ANALYZING EFFECTS AND IMPLICATIONS OF REGULATING CHARITABLE HYBRID FORMS AS CHARITABLE TRUSTS: ROUND PEG AND A SQUARE HOLE?

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I.
Nature of the Problem

One of the principle motivating forces driving the creation, expansion, and use of new formal hybrid business structures is a desire among various entrepreneurs, investors/funders, and policymakers to dedicate financial capital and other resources to areas of society that might not be as clearly or easily pursued under traditional forms.[1] These people have seen opportunities to address social problems in new and dif-

1. *See* William H. Clark, Jr. & Elizabeth K. Babson, *How Benefit Corporations Are Redefining the Purpose of Business Corporations*, 38 Wm. Mitchell L. Rev. 817, 819, 821, 838 (2012); Briana Cummings, *Benefit Corporations: How to Enforce a Mandate to Promote the Public Interest*, 112 Colum. L. Rev. 578, 582, 584, 588 (2012); Lisa M. Fairfax, *Doing Well While Doing Good: Reassessing the Scope of Directors' Fiduciary Obligations in For-Profit Corporations with Non-Shareholder Beneficiaries*, 59 Wash. & Lee L. Rev. 409, 417 (2002); Ryan J. Gaffney, *Hype and Hostility for Hybrid Companies: A Fourth Sector Case Study*, 5 J. Bus. Entrepreneurship & L. 329, 330 (2012); Robert A. Wexler, *Effective Social*

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ferent ways with financial resources, business models, and compensation structures and incentives not normally targeted to such problems with the same vigor, if at all. They have wanted clearer and simpler legal contexts within which to pursue their purposes and help others do likewise.

It is not that both profit distribution and social or charitable mission are not simultaneously possible under traditional forms. Certainly they are, and various enterprises exist to prove the point,[2] including well-known examples such as Ben & Jerry's, Google and its "dot org" division, the Calvert funds, the Omidyar Network, and certain for-profit hospitals and schools. Others are less well-known, such as businesses that have received program-related investments from private foundations. But a growing impatience with the complexity and real or perceived barriers of existing forms contributed to the emergence of new taxable forms designed to make the combination of profit distribution and social or charitable mission less complicated and more accessible.[3]

Enterprise—A Menu of Legal Structures, 63 EXEMPT ORG. TAX REV. 565, 565 (2009).

2. *See* MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 15-17 (2004); Fairfax, *supra* note 1, at 417; James R. Hines, Jr. et al., *The Attack on Nonprofit Status: A Charitable Assessment*, 108 MICH. L. REV. 1179, 1187-88, 1202 (2010); Christopher Lim, *Google.org, For-Profit Charitable Entity: Another Smart Decision by Google*, 17 KAN. J. L & PUB. POL'Y 28, 28-29 (2007); Alissa Mickels, *Beyond Corporate Social Responsibility: Reconciling the Ideals of a For-Benefit Corporation with Director Fiduciary Duties in the U.S. and Europe*, 32 HASTINGS INT'L & COMP. L. REV 271, 274 (2009); J. Haskell Murray & Edward I. Hwang, *Purpose with Profit: Governance, Enforcement, Capital-Raising and Capital-Locking in Low-Profit Limited Liability Companies*, 66 U. OF MIAMI L. REV. 601, 607-08, 614 (2011); Dana Brakman Reiser, *For-Profit Philanthropy*, 77 FORD. L.REV. 2437, 2467-68 (2009); W. Derrick Britt et al., *Frequently Asked Questions: Proposed Amendments to the California Corporations Code for a New Corporate Form: The Flexible Purpose Corporation and Senate Bill 201*, CALIFORNIA WORKING GROUP FOR NEW CORPORATE FORMS 2-3 (Feb. 23, 2011), http://www.law.columbia.edu/null/Final+FAQ+on+Flexible+Purpose+Corporation+%2800312058%29?exclusive=filemgr.download&file_id=59229&showthumb=0.

3. *See* Britt et al., *supra* note 2, at 2-3; Clark & Babson, *supra* note 1, at 817, 829, 832; Cummings, *supra* note 1, at 578, 582, 588-89; Michael D. Gottesman, *From Cobblestones to Pavement: The Legal Road Forward for the Creation of Hybrid Social Organizations*, 26 YALE L. & POL'Y REV. 345, 346 (2007); Christopher Lacovara, *Strange Creatures: A Hybrid Approach to Fiduciary Duty in Benefit Corporations*, 2011 COLUM. BUS. L. REV. 815, 818-19 (2011); Murray & Hwang, *supra* note 2, at 601, 607-08; Keren G. Raz, *Toward an Improved Legal Form for*

As is frequently the case with new approaches—especially those that are disruptive—the opportunities are accompanied by new ambiguities. With respect to the new taxable hybrid business forms, questions are raised about how to regulate them, particularly those that permit focus on charitable purposes (which I refer to as "charitable hybrids"), and the impact of various strategies for such regulation on operations, including possibly the perpetuation of social problems that might otherwise be reduced, minimized, or even solved.

One prominently discussed approach to regulating these new hybrid forms, specifically charitable ones, seeks to subject them to charitable trust laws. That approach, however, has significant potential for negative consequences related to legislative intent and how charitable hybrids are financed and managed.

Perhaps the most meaningful repercussion could be increased restraints on how or even whether charitable hybrids distribute profits and allocate appreciated property.[4] Such a result could be disastrous for enticing new capital or introducing innovative solutions into efforts to solve problems and implement solutions that have traditionally depended on attention from governments or exempt, charitable enterprises given the limited sources and amounts of funding available to them.

Other ramifications for financing and managing charitable hybrids could include the following:

- restrained flexibility to change either their purposes or operations in light of models or tactics that seem to be succeeding or failing;[5]

Social Enterprise, 36 N.Y.U. REV. L. & SOC. CHANGE 283, 286 (2012); Dana Brakman Reiser, *Benefit Corporations—A Sustainable Form of Organization?*, 46 WAKE FOREST L. REV. 591, 607 (2011) [hereinafter Brakman Reiser, *Benefit Corporations*]; Dana Brakman Reiser, *Governing and Financing Blended Enterprise*, 85 CHI.-KENT L. REV. 619, 643 (2010) [hereinafter Brakman Reiser, *Blended Enterprise*]; Felicia R. Resor, *Benefit Corporation Legislation*, 12 WYO. L. REV. 91, 99 (2012); Ashley Schoenjahn, *New Faces of Corporate Social Responsibility: Will Entity Forms Allow Businesses to do Good?* 37 J. CORP. L. 453, 471 (2012); Wexler, *supra* note 1, at 565; Robert A. Wexler, *Social Enterprise: A Legal Context*, 54 EXEMPT ORG. TAX REV. 233, 244 (2006).

4. *See infra* notes 102, 105 and accompanying text.

5. *See* discussion *infra* Part III.C.1.

- fewer avenues for merging, terminating, or disposing of assets, which could restrict or even extinguish certain exit strategies for funders;[6] and
- restricted capacity to compensate managers and other insiders, especially if they are also investors.[7]

Given that charitable hybrids are not tax-exempt under current law, that contributions to them are not deductible as charitable, and that they are pursuing charitable outcomes intended to benefit society and the public more broadly, it is counterintuitive and counterproductive to impose artificial and/or unnecessary barriers to their success.

Fortunately, it is not required that charitable hybrids be uniformly treated as charitable trusts. There are sound arguments against doing so, not the least of which is that such a construction could effectively nullify the statutes, which could not have been the legislative or gubernatorial intent. Also, strong alternatives exist for addressing legitimate regulatory concerns, including the prevention of fundraising scams and protecting the credibility of the charitable sector and the integrity of when and how charitable trust law applies. These alternatives could actually broaden the available oversight, causes of action, remedies, and consequences for failure to abide by the charitability requirements of the new forms.

Driving the analysis is the extent to which assets are dedicated to charitable purposes and the corresponding degree of fiduciary responsibility an enterprise and its personnel must exercise in pursuing those purposes. There is a need to ensure clarity as to how regulators interpret their responsibilities, jurisdiction, and authority vis-à-vis charitable hybrids because that ambiguity might itself inhibit or prevent engagement at systemically meaningful levels.

In the meantime, hybrid structures are being used. Entrepreneurs, investors, socially motivated people, and others have eagerly embraced these new ways of forming and doing business. There are 942 low-profit limited liability companies ("L3Cs")[8] organized in nine states and two Indian nations.[9]

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6. *See* discussion *infra* Part III.C.2.

7. *See* discussion *infra* Part III.A.

8. INTERSECTOR PARTNERS, L3C, http://www.intersectorl3c.com/l3c_tally.html (last visited Nov. 25, 2013).

These L3Cs by operation of law must prioritize significantly furthering charitable purposes[10] and therefore are the hybrid structure most susceptible to being enveloped by charitable trust law. Benefit corporations are available through statutes in twenty states,[11] and 865 entities have been certified as B corporations ("B corps"),[12] which, as discussed below, are distinct from benefit corporations. There are also eight flexible purpose corporations, which is a corporate form currently only available in California.[13]

The preceding numbers are only for the formally structured enterprises and do not count the unknowable volume of

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9. 805 ILL. COMP. STAT. ANN. §§ 180/1-10, 1-6, 5-5 (2011); LA. REV. STAT. ANN. §§ 12:1301(A)(21), 1302(C), 1305(B)(3), 12:1306(A)(1), 1309(A) (2010); ME. REV. STAT. tit. 31 §§ 1502, 1508, 1559, 1611 (2011); MICH. COMP. LAWS § 450.4102 (2010); N.C. GEN. STAT. §§ 57C-2-01, 57C-2-21, 55D-20(a) (2012); R.I. GEN. LAWS. §§ 7-16-2, 7-16-9, 7-16-49, 7-16-76 (2012); UTAH CODE ANN. §§ 48-02c-412, 48-02c-1411 (West 2009); VT. STAT. ANN. tit. 11, §§ 3001(23), 3005(a), 3023(a) (West 2012); WYO. STAT. ANN. § 17-15-102(a)(ix) (repealed 2010); CROW LAW AND ORDER CODE §§ 18-5-102, 18-5-108, 18-5-705 (2009); OGLALA SIOUX TRIBAL COUNCIL ORDINANCE 09-23 (2009). *See* Elizabeth Carrott Minnigh, *A Brave New World: The L3C, Benefit Flexible Purpose and Social Purpose Hybrid Models*, 53 TAX MGMT. MEMORANDUM 475, 481 nn. 86-96 (Dec. 31, 2012). In June 2013, North Carolina effectively reversed its LIC Act as of January 1, 2014 by passing a new LLC Act that deletes references to L3Cs except for those that already exist.

10. *See* Murray & Hwang, *supra* note 2; Brakman Reiser, *Blended Enterprise*, *supra* note 3; John Tyler, *Negating the Legal Problem of Having "Two Masters": A Framework for L3C Fiduciary Duties and Accountability*, 35 VT. L. REV. 117 (2010).

11. *See, e.g.*, CAL. CORP. CODE § 14600 (West 2012); HAW. REV. STAT. §§ 420D-1-420D-13 (2012); 805 ILL. COMP. STAT. ANN. 40 (effective Jan. 1, 2013); LA. REV. STAT. §§ 1801-1832 (2010); MASS GEN. LAWS ch. 156E (2012); MD. CODE. ANN. CORPS. & ASS'NS §§ 5-6C-01 to 6C-08 (West 2012); N.J. STAT. ANN. §§ 14A:18-1-:18-11 (2012); N.Y. BUS. CORP. LAW. §§ 1701-1709 (McKinney 2012); S.C. CODE ANN § 33-38-110 (2012); VT. STAT. ANN. tit. 11A, §§ 21.01-08 (West 2012); VA. CODE ANN. §§ 13.1-782-791 (West 2012). *See* Minnigh, *supra* note 9, at 475 nn. 7-18.

12. CERTIFIED B CORPORATION, http://www.bcorporation.net (last visited Nov. 25, 2013).

13. *See Business Programs*, CAL. SEC'Y OF STATE, http://kepler.sos.ca.gov/cbs.aspx (last visited Nov. 25, 2013). The State of Washington offers a social purpose corporation option that is very similar to the flexible purpose corporation in California. *See* Minnigh, *supra* note 9, at 479-80. There were eleven such entities as of the latest search. *Corporations and Charities Division*, WASH. SEC'Y OF STATE, http://www.sos.wa.gov/corps/search_results.aspx?search_type=simple&criteria=all&name_type=contains&name=social+purpose&ubi= (last visited Nov. 25, 2013).

