A CONSIDERATION OF AN LLC FOR A 501(C)(3) NONPROFIT ORGANIZATION

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I. INTRODUCTION: BACKGROUND AND SCOPE OF ARTICLE

What is called "the nonprofit sector"[1] includes a wide variety of organizations whose diversity can be glimpsed, though not fully appreciated, by the list of organizations that may be recognized by the Internal Revenue Service ("IRS") as exempt from taxation under § 501(c) of the Internal Revenue Code.[2] This list includes religious, health care, charitable, and similar organizations; social welfare organizations; business leagues like a chamber of commerce; social and recreation clubs, for example, a country club; labor and agriculture organizations; fraternal beneficiary societies or associations; and numerous other kinds of organizations.[3] As with any sector with myriad organizations, considerable further diversity would be apparent if the organizations were grouped according to their budgets or revenues and expenditures, their assets, number of paid employees, number of volunteers, or amount of contributions or grants.[4] According to the Urban Institute, public charities, or ones exempt pursuant to § 501(c)(3) of the Internal Revenue Code, "accounted for 63 percent of registered nonprofits in 2008 and 59 percent of reporting nonprofits," grew sixty-one percent in number from 1998 to 2008, and "reported $1.4 trillion in revenue and $2.6 trillion in assets in 2008."[5] A large number of these are "small charities." Nearly half—forty-five percent—reported annual expenses of less than $100,000, and another 28.9% reported expenses between $100,000

1. *See, e.g.*, JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 2 (4th ed. 2010); BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 23 (10th ed. 2011). The "nonprofit sector" is known by various other adjectives, including "tax-exempt, voluntary, nongovernmental, [and] independent." *Id.* at 24 (italics omitted).

2. Internal Revenue Code § 501(a) provides, "An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503." I.R.C. § 501(a) (2006). Subsection (c) lists twenty-nine such organizations. *Id.* § 501(c).

3. *Id.*

4. *See generally* KENNARD T. WING ET AL., THE NONPROFIT ALMANAC 139–236 (2008) (exploring the size, scope, and finances of some nonprofit organizations). The Urban Institute in Washington, D.C. conducts and publishes in-depth research, including *The Nonprofit Almanac* 2008, analyzing and evaluating the nonprofit sector. *Center on Nonprofits and Philanthropy*, URBAN INST., http://www.urban.org/center/cnp/index.cfm (last visited Oct. 9, 2011).

5. Kennard T. Wing et al., *The Nonprofit Sector in Brief: Public Charities, Giving, and Volunteering, 2010*, URBAN INST., at 2 (2010), http://www.urban.org/UploadedPDF/412209-nonprof-public-charities.pdf.

and $499,999.[6]

The nonprofit sector has been characterized as "a growth industry,"[7] and in a similar vein, another authority writes that the nonprofit sector and the federal tax law governing it "have a common feature: enormous and incessant growth."[8] Data compiled by the IRS confirms such growth and indicates that as of the end of 2009 the number of tax-exempt organizations and nonexempt charitable trusts approached two million.[9] That figure does not include churches and other religious organizations because they are not required to apply for recognition of tax exemption or file annual returns,[10] nor does it include any organization claiming tax-exempt status that "normally does not have more than $5,000 annually in gross receipts."[11] It would also not include thousands, perhaps "hundreds of thousands,"[12] of unincorporated nonprofit associations, which may, but typically do not, file a Form 1023 and seek recognition as a tax-exempt

6. *Id.* at 2–3.

7. FISHMAN & SCHWARZ, *supra* note 1, at 12.

8. HOPKINS, *supra* note 1, at 23.

9. For the years 2006–2009, respectively, the IRS reported 1,726,491; 1,789,554; 1,855,067; and 1,912,695 tax-exempt organizations and nonexempt charitable trusts. I.R.S., U.S. DEP'T OF THE TREASURY, PUB. NO. 55B, 2009 DATA BOOK 56 (2009) [hereinafter IRS 2009 DATA BOOK], *available at* http://www.irs.gov/pub/irs-soi/09databk.pdf. In June of 2011, the IRS revoked the tax exemptions of 275,000 nonprofit organizations because they had not filed required information returns for three consecutive years. *See* Stephanie Strom, *I.R.S. Ends Exemptions for 275,000 Nonprofits*, N.Y. TIMES, June 9, 2011, at B3. Approximately a quarter of these were recognized as tax-exempt prior to 1980, and an analysis conducted by the Urban Institute concluded that "[w]hile it may be tempting to attribute the failing of these organizations to the recession, it is more likely that these organizations have been out of operation for many years." Amy S. Blackwood & Katie L. Roeger, *Revoked: A Snapshot of Organizations That Lost Their Tax-Exempt Status*, URBAN INST., at 2 (Aug. 2011), http://www.urban.org/url.cfm?ID=412386. A number of these nonprofit organizations, however, may simply not have understood the obligation to file despite efforts by the IRS to notify affected nonprofits. Strom, *supra* at B3. These organizations may reapply for recognition as tax-exempt. *Id.* In any event, for now, the number of nonprofit organizations was reduced accordingly. *Id.*

10. I.R.C. § 6033(a)(3)(A)(i) (2006); Treas. Reg. § 1.6033-2(g)(1)(i)–(ii) (2010); I.R.S., U.S. DEP'T OF THE TREASURY, PUB. NO. 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION 22 (2010), *available at* http://www.irs.gov/pub/irs-pdf/p557.pdf.

11. I.R.S., U.S. DEP'T OF THE TREASURY, PUB. NO. 557, TAX-EXEMPT STATUS FOR YOUR ORGANIZATION 22 (2010), *available at* http://www.irs.gov/pub/irs-pdf/p557.pdf; *see also* Treas. Reg. § 1.6033-2(g)(1)(iii).

12. REVISED UNIF. UNINCORPORATED NONPROFIT ASS'N ACT, Prefatory Note (2008) [hereinafter RUUNAA].

organization.

