Introduction

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L³Cs and State Arts Agencies

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Introduction

Jonathan Katz: Hello everyone! On behalf of the National Assembly of State Arts Agencies, welcome to today's web seminar. This afternoon we are taking a look at a new business model, the low-profit limited liability company, also known as the L³C.

One of NASAA's roles is to provide our members with insight into the changing landscape for how the arts are produced and distributed in America. Emerging "fourth sector" business models—including the L³C—are a part of that mix. As for-profit entities with social missions, L³Cs can blend philanthropic goals with venture capital approaches. State arts agencies foster many different kinds of collaborations, with both public and private partners, within and beyond the nonprofit realm. So we hope this web seminar provides a good point of departure for considering the possibilities of including L³Cs.

Today we are happy to have some of the original innovators of the L³C model and legislation to explain the concept and its potential. I'll hand things over to NASAA Director of Administration and Finance Wesley Taylor, who will get us started.

Wesley: As Jonathan mentioned, we hope to provide you with a solid foundation to consider the possibilities of the L³C. We are privileged to have with us today three presenters who are brimming with this knowledge. We will hear from the creator of the L³C legal structure, Robert (Bob) Lang, CEO of L³C Advisors L³C, Founder of Americans for Community Development and CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation, Inc. He will be joined by his compatriots Michael Martin, from Martin and Stilwell, LLP, an ardent advocate of social enterprise investing and expert on the potentials of the L³C in the arts community; and Bernard Hall, coauthor of the paper "L³C and the Arts." Now, I'm going to turn things over to Bob, Michael and Bernard.

L³Cs and State Arts Agencies

Bob: As you know, money is available from two sources outside of the government, the for-profit sector and the nonprofit sector. Most of the money is in the for-profit sector, and most of the money in the nonprofit sector has to go to things that cannot make any money. A lot of arts organizations earn some of their revenue with gift shops or concert tickets or through other sales. They are already in the space where donated dollars and government funding are not the sole source of the income. What we are trying to do with the L³C is create a structure that would allow more of the trillions of dollars in the for-profit sector to be invested in social causes like the arts to make for a more robust and dynamic sector.
The question we had was, How do we get more of that money? And how do we get groups who sometimes have common goals but disparate structures—like government agencies, individuals, nonprofits, foundations and for-profit companies—to work together better toward those goals, though they have had trouble doing so under the current structures? My solution was to develop an entity known as the L³C, which stands for low-profit limited liability company. Basically it is structured and based on the LLC format, and as with an LLC, its operational structure is based on the operating agreement. So we can have a very flexible organization that can operate in a space where normal for-profit investment dollars do not work out. For-profit investors like to get more than a 5% return on their money.

**Michael:** One of the nice things about an L³C being a for-profit entity is that we avoid a lot of the strictures, regulations and requirements that are inherent in operating within a nonprofit structure.

**Bernard:** That is why a lot of artists find this to be an advantageous business structure, because of this flexibility.

**Bob:** The L³C operates in that space between a pure for-profit and a true nonprofit. It is able to really bring together a good mix from foundations, trusts, donor advised funds (DAFs), nonprofits and for-profits in its organization. One of the keys to the L³C is that we can undertake a layered or tranched financing. We can use someone who will take a first-risk position, maybe a foundation or DAF, at a very low cost; the lower the cost the lower the cost of funds for the whole structure. This is a flip of the standard venture capital model. In venture capital financing, you find someone who will take the first risk but they also want higher return on their investment and a bigger chunk of the investment, and generally they do not leave a lot for anyone else when they are done. That makes it almost impossible to finance a business that isn’t going to earn a lot of money to begin with. Because of certain legal structures, we can flip that whole model on its head.