"hybrids" that operate under more traditional structures such as limited liability companies, joint ventures, subsidiaries of tax-exempt entities, for-profits that pursue charitable purposes, and other forms.

As is discussed below, neither the corporate hybrid forms nor the B corp designation requires that they pursue or adopt solely charitable purposes; therefore, their specific form under state law by itself does not risk conscripting them into the realm of charitable trust law. The danger for them generally arises if they include charitable purposes among their activities.[14] Similarly, the traditional approaches and forms do not, by virtue of their structure, risk being treated as charitable trusts, except obviously for charitable trusts themselves. Certain applications of these forms, however, risk being treated under the charitable trust regime because the justification for doing so is not grounded on the underlying form but instead is based on the presence of assets dedicated to charitable purposes and outcomes.

California's flexible purpose corporation law provides that nothing about the flexible purpose corporation itself removes businesses that operate under the form from oversight as a charitable trust to the extent such oversight is otherwise deemed applicable.[15] This still requires the exercise of judgment and affirmative assertions of jurisdiction by the attorney general to impose charitable trust law on specific enterprises, rather than with regard to the form itself. Illinois, on the other hand, seems to have eliminated the ambiguity in its L3C statute by expressly subjecting L3Cs in Illinois and their managers to the charitable trust regime,[16] which, although providing clarity, may actually deter the form's full deploy-

14. *See* discussion *infra* Part II.C.

15. CAL. CORP. CODE § 2700(e) (West 2012) ("[N]othing in this division shall be construed as negating existing charitable trust principles or the Attorney General's authority to enforce any charitable trust created"). *See also* Minnigh, *supra* note 9, at 478 n. 47.

16. 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*, *supra* note 3, at 616 n. 132.

ment. As such, Illinois L3Cs effectively are charitable trusts under Illinois law by virtue of their chosen form.

In the next section, the article describes the relevant characteristics of the applicable structures, including their approaches to charitability, taxability, affording charitable deductions, and distribution of income and appreciation of value. It then identifies key problems that universally treating charitable hybrids as trusts likely imposes for financing and managing these enterprises. With that perspective, the article presents the most common arguments for why charitable hybrids should (or even must) be treated like charitable trusts in order for attorneys general to fulfill their responsibilities to the electorate, the charitable sector more broadly, and the institution of "charitable trust." Finally, this article advocates that charitable hybrids do and must operate in an environment that continues to respect those responsibilities but solves for them in other ways and without the debilitating consequences of imposing the charitable trust regime.

II.
Characteristics, Features, and Descriptions of the Relevant Forms and Structures

Before we can truly dive into the rationale for imposing charitable trust law regulation and oversight on hybrid enterprises, it is necessary to generally understand those structures, how they are different from traditional forms and each other, and how they might be ensnared in the charitable trust web. As noted above, the primary new forms in America are the L3C, the benefit corporation, the B corp (which is a private certification rather than a form or structure), and the flexible purpose corporation.[17]

A. *L3C*

The L3C borrows from an area of law that had been unique to private foundations—the program related investment ("PRI")—and transplants the PRI elements into the lim-

17. In Maryland there is also the benefit LLC and in Washington, the social benefit corporation. *See* Minnigh, *supra* note 9, at 482. The United Kingdom has also been experimenting with various forms such as the "community interest company" and the "social enterprise LLP." *See* Murray & Hwang, *supra* note 2, at 20-21.

ited liability company framework.[18] For our purposes, the most essential characteristics of the L3C are that (1)(a) the enterprise must significantly further charitable, otherwise exempt purposes within the meaning of the Internal Revenue Code and (1)(b) would not have been formed but for the relationship to such charitable purposes; and (2) no significant purpose of the enterprise can be production of income or appreciation of property.[19] As we will see later, it is this first element—primacy of charitable purpose—that exposes the L3C to the most significant risk of being embraced by charitable trust law, although it may be the second element that exonerates it.

As part of the limited liability company ("LLC") framework, L3Cs share many similarities with LLCs. For instance, L3Cs allocate and distribute profits, but they do not themselves pay taxes unless they choose to do so by electing corporate status. They normally are a disregarded, pass-through entity so that taxes are the responsibility of the member(s). L3Cs are not exempt from income, sales, property, or other taxation because of their form. They may acquire and deploy deductions, credits and other favorable tax treatment because of expenses they incur and why they incur them, but their ability to do so is no different than any other LLC or for-profit business.

Other similarities to LLCs include that investments in and contributions to L3Cs are not deductible as charitable contributions.[20] Also, L3Cs enjoy much of the flexibility that is inherent in the LLC form by way of accessing and allocating capital and structuring governance, provided that the entity retains primacy of charitable purpose and that no significant

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18. *See* Murray & Hwang, *supra* note 2, at 23; Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 622; Tyler, *supra* note 10, at 117.

19. 805 ILL. COMP. STAT. ANN. 180/1-26 (2011); LA. RV. STAT. ANN. § 12:1302(C) (2010); ME. REV. STAT. tit. 31, § 1611.2 (2011); MICH. COMP. LAWS § 450.4102 (2010); N.C. GEN. STAT. § 57C-2-01 (2012); R.I. GEN. LAWS § 7-16-76 (2012); UTAH CODE ANN. § 48-2c-412 (West 2009); VT. STAT. ANN. tit. 11 § 3001 (West 2010); CROW LAW AND ORDER CODE § 18-5-102 (2009); OGLALA SIOUX TRIBAL COUNCIL ORDINANCE No. 09-23 (2009). *See also* Minnigh, *supra* note 9, at 481 n. 100; Murray & Hwang, *supra* note 2, at 623; Tyler, *supra* note 10, at 123-24.

20. One exception to this would be a single member LLC or L3C whose sole member is itself recognized by the IRS as exempt from taxation under § 501(c)(3), in which case contributions to the LLC or L3C may be deductible as charitable contributions. *See* IRS Notice 2012-12, 2012-6 I.R.B. 365.

purpose is generating profits or appreciation of value.[21] L3Cs are also hampered by the same limitations that apply to LLCs, including the deemed receipt of taxable income for which there may not be a distribution to pay and the reluctance of the market to adopt the form for high value transfers of control.[22]

B. *Benefit Corporations, B Corps, and Flexible Purpose Corporations*

Benefit corporation statutes require that, in making decisions for the company, operational and otherwise, directors must pursue general public benefit by more specifically ensuring "a material positive impact on society and the environment taken as a whole."[23] This general public benefit and the corresponding fiduciary duty of care under the statutes requires that directors consider the impact of decisions on shareholders; employees of the firm and its subsidiaries and suppliers; customers; community and society; the local and global environment; short and long term purposes; and the ability to accomplish the general and specific purposes.[24] The statutes do not mandate any particular priority or weighting of these interests nor do they require consistency over time, instead deferring to directors to determine those matters on a case-by-case basis as they deem appropriate under the circumstances.[25]

Benefit corporations may also incorporate "specific public benefits" that include, but are not limited to, those purposes that are identical to those considered "charitable" under Code §§ 501(c)(3) and 170(b).[26] Specific benefit purposes, however, are not constrained to the Code and may include pur-

21. *See infra* notes 101-02 and accompanying text.

22. *See* Britt, *supra* note 2, at 3-4.

23. *See* MODEL BENEFIT CORP. LEGISLATION § 102 (Clark et al. 2012), *available at* http://www.benefitcorp.net/storage/documents/Model_Benefit_Corporation_Legislation.pdf [hereinafter MODEL ACT]. *See also* Britt et al., *supra* note 2, at 13; Clark & Babson, *supra* note 1, at 838; Lacovara, *supra* note 3, at 825; Minnigh, *supra* note 9, at 476.

24. *See* MODEL ACT § 201(c). *See also* Britt et al., *supra* note 2, at 14; Clark & Babson, *supra* note 1, at 839-40.

25. *See* Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 598.

26. *See* MODEL ACT § 102. *See also* Britt et al., *supra* note 2, at 18 n. 15; Clark & Babson, *supra* note 1, at 838; Minnigh, *supra* note 9, at 476; Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 594 n. 22.

poses that are not themselves "charitable" or in furtherance thereof.[27] The statutes do not seem to permit prioritizing those specific public benefit purposes over the required "general public benefit purposes," which are most certainly broader than what might be considered "charitable" under federal or state law.

Unlike benefit corporations, the B corp is not a business form at all but instead is a private certification program operated by B Labs, itself a 501(c)(3).[28] B Labs has developed, tested, and revised extensive criteria over several years to assess commitment to social and/or public purposes (including those that may be charitable), and it has instituted processes to hold its certified companies reputationally accountable for adhering to that commitment. B corps may be corporations (including benefit and flexible purpose corporations), partnerships, or LLCs (including L3Cs), and their characteristics for income distribution, taxation, and otherwise are determined by the underlying form.[29]

Flexible purpose corporations are required to specify at least one "special purpose" that directors may consider in addition to or even at the expense of traditional shareholder economic interests when making decisions about operations, policies, and transactions.[30] Such special purposes can satisfy any of the following categories: (1) be charitable under the Code, (2) pursue any purpose carried out by a state nonprofit public benefit corporation, or (3) promote or minimize effects on employees, suppliers, customers, creditors, community and society, or environment.[31]

Like the benefit corporation, the flexible purpose corporation's purposes could include being charitable but need not be so limited and instead may encompass broader service to social and/or public benefit. Moreover, neither corporate hybrid structure's suggestion of charitable purposes, if any, requires that such purposes be prioritized over other interests,

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27. *See* Britt et al., *supra* note 2, at 18 n. 15; Clark & Babson, *supra* note 1, at 838.

28. *See* CERTIFIED B CORP., www.bcorporation.net.

29. *See* Brakman Reiser, *Benefit Corporation, supra* note 3, at 592; Brakman Reiser, *Blended Enterprise, supra* note 3, at 637 n. 131.

30. *See* CAL. CORP. CODE § 2602(b)(2) (West 2012). *See also* Britt et al., *supra* note 2, at 4; Minnigh, *supra* note 9, at 476.

31. *See* Britt et al., *supra* note 2, at 5.

although incorporators and subsequent directors could choose to impose such priority in the flexible purpose corporation.

There are no statutory limits on the ability of a benefit or flexible purpose corporation to earn and distribute profits or appreciate in value, and both structures pay taxes on income, property, and purchases in the same manner as other corporations. Also, investments in and contributions to benefit and flexible purpose corporations are not deductible as charitable contributions absent separate IRS or state agency recognition of them as exempt.

C. *Comparative Analysis and "Charitability"*

Below is a chart that summarizes the above information and includes comparative references to traditional for-profit business and charitable, tax-exempt forms as well.

	L3C	Benefit Corporation	B Corp	Flexible Purpose Corporation	For Profit LLCs, Partnerships and Corporations	Tax Exempt Charitable Organizations[32]
Distribute Profits to Owners	Yes	Yes	Yes	Yes	Yes	No (no owners)
Generally Exempt from Paying Taxes	No	No	No	No	No	Yes
Contributions Generally Deductible to Donors as Charitable	No	No	No	No	No	Yes
Must Be Charitable or Further Such Purposes	Yes (significantly further)	No	No	No	No	Yes (be charitable)
May Be Charitable	Not optional	Yes	Yes	Yes	Yes	Not Optional
May Pursue Social/ Public Purposes	Secondary to charitable purposes	Yes	Yes	Yes	Maybe (with limits)	Too broad
May Maximize Shareholder Value	No	Yes	Yes	Yes	Not Optional	No

32. Tax-exempt charitable organizations are not themselves a form but are included here for comparative purposes because they are frequently considered among the traditional structures or approaches.

Somewhat ironically, neither the benefit nor flexible purpose corporation seems required to compromise or subvert maximizing shareholder value to the broader social or public benefit or for charitable purposes. For instance, the benefit corporation requires that directors consider interests other than those of shareholders but does not mandate a priority regimen.[33] For the flexible purpose corporation, directors may, but are not required to, consider the special purpose interests in addition to or at the expense of shareholder interests.[34] Both forms effectively afford potential for altering the profit maximization paradigm and protect directors who do so,[35] but neither form actually mandates alteration of the paradigm as a matter of law.