Of particular interest, and the focus of this article, are those nonprofit organizations that are recognized as tax-exempt under § 501(c)(3) of the Internal Revenue Code.[13] First, there is the sheer number of such organizations and the growth that number represents. There are more than 1.2 million nonprofit organizations that are exempt from taxation under this section, representing growth by nearly half in the last decade.[14]

Second is the nature of these organizations and the fact that they are characterized by a public mission—religious, educational, or charitable, with a focus on the community or the public—and are not driven by the prospect or goal of *personal* financial profit. That, of course, is the dominant, defining characteristic of the nonprofit sector and particularly the 501(c)(3) nonprofit organization—the "non-distribution constraint"[15] that commands, in the words of § 501(c)(3), that "no part of the net earnings . . . [may inure] to the benefit of any private shareholder or individual."[16] It is not that they cannot engage in business in furtherance of exempt purposes—they can—or that they cannot

13. Internal Revenue Code § 501(c)(3) provides:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

I.R.C. § 501(c)(3) (2006).

14. According to the IRS 2009 Data Book, 1,238,201 of the 1,912,695 reported tax-exempt organizations and non-charitable trusts, or sixty-five percent, were 501(c)(3) organizations. IRS 2009 Data Book, *supra* note 9, at 56; *Giving USA 2011: The Annual Report on Philanthropy for the Year 2010*, GIVING USA FOUNDATION 19 (2011), http://www.givingusareports.org/products/GivingUSA_2011_ExecSummary_Print.pdf (reporting that as of 2010 there were 1,280,739 501(c)(3) organizations, representing a forty-eight percent increase over the 865,096 such organizations in 2001). These numbers include private foundations.

15. Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501–02, 595–96 (1981); Henry. B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838–40 (1980).

16. I.R.C. § 501(c)(3).

generate a "profit"—they often do. It is that they must serve "a public rather than a private interest,"[17] and "charity," to give one example of a qualifying purpose, is defined or interpreted very broadly in a way that explicitly conveys the importance and value of the work of these organizations to our society and to government at all levels.[18]

Third, organizations that are recognized as tax-exempt under § 501(c)(3) not only are not required to pay income and other taxes,[19] but donors to such organizations can receive a charitable deduction from adjusted gross income on which they would otherwise have to pay tax.[20] While the favorable tax treatment of 501(c)(3) organizations can certainly be justified for the benefits they offer, it is beyond clear that such treatment also comes at some cost to society in the form of foregone tax revenues, and perhaps in notions of fairness, which must necessarily underlie any tax system expecting and entitled to public support,[21] especially when there is widespread concern over national budget deficits and the economy. It is also true that there have been abuses and cases of questionable conduct by those responsible for directing or operating nonprofit organizations[22] that have prompted extensive

17. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2011).

18. Treasury Regulation section 1.501(c)(3)-1(d)(2) provides, in part, that the term "charity" includes:

> Relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Treas. Reg. § 1.501(c)(3)-(d)(2) (2011).

19. Ordinarily, but not always, an organization that is not required to pay federal taxes will also receive an exemption at the state and local levels from the obligation to pay state income, property, and sales taxes. *See* FISHMAN & SCHWARZ, *supra* note 1, at 440–45.

20. I.R.C. § 170(a)(1).

21. *See, e.g.*, Editorial, *It's Time for Tax Law Changes for Nonprofits*, DES MOINES REG., July 25, 2011 (reporting avoidance of unrelated business income tax by the Boys and Girls Clubs of America, decrying that "[n]onprofit hospitals are not required by law to provide one penny of charity care or any defined amount of 'community benefit,'" and asserting that "[e]ntities that do not want to pay taxes should prove they are providing a public benefit that is worth the cost to everyone else").

22. Prominent cases in the 1990s involved United Way, Adelphi University, and conversion or merger of nonprofit hospitals and health care providers to or

analysis of the nonprofit sector and rethinking of the legal requirements and expectations for exemption.[23]

As a result, for several years now the IRS has emphasized good governance. In a publication on the subject of governance and related topics,[24] it stated:

> The IRS believes that a well-governed charity is more likely to obey the tax laws, safeguard charitable assets, and serve charitable interests than one with poor or lax governance. A charity that has clearly articulated purposes that describe its mission, a knowledgeable and committed governing body and management team, and sound management practices is more likely to operate effectively and consistent with tax law requirements. And while the tax law generally does not mandate particular management structures, operational policies, or administrative practices, it is important that each charity be thoughtful about the governance practices that are most appropriate for that charity in assuring sound operations and compliance with the tax law. As a measure of our interest in this area, we ask about an organization's governance, both when it applies for tax-exempt status and then annually as part of the information return that many charities are required to file with the Internal Revenue Service.

The IRS then proceeded to discuss the role of mission, organizational documents, the governing body, governance and management policies, financial statements and reporting on Form

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into for-profit ventures. *See* Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 133–34 (1993); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 633–35 (1998). For a recent listing of reported instances of misconduct, see FISHMAN & SCHWARZ, *supra* note 1, at 6–12.

23. *See, e.g.*, STAFF OF S. COMM. ON FIN., REPORT ON EXEMPT STATUS REFORM (Discussion Draft 2004), *available at* http://finance.senate.gov/imo/media/doc/062204stfdis.pdf; *Panel on the Nonprofit Sector, Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Supplement to the Final Report to Congress and the Nonprofit Sector*, INDEP. SECTOR (Apr. 2006), http://www.independentsector.org/panel_supplement_redirect; *Panel on the Nonprofit Sector, Strengthening Transparency, Governance, Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector*, INDEP. SECTOR (June 2005), http://www.independentsector.org/panel_final_report_redirect.