**Michael:** I should mention here that foundation type investments are designed by regulation to take this front-end risk at a very low cost.
Bob: That's right. Foundations can make what is known as a program related investment (PRI). PRIs can replace grants in the 5% that they must give out every year. And because it replaces a grant, the law insists that it resemble a grant. Since there is nothing more high risk or lower return than a grant—you don't get any money back—this becomes a very interesting option for the foundation in that they might make something back. The really nice thing is although they are putting a little charitable money in up front, that is really the only charitable money the L3C will ever receive. It does not receive operational money every year after; it should earn its keep from that point forward.

Bernard: This is something that I really found interesting about the L3C. It can take advantage of program related money and gives the foundation a chance to give money to an arts organization to help it grow and sustain itself, but then money can come back to the foundation that can be turned around to help another organization that supports that foundation's mission. In a way it keeps recycling itself.

Bob: You just raised a point that we shouldn't forget. In order for a foundation to make a program related investment, its mission must align with whatever it is investing in. The operating agreement is basically a blank contract. All of the parties related to an LLC can in essence just sit down and write up an agreement. To give you an idea of how flexible this can be, let's assume that I was going to start an LLC with Michael and Bernard. We could write up an agreement that states that Michael was going to put in all of the money, Bernard was going to do all of the work and I was going to receive all of the profits. And if they sign that agreement then it is completely, totally legal and that is the model under which the company would operate. The L3C has that same type of flexibility.

On the other hand, the L3C, by state charter, states that it has to have a social or charitable mission. So built into its DNA is that factor. The operating agreement generally states what its social mission will be. The L3C must perform its charitable mission before it worries about making any money. You are guaranteed the best of both worlds, the flexibility of a for-profit and the dedication that normally comes with nonprofits. If we can get foundation PRIs into our L3C an interesting thing happens: it will leverage a lot of the market-driven money invested because we can offer the investors in the other tranches market return on their money.

Michael: When a nonprofit organization forms under state law it is, by statute, asked to have a charitable purpose stated. The legislation related to a nonprofit corporation says that this is what it has to be: A, B or C. What we've done is taken the for-profit LLC and married the nonprofit charitable purposes clause to it, and made it an entity that can operate in the for-profit arena but for charitable purposes.

A few quick thoughts on the parameters of the L3C. The first thing is that the company must significantly further the

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The Limited Liability Company (LLC)

- Governed by an operating agreement.
- In addition, the LLC operating agreements will include provisions that guarantee the charitable or public benefit orientation of the enterprise.
- Management flexibility: Members may participate or be passive.
- Ownership Flexibility: Each operating agreement can be tailored to meet each member’s own particular needs — profits may be allocated in proportions that are different from capital contributions.
- The L3C is designed for PRIs (Program Related Investments) by foundations — it leverages limited foundation dollars to access trillions of market-driven investment dollars through (tranched) layered investing, which lowers the risk to other investors while increasing their potential rate of return.

What are the Parameters of the L3C?

- The Company significantly furthered the accomplishment of one or more charitable or educational purposes within the meaning of Section 170(c)(2)(B) of the IRS Code of 1986, 26 U.S.C. Section 170(c)(2)(B); and would not have been formed but for the company’s relationship to the accomplishment of charitable or educational purposes.

- No significant purpose of the company is the production of income or the appreciation of property; provided, however, that the fact that a person produces significant income or capital appreciation shall not, in the absence of other factors, be conclusive evidence of a significant purpose involving the production of income or the appreciation of property.

- No purpose of the company is to accomplish one or more political or legislative purposes within the meaning of Section 170(c)(2)(D) of the IRS code of 1986, 26 U.S.C. Section 170(c)(2)(D).
accomplishment of one or more charitable or educational purposes. The idea here is that it is not a guarantee, but it has to make a good faith due diligence effort to further those purposes.

**Bob:** The word *furthers* is very important here. Many mistakenly think that the L³C must spend all of its time on the charitable purpose, and that is not true at all. All this says is that in the scope of its operation it should have the significant purpose of furthering a charitable purpose. For example, we could own a bakery and as long as we used the money that we made to help fund a charitable purpose, like purchasing food to help feed the homeless from the backroom, we are furthering the accomplishment.