The only real protection that socially minded or charitably focused investors may have in such circumstances is to be directors themselves, to control enough shares to be able to appoint and replace directors who share their priorities, to catch the directors neglecting duties that might exist to consider relevant interests, or to ensure that organizing documents exceed statutory graces by enshrining priorities in those documents.[36] Investors who want their social or charitable priorities to survive will need to ensure control of enough shares to prevent changes to such purposes. To ensure that such priorities survive their involvement, they will need to deploy creative securities restrictions and estate planning techniques, possibly leaving their more than two-thirds ownership interest to a charitable entity that can prevent changes and ensure ongoing fealty to the social or charitable purposes.

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33. *See* Britt et al., *supra* note 2, at 14; Clark & Babson, *supra* note 1, at 839-41; Ann E. Conaway, *Lessons to be Learned: How the Policy of Freedom to Contract in Delaware's Alternative Entity Law Might Inform Delaware's General Corporation Law*, 33 DEL. J. CORP. L. 789, 794 (2008); Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 597-98.

34. *See* Britt et al., *supra* note 2, at 4.

35. *See* Britt et al., *supra* note 2, at 4-5, 11; William J. Callison, *Putting New Sheets on a Procrustean Bed: How Benefit Corporations Address Fiduciary Duties, the Dangers Created, and Suggestions for Change*, AM. U. J.L. & BUS. (forthcoming) (manuscript at 12-13), *available at* http://ssrn.com/abstract=2102655; Clark & Babson, *supra* note 1, at 840-41, 848-50; Conaway, *supra* note 28, at 798-99; Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 597-98.

36. Regarding shareholder enforcement in corporate hybrids, see Brakman Reiser, *Benefit Corporations, supra* note 3, at 604-05.

The L3C, on the other hand, inverts traditional duties and conceptions by permitting distribution of profits and appreciation of value for the benefit of owners (which is prohibited in traditional tax-exempt, charitable forms) and by prioritizing furtherance of charitable purposes in decision-making (which is prohibited in traditional for-profit business forms).[37]

Another feature that differentiates the L3C from the other new hybrid forms is the extent of their respective scopes. "Charitable" as required in the L3C form is not synonymous with "general public benefit" or "specific public benefit" under the benefit corporation structure or with "special purposes" as in the flexible purpose corporation form. There is a subset of both "specific public benefit" and "special purposes" that are very similar if not identical to the "charitable" requirement of the L3C, but there is room in both corporate hybrid forms to avoid charitability entirely. For instance, it is not automatically "charitable" under state or federal law to consider the effects of decisions on employees, customers, or even the environment, although doing so satisfies the permitted machinations of benefit and flexible purpose corporations. Even so, there are plenty of applications of both the benefit and flexible purpose corporate structures that could render them "charitable" or operating to significantly further such purposes, but these applications are not automatic as a matter of law as they must be with the L3C.

Yet another distinction important to our analysis is how the "charitable" requirements of the L3C relate to requirements for exemption under the Internal Revenue Code. The L3C must "significantly further[ ] the accomplishment of" charitable purposes as defined by federal law.[38] Organizations exempt under 501(c)(3) must be both organized and operated "exclusively" for charitable purposes.[39] The IRS and the courts have interpreted "exclusively" to mean "primarily," which, unlike the term "exclusively," accommodates some degree of other activity. In practice, the regulations state that the

37. *See* Brett A. Seifried, *Mind the Gap: Using the History and Theory of Profit and Nonprofit Corporations to Remedy the Problems of Social Enterprise in Low-Profit Limited Liability Companies – A Theory and Practice Approach* 42 (2012), http://ssrn.com/abstract=2083827.

38. *See supra* notes 10, 19 and accompanying text.

39. I.R.C. § 501(c)(3) (2006); Treas. Reg. § 1.501(c)(3)-1(c)(1) (2006).

IRS can deny tax exemption and charitable deductions to an organization if "more than an insubstantial part of its activities" are not exempt.[40] Therefore, it appears that under the federal tax code "exclusively" is defined as "primarily," which may mean "substantially."

The semantics and principles that underlie them become even more convoluted with the introduction of the unrelated business income tax and "functionally related business." In the case of the former, otherwise tax-exempt charities pay federal income taxes on income generated by a trade or business that is "not substantially related" to its 501(c)(3) purposes.[41] Not only is unrelated business income taxable, but too much of it can threaten exempt status if it is more than an insubstantial amount the detracts from charitable purposes being "exclusive."[42] In the case of "functionally related business," the income may be taxable but the operation is related enough to charitable purposes that exempt status is not jeopardized.[43]

Presumably for federal income tax purposes, there are differences between "significantly further[ing]" charitable purposes as required for a PRI (and by extension for the L3C),[44] being organized and operated exclusively/substantially in pursuit of charitable exempt purposes, having business income that is not substantially related to such purposes, and having activity that is functionally related to such purposes but not substantial enough to support revoking a charity's exempt status. Those same differences are then relevant to the L3C, which is derived from and incorporates the PRI character, thereby making federal tax analysis of charitable purposes directly relevant for state attorneys general and their regulation and oversight of L3Cs.

As such, the semantic distinctions regarding "charity" discussed in the preceding paragraphs are important to explore in the next section of conditions under which state law subjects certain assets and entities to charitable trust regulation

40. I.R.C. § 501(c)(3); Treas. Reg. § 1.501(c)(3)-1(c)(1) (2006). *See also* BRUCE HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 72-73 (10th ed. 2011); John D. Colombo, *Commercial Activity and Charitable Tax Exemption*, 44 WM. & MARY L. REV. 487, 495-96 (2002).

41. I.R.C. § 513(a) (2006).

42. *See* HOPKINS, *supra* note 40, at 72-73, 635 (citations omitted).

43. *See* I.R.C. §§ 513, 4942(j)(4) (2006).

44. *See supra* note 19 and accompanying text.

and oversight (whether L3C, benefit or flexible purpose corporation, or otherwise). The distinctions become decisive for concluding that such a unilateral imposition is not generally appropriate for charitable hybrids.

III.
Effects on Financing, Capital Raising, and Operation of Charitable Hybrids If Regulated as Charitable Trusts

There are several problems for charitable hybrids if they fall under the rubric of charitable trust law. Some are more basic, such as compliance with possible registration and filing duties. Others are fiduciary, such as the extent of duties of care and loyalty and application of the business judgment rule in decision-making, whether in day-to-day operations or in change-of-control circumstances.[45] Still others directly impact the operational health and finances of these enterprises from raising equity capital at the earliest stages to distributing profits and recognizing value at various exit points. Given the nature of the symposium and focus of this journal, it is these latter problems that are the focus of this section. The following section explains why the problems identified in this section should not be relevant because these forms should not be treated as trusts.

A. *Distribution of Profits and Appreciation of Capital*

Under trust law, those responsible for the trust's assets have an almost unqualified duty of loyalty.[46] The interests of the trust and its beneficiaries must always supersede any interests that a trustee may have such that trustees are prohibited from dealing with trust property in any way that furthers their

45. Treatment of fiduciary duties is a complicated subject and is made more complex by trying to undertake an analysis of duties for LLCs, L3Cs, for-profit corporations, charitable corporations, benefit and flexible benefit corporations, and charitable trusts. The differences can be material and should not be ignored by policymakers, practitioners, investors, entrepreneurs, creditors, or others. However, these complications and their materiality deserve greater attention than is appropriate for this article. For a discussion of an approach to fiduciary duties in the L3C structures and their differences from LLC and other forms, see Tyler, *supra* note 10.

46. Fremont-Smith, *supra* note 2, at 195.

own interests.[47] This includes avoiding—not merely managing—possible conflicts of interest.[48] The duty can be so rigid that liability attaches even if a self-dealing activity is inadvertent or undertaken in good faith, and the trustee can be liable even if the beneficiaries are not harmed.[49]

Trust law also imposes a duty of care by which trustees are expected to exercise reasonable judgment "after serious and responsible consideration, prudently, and in accordance with fiduciary standards" that prohibit unreasonably disregarding purposes of the trust or standards of judgment apparent from the trust instrument.[50] For charitable trusts, those "purposes" are and must be charitable and in service to the corresponding public good in lieu of more specifically named beneficiaries. For charitable hybrids, there will likely be other purposes that also must receive due attention, and, as long as the charitable trust system recognizes those as "purposes of the trust," it may be okay. As we shall see later, however, charitable trust law does not easily permit the pollution of purposes that are not charitable, and doing so could even prove fatal for the trust regime.

In assessing claims, courts generally hold trustees to a standard of liability for negligence, as opposed to the more forgiving standard of gross negligence that usually accompanies liability for directors of corporate entities.[51] In more modern evolutions of trust law, and absent state law to the contrary, donors often reduce trustee obligations from what may otherwise be draconian standards and consequences for breach.[52] But even donors are not able to excuse or exculpate

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47. *Id.* at 195; *see also* RESTATEMENT (THIRD) OF TRUSTS § 78(1)-(2) (2003); RESTATEMENT (SECOND) OF TRUSTS § 170 (1959); AUSTIN W. SCOTT & WILLIAM F. FRATCHER, LAW OF TRUSTS §§ 170-170.25 (4th ed. 1987).

48. FREMONT-SMITH, *supra* note 2, at 195.

49. *Id.*

50. *Id.* at 145-46 (citing Bos. Safe Deposit & Trust Co. v. Stone, 203 N.E.2d 547, 552 (Mass. 1965)).

51. *Id.* at 201. A significant issue for courts as they evaluate claims against directors of exempt, charitable corporations is whether to deploy a standard of negligence or gross negligence, although the prevailing approach seems to adopt the gross negligence standard that applies to corporate directors. *Id.* at 202.

52. *Id.* at 188, 196.

for willful/deliberate violations, gross negligence, bad faith, dishonesty, or "acts from which a trustee profits personally."[53]

In any case, remedies for breaching the duty of loyalty to the trust and its beneficiaries also reflect the forbidden nature of dealing for one's own interests when a trustee. Not only do remedies include restoring losses caused by the breach, but they also can require disgorging of profits made in the course of administering the trust.[54] Under ordinary circumstances, these standards are appropriate, but charitable hybrids are not ordinary.

If charitable hybrids are treated like trusts, then it may not be possible for corporate officers and directors and L3C managers to also be investors in those enterprises. As investors, their decisions could benefit them personally, which compromises the duty of loyalty owed to a trust. Such investors may not be able to retain profits and could be liable for losses—even losses incurred in good faith and based on fully informed decision making by those without a conflict. Those risks could be significant because of the underlying nature of charitable hybrids.

There is no financial upside for directors, officers or managers to also invest in charitable hybrids that are deemed to be charitable trusts. Making a capital infusion in such circumstances involves putting their money at risk without the ability to make a return, whether profits or interest, and without even being eligible for a charitable deduction.

While it may be that such persons are not always investors, it is not uncommon—and indeed may be expected—for there to be such overlap in startup and early-stage companies. Even though profits may not be the primary (or even a significant) purpose, there is value in ensuring that the people running an enterprise have a vested interest in its success, which is common among taxable entities. Even among exempt charities it is routine for board members to be expected to support the organization with financial contributions or to have financial

53. *Id.* at 196-97, 199.
54. *Id.* at 197, 309.

"skin in the game," although they at least get to take the deduction.[55]

In addition, the trust regime would further prohibit the use of equity as a compensation tool to ensure incentive alignment, even with the entity's charitable purposes. For instance, instead of awarding shares or ownership units based on stock price or book value or earned revenues, shares or units could be awarded for achieving milestones with regard to the organization's charitable objectives. It seems like society and the public would welcome successful charitable outcomes, and an incentive compensation system based on awarding shares or units for achieving such outcomes might be worth considering. The trust regime would prohibit such a system for charitable hybrids because of its reliance on what it considers fundamentally compromised interests.

B. *Compensation of Managers/Trustees and Insiders/Disqualified Persons*

Compensation could be affected in other ways as well, including for those who are not investors. Principally, all compensation must be reasonable, which seems appropriate.[56] Compensation in a charitable hybrid that is too high may be considered a waste of charitable trust assets,[57] for which there can be liability to the attorney general for breach of fiduciary duty, even if the compensation is approved by the owners, who also may be considered a category of beneficiary. A standard of reasonableness may be affected by equity compensation (if permissible) because of the potential for the interest to appreciate in value over time. Perhaps at the time it is awarded it may not be very valuable, but over time and with great success it could be extraordinarily valuable and could possibly even

55. As is noted later, this statement should not be interpreted to infer that I support allowing charitable deductions for investments in or contributions to charitable hybrid forms. *See infra* note 123 and accompanying text.