24. I.R.S., U.S. DEP'T OF THE TREASURY, GOVERNANCE AND RELATED TOPICS – 501(C)(3) ORGANIZATIONS (2008), *available at* http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

990, and transparency and accountability and their importance to the requirements of § 501(c)(3).[25] Though speaking in terms of "governing boards" and mission and policies adopted by the "board of directors," the IRS disavowed a mandate for a particular management structure.

Structure of course is a function of the choice of form of organization that the organizers of a 501(c)(3) nonprofit make. In fact, good governance practices may be and regularly are achieved, and not achieved, in every management structure. What form to choose? While the charitable trust form is an option and, for some, the unincorporated nonprofit association may be a viable choice, the "predominant" form of charitable organization in the United States is the nonprofit corporation.[26] Nonprofit corporation law, like for-profit corporation law, is considerably more structured and detailed than unincorporated entity statutes. For example, the Model Nonprofit Corporation Act ("MNCA")[27] deals with selection,

25. *Id.*

26. FISHMAN & SCHWARZ, *supra* note 1, at 48–53. A well-drafted charitable trust can accomplish much of what the corporate form would offer and is an available choice, but unlike England, it has not been as popular as the nonprofit corporation in the United States. *Id.*; *see also* A.L.I., PRINCIPLES OF THE LAW OF NONPROFIT ORGS. § 200 cmts. c–d, at 5–7 (Council Draft No. 5, 2007). Organizers of a 501(c)(3) nonprofit could choose to remain unincorporated, but if they later sought recognition as a tax-exempt organization, the "association" would have to elect to be taxed as a corporation and begin to observe formalities that unincorporated associations can avoid. *See* I.R.C. §§ 501(c)(3), 7701(a) (2006). Moreover, at common law a number of problems beset the unincorporated association. The National Conference of Commissioners on Uniform State Laws addressed some of these in the Uniform Unincorporated Nonprofit Association Act (1996), adopted by twelve jurisdictions, and even more in the Revised Uniform Unincorporated Nonprofit Association Act (2008), which has been adopted so far in four jurisdictions. RUUNAA (2008). For some organizations—particularly a congregational faith for which incorporation and the mandate to have a board of directors with statutory authority is ill-suited to their faith—an unincorporated nonprofit association may be a viable and preferred choice. Sarah J. Hastings, *Cinderella's New Dress: A Better Organizational Option for Churches and Other Small Nonprofits*, 55 DRAKE L. REV. 813, 816–17, 843–47 (2007). But many jurisdictions have not adopted these Uniform Acts, and many uncertainties, obstacles, and personal risks attend the choice of an unincorporated nonprofit association.

27. The Model Nonprofit Corporation Act was developed and approved by the Committee on Nonprofit Corporations of the American Bar Association's Section on Business Law. MODEL NONPROFIT CORP. ACT (2008) [hereinafter MNCA]. The first edition was promulgated in 1952, and that in turn was revised in 1987 and 2000 in the second edition. Throughout its development there has been a consistent effort to track the Model Business Corporation Act where possible and appropriate. *See* Lizabeth A. Moody, *Foreword* to MNCA, at xix–xxiv (3d ed. 2008).

resignation, and removal of directors, and their terms;[28] meetings, action without a meeting, call and notice of meeting, waiver of notice, quorum, and voting;[29] and officers' duties, standards of conduct, resignation, and removal[30] in considerably more detail than unincorporated entity statutes, if they deal with them at all. Many of these provisions have come to be enabling provisions, subject to individual nonprofit organizations' choices in their articles and bylaws, but as in all corporate law the prevailing wind is regulatory and mandatory unless permission otherwise is granted in the statute. Moreover, other than provisions that enable or permit choice or variation, there is not the freedom to create and describe the organization and its processes in a way, for example, that unincorporated entity law presumes.

In contrast to the corporation, in the business world the limited liability company, or LLC, has become the predominant choice of form in which to organize a business, and many more LLCs are being formed today than corporations.[31] The reasons for that are commonly understood and widely appreciated. The LLC provides its members with the limited liability shield of a corporation[32] and the flow-through or conduit taxation for a partnership that means there is no tax at the entity level.[33]

28. MNCA § 8.04–.05, .07–.09.

29. *Id.* § 8.20–.24.

30. *Id.* § 8.41–.43.

31. The 2010 Annual Report of the Delaware Division of Corporations discloses that there were nearly three times the number of LLCs formed compared to corporations for the years 2008 (81,923 versus 29,501), 2009 (70,274 versus 24,955), and 2010 (82,027 versus 28,181). *See* DEL. DIV. OF CORPS., 2010 ANNUAL REPORT (2010), *available at* http://corp.delaware.gov/10CorpAR.pdf; Harry J. Haynsworth, *The Unified Business Organizations Code: The Next Generation*, 29 DEL. J. CORP. L. 83, 85 n.25 (2004) (stating that in 2002 in Wisconsin there were 18,132 LLCs formed, compared to 5,752 corporations). The experience in Iowa in 2009 was similar, with 8,569 LLCs being formed compared to 2,734 corporations. *Annual Report of Iowa*, INT'L ASS'N OF COMMERCIAL ADM'RS (2009), http://gavinm.com.c25.sitepreviewer.com/iaca/?country=USA&state=IA&section=BOS&print=true&year=2009. *See generally* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LLPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459 (2010).

32. *E.g.*, REVISED UNIF. LTD. LIAB. CO. ACT § 304 cmt. (2006) [hereinafter RULLCA].