**Michael:** That is exactly right. Whether it is furthering or whether it isn't is subjective in each case. For instance, what happens if that bakery diverts that purpose or those revenues to creating a franchise chain?

**Bob:** Then they are in the position of being in violation of their operating agreement and of the state charter under which they were organized.

**Michael:** So, it doesn't kill them, but it does kill it as operating as an L³C, right?

**Bob:** Right, but now the foundation that made the original investment can get in trouble with the IRS if it continues to do it. The foundation is therefore likely to have a clause in the operating agreement that allows them to take certain actions, like dissolving the L³C or converting it into an LLC or withdrawing the capital. That is the advantage of the flexibility of the operating agreement. You can build in those contingencies. To divert a little bit here, there are some times when an L³C maybe should stop being an L³C. Maybe this isn't the case so much with the arts.

For instance, though, we talked to an Indian tribe in the middle of nowhere with a large reservation. As you drive through there is really nothing there. Why? Because Indian law as it is set up makes it almost impossible for anyone but the tribe to do anything in Indian reservations, and no one wants to give money to the tribe. Now if they were to set up an L³C, there are foundations who have a mission to help Indian tribes. So what if they set up an L³C hotel, maybe a Sheraton franchise, and a foundation put up 20% of the cost of building that hotel in first risk position as a PRI. If the foundation takes first risk position, there is probably mortgage money available for the other 80% of the hotel (although maybe not today with the current insanity, but under normal conditions). So they open a hotel and it is very successful, and within a couple of years they are running at 90% occupancy. At that point we have achieved a charitable mission of economic development and creation of Indian-owned businesses. So the foundation makes a nice long-term payout deal so that they can withdraw their capital and the L³C converts to an LLC so that they no longer are constricted in anyway. There is a good reason to terminate the L³C agreement in this case.

In nonprofits that is kind of difficult. If you create a nonprofit theater and it becomes successful, it is really difficult to convert it into a for-profit even though it may run better and be better off if it could be. Changing a nonprofit to a for-profit is really difficult.

**Michael:** This, the Indian tribe example, is what we call an organic exit strategy rather than a unilateral exit strategy when the foundation determines unilaterally that the exempt purposes are not being followed and wants its capital back.

**Bob:** The final parameter we'll mention here is that the L³C will not have a purpose to accomplish one or more political or legislative goals. This helps keep things in line with the IRS code and keeps Congress happy.
Donor advised funds (DAFs) are an interesting feature that has come along in the last few years. They can do many of the things that foundations can do, but don’t have a yearly donation requirement. They are very easy to set up and can replace a foundation PRI in an L³C. There are commercial vendors that can set them up and there are nonprofits, like a community foundation, that can set up a DAF.

There are two nice things about DAFs. One, the donation actually gets tax credit at the public charity rate rather than the foundation rate, so it is a better tax deduction. Two, it is fast. People get particularly passionate about something, and if you have an L³C and people who really want to see it happen, they can create a donor advised fund usually within about 24 hours. The joke within the sector is, "Give me the information over breakfast and pop the cork over dinner."

**Michael:** That is in contrast to a foundation that takes six to nine months to get in place with an IRS designation letter.

**Bob:** In both cases, the PRI or DAF, the investment has to be for charitable purposes. That is why it works in an L³C. The other thing about the DAF is that once the money gets there the donor no longer has any say. The fund manager would play the role that the foundation would otherwise, being on the board or signing the operating agreement, etc. This can be an interesting way from a pragmatic point of view of getting the donation of an individual into a company that is going to do good, yet keep them out of the running of the organization. I think everyone can agree that there are times when you really want someone’s money, but you really don’t want them involved otherwise.

Let’s talk about a few examples here. Historic preservation and community revitalization are interesting areas, because a lot of times they involve structures that can work really well for the arts, like an old theater or school building that can be converted to a community arts center. These are the kinds of projects where you can revitalize a building while at the same time make the building self-sufficient.