56. Compensation at for-profit enterprises must be "reasonable" in order to be deductible. *See* Hines et al., *supra* note 2, at 1194-95. Compensation at charities must be reasonable at the risk of intermediate sanctions and/or exempt status. *See* I.R.C. § 4958 (2006); Treas. Reg. § 1.501(c)(3)-1(f) (2006). Private foundations are more specifically prohibited from paying its disqualified persons compensation that is excessive. *See* I.R.C. § 4941 (2006).

57. *See* FREMONT-SMITH, *supra* note 2, at 142.

surpass charitable trust and exempt charity standards for reasonableness. Under a charitable trust regime, liability could ensue.

It is not clear what effect, if any, the emerging and growing efforts of attorneys general and state legislatures to impose universal compensation limits on charities might have on charitable hybrids. There are certainly arguments that there should be no effect. Presumably, state statutes that limit compensation at tax-exempt charities would not apply to charitable hybrids because they are not tax-exempt. However, it is possible that efforts could be made to bring charitable hybrids under that umbrella in which case questions might arise about the government's ability or right to set compensation caps for any and/or all entities—including purely for-profit, taxable entities—simply because it contracts with or otherwise receives money from the government.

C. *Mergers and Transfers of All or Substantially All Assets and Other Permissions*

Decisions about compensation are not the only ones likely to change for charitable hybrids under a charitable trust regiment. Such a regime would severely restrain or even prevent efforts by charitable hybrids to change their purposes and/or administration, to merge, to dispose of all or substantially all of their assets, or even to delegate certain duties.[58] These outcomes could not have been intended by the legislatures and are particularly suspect in light of the fact that, as is discussed in the next part of this article, the charitable hybrid forms generally do not meet the requirements for imposing trust regulation or oversight on them.

1. *Changing Purposes and Converting from Hybrid Status*

Any number of changes for charitable hybrids could be impacted by charitable trust treatment: changes from one charitable purpose(s) to another, adding purposes that may or may not be charitable,[59] or converting from a charitable, tax-

58. *See id.* at 139-40 (ability to delegate); *id.* at 156 (change of purposes or administration); *id.* at 167, 319 (disposing of substantially all assets); *id.* at 319 (mergers).

59. Recall that in none of the new forms are charitable purposes the sole possibility, even in the L3C where charitable purposes are most notably

paying hybrid to "regular," non-hybrid status. The first two are mostly operational while the third is structural. If treated as charitable trusts, even the operational changes could require notice to the attorney general. However, notice of changed purposes or administration could be the least of the problems because it may be that *cy pres* and deviation procedures apply such that actual approval of the attorney general and/or a court may be required.[60] If that is the case, then not only do managers and owners lose flexibility that might be important for competitive advantage—particularly relative to other tax-paying enterprises—but they may lose opportunities for success in achieving charitable outcomes.

For instance, a charitable hybrid formed to determine the viability of an approach to how electrical impulses can process information for prosthetic devices to function better might discover that a side effect of the electrical impulses stimulates certain brain activity that seems to reverse the effects of Parkinson's or Alzheimer's. Or the same hybrid develops a nano-device that converts human electrical impulses into a power source for the prosthetic that could also be used in mobile devices. Both results are completely disconnected from their original research and charitable purposes.

In both cases, a charitable hybrid treated as a trust may need to first petition the court or the attorney general for approval to expand from its originally stated charitable purposes. While the first deviation might be approved relatively easily, the second is more suspect given its broadly commercial applications. It might be more efficient to instead set up a new entity or to license the technology, but that could have its own undesirable implications for expenses, branding, governance, and other operations. In either event, the decision should be one of management rather than government; by making it the latter, society could be deprived of the benefits that the changes might bring about.

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given priority. *See* Minnigh, *supra* note 9, at 482. For changing purposes of a flexible purpose corporations, see *id.* at 478 n. 45 (citing CAL. CORP. CODE § 3000(b) (West 2012) regarding changing purposes). For benefit corporations, see *id.* at 476 n. 24 (citing MODEL ACT § 201(d) regarding changing purposes).

60. Regarding *cy pres* and deviation, see FREMONT-SMITH, *supra* note 2, at 156.

Structural conversions would be similarly constrained, thereby effectively negating the extensive procedures provided for by the state legislatures for converting a benefit or flexible purpose corporation to "regular" corporate status.[61] Notably, the statutes do not require notice to the attorney general for such conversions. An attorney general or court unilaterally imposing such a notice obligation or even right of approval could evoke questions about respecting the authority of the legislative branch and possibly usurpation by the executive and/or judicial branches of government. The legislatively provided procedures for converting from benefit or flexible purpose corporation status are entitled to respect, that imposing a charitable trust overlay denies.

The L3C statutes also expressly acknowledge possibilities for converting from L3C status into a regular LLC, thereby shedding the trappings of PRI elements,[62] but the procedure for doing so seems deceptively simple.[63] The statutes generally seem to permit automatic conversion to LLC status upon failing to meet any of the required elements without regard to whether such failures are intentional or accidental.

Such a simplistic approach, however, threatens the very essence of the L3C because it so easily forgives noncompliance with the L3C's core requirements, including potentially even primacy of charitable purpose. Surely there should be some consequence for not taking the L3C's core requirements seriously, and there should be some mechanism for those who do take the requirements seriously to hold others involved accountable for their failure to do so. Moreover, it does not seem plausible that legislatures could have intended for one part of an action to essentially nullify another aspect of its same act.

Arguably, the procedure for converting from L3C to LLC status should be consistent with the standards for being an

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61. For converting flexible purpose corporations, see Minnigh, *supra* note 9, at 478-79 n. 57 (citing CAL. CORP. CODE § 3002(a) (West 2012)). For benefit corporations, see *id.* at 477-78 n. 41 (citing MODEL ACT § 105(a) regarding converting to traditional form).

62. *See id.* at 482 n.103 (citing state statutes for conversion upon failing to satisfy an L3C element and noting that North Carolina does not provide for administrative conversion for failure to qualify).

63. *See* Murray & Hwang, *supra* note 2, at 649 n. 270; Brakman Reiser, *Blended Enterprise*, *supra* note 3, at 629-30; Tyler, *supra* note 10, at 149, 159.

L3C in the first place. It should not be enough that someone was not paying attention or even that most members have changed their minds. Such a low standard leaves too much potential for immitigable abuse and no recourse for minority positions about the continued priority of furthering charitable purposes. Even room for members to unanimously agree to simply "change their minds" seems too easy and ripe for abuse.

One possible approach might be to require due consideration that either the specific charitable purposes have been appropriately furthered so that success can be declared, or there should be a determination that the charitable purposes are more likely to be furthered if profits and value had a greater role for the enterprise than is permissible under the L3C. Such an approach is consistent with the L3C structure and its emphasis on primacy of charitable purpose, particularly if such emphasis informs applicable fiduciary duties.[64]

The standard could be met by adopting some variation of the business judgment rule specifically modified to the L3C's circumstances. It might ensure that those involved considered enough data and information that both supports and opposes arguments for converting, and that those who continue favoring primacy of charitable purpose are treated fairly in the conversion (although their specific contractual provisions upon forming or joining the L3C, if any, could ensure more effective protections and processes).[65]

The more difficult aspect of the business judgment rule to apply to an L3C conversion will be meeting requirements about conflicts of interest because, presumably, all members will have a financial interest in the conversion and therefore something to gain from it. Perhaps some type of notice to the attorney general and the public about the conversion and its reasons could mitigate that problem. An attorney general who is aware of other complaints about a particular entity might then have additional information and further context for taking some possible enforcement action. It may be that notice to the attorney general with presumptive approval absent objec-

64. *See* Tyler, *supra* note 10, at 147-49, 159.

65. *See* I.R.S. Priv. Ltr. Rul. 2006-10-020 (Mar. 10, 2006) (private foundation reserved certain approval and veto rights in order to preserve its program related investment in a limited liability company organized as an angel investment fund). *See also* Tyler, *supra* note 10, at 126 n. 38.

tion and an explanation within a short period of time could work.

Given the ambiguity and/or vagueness about converting in the L3C process, it may be that the attorneys general in their regulatory function and the courts as interpreters and appliers of the law do have roles with regard to how L3Cs convert to LLC status. In any case, guidance or perspectives on this topic would be useful for members, managers, creditors, and others who have or are interested in obtaining financial and operational interests in L3C.

2. *Merging, Distributing Assets, and Terminating*

Benefit and flexible purpose corporation statutes also present reasonably comprehensive protocols for mergers and asset transfers,[66] but they do not contemplate obtaining permission from the attorney general or a court. The L3C is silent and therefore particularly vulnerable to intervention by the attorney general on the basis of trust law.

But any charitable hybrid that is considered a charitable trust—whether by virtue of its form or particular application of a structure—will be restricted in its ability to merge and/or distribute all or substantially all of its assets.[67] At a minimum, some notice to the attorney general may be required, which may result in the attorney general affirmatively seeking to prevent or otherwise intervene in the transaction.[68] More onerously, actual approval of the attorney general or a court could be required, in which case the merger and/or distribution becomes a decision of government rather than of the owners.

One reason this possibility is disconcerting is the lack of clear rationale or standards for removing these decisions from the owners, unlike what applies in the context of exempt char-

66. For flexible purpose corporations, see Minnigh, *supra* note 9, at 479 n. 59 (citing CAL. CORP. CODE §§ 3100, 3201, 3301, 3401 (West 2012) regarding mergers, reorganizations). For benefit corporations, see *id.* at 478 n. 42 (citing MODEL ACT § 105(b) regarding merger or asset sale).

67. *See* FREMONT-SMITH, *supra* note 2, at 167 (disposing of assets); *id.* at 319 (merger and disposing of assets)

68. Examples of recent attorney general involvement in charities include various matters involving the Hershey Trust and School in Pennsylvania, the Maddox Foundation and disputes regarding it in Tennessee and Mississippi, and the Michigan Attorney General's efforts to require the Ford Foundation to spend more in the Detroit area, among others.

itable enterprises, antitrust, or public commodities. A possible rationale could be to ensure that decisions are made in good faith and consistent with fiduciary obligations and/or the statutorily mandated considerations. This basis may be less applicable for the corporate charitable hybrids than for the L3C, which most clearly enunciates the priority of furthering charitable purposes. Even with a rationale in place, the absence of a standard effectively means that the transactions are subject to the goodwill and available time of the attorney general and her/his staff, which opens such transactions to the uncertainties of potentially arbitrary or even politicized decision-making.

Another reason for concern is that, for benefit and flexible purpose corporations, the attorney general could be usurping authority not directly given to her/him in light of the detailed procedures explicitly set out in the legislation.[69]

Investors, owners, creditors, managers, and others involved with charitable hybrid forms—including the public—are entitled to more certainty than is provided by subjecting them to charitable trust law. That is particularly true given the conclusion that such hybrid forms do not meet the requirements for such imposition.

Decisions to terminate the enterprise are potentially even more damaging for charitable hybrids if treated as trusts. Typically, terminating an exempt charity, whether a trust or a corporation, requires transfer of all of the assets to an entity that can satisfy the requirements of charitability as declared and practiced by the transferring entity.[70] A charitable trust regime, then, could prohibit asset distributions (a.k.a. return of capital) to the owners/investors of charitable hybrids upon

69. 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. CAL. CORP. CODE § 2700(e) (West 2012) ("[N]othing in this division shall be construed as negating existing charitable trust principles or the Attorney General's authority to enforce any charitable trust created"). *See also* Minnigh, *supra* note 9, at 478 n. 47. 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.

70. *See* FREMONT-SMITH, *supra* note 2, at 184-85. *See also* I.R.C. § 501(c)(3) (2006); RESTATEMENT (THIRD) OF TRUSTS § 67 cmt. e (2003).

dissolution and liquidation and would even further restrict their ability to select a recipient other than one devoted to the same charitable purposes.[71] Loans may not be similarly affected, but this mandate threatens equity of all forms, whether as the return of capital contributions, the realization of appreciated value, and even the ability to monetize equity (whether vested or as options) provided as part of compensation. This approach renders any equity effectively worthless to anyone except an exempt charity.

