3.1 LOW-PROFIT LIMITED LIABILITY COMPANY (L3C)

ADVANTAGES

- ✓ Has the advantages generally associated with limited liability companies
- ✓ Highlights and brands an organization as having a social or charitable purpose other than the maximization of profits
- ✓ May provide access to third parties, consumers, strategic partners, investors and others whose interests are aligned with the organization's social or charitable purposes

DISADVANTAGES

- ☒ The same disadvantages associated with LLCs also apply to L3Cs
- ☒ May be easy to intentionally or unintentionally enter into and leave L3C status depending on the state of formation
- ☒ Relatively new variation of LLC; impact on capital raising is not clear
- ☒ Original intent of providing easier access to program-related investments by foundations has not materialized
- ☒ No special federal tax treatment advantages over traditional LLCs

CASE STUDY

Pingree Detroit, a Michigan low-profit limited liability company, was founded to provide living wage work for veterans and residents of Detroit through creating sustainable bags, accessories and footwear. Pingree Detroit products are handmade though completely non-toxic processes, using American-made, often up-cycled materials, including leather reclaimed from the Detroit auto industry. As a worker-owned company, 77% of its profits are shared with its employees. For more information, please visit http://www.pingreedetroit.com.

The *Chicago Reader,* an Illinois low-profit limited liability company, is Chicago's largest free alternative weekly newspaper, known for its in-depth coverage of Chicago politics and culture. The newspaper is independently-owned and prides itself on an equitable approach to community coverage, staffing, and vendor supply. For more information, please visit http://www.chicagoreader.com.

a) Overview

A low-profit limited liability company, or L3C, is a form of LLC that has been authorized by amendments to existing LLC statutes in a number of states, including Illinois, Louisiana, Maine, Michigan, Rhode Island, Utah, Vermont and Wyoming.[72] An L3C that is formed in any of these states may operate in any state, although it may be required to become qualified to do business in that state through making one or more filings in that state. In addition, L3C legislation is currently pending in many states. According to interSector Partners, L3C, as of March 2019, 1,651 entities had organized as L3Cs and were showing as

72. See http://socentlawtracker.org/. The L3C has also been adopted in the following federal jurisdictions: Puerto Rico, the Oglala Sioux Tribe, the Crow Indian Nation of Montana and the Navajo Nation. North Carolina repealed the state's L3C law effective as of January 1, 2014.

active by the various Secretaries of State.[73] Vermont was the first state to enact legislation in 2008.

Under state law governing L3Cs, an LLC may designate itself an L3C if the company is formed for a charitable purpose and it satisfies certain other criteria. An existing LLC may also convert to an L3C. Advocates of the L3C claim that it helps to attract investments from socially conscious investors and that it may encourage private foundations to make "program-related investments," which the L3C can then leverage to advance its purpose and attract for-profit investments.[74] However, many practitioners believe that the L3C has no real advantage over an LLC. They argue that an LLC can function as an L3C by incorporating similar elements into its operating agreement, and that an L3C does not convey any federal tax benefits over an LLC with respect to program-related investments.[75] Instead, the L3C designation may mislead private foundations into mistakenly believing that their investments in an L3C will automatically qualify as program-related investments under federal tax laws.

The L3C has many of the same features as the LLC. This section will address only areas in which the L3C differs from the LLC. Please see Section 2.4 for additional information regarding LLCs.

b) Organizational Structure

As with an LLC, the corporate governance, management, distribution and ownership structure of an L3C is flexible and can be tailored to an organization's desired structure. See Section 2.4 of the Guide for a discussion of these matters.

c) Establishment Costs and Documentation

Documentation

Establishing an L3C requires several state and federal filings and the drafting of certain organizational and governance documents (all of which are also required for establishing an LLC). Like an LLC, an L3C is established by filing articles of organization with the state. An L3C should then establish an operating agreement to govern its operations. See Section 2.4 for establishment costs and documentation required for LLCs. An existing LLC may also be converted to an L3C, either automatically or by making certain filings with the state (depending on the state).

In some states, organizations may become subject to the requirements applicable to L3Cs even if they do not intend to be. For example, in states that define an L3C as an LLC that is established to further the accomplishment of one or more charitable or educational purposes and also satisfies certain other requirements for exempt organizations under federal tax law, an LLC seeking to become an exempt organization under federal tax law may become an L3C in the state of its organization, regardless of whether it elects to become one.[76]

Articles of Organization

In addition to satisfying the general requirements applicable to LLCs, the articles of organization and/or the operating agreement of an L3C must set forth an appropriate purpose. For example, an L3C being

73. See https://www.intersectorl3c.com/l3c.
74. Under Section 4944(c) of the Internal Revenue Code.
75. See Elizabeth Schmidt, Vermont's Social Hybrid Pioneers: Early Observations and Questions to Ponder, Vt. L. Rev., Vol. 35, No. 1, pp. 163-209, Fall 2010.
76. This is the case under Wyoming law, for example.See Wyo.Stat. 17-29-102(a)(ix).

formed in Illinois must include an L3C designation in its title and must include an appropriate purpose in its articles of organization. The organization is required to amend the articles of organization to remove the purpose and the L3C designation if the LLC is no longer eligible to identify itself as an L3C.[77]

