creditors) and the public. Of course, the entity could no longer use the “L3C” designation, which is its own type of notice. See Tyler, 2010, Negating.

23 See Tyler, 2013, NYUJL&B.
organization’s charitable purposes. Not only that, but it may be that the “conspiracy of the whole” would also need to entice officers and managers who themselves may have separate authority and responsibility to preserve primacy of charitable purposes.

In the for-profit, business context, it is not a sufficient defense to having violated the law for corporate directors, officers and managers to assert that they were only doing what the owners wanted them to do, even if that desire was unanimous. There is an independent responsibility that attaches so that the governance and day-to-day management personnel must either resign or refuse when confronted with a dictate to violate the law.

Managers of limited liability companies similarly lack permission to violate the law because it happens to be what the owners/members want. As flexible as most LLC statutes and uniform laws are with regard to deferring to the members’ ability to define the terms of their engagement, including with regard to fiduciary duties, even they do not permit waivers or releases for conduct or decisions that involve intentional or willful misconduct or violations of law.24

Similarly, the core elements of the L3C, as statutory declarations of public policy, should not be permitted to be waived or released without an express statement from the legislature to that effect. The absence of such a statement suggests a standard other than deference to the capricious will of members. If the members cannot or will not abide by that standard, then it seems as if the choices for the managers of the L3C are the same as those presented to directors, officers, and managers of corporate entities in similar circumstances – resign or refuse, including possibly seeking third party intervention.

In many ways, the responsibilities of directors, officers, and managers of charitable hybrid forms may be similar in this regard to those of exempt charities. Although there are no owners of such enterprises, any given director, officer, or manager may have standing to enforce the exclusive charitable purposes of the enterprise against their colleagues who would compromise or neglect those purposes.

Additionally, there may be third parties who have standing to pursue certain types of claims and remedies based on misrepresentations made to them in order to entice them to provide more favorable terms or conditions for engagement. Among these may be creditors, suppliers, or local taxing jurisdictions that reasonably rely to their detriment on a charitable hybrid having declared primacy of charitable purpose. Although these claims may not rise to the level of fraud – either civil or criminal – equitable actions and remedies may be very effective in holding an enterprise and its personnel accountable.25

C. Consistency with the Market

Inextricably bounded to discussion of charitable hybrid forms must be how they should function in our nation’s economic system, including tax treatment, and as a result what effect they should have on that system. There is little doubt that these forms are (and

25 These strategies also may apply in the exempt charity context but are rarely if ever invoked because of the lack of reliance on representations when the entity has a letter from the IRS that it normally presents. There is no such letter for the charitable hybrid, which necessarily means greater reliance by third parties on representations by principals or their agents.
should be) disruptive, but questions remain about the nature and extent of their disruption. Should they be allowed to operate outside of the marketplace like exempt charities or should they be subject to the disciplines and competition of the market? How this question is answered will fundamentally drive the effect that charitable hybrid forms have on our markets, including the potential to stifle innovation and mid- and long-term individual and communal development.

How attorneys general approach these questions also will influence how they approach their regulatory and enforcement duties and responsibilities. There are compelling reasons to ensure that charitable hybrids disrupt the marketplace from within. Any other approach risks destruction rather than disruption, whether of the market or even the charitable, philanthropic sector.

Owners of these charitable hybrid forms are entitled to distribution of net profits, if any, and to realize the appreciated value of the business, if any. They also can take business losses as deductions, just as any other for-profit business investor. In other words, they are engaging the market and its risk/reward mechanisms. Those risks may be higher than normal and the rewards may not be as high as normal given charitable focus, but opportunities for financial gain may exist. In addition, although market level returns may be less likely, they are not prohibited and may be realized or even exceeded in certain instances. Moreover, the forms allow for investors that are motivated more by potential for financial gain than by pursuit of charitable outcomes. Thus, these forms should not be excused from the market.

Excusing charitable hybrids from the market could undermine competition with profit-oriented enterprises. After all, the corporate hybrid forms in particular will most likely operate in what is otherwise considered the for-profit space. Remember that the benefit and flexible purpose corporations are not required to pursue charitable purposes, much less make such purposes primary; nor are they even required to supplant shareholder primacy. Instead, they may choose to consider the effect of decisions on selected alternative constituencies or stakeholders when making decisions about the business and its operations. It is reasonable to presume from these standards that entities operating under the applicable forms will be competing with traditional for-profit enterprises.