Such an outcome is contrary to legitimate expectations normally associated with putting equity capital at risk (particularly in traditionally high-risk charitable endeavors), which might result in its loss but also has a possibility of its return, maybe even with gains. This outcome also is inconsistent with how similarly situated hybrids based on traditional forms seem to be and have been treated.

D. *Consolidating Thoughts*

Imposing trust law on charitable hybrids because of their form could thus severely constrain their abilities to attract capital and could materially affect how and with whom they engage as directors and managers. There are applications of trust law that would prevent owners from receiving distributed profits or realizing appreciated value, whether as part of ordinary operations or in conjunction with terminating the entity. These applications dramatically alter what capital might be available and how it is raised, which is already more complicated than it might be for traditional forms. They also change what exit strategies are available and how they might be executed, including for investors wholly committed to charitable outcomes.

All equity would be similarly affected, including what is awarded and earned as part of an incentive performance compensation system. It is one thing for equity to lose value because of risks inherent in operating a business; it is quite another for it to become worthless after the fact by operation of law.

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71. Perhaps the owners may be able to benefit from a pro rata charitable deduction if they distribute remaining assets to a 501(c)(3) entity.

Applying trust law to charitable hybrids also can cause numerous problems for how assets are valued—already a challenge for a charitable hybrid—which problems redound across several areas. For instance, valuation of investment rounds is likely to be substantially lower than it might be otherwise, not because of risks associated with the venture, which would be expected, but because of uncertainty associated with whether or how the attorney general might respond to a notice or request for approval. Similarly, credit, bond, and other borrowing opportunities could be diminished because of an inability to understand the value of assets that might support the transaction, including intangible assets, guarantees, and security interests.

Ultimately, the most troublesome effect is on the ability to pursue scalable solutions to certain charitable problems that plague society. Any number of such problems continue to afflict mankind because of the inability of traditional approaches to effectively defeat them, whether government, business, or exempt enterprises. Certainly, various efforts have defeated such problems and will continue to do so, but others seem resistant. Perhaps new approaches and new forms might break through and permit solutions and maybe even scale in certain spheres—not to replace any sector or even to interfere with deploying traditional forms. Charitable trust law would prevent this from occurring in charitable hybrids and in certain applications of traditional forms.

Applying charitable trust law to charitable hybrids could limit their available capital to only that which is otherwise available to exempt charities. Those resources are already available and allocated toward addressing society's charitable problems.

Essentially, charitable hybrids end up with all of the problems of being an exempt entity without any of the corresponding benefits. They are not tax-exempt; they pay income, property, sales, and other taxes.[72] They do not get to allow

72. At the risk of being accused of believing that exempt charities' assets are public money, see Evelyn Brody & John Tyler, *Respecting Foundation and Charity Autonomy: How Public is Private Philanthropy?,* 85 CHI.-KENT L. REV. 571, 571 (2010). Generally, one interpretation of tax exemptions and charitable deductions is that the public shares in the risk of failure and even helps pay for delivered outcomes. But that is not the case with tax-paying charitable hybrids, in which event the public has much less interest, if any, in

their contributors to take charitable deductions on their income taxes. They cannot issue or benefit from tax-exempt bond issuances. Their volunteers do not benefit from presumptions of immunity.

In many respects, because of these characteristics, the interests of the public and of attorneys general in regulating and overseeing charitable hybrids as trusts and imposing the above barriers on them—whether in fact or by ambiguity—cannot wholly align with their interests in regulating and overseeing actual charitable trusts and tax-exempt, charitable entities.

These outcomes cannot have been what legislatures intended by authorizing the forms in the first place. Fortunately, there are compelling arguments that these forms generally do not meet standards for treatment as charitable trusts. However, to the extent there is ambiguity about that result, the consequences for distributions, gains, compensation, mergers, transfers, ability to change purposes, and terminations should support resolving uncertainty against charitable trust oversight, particularly when there are other tools available for the attorney general to address legitimate regulatory and oversight concerns that might affect the public, charities, and even the charitable sector more broadly.

IV.
Could Charitable Hybrids Be Regulated as Charitable Trusts Using Current Standards?

In many ways, whether charitable hybrids are trusts under various theories and principles needs to be reconciled with why hybrid enterprises under traditional business forms are not treated similarly. Hybrid enterprises that combine a charitable or social mission and profit distribution have existed for some time.[73] Consider the following enterprises, which to my knowledge are not currently regulated as charitable trusts:

- Newman's Own, which dedicates all of its net profits to charity;

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preventing those who are bearing those risks from participating in financial upsides that might exist.

73. *See infra* notes 80-81 and accompanying text.

- Google, which has set aside 1% of its equity and profits for charitable purposes through its Google.org operating division;
- the Omidyar Network, the newly formed Gary Community Investment Company as a companion to the Piton Foundation in Denver, Good Ventures LLC and its sister enterprise Good Ventures Foundation, the Case Foundation and Revolution, and other similar combinations of private foundation and private investment vehicles that pursue philanthropic results;
- the Calvert funds and the angel investment fund addressed in Private Letter Ruling 2006-00-010;
- for-profit hospitals and schools;
- conversion entities that were tax-exempt charities but are now for-profit, taxable entities doing many of the same things they did before the conversion;
- whole-entity and ancillary joint ventures between for-profit and charitable, tax-exempt entities; and
- for-profit, taxable companies that receive program related investments or expenditure responsibility grants from private foundations.

The need for consistency and reliability is important for the integrity of attorney general oversight and the successful operation of charitable and other hybrid forms. After all, it should be remembered that charitable hybrids are ultimately intended to facilitate solving or at least mitigating problems that plague society. Efforts to get the regulatory and enforcement regimes right could contribute to extraordinary outcomes for society.

Much of the confusion and concern about charitable hybrid forms seems to originate from worry about the potential for confusion with traditionally charitable, tax-exempt enterprises and the threat of impermissible private gain.[74] Under common and statutory law, those worries and their resolution often rest with state attorneys general[75] who have primary (and

74. See David E. Spenard, *Panacea or Problem: A State Regulator's Perspective on the L3C Model*, 65 EXEMPT ORG. T. REV. 36, 37-38 (2010).

75. Most often, formal responsibility for regulating charities is vested in the attorney general, and I use "attorney general" throughout this article to reference the chief official of a state having primary responsibility for over-

most often the only) legal authority in the state for ensuring that charities and the people who oversee and manage them comply with applicable laws. Their authority includes ensuring exclusive/primary pursuit of charitable purposes, protecting against private benefit and other abuses and misuses of assets, shielding the public from unscrupulous fundraising tactics, and otherwise.

This responsibility is a remnant of charitable trust law that serves to fill a unique gap regarding charitable trusts that does not exist for regular trusts. Under regular trust law, specifically identifiable beneficiaries exist to hold trustees accountable for fiduciary and operational lapses, and they are motivated to do so.[76] Charitable trusts and charitable entities more broadly do not have such readily identifiable beneficiaries because they must serve missions and purposes and the underlying public that benefits from such focus. In fact, the presence of specifically identifiable beneficiaries might even negate the charitable nature of the enterprise and the accompanying exemptions and deductions.[77]

Absent identifiable beneficiaries, then, the public and our rule of law generally vest responsibility with the state attorney general to regulate, oversee, and enforce charitability of applicable enterprises.[78] As such, state attorneys general have primary if not exclusive standing to hold charities and their overseers and managers legally accountable for their operations under state law, including appealing to the courts for redress.[79] The IRS has degrees of authority specifically related to federal income tax, but charitability is broader than the federal income tax. Other state and local taxing authorities may have jurisdiction with regard to whether property tax exemptions are warranted, but such authority and accompanying

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seeing charities that organize and/or operate in their state, whether the attorney general, secretary of state, or some other position.

76. *See* FREMONT-SMITH, *supra* note 2, at 127.

77. *See* I.R.C. § 501(c)(3) (2006) (prohibiting private benefit).

78. *See* MODEL PROT. OF CHARITABLE Assets ACT § 3 (2011), *available at* http://www.uniformlaws.org/shared/docs/protection_of_charitable_assets/mpocaa_prestylefinal_jul11.pdf; FREMONT-SMITH, *supra* note 2, at 301.

79. *See* FREMONT-SMITH, *supra* note 2, at 301. The Internal Revenue Service may have the ability to impose excise taxes on organizations and individuals for violating various tax laws and regulations, particularly in the case of private foundations.

remedies are limited to tax implications. Again, charitability is not limited to tax law and more broadly encompasses such things as fundraising practices, donor intent, and fulfilling fiduciary duties.

Consequently, it is the attorney general who most comprehensively serves as guardian and enforcer, protecting both the public's interest in the integrity of the charitable sector and the sector's interests in ensuring the quality of its own reputation for those who function honorably within it.

Understandably, then, calls for regulating charitable hybrids as charitable trusts most commonly originate with the state attorney general. They are asking questions and making assertions about charitable hybrids because they do not want gaps in legitimate oversight, regulation, or enforcement. They also do not want the public to be confused or misled, at a minimum, or abused and fleeced, at worst, which means they also have practical reasons for such oversight. State attorneys general carry extraordinary responsibilities, and their honest pursuits of clarity in this new world of hybrid forms are to be commended and respected.

One of the most common assertions about charitable hybrids is that attorney general responsibilities attach to any and all enterprises that hold and/or use assets dedicated exclusively to charitable purposes.[80] This claim has a history that originated in England over 400 years ago and has been carried through the centuries with some modifications to the present and into our American legal system through the states.[81] The states have adopted various approaches to determining which assets, enterprises, and personnel are subject to attorney general oversight as charities. For instance, in Illinois, the law impresses the obligations of charitable trust upon legal entities "holding property for or solicited for any charitable purpose."[82] New York and Michigan treat any person or entity

80. *See id.* There are certain limits on this assertion as applied to religious organizations and churches, but those limits are not necessarily relevant for our purposes.

81. For an excellent and through presentation of the history of charity law, its originations and its evolution, see *id.*

82. 760 ILL. COMP. STAT. 55/3 (2011). *See also* FREMONT-SMITH, *supra* note 2, at 314.

that holds or administers property for charitable purposes as a trustee subject to charitable trust law.[83]

A second approach is more limited but still far-reaching. That is, charitable trust law applies when there is a specificity and/or declaration of intent that the assets be used for charitable purposes.

One expression of this approach adopted by some states is the Uniform Act for Supervision of Trustees for Charitable Purposes. The Uniform Act defines a charitable trustee as a person who holds property in trust pursuant to the terms of a charitable trust and any corporation that has accepted property to be used "for a particular charitable corporate purpose as distinguished from the general purposes of the corporation."[84] The Act further provides, somewhat circuitously, that it applies to trustees who hold "property for charitable purposes over which the Attorney General has enforcement or supervisory powers."[85]

The Restatement of Trusts (Third) also seems to emphasize the specificity approach. It imposes charitable trust treatment on any devise or donation to a charity "for a specific purpose" such that the recipient is thereafter deemed "the trustee for purposes of the terminology and rules of this Restatement."[86]

The Restatement of Trusts (Second) identifies a third approach that focuses on (1) manifestation of intention to create such a trust and (2) its dedication to a (3) recognized charitable purpose.[87]

Both Restatements impose restrictions and processes on the ability to deviate from the expressed charitable purposes of the donor with regard to "all funds devoted to charitable purposes."[88] This is the fourth approach, which is based on the

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83. *See* FREMONT-SMITH, *supra* note 2, at 314.

84. Unif. Act for Supervision of Trs. for Charitable Purposes, § 2. *See* FREMONT-SMITH, *supra* note 2, at 313.

85. Unif. Act for Supervision of Trs. for Charitable Purposes, § 1. *See* FREMONT-SMITH, *supra* note 2, at 313.

86. RESTATEMENT (THIRD) OF TRUSTS, § 28 cmt. a (2003). *See* FREMONT-SMITH, *supra* note 2, at 172.

87. RESTATEMENT (SECOND) OF TRUSTS, § 348 (1959). *See also* FREMONT-SMITH, *supra* note 2, at 133-34.

88. RESTATEMENT (THIRD) OF TRUSTS, § 67 cmt. e; RESTATEMENT (SECOND) OF TRUSTS, § 348, cmt. f. *See also* FREMONT-SMITH, *supra* note 2, at 184.

exclusivity of the purposes for which the assets may be used. For example, there is case law from California to the effect that "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."[89]

Applying the above four approaches—connection to charitable purpose, degree of specificity, manifestation of intent, and exclusivity of use—alone or in combination, the assertion is that the assets of charitable hybrids are themselves charitable, thereby requiring that the entities that hold them be treated as charitable trusts as a matter of law. There are nuanced but critical differences in these approaches. However, none seem adequate for generally subjecting charitable hybrids to trust law by virtue of their form or structure, at least no more so than currently happens when traditional business forms adopt hybrid purposes.