33. Under federal tax regulations popularly known as "check-the-box," a single member LLC is a "disregarded entity," while a multi-member LLC is presumed to be a partnership, resulting, in both cases, in no tax being imposed on or assessed to the LLC as an entity. *See* Treas. Reg. § 301.7701-3(c)(1)(i) (2011); I.R.S., U.S. DEP'T OF THE TREASURY, FORM 8832, ENTITY CLASSIFICATION ELECTION,

Moreover, LLC acts observe the characteristic right of unincorporated business associations that one chooses one's co-owners and, while economic rights are freely transferable, the transfer carries with it no management or information rights to the transferee.[34] Significantly, LLC acts invariably represent "default" legislation allowing parties to create their arrangement and describe their deal as they want, stating explicitly that the Act governs only "[t]o the extent the operating agreement does not otherwise provide," and providing further only a minimum number of provisions that cannot be varied.[35]

The question arises whether the limited liability company is available as a form in which to organize a nonprofit organization, and specifically, a 501(c)(3) nonprofit. It might be appropriate particularly for smaller charities,[36] where flexibility contemplated by LLC legislation might reduce the burden and expense of observing formalities and allow those running the nonprofit to focus on mission and goals. But is this form that was developed in the business context to shield private owners from personal liability and minimize taxes on earnings distributable to owners available in or sensible for the nonprofit world? Does the LLC offer the structure or assurance of "a well-governed charity" that nonprofit law and the IRS require? These questions implicate the purposes for which an LLC may be formed, the manner in which it is managed, the non-distribution constraint and control of assets, fiduciary duties, and the enforcement of fiduciary duties and protection of charitable assets.[37] This article turns to an examination of these issues.

II. THE LLC IN THE NONPROFIT ORGANIZATIONAL WORLD: USE AND CONDITIONS

In truth, the limited liability company is being used in the nonprofit organizational world and has been for many years. First, in certain carefully prescribed circumstances, a 501(c)(3) nonprofit can enter into a joint venture in the form of an LLC with a for-profit entity and not lose its exemption. In Revenue Ruling

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CAT. NO. 22598R (2011) [hereinafter I.R.S. FORM 8832], *available at* http://www.irs.gov/pub/irs-pdf/f8832.pdf.

34. *See* RULLCA §§ 501–502.

35. *See id.* § 110(b)–(c).

36. *See* Wing et al., *supra* note 5, at 2–3.

37. *See infra* Part III.

98-15, the IRS determined that a charitable nonprofit organization could enter into a joint venture in the form of a limited liability company with a *for*-profit organization, without forfeiting its tax-exempt status and ability to receive charitable contributions, provided that its participation was properly structured to further its exempt purposes.[38] In its Revenue Ruling, the IRS described two situations, in one of which the exemption was preserved, while in the other it was lost.[39] In the former situation a nonprofit operating an acute care hospital contributed all of its assets to a newly formed LLC that was going to be operated by the for-profit entity, which also contributed assets.[40] The ownership interests of the two were proportional to their contributions; the articles of organization and operating agreement provided for a governing board consisting of three individuals chosen from the community by the 501(c)(3) nonprofit hospital and two selected by the for-profit entity; the articles and operating agreement also required the board to operate the LLC in a manner furthering the charitable purposes of the nonprofit; and distributions were proportional to ownership interests.[41] None of the nonprofit's officers, directors, or key employees involved in the decision or planning was promised any employment or inducement or had any personal financial interest in the LLC.[42] The nonprofit charitable health care mission would be fulfilled by the LLC, and it would utilize distributions it received to make grants "to support education and research and give resources to help provide health care to the indigent."[43] On these facts the IRS held that the nonprofit would continue to qualify as a 501(c)(3) organization when it formed the LLC with the for-profit entity. A similar result may be achieved in a joint venture taking the form of an LLC where the joint venture activity is "ancillary" to the nonprofit's primary operations but an insubstantial part of its total operations;

38. Rev. Rul. 98-15, 1998-1 C.B. 718 [hereinafter Rev. Rul. 98-15]. These joint ventures are discussed and analyzed thoroughly in several leading sources. *See* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 1.09 (1994 & Supp. 2011-1); HOPKINS, *supra* note 1, § 30.3; *see also* Robert R. Keatinge, *LLCs and Nonprofit Organizations: For Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553, 563 (2009).

39. *See* Rev. Rul. 98-15, *supra* note 38 (providing two situations to show when a nonprofit organization would or would not lose its tax exemption).

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.*

where attention is similarly paid to exempt purposes, structure, and control over assets and operations; and where there is assurance of proportionality in distributions.[44]

Second, 501(c)(3) nonprofits regularly employ the device of a single member limited liability company to form a subsidiary that will hold property or operations that carry risk. Imagine a nonprofit that owns and operates a number of nursing homes and care facilities in communities across the state. Each carries predictable risks. These risks can be isolated in one or more nonprofit LLC "subsidiaries," and the parent nonprofit shielded from liability. Or a donor may be prepared to contribute valuable real property to a nonprofit, but there is a risk of environmental claims. The nonprofit can form an LLC to receive and hold the property, thus shielding itself from liability, but may report the property as an asset of its own on informational returns required by the IRS.[45] For purposes of tax-exemption, under the "check-the-box" regulations,[46] the LLC formed by the nonprofit would be a "disregarded entity."[47] As such, it would not have to file a new or separate Form 1023 to apply for recognition as a tax-exempt organization, and the IRS would look to the organization and operation of the parent to assure itself of compliance with relevant laws and regulations.

Third, and with reference to the specific issue under consideration of whether the limited liability company form can be or is being used as the structure for a 501(c)(3) nonprofit

44. Rev. Rul. 2004-51, 2004-1 C.B. 974; *see* BISHOP & KLEINBERGER, *supra* note 38, ¶ 1.09[2][c][iii]; HOPKINS, *supra* note 1, § 30.4, at 928–30.