For example, let’s take an old historic factory complex and convert it. Part of it can be used for a restaurant; part of it can become commercial offices, who would pay market rate rent; part for retail, also market rate renters—you don’t have a real estate developer who is trying to make a profit. You are in the situation where that profit can subsidize art operations that can be in that building. So you can easily have a theater group, or classes or a museum all taking advantage of a lower or even zero cost of operation depending upon the other occupants of the building. That arts component is supported by the totality of the income from the whole, but there is not a lot of money made, which is okay because we are focused on doing some good.
**Michael:** So in effect what happens is maybe you have a first floor of retail, a second of offices, a third for an arts venue and then maybe a fourth and fifth of luxury condos, and you can attract arts organizations without a high front-end cost.

**Bob:** This is obviously something that you can't do with a nonprofit. And a normal for-profit investor is not going to take on the risk factors to make something like this happen.

I want to talk a little bit more about layered investment and how tranche can work out. The equity investment, which would be a foundation or DAF, would get 1%. Then we find some socially motivated investors, and there are a number of them around, who want reasonable security, but they don't mind taking a moderate return. And then you get your senior tranchers for whom 6% is good, because even if the entity fails, say in the case of our historic preservation example, that building is still worth more than 50% of the investment. It will sell off and the market-driven investors will get their money back, so they are pretty safe.

What you will notice is that the blended rate of return is only 4%. Maybe that is all the total L3C can generate, because maybe it is subsidizing the theater or providing free space for artists. It can't earn any type of a market developer's rate of return, but because you can allocate the 4% return in different ways, you end up with everyone getting what they want.

**Michael:** As mentioned, the governance of the L3C is with an operating agreement just like a regular LLC. An L3C is a for-profit and designed to run just like a regular LLC. It can be run either by managers or members, depending again on the decision you make in the agreement. Either way there will be board officers and an oversight function.

It is important to realize that at any point and time the foundation, no matter if they are in a minority position or not, will always have a unilateral right to withdraw and take their capital back if they make a determination that the L3C is not operating in accordance with its agreed upon charitable purpose. The governance can be made up a number of ways: with an official board of directors where the managers support that function or made up of the nonprofit and for-profit members with stakes in the L3C, etc. Another important feature: even though the L3C doesn't have reporting requirements, the foundation will, so the foundation will have a duty to report how that money in the L3C helps support their mission.
Bob: Let’s get into some very specific examples, for instance, production of a stage show with a message. I saw a few years ago a one act play, *Ann and Emmitt*, with a very strong social message. The producers are now currently looking for funding and are considering doing it as an L³C. From a foundation point of view, disseminating the message about the evils of discrimination would be a mission fit; and for the producers, they would like to get back their investment and make a bit of a profit. So if it is set up as an L³C with the foundation making that first risk investment, and it attracted other investors, a few things might happen. It could perhaps be staged on Broadway if the money is available to bring it up to those standards, and that brings with it additional cachet. If it succeeds, the message will get out. Even if it doesn't succeed, the foundation will still have a play that disseminates its message with the cachet of Broadway that could conceivably run for years off Broadway and in schools nationwide. It becomes a win-win for the foundation that will most likely have a greater impact than other more traditional messaging approaches.

A museum is another interesting idea. I have a friend who is a museum consultant, and if you ask him what a museum’s competition is he will tell you flat out that it is Disney World. People are going to the museum for entertainment not for an educational experience, although it can be both. Often what happens is that what the patron wants to buy in the gift shop and what a nonprofit museum feels it can sell without having unrelated business income tax (UBIT) issues are not the same. So museums are missing out on opportunities.

Michael: Another aspect of this is that when a nonprofit museum operates all of these ancillary functions, they are constantly faced with these UBIT issues, and an L³C is a perfect solution to those issues.