A. *Connection to Charitable Purposes*

At one point along the spectrum, there are the general pronouncements of states like Illinois that appear to conscript assets because they are connected in some way to a charitable purpose.

Illinois certainly makes that assertion about the L3C and its assets because it explicitly declares that L3Cs are unequivocally within the ambit of the state's charitable trust law.[90] There is no escaping that result in Illinois, and L3Cs that incorporate and operate in Illinois do so presumptively knowing that they are hamstrung. However, there is at least some question about whether doing so was appropriate. Although explicit with regard to the L3C, the justification reaches broader than this specific form and seems to extend to any entity and all charitable assets.

The approach in Illinois gives rise to a number of questions. Would Illinois treat Newman's Own as a charitable trust? What about the Omidyar Network, Gary Community Investment Company, Revolution, Good Ventures LLC, and other combinations of private foundations with other forms by

89. Pac. Home v. Los Angeles Cnty., 264 P.2d 539, 543 (Cal. 1953).
90. *See supra* note 16 and accompanying text.

which philanthropists pursue their charitable and social objectives? Or for-profit hospitals (particularly conversion hospitals) and schools or joint ventures that cross profit and charitable boundaries? What about pharmaceutical companies that have accepted PRI funds from the Bill & Melinda Gates Foundation to develop and deliver vaccines in the developing world; are these firms now subject to state attorney general oversight and enforcement as charitable trusts? Is a family that has affirmatively decided to tithe, and budgets accordingly, subject to charitable trust law and enforcement by the attorney general? Or the billionaires who have signed the Giving Pledge committing half of their assets to charitable purposes; can a state attorney general take them to court to enforce the pledge? Are their assets held pursuant to charitable trust?

The logic that permits attorney general oversight based on a vague connection to charitable purposes could lead to a "yes" answer to each of the preceding questions at least to the extent of the "charitable" assets. That answer, however, may not reflect the reality of how oversight actually happens or should happen in such circumstances.

But there is small comfort to be gained from the unlikelihood of enforcement by any given attorney general. Moreover, such an attitude, particularly if advocated by a public official, undermines the validity, reliability, and consistency that society reasonably expects from the rule of law. It also exposes organizations to risks of politicization and selective enforcement by any particular attorney general who may not approve of the purposes a particular person or company is supporting and chooses to invoke the inevitable violations of charitable trust law to impose their values (or at least prevent the exercise of will by such person or company). For instance, someone may not like the politics of the Koch brothers or George Soros, but their use of purely personal, private funds to support charitable purposes should not mean that they must comply with charitable trust demands on their privately held, non-501(c)(3) enterprises.

Consequently, the theory for enveloping charitable hybrids with trust law because of their connections to charitable purposes seems overreaching and extreme, particularly given the potential for inconsistency in enforcement and application. If that is the case, then, it seems that Illinois likely went further than it needed to by explicitly subjecting L3Cs to chari-

table trust law, although Illinois may have had reasons for doing so that are unrelated to charitable trust principles. Regardless, those who invest in and operate and manage Illinois L3Cs must be mindful of their obligations as "charitable trusts."

B. *Specifically Identified Charitable Purposes, Manifestation of Intent to Create a Trust, and Exclusivity of Purpose*

Other approaches rely on more substantive conditions than a mere connection to charity and thus are less far-reaching although potentially as confusing. For example, the approaches in the Restatements rely on the presence of (1) a "specific" charitable purpose or (2) "manifestation of intent to create such a trust."[91] Another set of approaches relies on the assets being "dedicated" to or "solely" for charitable purposes, which seems to equate with the standard for exemption under § 501(c)(3).[92] These approaches also should be considered for consistency in operation without regard to the specific form or structure based on how the analysis would apply to Newman's Own, Omidyar, for-profit hospitals and schools, companies that receive PRIs from foundations, and otherwise.

These approaches present unique challenges for charitable hybrid pursuits, whether formally structured or not. For instance, is a statement of general intent, without more, to be organized and operated to further charitable purposes specific enough to create trust duties? How explicit must the manifestation of intent be to create a trust, or can it be inferred or implied by context, facts, circumstances, or otherwise? What does it mean for assets to be devoted to or dedicated to or solely for charitable purposes when the general disposition and purposes of an enterprise intrinsically tolerate or even encourage use of assets to generate and distribute profit and to permit private gain from appreciation of capital values? Each of these questions is relevant to charitable hybrids. Although the analyses differ for each of the forms, the results should be the same—they are not charitable trusts because of their form.

91. *See supra* notes 86-87 and accompanying text.
92. *See supra* notes 88-89 and accompanying text.

1. *Benefit Corporations*

It is doubtful that any variation of the benefit corporation would meet these requirements. Benefit corporations must pursue "general public benefit" by having "a material positive impact on society AND the environment taken as a whole."[93] The statutes further require that directors consider the effect of decisions on shareholders, various employee groups, customers, community, and long- and short-term interests.[94] None of these groups is inherently a category generally deemed "charitable"; similarly, the environment taken as a whole may or may not be considered charitable in its own right.[95] Consequently, a benefit corporation that commits only to broadly stated general public benefit purposes is not likely to meet any of the standards for imposing charitable trust obligations.

A benefit corporation, however, may also commit to pursuing specific public benefit, which permits declaring purposes that may include (but are not required to be limited to)

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93. *See* MODEL ACT, §§ 102 and 201 (emphasis added); Britt et al., *supra* note 2, at 16; Clark & Babson, *supra* note 1, at 838; Michael R. Deskins, *Benefit Corporation Legislation, Version 1.0: A Breakthrough in Stakeholder Rights?* 15 LEWIS & CLARK L. REV. 1047, 1063-64 (2011); Lacovara, *supra* note 3, at 824-25; Minnigh, *supra* note 9, at 476; Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 597; Resor, *supra* note 3, at 102.

94. *See* MODEL ACT § 301(a)(1); Britt et al., *supra* note 2, at 17; Clark & Babson, *supra* note 1, at 839-40; Deskins, *supra* note 85, at 1066; Lacovara, *supra* note 3, at 824-25 n. 29; Minnigh, *supra* note 9, at 476-77; Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 598-99; Resor, *supra* note 3, at 107.

95. *See* I.R.S. Priv. Ltr. Rul. 86-20-082 (Feb. 21, 1986) (Although various activities protecting and restoring the environment "can be charitable, the performance of these activities is not always charitable."). The IRS has recognized that preserving and protecting the "'natural environment for the benefit of the public'" serves a charitable purpose. HOPKINS, *supra* note 40, at 229 (citation omitted). However, more is required than merely considering the "environment as a whole" as has been demonstrated by IRS refusal to recognize exemptions for organizations that restricted land use without changing the environment or where the land lacked "'distinctive ecological significance'" or if public benefit was "'too indirect and insignificant.'" *Id.* (citations omitted). *See also* Clark & Babson, *supra* note 1, at 842; I.R.S. Priv. Ltr. Rul. 2010-17-066 (Apr. 30, 2010) (noting that the organization is not entitled to exemption because organization's "[e]nvironmental benefits . . . would be non-specific and indirect" and private benefits from activity not merely indirect, incidental and inevitable).

those generally recognized as meeting standards for being charitable.[96] Notably, specific public benefit purposes supplement and do not replace the general public benefits such that the enterprise must simultaneously pursue all of the declared purposes.

As such, the benefit corporation, as a business form, seems to lack the requisite manifestation of intent to create a charitable trust or desire to dedicate, devote, or commit to use assets solely for charitable purposes, even if it adopts a specific public benefit that is charitable.

However, certain assets of a benefit corporation could be partially impressed into charitable regulation in much the same way that the trust department of a bank must comply with charitable obligations. Doing so likely requires degrees of clearly expressed intent to impose such obligations, detailed statements of charitable purposes, and sufficient separation of such funds from the profit and value-appreciation orientation of the enterprise. In other words, it seems like it would take a lot of work and drafting to get to the point where some part of a benefit corporation is enveloped with charitable trust duties and restrictions; it would be far easier and much cleaner just to create a charitable trust and designate the benefit corporation as trustee.

Thus, it appears unlikely that a benefit corporation should be treated as a charitable trust, either in whole or in part, and becoming so accidentally should be prevented by the substantial degrees of clearly expressed intent and specificity that should be required.

2. *Flexible Purpose Corporation*

Unlike the benefit corporation, the flexible purpose corporation's special purposes must be more explicitly stated and are not generally presumed in the same way as the benefit corporation's general public benefit. Moreover, permissible special purposes are generally fewer and narrower, although they may consider effects of decisions on creditors who are not part of the benefit corporation litany. Like specific public benefit,

96. *See* MODEL ACT §§ 102 and 201; Britt et al., *supra* note 2, at 13 n. 15; Deskins, *supra* note 93, at 1064; Lacovara, *supra* note 3, at 824 n. 28; Minnigh, *supra* note 9, at 476; Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 597-98; Resor, *supra* note 3, at 101-02, 107.

the flexible purpose corporation's special purposes can be charitable in the same way as under 501(c)(3), but they do not need to be.[97] In fact, "special purposes" can include promoting or minimizing effects on employees, suppliers, customers, creditors, or the environment, none of which is inherently charitable. Therefore, it seems inappropriate to universally assert that entities that deploy the flexible purpose form are subject to charitable trust law.

Instead, there must be an analysis of specific applications of the form that adopt recognized charitable purposes, particularly with regard to declarations about prioritizing economic interests or not, and whether those purposes are exclusive or in addition to other permissible pursuits. The California legislature appears to have understood this need in light of the language in the statute that acknowledges possibilities that charitable trust law might apply in given situations.[98] Recall that the flexible purpose corporation may specify one or more special purposes "in addition to creating economic value" that directors may consider "in addition to or even at the expense of traditional shareholder economic interests when making decisions about operations, policies, and transactions."[99] Given this language, it seems that economic interests remain enough of an intrinsic purpose of the flexible purpose corporation that its directors and managers cannot wholly ignore them and may even prioritize them. As such, charitable special purposes are never exclusive or sole and cannot be presumed to even be primary.

Even if it is possible to maneuver enough of the levers to effectively dedicate or devote all of a flexible purpose corporation's assets exclusively and solely for charitable purposes, it is not clear why someone would want to use this form to accomplish what is more clearly and readily available through other existing forms: charitable trusts and/or nonprofit public benefit corporations. Consequently, the harder situations will involve flexible purpose corporations with more than one special purpose in addition to one that is charitable and/or enti-

97. *See* discussion *supra* Part II.B.

98. *See* CAL. CORP. CODE § 2700(e) (West 2012). *See also supra* note 15 and accompanying text.

99. Britt et al., *supra* note 2, at 4.

ties that do not negate economic interests entirely but welcome such interests to some degree.

Specificity of purpose may not be an issue, even in these harder cases, because satisfying the requirements of the form seem to require "at least one clearly specified" special purpose. If one of those purposes is charitable, it must be clearly specified, but it may not be the sole purpose in light of the apparently omnipresent economic interests.

The latter two standards are less likely to be met to the extent appropriate to encompass the entire enterprise with charitable trust oversight. It seems unreasonable to imply a manifestation of intent to create trust duties over assets contributed generally to an enterprise whose purposes are not exclusively charitable and include generating and distributing profits and recognizing appreciated property value. Of course, the contribution could be accompanied by an explicit manifestation of such an intent and acceptance thereof, which should not convert the entire enterprise into a charitable trust, but at most would only add trust responsibility with regard to those unique assets, no differently than any other taxable entity.

Therefore, entities that form as either benefit or flexible purpose corporations should not be regulated or overseen as charitable trusts simply because of their form generally. Very specific uses of the forms may fall within the charitable trust realm in much the same way that very specific uses of the corporate or limited liability company forms may be similarly treated for similar reasons.

