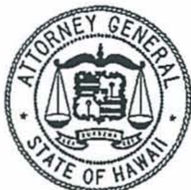
SB674

Measure Title:	RELATING TO LOW-PROFIT LIMITED LIABILITY COMPANIES.
Report Title:	Low-Profit Limited Liability Company
Description:	Provides for the creation of low-profit limited liability companies under the uniform limited liability company act.
Companion:	
Package:	None
Current Referral:	CPN



TESTIMONY OF THE DEPARTMENT OF THE ATTORNEY GENERAL TWENTY-SIXTH LEGISLATURE, 2011

ON THE FOLLOWING MEASURE:
S.B. NO. 674, RELATING TO LOW-PROFIT LIMITED LIABIITY CORPORATIONS.

BEFORE THE:

SENATE COMMITTEE ON COMMERCE AND CONSUMER PROTECTION

DATE: Friday, February 25, 2011 **TIME:** 9:00 a.m.

LOCATION: State Capitol, Room 229

TESTIFIER(S): David M. Louie, Attorney General, or
Hugh R. Jones, Supervising Deputy Attorney General

Chair Baker and Members of the Committee:

The Attorney General is opposed to this legislation for the reasons explained below, and for the reason that enabling federal legislation makes this proposal "premature."

Under the common law and under various Hawaii statutes and federal laws, the Attorney General has oversight authority over public charities, private foundations, and charitable trusts[1].

How this Bill Changes Current Law

This bill creates a new type of charitable entity that is potentially subject to less oversight and fewer constraints on the extent to which its charitable assets can be diverted from public purposes to private, for-profit interests.

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[1]These statutes include chapters 323D, 414D, 517E, 467B, and section 431:1-204(c)(1)(C), Hawaii Revised Statutes, and the Federal Telemarketing Sales Rule.

Key Points of Legislation

The legislation is potentially inconsistent with existing law.

This bill authorizes the formation of "low-profit limited liability companies" (L3Cs), distinguishable from other types of LLCs because of their declared commitment to significantly further the accomplishment of charitable purposes. Proponents suggest that the purpose of the L3C designation is to signal to charitable foundations that the entity is qualified to receive "program-related investments" in conformance with Internal Revenue Service (IRS) requirements. Because L3Cs purport to have charitable purposes, it would appear that they are subject to the Attorney General's statutory and common law oversight authority over charitable organizations. See chapter 467B, Hawaii Revised Statutes and provisions of chapter 414D, Hawaii Revised Statutes regarding the Attorney General's oversight role over charites that operate in corporate, as opposed to trust form ("public benefit corporation").

While creating a new form of charitable entity, this bill provides no oversight authority by any state government agency, and it is not clear whether the intent is to supplant some portion of the Attorney General's existing authority over charitable organizations.

The bill's enforcement mechanisms are inadequate.

The bill does not provide any clear remedy for the recovery of charitable assets if the L3C fails to significantly further charitable purposes or if the for-profit L3C members fail to

keep private profit motives secondary to charitable accomplishments. Thus, the bill provides few deterrents to prevent private, for-profit interests from utilizing the L3C format for private gain to the detriment of the organization's charitable purposes.

In addition, there are no clear standards or guidance for concluding that the L3C is no longer operating in conformance with legislative requirements. As one example, it is difficult to reconcile the bill's requirement in section 2, amending section 428-105, Hawaii Revised Statutes, that L3Cs may not have as a significant purpose the production of income, with the proponents' description of how L3Cs will work in practice. Proponents claim that L3Cs provide a mechanism through which charitable foundations can attract private capital to charitable ventures by subsidizing the financial risks and returns to market-rate investors who are more interested in the production of income than charitable accomplishments. While the bill tracks IRS regulations pertaining to program-related investments, in doing so, it changes the context from an assessment of the foundation's purpose for making the investment, to an assessment of the overall purposes of the L3C. This would presumably require weighing each of the members' varying interests to make some determination as to their cumulative impact on the purposes of the organization. How many market-rate L3C investors does it take before one concludes that a significant purpose of the L3C is to produce income?

This legislation is premature, unnecessary, and fails to accomplish its stated objectives.

The proponents contend that the bill confers no benefit that does not already exist under the law, but that the L3C format will simplify the process for program-related investments and encourage greater program-related investment activity. However, without federal legislation, this bill will have little impact on foundations' program-related investment decisions. Federal legislation is not on the immediate horizon and there have been no federal congressional hearings on the concept. Noted legal commentators concur that L3Cs without Congressional action serve no purpose:

> In our view, without changes to federal PRI rules, the L3C construct has little or no value. Indeed, the existence of the state law form without matching federal income tax substance, is dangerous since the ill-advised may assume value and use the form. Therefore, unless and until tax law embraces the L3C, the form should be shelved.

J.W. Callison & A. Westval, "*The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures,*" Vol. 35 Vermont Law Review at p.274 (2010)

The Legislature should await the outcome of federal initiatives to ensure that any legislation Hawaii adopts is consistent with federal law. If foundations and their counsel conclude that they have program-related investment projects that

fall within IRS restrictions, there currently are no legal barriers that prevent them from undertaking such endeavors.