Also, there is no evidence that choosing to consider other constituencies when making decisions so weakens an enterprise that excusing it from the market or any of its component parts is justified because of form. Among the charitable hybrid forms, only the L3C has a reasonable chance of demonstrating such a diminished capacity because of the mandatory primacy of charitable purpose; after all, we have a charitable sector in part because of the absence of market solutions to serve their underlying opportunities or meet their problems. But, L3Cs are not exempt charities so even they should not be excluded from the marketplace.

One of the most commonly mentioned ways of excusing charitable hybrid forms from the market is by affording them tax-favored treatment because of their structure alone. There is no reason to believe that these forms should not compete on the same terms as profit-oriented, tax paying entities or that tax incentives are necessary or desirable to induce investment. Additionally, there is no reason to exclude such income from the tax base such as
there is with the earnings of and contributions to exempt charities.  

This is not to suggest that charitable hybrid forms should not benefit from tax incentives or other treatment. Instead, it is to advocate that they should not benefit because of their statutory form. Other normal tax treatment should be available, whether charitable deductions for contributions they make, research and development credits, business losses, etc., but those are available because of activities expressly undertaken rather than because of form. This approach is consistent with how tax favored treatment is otherwise bestowed. The reasons for deviating from that approach must be better explained and achieve a level of compulsion that seems out of reach.

Another basis for retaining charitable hybrid forms within the market is that doing so is consistent with applying market-oriented causes of action, remedies, and standing rather than those of charitable trust and charity law. If a rationale for not imposing the strictures of charitable trusts and charities is to permit distribution of profits, realization of value, and otherwise private decision-making of the market, then it seems only natural that the rationale implicitly incorporates the boundaries and limitations of that market as well.

Of course, the flip side of the market participation coin is that charitable hybrid forms should not also be subjected to the barriers of charitable trust and charity law that will interfere with application of these forms. Even more onerous, those barriers will prevent their successful implementation. That is not a result that legislators could have intended by enacting the legislation that gave rise to these forms. That result also counters the inherent good and desirability of success in achieving charitable outcomes and addressing problems that underlie the need for charitable intervention in the first place.

IV. CONCLUSION

The formal emergence of statutory hybrid forms has resulted in degrees of interest that have ranged from unbridled enthusiasm to predictions of cataclysm. Through it all, the forms are being used. Twenty states have adopted the benefit corporation, two the flexible/social purpose corporation, and eight the L3C. Regulators are faced with the very real prospect of determining how best to oversee regulation of over 1800 of these enterprises. Meanwhile, many entrepreneurs, investors, creditors, professional advisors, and others do not seem to be waiting for those determinations. Untold others, however, are and will continue to remain sidelined until there is greater certainty and clarity about these forms and how they will be regulated.

Their hesitation is understandable. After all, if decisions are made to regulate applications of these forms that include charitable pursuits under the rubric of charitable trust or charities laws, the implications could be profound for the ability to distribute profits, to use equity as part of a compensation system, to modify purposes, to merge or transfer assets, and otherwise. The fact that the Illinois legislature chose to specifically subject the State’s L3Cs to the charitable trust regime suggests that such an approach is taken seriously as an option despite its problems.

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26 See Reid 2013a and 2013b.
Among the problems are that these charitable hybrids do not meet the criteria for applying the blanket of trust or charities law as a matter of the forms themselves. The consequences for doing so render these forms inoperable, which then present a complementary separation of powers problem that pits legislative intent against executive enforcement as the latter essentially prevents the former’s intent from gaining traction. Absent evidence that alternative approaches cannot adequately protect the public interest, such an extreme result should be avoided. Fortunately, there are alternative approaches to regulating the enterprises that adopt these new forms, including causes of action and remedies grounded in fiduciary duty, securities fraud, consumer protection, equitable disgorgement, and lost limited liability.

These forms are not appropriate for every situation and probably should not be used in most circumstances. But there are situations in which their adoption can meaningfully align decision-making responsibility, standards, capital, and other resources to address problems or pursue opportunities that traditional forms may not be as well suited for solving or pursuing. Particularly if focused on that subset of private benefit and social good that society has determined to be legitimate charitable pursuits, it seems as if we should welcome innovative approaches and allocations to solving those problems or pursuing those opportunities, while simultaneously protecting against abuse. Applying a charitable trust or charities law regulatory framework unnecessarily over-emphasizes the latter and neglects the former.
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