45. I.R.S. Priv. Ltr. Rul. 200134025 (Aug. 24, 2001).

46. Treas. Reg. § 301-7701-3(c)(1) (2011); I.R.S. FORM 8832, *supra* note 33.

47. *See* I.R.S., U.S. DEP'T OF THE TREASURY, INSTRUCTIONS FOR LIMITED LIABILITY COMPANY REFERENCE GUIDE SHEET 1 (2011) [hereinafter GUIDE SHEET INSTRUCTIONS], *available at* http://www.irs.gov/pub/irs-tege/llc_guide_sheet_instructions.pdf ("A domestic LLC with a single owner is disregarded for federal tax purposes unless it elects to be regarded separately from its member, in which case it is treated as an association that is taxable as a corporation. A disregarded LLC whose sole owner is exempt from federal income tax under section 501(a) of the Code is not required to pay federal taxes or file a federal tax or information return; that is the responsibility of its sole owner. *See* Announcement 99-102[,] 1999-43 I.R.B. 545. The disregarded entity receives the benefit of its owner's tax-exempt status, including exemption from federal income tax, federal unemployment tax, and other federal taxes where applicable. A disregarded entity may also choose to report and pay employment tax for its employees. *See* Notice 99-6, 1999-3 I.R.B. 12. Nevertheless, the sole owner is generally protected against potential liabilities that may arise, under state law, from the activities of its disregarded entity.").

organization, the IRS has determined that two or more tax-exempt organizations can organize an LLC in which they will be members and the LLC will qualify as tax-exempt in its own right, provided that twelve conditions are satisfied.[48] However, the authorization is limited to 501(c)(3) nonprofits as the organizers and the IRS does not authorize individuals or non-501(c)(3)s to utilize the LLC to form a tax-exempt 501(c)(3) nonprofit organization.[49]

It is instructive to look at the twelve conditions in the context of the requirements stated in § 501(c)(3) and the IRS's emphasis on good governance policies and practices. They are:

1. Do the organizational documents (*e.g.*, Articles of Organization, Operating Agreement, comparable organizational documents (or their equivalents)) include a specific statement limiting the LLC to one or more exempt purposes?
2. Do the organizational documents specify that the LLC is operated exclusively to further the exempt purpose(s) of its members?
3. Does the organizational language require that the LLC's members be limited to section 501(c)(3) organizations, governmental units, or wholly owned instrumentalities of a state or political subdivision thereof?
4. Does the organizational language prohibit any direct

48. This position and these conditions were revealed in the IRS's continuing professional education regarding exempt organizations. RICHARD A. MCCRAY & WARD L. THOMAS, I.R.S., U.S. DEP'T OF THE TREASURY, LIMITED LIABILITY COMPANIES AS EXEMPT ORGANIZATIONS—UPDATE 29–32, *available at* http://www.irs.gov/pub/irs-tege/eotopicb01.pdf. The IRS has published a reference guide sheet stating these conditions and providing instructions. *See* I.R.S., U.S. DEP'T OF THE TREASURY, LIMITED LIABILITY COMPANY REFERENCE GUIDE SHEET (2011) [hereinafter GUIDE SHEET], *available at* http://www.irs.gov/pub/irs-tege/llc_guide_sheet.pdf ("This Reference Guide Sheet is designed to help process: (1) requests for information on the treatment, under federal tax law, of limited liability companies associated with tax-exempt organizations, and (2) IRC 501(c)(3) exemption applications filed by limited liability companies."). A joint venture between two nonprofit entities in the form of a limited liability company was one of the situations that the Drafting Committee for the Uniform Limited Liability Company Act (1994) had in mind when committee members decided to allow an LLC to be formed for any lawful purpose, whether or not for profit. *See infra* note 68.

49. GUIDE SHEET INSTRUCTIONS, *supra* note 47, at 3 ("An LLC applying for exemption under section 501(c)(3) cannot have any members that are individuals or are organizations other than 501(c)(3) organizations or governmental units or instrumentalities.").

or indirect transfer of any membership interest in the LLC to a transferee other than a section 501(c)(3) organization or governmental unit or instrumentality?

5. Does the organizational language state that the LLC's assets may only be transferred (whether directly or indirectly) to any nonmember, other than a section 501(c)(3) organization or governmental unit or instrumentality, in exchange for fair market value?
6. Does the organizational language provide that upon dissolution of the LLC, the LLC's assets will continue to be devoted to tax-exempt purposes?
7. Does the organizational language require that any amendments to the LLC's articles of organization and operating agreement be consistent with section 501(c)(3)?
8. Does the organizational language prohibit the LLC from merging with, or converting into, an entity that is not exempt under section 501(c)(3)?
9. Does the organizational language prohibit the LLC from distributing any assets, other than in exchange for fair market value, to members who have ceased to be either organizations described in section 501(c)(3) or governmental units or instrumentalities?
10. Does the organizational language include an acceptable contingency plan in the event one or more members of the LLC ceases at any time to be an organization described in section 501(c)(3) or a governmental unit or instrumentality?
11. Does the organizational language state that the LLC's tax-exempt members will expeditiously and vigorously enforce all of their rights in the LLC and pursue all legal and equitable remedies to protect their interests in the LLC?
12. Does the LLC represent, in a separate written statement, that all of its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity?[50]

It is apparent that these provisions are intended to provide assurance that the requirements of § 501(c)(3) are satisfied,

50. GUIDE SHEET, *supra* note 48.

perhaps some more than others. The first, second, sixth, and seventh conditions reflect and incorporate standard provisions to include in a nonprofit corporation's articles to assure that the nonprofit is organized and will be operated exclusively for exempt purposes and that charitable assets will remain dedicated to the public or charitable purpose, as § 501(c)(3) and accompanying regulations command.[51] The fourth, fifth, sixth, eighth, ninth, and tenth conditions are clearly intended to ensure that "no part of the net earnings . . . inures to the benefit of any private shareholder or individual," as explicitly required by § 501(c)(3).[52] Actually, the eleventh condition serves this same purpose. In requiring the organizational documents to state or demonstrate that "the LLC's tax-exempt members will expeditiously and vigorously enforce all of their rights in the LLC and pursue all legal and equitable remedies to protect their interests in the LLC," the condition reflects the IRS's concern over personal inurement and private benefit, excessive compensation, and conflict of interest transactions.[53] Obligations and duties that attend to members and management under applicable law will count for little if they are not faithfully observed and "expeditiously and vigorously" enforced, so the eleventh condition is in reality another expression of the IRS's emphasis on good governance practices.