Typically, under applicable state law, the L3C must define its purpose(s) in its articles of organization or operating agreement in accordance with the following:

- **The L3C must have or significantly further a charitable or educational purpose within the meaning of Section 170 of the Internal Revenue Code, and the L3C would not have been formed but for the charitable or educational purpose.**

- **The production of income or appreciation of property is not a significant purpose of the organization (although significant income or appreciation of property is not automatically evidence that the organization was formed for an improper purpose).**

- **The L3C must have no political or legislative purpose.**

In some states, the company's name must include the designation "L3C," and the designation must be removed if the company ceases to satisfy L3C requirements.[78]

Operating Agreement

Just as for an LLC, the principal organization document for an L3C is the L3C's operating agreement. The operating agreement is explored further in Section 2.4. In addition to the items covered by a standard LLC operating agreement, the operating agreement of an L3C should identify the purpose of the organization and identify the rights of each class of membership interests of the LLC.

Cost

The cost of establishing an L3C varies. As with LLCs generally, the main cost components include attorney fees for the preparation of documents; state filing fees for organization, qualification and securities filings; statutory representation fees for the L3C's agent for service of process; and any accounting-related fees for taxation-related advice and services. Attorney fees are affected by the complexity of the L3C's management, governance, distribution and ownership structure (as reflected in the L3C's operating agreement) and the number of additional documents required to set the L3C up for business (e.g., employment agreements, securities and regulatory filings). State filing and statutory representation fees are affected by the numbers of states and specific states in which the entity organizes, transacts business or sells securities. State filing fees vary from state to state, with some states imposing the same fees as they do for LLCs.[79]

Selecting a State of Organization

In addition to the general considerations for all LLCs addressed in Section 2.4, there are a number of other factors that should be considered when selecting a state of organization for an L3C. The organization

77. 805 ILCS 180/1-26(c).
78. See, e.g., Wyo.Stat. 17-29-705(e).
79. See, e.g., https://www.sec.state.vt.us/corporationsbusiness-services/fees-filings

should consider whether additional filing or other obligations apply in certain states but not others, and whether the specific laws related to L3Cs in the state are consistent with the organization's goals and operations.

d) Liabilities

Members of an L3C have limited personal liability for the business debts, judgments and actions of the L3C, consistent with such limitations applicable to LLCs generally. See Section 2.4. As a relatively new form of LLC, it is not clear whether members or managers of an L3C would have additional fiduciary duties related to the L3Cs charitable purpose.[80]

e) Governance and Regulatory Obligations

Governance Obligations

Just as with an LLC, many of an L3C's ongoing governance obligations are determined internally by the L3C through the L3C's operating agreement. See Section 2.4. State law may also compose additional governance obligations.

Regulatory Obligations

An L3C, like other entities, will be subject to federal, state and local regulatory requirements applicable to the type of business it operates. See Section 2.4 for a discussion of filings and other regulatory obligations applicable to LLCs generally.

f) Tax Treatment

An L3C, as a type of LLC, generally has several options related to its tax treatment. See Section 2.4 for a more detailed discussion of tax treatment of LLCs.

g) Financing

As a type of LLC, L3Cs have few formal restrictions on financing and raising funds. See Section 2.4 for a discussion of financing and fundraising matters applicable to all LLCs. In general, financing and fundraising issues applicable to all LLCs are also applicable to L3Cs. Although an L3C must have or further a charitable purpose, the L3C is structured as a for-profit entity. As a result, contributions to an L3C are not tax deductible.

Program-Related Investments

As noted above in the introduction to Section 3, proponents of the L3C suggest that in addition to traditional forms of financing, the L3C structure makes it more susceptible to equity investments by private foundations. However, as discussed above, there is significant disagreement on this point among practitioners in this area.

Tranched Investments

One point raised by proponents of the L3C is that an L3C's operating agreement could provide for different classes of membership interests structured in tranches to accommodate differing investor goals. For

80. See, e.g., John Tyler, Negating the Legal Problem of Having "Two Masters": A framework for L3C Fiduciary Duties and Accountability, Vt. L. Rev., Vol. 35, No.1, pp. 117-161, Fall 2010.

example, an L3C could have three tranches, or layers, of investors: (i) a class of membership interests that would have the highest risk and the lowest rates of return applicable to all investors, primarily held by private foundations making program-related investments; (ii) a second class of membership interests held by investors motivated by social benefit, which would carry less risk and more potential reward than that held by the first class; and (iii) a senior class of membership interests, which would be held by investors more interested in obtaining a high investment return. However, critics of the L3C note that tranched investing is already possible in a typical LLC (see Section 2.4 above), as the operating agreement need only be drafted to reflect different classes of membership interests. In addition, critics of the L3C have raised concerns that if the principal attribute of a tranched investment structure is to provide market or above market rate returns to for-profit investors, there is a serious risk that the program-related investment by a private foundation would be viewed by the IRS as resulting in a private benefit to the for-profit investor, which may jeopardize the status of the investment for the foundation, risking excise tax penalties as well as possible loss of the foundation's tax exempt status. This concern is applicable to both L3Cs and other LLCs.

h) Resources

For additional information, visit:

http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm

http://americansforcommunitydevelopment.org

http://citmedialaw.org/legal-guide/low-profit-limited-liability-company