Some might erroneously conclude that the purpose of this bill is to allow charitable organizations to earn profits, which they are somehow unable to earn now because of charities' "nonprofit" designation. This is not true. The term "nonprofit" is something of a misnomer. Charities are not prohibited from being self-sustaining or from generating income in pursuit of their charitable purposes. What distinguishes nonprofits from for-profit entities is that nonprofits are prohibited from distributing their profits to private interests. Nonprofits are allowed to pay reasonable compensation for goods and services, but to the extent their income exceeds their expenses, they are obligated to reinvest their profits for public, charitable purposes. In contrast, there is no similar constraint against distribution of net earnings on for-profit entities.

Since charities operate to serve public, not private interests, they are prohibited from conferring more than incidental private benefit in pursuit of charitable objectives. For example, a foundation might choose to provide a below-market-rate loan to enable a low-income family to purchase a home. Presuming there was no requirement that the home be purchased from any particular individual, the benefit to the seller from the foundation's loan to the purchaser is incidental to the accomplishment of the charitable purpose, and such an investment would likely qualify as an acceptable form of program-related investment. However, the greater the private benefit to particular persons or businesses that fall outside the class of charitable beneficiaries, the greater the potential to run afoul of program-related investment restrictions.

An L3C's declaration of charitable purposes is not, in and of itself, sufficient to eliminate the need for careful consideration of the terms of each program-related investment, and any related L3C operating agreements to ensure that the private benefit is no more than necessary to accomplish the charitable objectives. The suggestion that private foundations have underutilized, wide latitude to subsidize and confer benefits on private, market-rate investors, in pursuit of the foundation's charitable objectives, underestimates the complex and fact specific nature of the required legal analysis. It is true that, under some circumstances, such subsidies are permissible, but the terms of the operating agreement must be carefully structured to ensure that the charitable purposes of the venture remain paramount.

The L3C designation does nothing to make the legal analysis of whether an investment qualifies as a program-related investment any less difficult or factually specific than is presently the case. Furthermore, the bill seems intended to encourage charitable foundations to select program-related investment options that involve the direct subsidization of for-profit interests, a form of program-related investments that perhaps has the greatest potential for abuse. There are other forms of program-related investments that may present less risks of abuse and might enable foundations to retain a greater portion of their investment returns, such as direct low-interest loans to charitable beneficiaries or projects that rely solely on foundations' own capital. However, those options are unlikely to benefit market rate investors, and so they appear to be of little interest to L3C proponents.

Foundation assets are subsidized, in part, by the taxpaying public and thus careful consideration of this legislation is necessary to protect their interests.

It is important to bear in mind that the activities of private foundations are subsidized, in part, by all taxpayers. To encourage philanthropy, the tax code is structured to reduce the tax burden on charitable donors and charitable foundations by making charitable donations tax deductible, and charitable foundations tax exempt. However, in exchange for this preferential tax treatment, private foundations agree to abide by a variety of constraints on their activities to ensure they serve the public purpose for which they have received a tax benefit. The IRS restriction on program-related investments is but one example of such constraints. In some instances, charitable foundations' subsidization of the risk to market investors may result in public benefits that exceed private gains. Nevertheless, it is reasonable to expect public accountability from the private investors that seek to benefit from such subsidization. This legislation does not specify any form of public reporting of L3C activities or the benefits to private investors.

It is also of some concern that L3C proponents have suggested that the L3C bill is a starting point for an eventual goal of marketing a new type of complex financial instrument designed by investment bankers, ostensibly to spur greater amounts of socially responsible investing. The details of this plan are only vaguely described in L3C literature. The financial instruments sound similar to mortgage-backed securities, but would instead be backed by the assets of charitable foundations. Given the country's recent experience

with mortgage-backed securities, any legislation intended to facilitate the creation of securities instruments collateralized by charitable assets should be carefully considered.

Legal Commentators Believe L3Cs Will Not Be Effective

Legal commentators have criticized efforts to enact L3C legislation throughout the country and have also described these efforts as harmful:

> In short L3Cs can produce positive harm and, to date, the promoters have not addressed underlying systemic issues. Until these problems and issues have been resolved, it is appropriate that the lawyers (regulatory genes) have called out the L3C as an illusion and put an end to the mischief.

J.W. Callison & A. Westval, "*The L3C Illusion: Why Low-Profit Limited Liability Companies Will Not Stimulate Socially Optimal Private Foundation Investment in Entrepreneurial Ventures,*" Vol. 35 Vermont Law Review at p.293 (2010); see also, D. Chernoff, "*Less than Meets the Eye*, Taxation of Exempts (May/June 2010)(suggesting that L3Cs be called Lilacs instead – "Such bushes are indeed eye catching and produce a seductively sweet fragrance—for a while . . . [t]hen they just fade away.").

Fiscal Impact

The bill is unclear as to the extent of the Attorney General's oversight authority over L3Cs and, thus, the fiscal impact is unknown.

Recommended Action

We recommend against enacting this bill at this time and suggest that L3C legislation could be reconsidered in the event federal legislation related to program-related investments by charitable foundations is adopted.