The third condition is of a different order—a means to an end—that enables the IRS to look to nonprofit members' own articles of organization and bylaws, at the risk of revocation of the members' tax-exempt status, to be assured of the LLC's satisfaction of the organizational and operational tests, among others. But it also means that individuals who could form a nonprofit corporation and constitute its board of directors cannot instead organize a limited liability company, provide for it to be manager-managed perhaps, appoint themselves managers, and undertake to

51. Treas. Reg. § 1.501(c)(3)-1(a)-(c) (2011).

52. *See* I.R.C. § 501(c)(3) (2006); GUIDE SHEET, *supra* note 48.

53. *See, e.g.*, GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 2–4 ("The organization should regularly and consistently monitor and enforce compliance with the conflict of interest policy."); I.R.S., U.S. DEP'T OF THE TREASURY, FORM 1023, APPLICATION FOR RECOGNITION OF EXEMPTION, CAT. NO. 17133K (2006) [hereinafter I.R.S. FORM 1023], *available at* http://www.irs.gov/pub/irs-pdf/f1023.pdf (including a sample conflict of interest policy); I.R.S., U.S. DEP'T OF THE TREASURY, FORM 990, RETURN OF ORGANIZATION EXEMPT FROM INCOME TAX, CAT. NO. 11282Y (2010) [hereinafter I.R.S. FORM 990], *available at* http://www.irs.gov/pub/irs-pdf/f990.pdf (asking whether the reporting nonprofit has a conflict of interest policy).

comply with the law and regulations regarding 501(c)(3) nonprofit organizations. The problem they face, however, is less the IRS's refusal to extend the limited liability company to individuals and non-501(c)(3) organizations wanting to form a nonprofit, than it is state law and the rights of "members" of LLCs in earnings,[54] management,[55] and assets.[56] LLCs grew up in a business context, freeing members from a corporate structure and double taxation and letting them proceed as partners would, but with a limited liability shield for members and the ability through contract to structure their deal as they want, free of the mandates and regulatory culture which attends corporate practice, even with the trend towards "enabling" provisions authorizing corporations to vary many corporate norms. The key word in the third condition is "members," a term with clear and familiar legal significance under state laws authorizing the formation of limited liability companies. Of course, members in their articles and operating agreement may include the necessary statements and provisions that a 501(c)(3) organization's documents must contain, but what will prevent amendment—the seventh condition—and what will ensure enforcement of a nonprofit governing board's obligations and responsibilities—the eleventh condition? That, presumably, is the point of the twelfth condition: "Does the LLC represent, in a separate written statement, that all of its organizing document provisions are consistent with state LLC laws, and are enforceable in law and equity?"[57] This twelfth condition—focusing on the enforceability of provisions in the organizing documents—is especially understandable given the state of limited liability company law in 2001 when the IRS published its *Reference Guide Sheet.*

III. ISSUES AND DEVELOPMENTS IN STATE LLC LAWS AFFECTING THE AVAILABILITY OF AN LLC FOR USE AS A 501(C)(3) NONPROFIT ORGANIZATION

There have been developments in LLC law since 2001, however, and perhaps it is time to reevaluate the IRS's position. In 2003 the Uniform Laws Commission undertook a revision of the

54. *E.g.*, RULLCA § 404 (2006); Delaware Limited Liability Company Act, DEL. CODE ANN. tit. 6, §§ 18-503 to -504 (2011).

55. *E.g.*, RULLCA § 407; DEL. CODE ANN. tit. 6, § 18-402.

56. *E.g.*, RULLCA § 708; DEL. CODE ANN. tit. 6, § 18-804.

57. GUIDE SHEET, *supra* note 48, at 2.

1996 Uniform Limited Liability Company Act, and in 2006 it promulgated the Revised Uniform Limited Liability Company Act.[58] It has been enacted in six jurisdictions,[59] introduced in others, and is being studied in still more.[60] Quite apart from the Uniform Act, three states have adopted nonprofit LLC legislation,[61] and a fourth specifically included in its LLC statute language providing for a nonprofit LLC and explicitly incorporating relevant sections of the state's nonprofit corporation act so that they apply as well to LLCs.[62] Other states have amended their LLC statutes. Together these may address concerns the IRS has expressed about the limited liability company as an allowable form for a 501(c)(3) nonprofit organization where its organizers are not themselves 501(c)(3) organizations. This part of the article examines significant state law issues that have to be addressed if an LLC can serve as a vehicle for nonprofit activity more broadly than currently authorized by the IRS.

A. Is the Operation of a 501(c)(3) Nonprofit a Proper Purpose for an LLC?

At about the time the IRS was making known and later publishing the twelve conditions on the use of limited liability companies as exempt organizations,[63] the authors of a leading treatise on LLC law and taxation stated, "All enabling statutes require that a limited liability company have a business purpose. A limited liability company may not be a not-for-profit enterprise."[64]

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58. RULLCA, Prefatory Note.

59. The District of Columbia, Idaho, Iowa, Nebraska, Utah, and Wyoming. D.C. CODE §§ 29-1001–1075 (2011); IDAHO CODE ANN. § 30-6 (2011); IOWA CODE ANN. Ch. 489 (2011); NEB. REV. STAT. § 21 (2011); WYO. STAT. ANN. § 17-29 (2011).

60. *See, e.g.*, Memorandum from Ron Wargo, Chair, Bus. Law Section, State Bar of Cal., to Office of Governmental Affairs (June 1, 2010), http://www.calbar.ca.gov/LinkClick.aspx?fileticket=zu68OHm6zHI%3D&tabid=2796 (seeking to adopt RULLCA under California law).

