The Low-Profit Limited Liability Company ($L^3C$)

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The Low-Profit Limited Liability Company (L3C)

**Background**

The L3C is a business entity organized under the state laws of Michigan, North Dakota, Utah, Vermont, Wyoming, or Crow Indian Nation. As its name suggests, an L3C is essentially a limited liability company (LLC). Like a traditional LLC, the entity limits the liability of its owners (“members”) and provides “pass-through” income taxation. An L3C is organized in the same manner as an LLC, except for the L3C designation in the articles of organization and name of the company.

An L3C and LLC differ in that an L3C is organized for the purpose of furthering the accomplishment of one or more charitable or educational purposes, as defined in the IRS Code. In addition, the production of income and appreciation of property cannot be a significant purpose of an L3C. If at any time an L3C fails to satisfy one of the requirements for L3Cs under state law, its L3C status ceases and the entity continues to exist as an LLC.

Although L3Cs advance charitable and educational purposes like many traditional 501(c)(3) organizations, they are not exempt from federal or state tax and donations to the company are not tax-deductible. As a result, an L3C is often described as a cross between a non-profit organization and a for-profit company: “the for-profit with the nonprofit soul.” However, such a description is not necessarily limited to L3Cs as other business entities such as traditional LLCs, corporations, and partnerships can advance charitable or educational purposes while pursuing profits. What sets L3Cs apart is that they have taken the extra step of legally committing themselves to placing their social goals above financial goals.

**Basic Purposes**

The basic purposes of L3Cs vary depending on the source describing them. As a result, we turned to the purposes provided by Americans for Community Development (ACD). According to ACD, the purposes of the L3C are to:

- **Signal** - potential funding sources that the company’s pursuit of profits is secondary to its advancement of a charitable or educational mission,
- **Attract** - Program Related Investments (PRIs) without the need for IRS private letter rulings, and
- **Increase** - socially beneficial investments by bringing together various sources of funding (e.g., foundations, governments, individuals, and market rate investors) under a flexible structure that facilitates tranching or layering.

The interdependency of these purposes is evident in the following statement by the Vermont Secretary of State: “The basic purpose of the L3C is to signal to foundations and donor directed funds that entities formed [as L3Cs] intend to conduct their activities in a way that would qualify

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1 Americans for Community Development, http://americansforcommunitydevelopment.org/
2 Robert Lang, CEO of , is credited with creating L3Cs and is a member of ACD.
as program related investments.”

The overarching theme in the purposes appears to be the increased flow of money from foundations and donor directed funds into “do good” for-profit ventures that are underserved by capital markets.

Increasing PRI was the intention of the creator of the L3C concept, Robert Lang, CEO of the Mary Elizabeth and Gordon B. Mannweiler Foundation. We contacted Mr. Lang and he described the value of the L3Cs as follows:

The secret to the L3C is to improve the credit of the structure so as to lower the cost of capital. We turn the venture capital model on its head by having a foundation(s) take the place of a venture capitalist and replace high return, first loss capital with low return, first lost capital.

Mr. Lang recognizes that developing the environment for L3Cs to thrive will take time and has been focusing his efforts on getting legislation passed in key states and at the federal level as first steps. Over time he believes the full potential of the L3C should evolve. For example, when commenting on the possibility of a secondary market in L3C securities, Mr. Lang stated:

Yes eventually an exit strategy makes a lot of sense. But we have to crawl before we walk and walk before we run. It makes no sense to open a used car lot if there are no cars to sell. So yes we do anticipate creating a secondary market in time.

Our research indicates that the L3C is currently serving different purposes than originally intended and will most likely continue to do so in the near future. Foundations and L3Cs should consider the current usage of the L3C when evaluating its potential as a conduit for PRIs.

PRIs

Given that attracting and increasing PRIs made by foundations and donor directed funds are two of the purposes of L3Cs, it would be helpful at this point to provide background information on these investments. PRIs are investments made by foundations to support charitable activities that involve the potential return of capital.4 PRIs include financing methods commonly associated with banks or other private investors, such as loans, loan guarantees, linked deposits, and equity investments in non-profits and for-profit ventures for charitable purposes.5

For the recipient, the primary benefit of PRIs is access to capital at lower rates than may otherwise be available. For the funder, the principal benefit is that the repayment or return of equity can be recycled for another charitable purpose.6 For private foundations, PRIs also can count toward their annual requirement to disburse 5% of the fair market value of investment assets.