3. *L3C*

Addressing the L3C as a form is less clear because of the statutorily mandated primacy of significantly furthering charitable purposes under the Code over producing income or appreciating value, which not only cannot be a competing purpose with charitability, but also cannot be a significant purpose of the enterprise.[100] Notably, however, L3C statutes do not necessarily preclude other purposes or wholly prohibit production and distribution of income or appreciation of value. Instead, the statutes resolve issues of priority and relative

100. *See supra* note 19 and accompanying text.

weight—a feature noticeably missing from the benefit and flexible purpose corporate forms.

With regard to the specificity standard for charitable trust law, it is not clear whether L3C statutes mandate the requisite specificity of charitable purpose or if the governing documents can generally declare commitment to the requisite elements and, consistent with a long line of precedent among tax-exempt charities, add an "including but not limited to" description of more detailed expectations. Such an approach is enough for the IRS to recognize an organization as an exempt charity. But it is not clear whether a general declaration followed by a non-exclusive scope or list is or should be detailed enough for the L3C form to satisfy the specificity standard for being declared a charitable trust. In the absence of evidence of abuse, there is an argument that ambiguity in this instance should not be enough to regulate and oversee L3Cs as charities.

Additionally, the "specificity" standard for trusts dovetails with the exclusivity standard implied by the words "devoted," "dedicated" and "solely for" charitable purposes, which is similar or even equivalent to what is required for charitable tax exemption. However, it is not obvious that either standard equates with "significantly furthering charitable purposes" that is the central tenet of the L3C form, even if "exclusive" is interpreted as substantially or primarily in the case of exemption.

An argument that these are different standards can at least be inferred from the fact that PRIs, which are the source of the L3C standard for "significantly furthering charitable purposes," are not restricted to tax-exempt, charitable entities but may be made to taxable, profit-oriented entities under certain conditions. If the standards are the same for grant activity and for PRIs, then there is no need to differentiate PRIs from regular grant-making, yet the law and regulations clearly make distinctions. Those differences are material for the L3C and how it is regulated as a business form.

Another critical distinguishing feature of the L3C is that it permits some focus on and attention to earning profits for distribution to private interests and accumulation of value for the benefit of the same interests, as long as such focus and attention are not significant purposes of the L3C. Importantly, the statutes do not just create a hierarchy such that revenue and

value are secondary to furthering charitable purposes.[101] Instead, they cannot be a significant purpose of the enterprise at all, but they still are permissible. That ability materially differentiates the L3C from otherwise tax-exempt, charitable entities for which there are absolute prohibitions on private distribution of profit and realization of value.[102]

The L3C also must address the fact that exempt charities are permitted to earn profits, and there are even gradations of profit—related, unrelated, and functionally related. These categories have been established for purposes of determining whether a charity should pay taxes (which they generally do on unrelated and functionally related income but not for related income[103]) or if their level of unrelated activity is such that the entity is no longer operated exclusively/primarily for charitable purposes and thus is no longer exempt.[104] However, in no event is it permissible for the tax-exempt charity or a charitable trust to distribute its income to private "owners" such as is allowed or even expected in the L3C.[105]

The ability to allow private parties to partake in the enterprise's revenues and value appreciation is a substantially distinguishing feature of the L3C. That feature alone seems enough to undermine arguments that L3C assets are devoted or dedicated to or solely or exclusively for charitable purposes such as is required for treating them as charitable trusts. Of course, an L3C's members could affirmatively eschew these rights, which might inject the entity (but not the overall form) into the charitable trust regime, but possibilities for unique applications under rare circumstances do not justify broadly painting an entire form with the charitable trust brush.

Unlike with unrelated business taxable income, which may threaten a charity's exempt status if it reaches impermissible levels, there is no such limit for the L3C's income or value appreciation. In fact, as is the case with PRIs that inspired the L3C form, the statutes make clear that market or even above-market levels of return do not necessarily defeat an entity's

101. *But see* Spenard, *supra* note 74, at 41.

102. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise,* 89 YALE L. J. 835, 838 (1980).

103. *See* I.R.C. §§ 501(c)(3), 513 (2006).

104. See HOPKINS, *supra* note 40, at 72-73, 635 (citations omitted).

105. *See* I.R.C. § 501(c)(3); FREMONT-SMITH, *supra* note 2, at 198, 301; Hansman, *supra* note 102, at 838.

status as an L3C[106] any more than such actions defeat a PRI.[107] That is one of the misnomers of the L3C: profits do not need to be low; they just cannot be a significant purpose.[108] Consequently, then, it is possible (but unlikely given the charitable focus and projected risk profile) that the profits being distributed by an L3C to its members could be meaningful in certain circumstances. Although an L3C's members can contract against such a prospect by adopting self-imposed limits, the possibilities by themselves weaken arguments that L3Cs as a business form are dedicated, devoted, or solely or exclusively for charitable purposes.

This analysis also affects the standard for imposing charitable trust laws based on a manifestation of intent to create such a trust. As with the benefit and flexible purpose corporate forms, someone might structure an L3C in such a way that it meets the standard, but doing so would require some work and is improbable given the strength of existing forms to meet those objectives.

Moreover, the fact that someone entrusts assets to an L3C (or any other hybrid) in many ways should be interpreted as an intentional decision to decline to use those available traditional structures and to affirmatively embrace the characteristics of charitable hybrids that make them different.

Therefore, it seems dangerous to interpose a manifestation of intent to create a charitable trust out of the L3C general form when

> (1) there is not the requisite specificity of charitable purpose;

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106. *See* Tyler, *supra* note 10, at 124. The L3C statutes provide that "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." *See* 805 ILL. COMP. STAT. 180/1-26 (2011); LA. REV. STAT. ANN. § 12:1302(C) (2010); ME. REV. STAT. ANN. tit. 31, § 1611.2 (2011); MICH. COMP. LAWS § 450.4102 (2010); N.C. GEN. STAT. § 57C-2-01 (2012); R.I. GEN. LAWS § 7-16-76 (2012); Utah Code Ann. § 48-02c-412 (West 2009); VT. STAT. tit. 11, Ch. 21, §§ 3001(23) (West 2010); WYO. STAT. ANN. § 17-15-102(ix) (2010);

107. *See* Treas. Reg. § 53.4944-3(a)(2)(iii) (1972); Tyler, *supra* note 10, at 124.

108. *See* Tyler, *supra* note 10, at 124.

(2) there are differences between "operating for" and "significantly furthering" charitable purposes and between PRIs and grants to exempt charities;
(3) there may be other permissible purposes for the L3C in addition to furthering charitable purposes provided that they are secondary; and
(4) distribution of income and appreciation of value to private entities is both permitted and expected in the L3C as long as doing so is not a significant purpose of the entity and its management.

Thus, the L3C as a form fails to meet standards required for interjecting regulation or oversight as charitable trusts. What could cause a specific L3C entity to be so regulated could be exclusively adopting charitable purposes—not merely substantially furthering them—and disavowing any ability to distribute revenues to private owners or to permit them to realize appreciated value.

It is entirely possible that certain charitable hybrid entities, L3C and otherwise, could be subject to charitable trust law when they have a charitable purpose identified with requisite specificity, the clearly manifested intent to create such a trust, and/or the requisite exclusivity of purpose. But people are choosing charitable hybrid forms and forgoing traditional structures for reasons that should not be ignored by making presumptions that are contrary to the express elements and characteristics of these forms. Furthermore, those who make such assumptions must reconcile the inevitable inconsistencies in treatment of "charitable" LLCs, joint ventures, for-profit subsidiaries of charities, and other enterprises that share many relevant characteristics with charitable hybrids. Finally, there is potential for extraordinary irony if a prioritizing charitable purpose actually increases the likelihood of more restrictive treatment that prevents accomplishing those purposes and impedes realizing their benefits for society.

V.
If Not Regulated as Charitable Trusts, Then How Might Charitable Hybrids Be Regulated and Overseen?

Suggesting that charitable hybrids should not universally be treated as charitable trusts as a matter of their business

form is not the same as saying that they should not be regulated or that there is no role for the attorney general; quite the contrary. In addition, these forms are more likely to attract capital and operate successfully if there are reasonable, consistent understandings of their regulatory and enforcement environments, including their connections to governance and its central role in fostering investor confidence.[109]

Attorney general concerns about charitable hybrids seem to focus on three related areas: (1) responsibility (where it exists) to regulate charitable fundraising; (2) desire to protect the public and the charitable sector from confusion about which organizations/activities function in the charitable realm with legitimate expectations regarding "halo" connotations and which do not; and (3) concerns about the propriety of permitting the generation of monetary returns, if not potential wealth, in a context of addressing society's problems, particularly if there is real or perceived abuse or misuse of the charitable hybrid forms.[110]

It is not necessary to resort to charitable trust law, even if it could apply, to address these concerns. Actually, other sources for causes of action, standing, and remedies could expand the means by which owners and operators of charitable hybrids can be held accountable. For instance, under charitable trust law, the attorney general is usually the only person who has standing to enforce breaches, including of fiduciary duties.[111] A more expansive enforcement regimen that incorporates both civil and criminal tools could extend standing to others, including owners (especially minority owners committed to furthering charitable purposes), other fiduciaries and managers, prosecutors at the local and federal levels, and possibly even creditors and others who reasonably rely on representations regarding the charitable hybrid.

The corporate hybrid forms are already explicit about protecting directors from breach of duty actions and other claims by shareholders for considering general public pur-

109. *See* Sandra K. Miller, *What Fiduciary Duties Should Apply to the LLC Manager after More than a Decade of Experimentation?*, 32 J. CORP. L. 565, 571 (2007).

110. *See, e.g.,* Spenard, *supra* note 74, at 36. *See also* Letter from Members of the National Association of State Regulators to Marcus Owens (Mar. 19, 2009) (on file with the author and the *N.Y.U. Journal of Law & Business*).

111. *See supra* notes 78-79 and accompanying text.

poses, special public purposes, and specific purposes—all other than and possibly to the detriment of profits. These statutes also vest rights in shareholders—but only in shareholders—to hold directors accountable for failing to consider those alternative purposes that they adopted.

Somewhat similarly, members of the L3C should also be able to hold managers and fellow members accountable for failing to prioritize charitable purposes or for over-emphasizing increased profits and appreciation of value. The L3C statutes are not nearly as clear about this as are the benefit and flexible purpose corporation statutes. At a minimum, L3C members should have contractual claims, unless such contracts are permitted by general LLC principles to release or waive duties that should otherwise attach.[112] But such duties should not be able to be released or waived in any event.[113] The duties should be more than contractual; they should be fiduciary based on the language of the L3C statutes that unequivocally establish duties, priorities, and even weights.

Fiduciary claims give rise to an entirely different set of claims and remedies to complement those available under contract law. For example, under contract law, remedies are restricted in that they generally seek to put the parties in the positions they would have been in had the obligations been performed, including generally not allowing punitive damages, recovery of attorneys' fees and other costs unless provided for in the underlying contract, and presumptions against damages for lost profits and business opportunity. On the other hand, fiduciary claims and remedies have a more substantial equitable component and could permit punitive damages, recovery of attorneys' fees and other costs (at least as a proxy for other damages), and lost "business" opportunity if able to be reasonably quantified, which could be one important means for disgorging profits improperly gained because of failure to adhere to charitable priorities.[114]

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112. *See* Tyler, *supra* note 10, at 146-50.

113. *Id.*

114. Of course, one of the persistent problems with social enterprise is how to measure and place values on social change that are not easily captured in financial terms. In light of possibilities that the breach of duty to charitable purposes may actually result in financial gains, the burden will be on the plaintiff to prove other damages and harms based on the intended charitable purposes.

Each of the above depends on shareholders, members, directors, and/or officers to hold their colleagues accountable, possibly even in the face of profitability and other value creation. As such, there needs to be at least one person among the group who is willing and able to remain faithful to the role of charitable purposes in the enterprise. But members of these groups are "uniquely hamstrung as enforcers."[115] Members of these groups may not be equally motivated by or committed to the same balancing of profits and gains against charitable purposes; moreover, motives and desires of those involved can change with time and circumstances, and even the personnel involved with making decisions can also change.[116]

None of the new charitable forms extend standing or rights to third parties, except that the benefit corporation statutes allow incorporators to designate a third party, but none is required and presumptions in the statutes are against creating liability to third parties.[117] Even so, the potential group of people with standing to enforce adherence to charitable priorities is still broader than relying solely on the attorney general as is available under the charitable trust system.