61. Kentucky, North Dakota, and Tennessee. *See* KY. REV. STAT. ANN § 275.520–540 (2011); N.D. CENT. CODE § 10-36-01 (2011); TENN. CODE ANN. § 48-249-309 (2011).

62. The fourth state is Minnesota. *See* MINN. STAT. § 322.B (2011).

63. GUIDE SHEET, *supra* note 48, at 1–2.

64. CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES: TAX AND BUSINESS LAW ¶ 5.03 (1994 & Supp. 2002) (footnotes omitted). The authors based this conclusion on some statutes directly requiring a business purpose and other statutes implying a for-profit purpose on account of statutory provisions for distribution of profits. They added, "It would make no sense to allow a limited liability company to function as a not-for-profit organization. A

While the view that all LLC enabling statutes require a business purpose undoubtedly was accurate at the time, LLC legislation in several states has changed since that time.[65] For example, Delaware authorizes a limited liability company to "carry on any lawful business, purpose or activity, whether or not for profit, with the exception of the business of banking"[66]; the 1996 Uniform Limited Liability Company Act—enacted in eight states—provided that a limited liability company could be organized "for any lawful purpose"[67] and specifically defined "business" to include "every trade, occupation, profession, and other lawful purpose, whether or not carried on for profit"[68]; and the Revised Uniform Limited

limited liability company exists to have partnership tax status, and not-for-profit entities are subject to an entirely different regime." *Id.* at n.59. Later editions of Bishop & Kleinberger take note of the changes in the text while continuing to conclude that an LLC is much better suited for a for-profit business enterprise than a nonprofit tax-exempt organization. *See* BISHOP & KLEINBERGER, *supra* note 38, ¶ 5.03[1]. For another author who reaches the same conclusion, see MATTHEW DORÉ, IOWA BUSINESS LAW AND PRACTICE 283, 295, 295 n.12 (2010).

65. *See infra* notes 76–83 and accompanying text.

66. Delaware Limited Liability Company Act, DEL. CODE ANN. Tit. 6, § 18-106(a) (2011).

67. UNIF. LTD. LIAB. CO. ACT § 104 (1996). The eight states that have adopted the Uniform Limited Liability Company Act are Alabama, Hawaii, Illinois, Montana, South Carolina, South Dakota, Vermont, and West Virginia; the Virgin Islands have also adopted the Act. *Id.* at References & Annots.

68. *Id.* § 101(3). Colorado law is to the same effect. An LLC may be organized "for any lawful business" purpose; and, "business" is defined as "any lawful activity." COLO. REV. STAT. ANN. § 7-80-102(3), -103 (2011). Whether organizers should be able to form a limited liability company for nonprofit purposes was raised and discussed at both the 1993 and 1994 Annual Meetings of the National Conference of Commissioners on Uniform State Laws.

In 1993, on the morning the proposed Uniform Act was first being read, the Chair of the Drafting Committee, Florida Uniform Law Commissioner Edward I. Cutler, said, "And may I comment, this [section 112 of the Act] is where you find the answer, that the act is designed to deal with even non-businesses, as well as nonprofit enterprises." Transcript of the Twelfth Session of the 1993 Annual Meeting of the Nat'l Conference of Comm'rs on Unif. State Laws 38 (Aug. 5, 1993) (on file with author). Commissioner Carl H. Lisman of Vermont rose immediately to comment on this position, stating, "It seems to me that the committee ought to give serious reconsideration to its decision to sweep into the jurisdiction of this act nonprofits and non-businesses." *Id.* Commissioner Lisman went on to say that in contrast to the Model Nonprofit Corporation Act and the Uniform Unincorporated Nonprofit Associations Act, "there are lots of provisions in this act that are inappropriate for non [sic] for profit entities." *Id.* He declined to make sense of the house motion at the 1993 Annual Meeting, but he said he would revisit the issue at the next Annual Meeting if the Drafting Committee's position remained the same. Speaking to Commissioner Lisman, Drafting Committee member Commissioner Howard Swibel of Illinois explained:

We are basically putting it out there for one reason, which is to elicit

> response from effected [sic] parties. There are, for example, a lot of joint ventures now between not for profit corporations which could be facilitated by the use of this kind of device. We are looking for input from affected parties on this issue.

Id. Commissioner Lisman adhered to his position. If the joint venture was "profit motive oriented," he believed the Act should cover them; and "[i]f they're not profit motive oriented, it doesn't matter to me whether the constituent members are for profits or non-profits. They shouldn't be covered by this act. They're not tax driven. They're not limited liability driven in the sense that a for-profit organization is." *Id.* at 38–39. The issue was taken under advisement for consideration by the Drafting Committee and reported to the Conference in 1994.

In 1994 the issue of whether organizers of a nonprofit organization could utilize a limited liability company formed under the Uniform Act was identified as a significant policy issue for the Conference at its Annual Meeting. Vermont Commissioner Carl Lisman rose again to address the issue:

> I don't want to let the issue pass again. This is the first meaningful section that deals with whether or not a limited liability company is going to also be allowed to usurp the field of non-profit entities. There are a number of provisions in this act that deal with the formation and conduct and termination and so forth of a limited liability company that make absolutely no sense in the context of non-profits. The committee has acknowledged that it is an issue that they have not fully resolved. It arises on Line 6 on Page 24 in the phrase 'for any lawful purpose.' Maybe it ought to be 'for any lawful for-profit purpose or any lawful business purpose.' Rather than—this is not a new issue—rather than force the issue at this time, I call it to the attention of the floor. It will be raised as we get further on, when we get into more substantive sections.