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5 Id.
6 Id.
Currently, PRIs comprise only a small percentage of the distributions made by foundations. According to the Foundation Center, of the many thousands of grantmaking foundations in the United States (~72,000), only a few hundred make PRIs. In 2006, only 0.72% of qualifying distributions by foundations were PRIs.\(^7\) This amounted to approximately $310.5M of PRIs in 2006.\(^8\)

Research Findings

**The Current Purposes of L\(^3\)Cs**

Our research indicates that L3Cs are serving as an attractive alternative to the formation of 501(c)(3) organizations, a beneficial signal to non-investors (e.g., potential beneficiaries, peers, and friends/acquaintances), and a source of intrinsic benefit to the members of L3Cs.

As part of our research, we sent a brief email questionnaire, and in some cases a follow-up questionnaire, to almost half of the L3Cs registered in Vermont. We received responses from about a third of the companies contacted. Almost all of the respondents stated that the reason why they chose the L3C entity was to avoid the shortcomings of incorporating as a 501(c)(3) organization. Cited shortcomings included the time and effort required to form a 501(c)(3), the loss of control to a board of directors, and lack of flexibility in terms of business model and revenue stream development.

Several of the respondents stated that the L3C designation sent beneficial signals to non-investors such as potential beneficiaries, nonprofit peers, and friends/acquaintances. “Legitimacy,” “curiosity,” and “receptive” were terms used to describe some of the benefits. Zirgoflex L3C explained to us that the L3C designation enhanced their conversations about the company with individuals and the novelty of the entity provided the company with a “coolness” factor. More importantly, Zirgoflex interfaces with museums and artists, which normally prefer not to work with traditional for-profits, and the L3C designation has enabled it to be treated as a colleague rather than a for-profit vendor.

The responses to our questionnaire also indicated that the individuals creating L3Cs took pride in the designation and viewed the organization as a means of self expression. One respondent stated that the designation was a statement of principles and that it underscored their own commitment to a social mission. Another respondent viewed the organization of an L3C as a way to “let people know you are ‘doing good’ [and doing so] spreads the seed for others to follow suit.” Overall, the respondents at a minimum expressed a general sense of satisfaction in their participation in the L3C movement and were optimistic about the entity’s potential in the coming years.

**The Inability of L3Cs to Achieve Their Intended Purposes**

Our research also indicates that the L3C will only marginally achieve its intended basic purposes. Foundations and donor directed funds are currently unreceptive to the L3C signal and

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\(^7\) Foundation Center, http://foundationcenter.org/findfunders/statistics/pdf/01_found_fin_data/2006/02_06.pdf
the signal itself could be confusing to such organizations. The purpose of attracting PRIs without the need for private letter rulings is for the most part moot, as the vast majority of PRIs in for-profit companies are made without private letter rulings. Finally, the relatively small amount of PRIs is primarily a cultural issue within foundations and donor directed funds, and the presence of L³Cs will only have an indirect impact on achieving the necessary cultural transformation.

**First Basic Purpose - Signal**

Only a couple of the L³C respondents had sought PRIs from foundations. Those companies were unsuccessful and reported that the foundations they approached were uninterested and unaware of the L³C entity. One of the respondents was also unsuccessful in his efforts to secure funding from corporations and venture capitalists.

Our conversations with foundations and donor directed funds helped to explain the respondents’ experience. The organizations did not think that any L³Cs had received money from foundations. The explanation was that most foundations do not make PRIs and those that do, did not see a need for L³Cs in that they have been able to “do everything that they needed to do” without the existence of such an entity. That is to say, foundations are more concerned about mission match (i.e., the for-profit’s business activities meaningfully further the foundation’s mission) and the ability to generate returns than about whether the company has articulated its social mission in its articles of organization or incorporation or is committed to keeping its profits low.