Bernard: An example of this is the [21c Museum](https://www.21cmuseum.org) in Louisville, Kentucky. That museum is actually a museum and a hotel. It runs as a for-profit business structure, but has had a foundation that split off from it called the International Contemporary Art Foundation that in 2008 structured itself as a nonprofit.

Bob: That is interesting. I know a lot of you are probably thinking, What about all the tax deductions for the giving of artwork? Well, you can actually set up a foundation, like Bernard mentioned, that can own the work you show. Then all the operation expenses and ancillary functions are run by an L³C, and its charitable function is to exhibit the work owned by the foundation. Now the foundation can receive the tax deductible gifts of work and then rent the work to the L³C, and the funds received from the L³C can be used for acquisition and conservation. What you get is the best of both worlds. The same thing can happen in other fields. Quite often we are restricted by the amount or type of income, and you can bypass much of that by a blend of organizations like a foundation and an L³C.

Michael: This is a good segue to our Q&A session, but I want to anticipate one beforehand. I am sure one question an arts administrator or someone working with them will have is, How do we do this with a traditional nonprofit arts organization? There are really two conceptual ideas. One, an arts organization structured as a nonprofit can do a partnering or joint venture arrangement with an L³C, and there are currently existing bright-line rules for doing that. On the other hand, like the play you were discussing, it could start out as a start-up with an L³C with some foundation and some for-profit money. So what we have are two basic ways that an L³C can be deployed to put more money on the table for arts organizations.
Bob: Remember one thing. An L³C can earn significant money, although its purpose can't be to earn significant money. The IRS recognizes it might get in a situation where this might happen. For example, if you are building a home for the elderly and you have to drill a well for water, but in the process you strike oil, everyone in the foundation and the home can benefit from the money from that oil. It wasn't your purpose to strike oil; if it had been, your nonprofit dollars would be in trouble, but the fact that you struck it the IRS recognizes as serendipity. Obviously the excess money that the foundation brings back in as income must go back into its endowment and increase the amount of money it needs to give out each year, but it acts just like making a good investment.

Q&A

Wesley: Thanks very much, Bob, Michael and Bernard! Now let's transition to some Q&A. We've had some great questions from the audience, so let's get started. We have a question about operating agreements. Based on what you talked about, it seems that a lot of the success of an L³C depends on how the operating agreement is written. Are there any models or checklists available, or factors to make sure that you include, or mistakes to avoid?

Bob: We do have some on the Americans for Community Development website and we are in the process of developing more. We are also able to recommend attorneys well versed in this area who can help develop a strong operating agreement. The examples on our website, however, give you a good base of the kind of things that should be included.

Michael: We encourage you to use the operating agreement examples on the website as conversation starters. They do not constitute legal advice and are really there for educational purposes only. That being said, take a look and bring them to your advisors. The other thing I'd like to say is no operating agreement has its twin. The operating agreement is a deal specific document, yes there are certain requirements that each one has to have, like the purpose statement, but beyond that it is really open to your situation. I think these examples are really there as a starting point for a conversation between arts administrators and their advisors.

Wesley: Our next question is from Kentucky. What are the implications of running an L³C in a state that has not yet passed legislation authorizing them?

Bob: In essence there are none. Under the fair faith and credit clauses of the Constitution, one state has to recognize the laws of another state. Since all states have LLCs, they have to recognize the variant forms of the LLC even if it doesn't come from their state. Just as you might form a Delaware corporation and operate in Kentucky, you can form a Vermont L³C and operate in Kentucky. The only implication is clerical: you will have to come back after registering in Vermont and register in Kentucky as a foreign entity.

Michael: You pay a fee to do that and you get your registration, and if you follow Kentucky rules you get to stay and do business and you get to take advantage of the Kentucky rules allowing you to sue and assert claims under Kentucky law.

Bob: The cost is usually minimal, a few hundred dollars. It just means one more reporting at the end of the year.
Wesley: That leads nicely into the next question. Is there anywhere that you can go to find a list of L³Cs that have been incorporated in a state or city?