Also, recourse is not limited to causes of action and remedies founded on contract and fiduciary duty, nor is recourse only available from the civil realm. Other sources could include civil and criminal enforcement of state and federal securities laws, fraud and misrepresentation, consumer protection, conspiracy to defraud, and possibly even the Racketeer Influence and Corrupt Organization Act ("RICO") if the circumstances are right, which allows for treble damages and even pre-trial forfeiture in some cases.[118] Illinois specifically

115. Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 613.

116. *See* Tyler, *supra* note 10, at 155-56; Raz, *supra* note 3, at 295.

117. *See* Brakman Reiser, *Benefit Corporations*, *supra* note 3, at 605, 613; Brakman Reiser, *Blended Enterprise*, *supra* note 3, at 642. *See also* Britt et al., *supra* note 2, at 10-12 (discussing flexible purpose corporations and the rationale for not vesting third party enforcement rights); Clark & Babson, *supra* note 1, at 849; Minnigh, *supra* note 9, at 478 (statute creates no rights or causes of action in anyone but shareholders of flexible purpose corporation) (citations omitted); MODEL ACT § 301(d) ("[D]irector does not have a duty to a person that is a beneficiary of the general public benefit purpose or a specific public benefit purpose of a benefit corporation arising from the status of the person as a beneficiary.").

118. *See* 18 U.S.C. §§ 1961-1968 (2006); 18 U.S.C. § 1963(d) (2006) (pretrial forfeiture and performance bond); 18 U.S.C. § 1964 (2006) (treble

criminalizes soliciting money under false pretenses, and misrepresentations while raising capital for a charitable hybrid could run afoul of consumer fraud and deceptive business practices laws.[119]

Similar claims could be pursued through the Federal Trade Commission. The FTC's primary mission is to enforce consumer protection laws, and its activities have not historically extended to charity fraud, but it could be useful for enforcement with regard to charitable hybrids.[120]

Particularly in the case of an L3C that fails to abide by the primacy of charitable purpose requirements, it may be appropriate to resurrect the *ultra vires* doctrine. Then, attorneys general and others might be able to assert that certain transactions exceed the power of the enterprise to have undertaken the transaction in the first place. Transactions could be unwound, illicitly acquired funds could be returned, and it might also present another tool for disgorging improper profits. If circumstances are severe enough, such that intent to deceive exists, it might even by appropriate to pierce corporate/business veils that shield owners, fiduciaries and managers against personal liability.

In many ways, then, there may be more legal avenues for ensuring that charitable hybrids remain appropriately faithful to properly prioritized charitable purposes than are available under charitable trust law. Moreover, these additional legal strategies should be supplemented by actual market forces that normally do not exert pressure on charitable trusts and exempt, charitable organizations. Those forces can serve as another check on how charitable hybrids operate consistent with their purposes, at least to the extent that competitors will want to ensure that such forms do not have a competitive advantage.

If for no other reasons than the potential for return of capital, distribution of profits, and appreciation of value, charitable hybrids should operate within the commercial marketplace. These reasons become even more compelling if such forms are used to leverage commercial-like returns or to af-

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damages). Among the required predicate offenses for a RICO claim are fraud and securities fraud. 18 U.S.C. § 1961 (2006).

119. *See, e.g.*, FREMONT-SMITH, *supra* note 2, at 371-72 (citations omitted).

120. FREMONT-SMITH, *supra* note 2, at 424.

firmatively allocate risk among various investors with different tolerances and return expectations. Otherwise, there is a substantial risk of distorting the market, the underlying risks, and the returns. Problems with such distortions extend beyond ill-gotten financial gains and could result in under-appreciating various social problems and over-estimating the ability to sustain or replicate purported solutions. Those errors then could lead to misjudgments about strategies and misallocation of resources.[121] It could even inappropriately damage traditional structures that operate in the relevant space, whether for-profit or tax-exempt, especially if the hybrids benefit from artificial stimulus or support. Ultimately, too many people may suffer in ways and for reasons that are avoidable.

The potential for charitable hybrids to distort the market is not limited to the effect on investors. Use of charitable hybrids to sustain businesses and strategies that reasonable market forces have suggested should be abandoned may result in short term comfort as jobs may be temporarily saved, but doing so merely postpones the inevitable and potentially exacerbates or prolongs already difficult circumstances for individuals, communities, and the economy. It could even inhibit creativity and innovation as new skills and opportunities that might otherwise be developed and identified are instead neglected or even buried.

This is not to suggest that there should not be safety nets or that charitable hybrids are not appropriate vehicles for pursuing such nets or other opportunities. In fact, in many instances these forms can be ideally suited for such endeavors as long as they are deployed so as to operate within the market and not as if inoculated against it.

One way of protecting charitable hybrids from the market—an undesirable outcome—would be to provide them with tax-favored treatment based entirely on the form by which they exist.[122] Not only could such treatment distort the market, but

121. *See* Tyler, *supra* note 10, at 153.

122. *See generally* Anup Malani & Eric A. Posner, *The Case for For-Profit Charities,* 93 VA. L. REV. 2017 (2007) (supporting tax benefits for for-profit charities); Hines et al., *supra* note 2 (opposing such tax benefits). *See also* Lloyd Hitoshi Mayer & Joseph Ganahl, *Taxing Social Enterprise,* STAN. L. REV. (forthcoming) (draft on file with the author).

it also could wreak havoc with the tax code for at least a couple of reasons.

First, tax benefits normally seem based on the taxpayer meeting certain expectations for behavior having nothing to do with its form of existence. Even 501(c)(3) and other 501(c) enterprises do not receive exemption based on their form. Charitable exemptions are available to trusts, corporations, LLCs, and even unincorporated associations; each of these has non-exempt counterparts as a matter of form, and the benefits are available because of behavior and commitments rather than because of form. There is no reason to treat charitable hybrids any differently; available tax benefits should derive from behavior and commitments rather than their form, particularly in light of the ability of charitable hybrids to convert to "regular" status.

Second, exemptions for charitable hybrids and charitable deductions for their investors threaten already fragile approaches to taxation based on principles such as consumption and redistribution of wealth.[123] Favorable tax treatment for charitable hybrids would need to be consistent with and reconciled against those principles and strategies, and it is not clear that such consistency is likely.

Charitable hybrids and their owners should be able to claim tax benefits and treatment in the same way as other profit-distributing, tax-paying enterprises. Investors should be able to deduct capital losses, and the forms and their investors (as the case may be) should be able to deduct operating expenditures and take credits for activities such as research and development, etc., but none of these benefits should be based on the form of the enterprise.

Of course, implicit in worrying about taxation of charitable hybrids is a presumption of success in achieving charitable outcomes and generating value to be taxed. Removing charita-

123. Another tax-related concept that may need to be explored should be whether charitable hybrids are more like nonprofit, non-stock corporations or more like profit-seeking enterprises. The differences may be subtle but they may be meaningful if profits, distributions, and appreciation are subverted to charitable or other social purposes. Even the L3C does not prohibit income distribution or capital appreciation but it is possible for any of the charitable hybrid forms to completely subvert profits and gains, which could have its own implications for taxation and the principles and strategies that underlie it.

ble hybrids from the market, including by bestowing artificial tax benefits, could actually interfere with potential for that kind of success. Decisions by attorneys general or courts to treat such forms as if they are charitable trusts would almost certainly have that effect.

Those decisions could also have a much more substantial effect on and could cause damage to the separation of powers doctrine, which may need further exploration. Various state legislatures clearly intend for the existence and operation of charitable hybrid forms. It can be assumed that the legislatures knew about the existence of applicable law regarding charitable trusts. What cannot necessarily be presumed (except in Illinois for the L3C) is that they intended their subsequent actions in creating these new forms to be subservient to such laws in their entirety such that all entities formed pursuant to the new forms must be treated as charitable trusts. What can be presumed is that individual applications of the forms can be analyzed consistent with charitable trust laws and principles, which presumptions permit both sets of laws to co-exist and be reconciled with each other.

Uniformly subjecting those forms to charitable trust law creates conflict among these laws and effectively defeats reasonable applications of the forms. By taking such a stance, I can't help but wonder if attorneys general and courts usurp legislative functions and effectively displace state legislatures.[124] It is one thing for executive and judicial branches to refrain from enforcing legislation, but it is quite another for a non-law-making branch to affirmatively superimpose a possibly unintended regimen on legislative action to the point of effectively negating that action.[125] To prevent that outcome and preserve the sanctity of the separation of powers doctrine, charitable trust law should not be superimposed on charitable hybrids as a matter of their form absent a clear expression of

124. This would not necessarily apply to Illinois in which the state legislature declared its intentions to subject L3Cs to charitable trust law. *See supra* note 55 and accompanying text.

125. At an even more esoteric level, it might be worth trying to understand what effect that behavior may have on the federal government's obligations under the Constitution that require it to protect and preserve our nation's presumptive republican form of government even at the state level. *See* U.S. CONST. art. IV, § 1 ("The United States shall guarantee to every State in this Union a Republican Form of Government . . . .").

legislative intent such as that provided by the Illinois legislature. Of course, whether the legislature should make such an expression should be given serious consideration in light of the self-defeating implications of that intent and the presence of effective means to fill the gaps that trust law is invoked to fill.

In addition to the legal reasons discussed in the preceding section for not treating charitable hybrids as charitable trusts, there are innumerable practical reasons for avoiding such treatment. Among these are that the pool of people to enforce a hybrid's charitable purposes is broader than those who have standing to enforce charitable trust duties. The causes of action and the available remedies are potentially more expansive. Unlike exempt, charitable entities, hybrids do and should operate within and subject to market forces, which affords a degree of oversight not otherwise engaged with charities. That also means not creating artificial tax benefits for hybrids merely because of their form. Finally, imposing a trust regime not authorized by the legislature may have implications for our system of government's reliance on separation of powers that may be undermined by adding executive barriers to deployment that effectively defeat legislative intent.

VI.
CONCLUSION

It is both appropriate and necessary that charitable hybrid forms be properly regulated. The challenge has been arriving at standards for what is "proper." The Illinois legislature resolved that dilemma for the L3C by explicitly subjecting all entities that adopt that form and their members and managers to the State's law of charitable trusts. The California legislature acknowledged the possibility of trust law applying to the flexible purpose corporation but took no position other than to declare that the statute did not negate the possibility. Other states and state attorneys general are wrestling with the issue.

Progress in the debates and discussions will be helped if the parameters are clear and consistent. For instance, not all L3Cs receive funds from an exempt, charitable entity, much less from a private foundation; in fact, very few receive such funds or have such relationships. Not understanding that fact risks regulating all L3Cs badly as does neglecting possibilities

for other than charitable purposes to supplement or complement those that must be primary. Similarly, not realizing that state legislatures have vested nearly unassailable discretion in directors of benefit and flexible purpose corporations to derive their own sense of priorities and/or weights for their respectively identified or selected stakeholders could result in a more restrictive business judgment rule rather than a more liberal, permissive one or a narrower duty of care than the legislation seems to require.

It also should be remembered that enterprises that adopt these forms function in the marketplace. How they are regulated will have an affect on their ability to do so, which could advantage them while harming non-hybrid competitors. Awareness of likely or potential consequences for that engagement should be part of the discussions.

Regulation of charitable hybrids also may affect how adaptations of traditional forms are regulated, which could have its own implications for the market. For example, should an LLC that otherwise satisfies all of the requirements for being an L3C be regulated differently than an L3C? Lack of consistency could inject new uncertainty in an already somewhat cloudy sphere, which clouds ironically are part of what inspired the new forms.

For a variety of reasons, the charitable trust regime should not be imposed on charitable hybrid forms as a whole, rather than as discrete applications of the forms. The forms generally do not satisfy definitions of "charitable trust." Alternatives exist to address the legitimate concerns of regulators. And charitable trust law would prevent these forms from operating as legislatures intended by negating their ability to distribute earned profits, to permit owners to realize appreciated gains, to use equity as part of the compensation structure, and to transfer assets, merge, terminate, or modify their purposes within applicable procedures.

Demand is clearly high—and likely growing—among entrepreneurs, investors, policy makers, some lawyers, customers, and others for a selection of new business forms from which to choose that will simultaneously permit generation and distribution of profits and value while also pursuing (or even prioritizing) social, public, and/or charitable purposes. The right approaches to regulation can help ensure that the demand is satisfied and implemented in ways that advance society.