Depending on the funding source, for-profits may also be required to meet additional criterion. One donor directed fund described a for-profit candidate for a PRI as one that is creatively operating in an area where there are no other nonprofits. As a result, L³Cs have to meet the same heightened criteria and undergo the same level of due diligence applied to traditional for-profit companies. Viewed in this light, L³Cs do not provide meaningful advantages over traditional for-profit companies in securing PRIs.

A further complication for L³Cs, is that the designation itself can send a confusing message to foundations and donor directed funds. A foundation that makes PRIs explained to us that a for-profit company that signals low profits through an L³C designation raises concerns that its business model does not allow it to properly function in capital markets. Such a concern is important as foundations are concerned about the ability of a potential for-profit PRI recipient to generate returns. It is also important to note that PRIs are often made as a last resort when an organization, typically a charitable nonprofit but occasionally a for-profit, has been unable to secure financing from traditional sources. Thus, an L³C designation could result in a company being placed in this last resort category of PRIs by default, thereby making it more difficult to secure PRIs. The difficulty could be insurmountable for L³Cs in the startup or early growth stage.

The L³C designation could also make it difficult for a foundation to understand whether an investment in the company represents a mission related investment (MRI), which is an

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investment that generates a market rate return, or PRI. Such a situation would most likely arise with L3Cs that are generating market returns for a subset of its members and providing a foundation with a below market return. The distinction can be important to a foundation as PRIs can count toward their 5% disbursement requirement and are often treated as liabilities because of their lower returns.

Second Basic Purpose - Attract

Regarding the second basic purpose, the expectation that L3C designation will minimize the costs of obtaining private letter rulings and thereby, encourage a significant amount PRIs in L3Cs appears to be misplaced. Our conversations with foundations and donor directed funds indicated that they are comfortable with their evaluation of for-profits and their eligibility for PRIs, especially as none of them reported seeking private letter rulings.

For example, F.B. Heron, which has 11% of its assets tied up in PRIs, has not sought private letter rulings and reported to us that it has not had a PRI-related problem with the IRS. When presented with a for-profit with questionable eligibility, their lawyers are consulted and the investment team is asked whether they would invest in the organization. If the lawyers support eligibility and the investment manager would not invest in the company, the foundation feels comfortable moving forward with the PRI without a private letter ruling. Such decisions to move without obtained private letter rulings predominate the community as hundreds of foundations make PRIs ($310.5 M worth of PRIs in 2006) and only between 20 and 25 private letter rulings have been issued in the past 10 years. As a result, for-profit companies already have the ability to attract PRIs without private letter rulings. Any cost savings from expedited private letter rulings on L3Cs will not be a relevant benefit to foundations.

Third Basic Purpose - Increase

With regard to the last basic purpose, the L3C by itself will only marginally increase the amount of socially beneficial investments, specifically PRIs, made by foundations and donor directed funds. Americans for Community Development attributes the lack of PRIs in part to foundations’ perception that the transaction costs associated with making PRIs are quite high. We have explained why this is not a satisfactory explanation.

Our research has clearly revealed that the primary cause for the lack of PRIs is cultural. More than one foundation informed us that there is a divide between the program and investment sides within foundations. As a result, it has been difficult for foundations to understand the benefits of PRIs. Most boards of directors still hold the traditional view that their fiduciary duty is to make grants and ensure the perpetuation of the foundation. An argument was made that the boards need to look beyond their grant making responsibility and serve as a bridge between the program side, which is more inclined to see the benefit of PRIs, and the investment side, which is focused on returns. The sentiment was that strong leadership by boards is the key to achieving meaningful increases in PRIs. This cultural issue has been addressed within organizations that

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are PRI leaders without the presence of $L^3Cs$ and it can continue to be addressed in the future without the entity.

We do not completely discount $L^3Cs$ involvement in the cultural transformation. They can help, albeit marginally, by stimulating the conversation in some board meetings where the issues have yet to be discussed. However, we believe that it is clear that the existence of the $L^3C$ alone will not directly increase the amount of PRIs.