Bob: Unfortunately there is no keeper of that info. The states have not recognized it as a profit center yet, so you cannot purchase that information right now. You’d have to go to your secretary of state and probably download the entire database of LLCs and sort for L³Cs.

Michael: There are about six hundred or so that have been organized at this point.

Bernard: While I was undertaking my research I came across a website called interSector Partners, L³C that has a pretty decent list of L³Cs in the different states.

Wesley: Our next question is from Nebraska. Have you been tracking, or have found, a critical mass of foundations who have recognized L³Cs, or have you seen a rise in PRI investments in L³Cs?

Bob: There is an old saying in the foundation world, "If you've seen one foundation, you've seen one foundation." There are over 80,000 foundations and they all have their own ideas about how they operate and how they do what they want to do. They are essentially private, although they report to the IRS. Some you can go to their website and find out anything you’d like to know, but they do not have to do that. The IRS does not really track PRIs. They get reported to them, but it is far back in the Form 990 and it is not a section that is separated out and tracked. If you wanted to know how many PRIs are out there and what they are all about, you'd have to go somewhere like Guidestar and go through all 80,000 990s and read that section on each one.

Michael: An L³C is like any other business. You have to do a business plan and address the question of why someone should do business with you. A foundation is not going to just show up with a PRI just because you formed an L³C. It is like getting money from a foundation any other way. You have to prove to them that you fit, and some foundations that may claim to not do PRIs may fit with your business and make an exception and some who regularly do PRIs may feel they don't fit. That being said, in the past we've seen a resistance to PRIs because foundation managers, I think, don't often understand them or are afraid of them getting wrong.

Bernard: And this is where I think that state arts agencies are going to be helpful. You are one of the primary trainers and disseminators of information for art managers and entrepreneurs, and you can help them understand the benefits of an L³C as an option.

Bob: The more people who ask for PRIs, the more foundations will become aware of them. When I started this, only about 5% of foundations had ever given a PRI. I'm not sure if the numbers have gone up, but the number of conversations has definitely increased. A lot of foundations that had never heard about it—and remember the law permitting PRIs has been on the books since 1969—are now beginning to talk about it. And of course don't forget DAFs. They are a great way of circumventing the PRI process. From a state arts point of view, we have Federal Bill H.R. 3420 called the Philanthropic Facilitation Act, which makes it easier for foundations to do PRIs. That bill now has five sponsors, both Democrat and Republican. I will also mention that the Obama administration has become aware of PRIs, and put out a statement recently stating that they'd like to see more of them.

Wesley: We have a question about capital for L³Cs and its impact on nonprofits. In communities where L³Cs exist, is there any research about how their presence has affected contributions to nonprofits? Where individuals or foundations are choosing to invest their money for the chance at a profit over a tax break?

Bob: This is a usual comment. But we have never found a specific example where a foundation dropped a grantee in favor of a PRI. I know an example of a corporate foundation that has given money to a nonprofit to find out if an L³C would actually help that...
nonprofit carry out its mission. The foundation is actually offering to help fund the nonprofit's L³C if by owning it the nonprofit can achieve its mission more effectively. Ultimately the thing to remember is that if the foundation makes a one-time investment in an L³C and that starts returning money to the foundation, even at 1-2%, two things happen. First, the L³C will not come back to the foundation for money the next year, and secondly, the foundation will have more money to give away. If the L³C works, it is putting more money in the bucket, not taking it out.

**Michael:** It is about expanding capital resources for nonprofits and the arts.

**Wesley:** We have one final question. If I am an artist interested in starting up an L³C instead of a standard LLC, what should my first step be?

**Michael:** A business plan. You need to start out with basic business steps and establish why someone should invest or trade with you.

**Wesley:** Well, that is all the time we have for questions today, but I'd like to close with thanks to our presenters, Bob Lang, Michael Martin and Bernard Hall, for sharing their information and advice with us today. And thanks to all of you for joining us, as well.