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TO THE SENATE COMMITTEE ON COMMERCE AND CONSUMER PROTECTION
THE TWENTY-SIXTH LEGISLATURE
REGULAR SESSION OF 2011

Date: Friday, February 25, 2011
Time: 9:00 am
Conference Room: 229

TESTIMONY ON SENATE BILL NO. 674
RELATING TO LOW-PROFIT LIMITED LIABILITY COMPANIES

TO THE HONORABLE ROSALYN H. BAKER & THE HONORABLE BRIAN T. TANIGUCHI, CHAIRS, AND MEMBERS OF THE COMMITTEE:

Thank you for the opportunity to testify. My name is Tung Chan, Commissioner of Securities for the Business Registration Division (BREG), Department of Commerce and Consumer Affairs ("Department"). The Department opposes this bill and requests that it be held.

This bill amends HRS chapter 428 to provide for a limited liability company ("LLC") to elect to become a "low-profit limited liability company" ("L3C"). We oppose this bill as another vehicle that attempts to blur the lines between for-profit and nonprofit entities, causing public confusion, increasing expenses to business registry fee payers and creating unnecessary business registration entities that increase bureaucracy without adding value.

Proponents of L3Cs argue that these entities are tailor-made to receive investment funds from private foundations and insulate the foundations from IRS penalties and from IRS challenges to tax exempt status. Foundations, like other charitable organizations, are required to keep their assets safe to ensure they can continue their charitable work. L3Cs were created to exploit an exemption for certain below-market investments that qualify as "program-related investments" or "PRIs". These investments may often be low profit because they have both a business interest and social cause.

Unfortunately, the success of IRS compliance to protect a foundation's charitable dollars turns on the actual activities of the investment LLC, not on whether it is registered as a special entity with the State's ministerial business registry. The IRS has not recognized L3Cs with any tax privileges and it is not possible to categorically privilege any type of entity as automatically complying with IRS requirements.

Furthermore, L3Cs are confusing to the public. They lead to incorrect assumptions that L3Cs facilitate IRS approval for foundation investments. The confusion and the increased cost of the registry to administer this new designation are particularly unwarranted since, as the American Bar Association noted, L3Cs put investors in the same position as those investing in a regular LLC. Basically, anything you can do under L3Cs, you can already do under the existing LLC laws.

For these reasons and more, the American Bar Association passed a resolution on April 23, 2010 formally opposing L3Cs and "respectfully urg[ing] all state legislatures

not to adopt L3C legislation." The New York Council of Nonprofits, an 83 year old organization with a membership of 2800 charities ("NYCON"), has called the L3Cs part of the "national craze" to intentionally blur the lines between for-profit and nonprofit entities, citing this craze as dangerous and misleading to the public. We agree with both the American Bar Association and NYCON, and we ask that this committee continue to protect the Hawaii public by holding this bill and the many others like it that continue to attempt to co-opt Hawaii into this dangerous and misleading national craze at the expense of the Hawaii public and fee payers.

The estimated IT cost of implementing the bill is $125,000 to integrate this new LLC into a nine database structure with over a million records in each database. Since the Division does not have the excess funds to implement this new designation, we would have to ask for an appropriation.

For these reasons, we respectfully ask that this bill be held. Thank you for the opportunity to testify.

Testimony for Low-Profit Limited Liability Company
In Support of the SB 674, Low-Profit Limited Liability Company (L3C)
For Public Hearing on February 25, 2011

Members of the Committee:

Thank you for this opportunity to testify in regards to SB 674, in support of the Low-Profit Limited Liability Company (L3C) business entity to be established in Hawaii.

The establishment of this type of business entity was established in Vermont and can currently be formed in Michigan, Wyoming, Illinois, Utah, Louisiana, and North Carolina. Arkansas, Iowa, Indiana, Arizona, Maryland, Rhode Island, Montana, Oklahoma, Oregon and New York, along with the state of Hawaii are currently pending in L3C legislation.

The L3C Corporation was designed to serve as a hybrid between a non-profit and a for-profit business. Due to the economic status, funding, resources and volunteers are shrinking rapidly along with potential investors. The L3C is unique in that it can leverage foundations' program-related investments. Although L3C corporations cannot solely be driven for profit and are prohibited from making profit their primary objective, the L3C can draw its capital from both charitable foundations/organizations as well as private investors. Foundations are also able to buy ownership shares, contribute loans and financially interact with the L3C Corporation.

L3Cs are mainly designed for the social entrepreneur, to serve a philanthropic need and social commitment to society. By incorporating as an L3C, companies are able to create programs and provide services for social good without being burdened or restrained by lack of funding or resources.

I would like L3Cs to be established in the state of Hawaii so organizations that work toward social good and philanthropic causes will not be restrained by how much the organization makes or the funds that are made available to them. Non-profit organizations that solely rely on the government for revenue and assistance will have new means of support and will be able to become more independent.

Thank you for this opportunity to testify in support of SB 674. I urge the Committee to support this bill and the establishment of L3Cs in the state of Hawaii.