Transcript of the Proceedings in Committee of the Whole, Unif. Ltd. Liab. Co. Act, 1994 Annual Meeting of the Nat'l Conference of Comm'rs on Unif. State Laws 51–52 (July 29, 1994) (on file with author). Committee Chair Edward I. Cutler responded that Commissioner Lisman's comments "com[e] from the chairman of the Unincorporated [Nonprofit] Association Committee of this conference, and it's a well taken point." *Id.* He went on to explain that the inclusion of nonprofit organizations within the scope of the LLC Act was a position urged by Millard Ruud, Uniform Law Commissioner from Texas and National Conference Reporter for the Uniform Unincorporated Nonprofit Associations Act, who was not on the floor at the time. Commissioner Cutler said:

> I would like him to explain it, whereby we will put cautionary remarks in the comment that will disclose the problems to anyone who wants to organize a limited liability company for non-profit purposes, or include a non-profit entity as a member of a limited liability company, the various points you have in mind. We thought it would be throwing the baby out with the bath water if we did not permit certain kinds of non-profit organizations to be allowed to use the limited liability company format.

Id. at 52–53. Commissioner Lisman observed that Commissioner Ruud had not thought the issue would arise until the afternoon, "which is why I think in part we want to defer further discussion of the issue." *Id.* at 53.

The issue was raised at the end of the day. Recognized by the Chair of the Committee of the Whole, Commissioner Lisman stated, "The consensus is to let the matter ride and let you do it in a comment." *Id.* at 241. Commissioner Matthew S. Rae, Jr., of California, disagreed with this position. "I see no reason why there should be a not for profit entity that would be a limited liability

Liability Company Act ("RULLCA") similarly provides that an LLC "may have any lawful purpose, regardless of whether for profit."[69] If profit, or even business, need not be the purpose of the LLC, individuals can readily draw on the LLC to hold title to property,[70] which may not represent a "business" in common parlance[71] but nevertheless can be advantageous to business and estate planning.[72]

But does "any lawful purpose" or "regardless of whether for profit" mean that these statutes contemplate and authorize formation of a nonprofit organization that could qualify as a 501(c)(3) nonprofit? Certainly it should be clear that the language regarding permissible purposes is *broad* enough to encompass the exempt purposes articulated in § 501(c)(3), and it should not be a sufficient objection to the use of an LLC for a charitable nonprofit enterprise that it is inconsistent with state law because it lacks a "for profit," "business" purpose.[73] If we take the case of RULLCA, is that

company. It seems that we're doing this simply for tax purposes." *Id.* at 242. Accordingly, he moved "that the act be limited to for profit businesses." *Id.* Drafting Committee Chair Cutler stated again that tax reasons were not the only reasons for forming an LLC, that "problems with tax or anything else" would be dealt with in an Official Comment to section 112, and that "the consensus is that we have good reason to let them do it if they can." *Id.* ABA Adviser Robert Keatinge noted that the issue "has been discussed fairly extensively around the country and certainly around the drafting table on this act." *Id.* at 243. "Many of the concerns that have been validly raised are concerns that relate not to whether an entity is organized for profit or not," he said, "but whether an entity is tax exempt." *Id.* It was his opinion, and he thought that of the members of the Drafting Committee as well, "that's something that is best left to the Internal Revenue Code." *Id.* Commissioner Rae's motion did not pass. *Id.* at 244.

The Official Comment to section 112 of the Uniform Limited Liability Company Act (1994) reads in full:

> "Business." A limited liability company may be organized to engage in an activity either for or not for profit. The extent to which contributions to a nonprofit company may be deductible for Federal income tax purposes is determined by federal law. Other state law determines the extent of exemptions from state and local income and property taxes.

UNIF. LTD. LIAB. CO. ACT § 112 cmt. (1994).

69. RULLCA § 104(b) (2006).

70. BISHOP & KLEINBERGER, *supra* note 38, ¶ 5.03[1].

71. The Revised Uniform Partnership Act defines "business" to include "every trade, occupation, and profession," and the section on partnership formation provides that the holding of property jointly does not give rise to a presumption of partnership formation, "even if the co-owners share profits made by the use of the property." REVISED UNIF. P'SHIP ACT §§ 101(1), 202(c)(1) (1997).

72. In drafting committee meetings for RULLCA, the example of a family owning a cabin or lakeshore property through an LLC was a frequent example of the utility of RULLCA's language "regardless of whether for profit."

73. *See supra* note 68 and accompanying text.

what the Drafting Committee or the Conference intended? The answer to that question is less than clear. One of the goals of the drafting committee was to expand the availability and advantages of the LLC as a form of organization.[74] But again, does that mean that a limited liability company formed under the planned, revised uniform act was intended to be available to organize a *501(c)(3)* nonprofit? The prospect was noted and discussed at the first meeting of the Uniform Law Commissioners to consider a proposed Revised Act,[75] and the preliminary and ultimate position of the Drafting Committee was to leave crucial protective provisions to other law, but to envision and authorize an LLC without a for-profit purpose.

As indicated earlier,[76] some states have adopted nonprofit LLC legislation. Tennessee, for example, adopted the Nonprofit Limited Liability Company Act of 2001.[77] What the statute did was to authorize a nonprofit tax-exempt corporation to organize an LLC as the sole member, thus assuring that the LLC was a

74. Transcript of Annual Meeting of Nat'l Conference of Comm'rs on Unif. State Laws 5 (Aug. 6, 2003) (listing the remarks of Commissioner and Chair, David S. Walker). One example of a permissible use of an LLC under a revised, expanded Uniform Act was a residential cooperative. *Id.* at 6–8 (providing the remarks of Commissioner Hiroshi Sakai, ABA Advisor Robert R. Keatinge, and Commissioner Harry Haynsworth).

75. *Id.* at 5 (listing the remarks of Commissioner and Chair David S. Walker); *id.* at 8 (listing the remarks of Commissioner William R. Breetz, Jr.). Commissioner Walker represented that the Drafting Committee's position "is that we should leave [provisions in state laws addressing the role of the state in ensuring that property given for charitable purposes continues to serve those charitable purposes] to other [state] law rather than to build into this statute on limited liability companies protections of that charitable purpose." *Id.* at 5. Commissioner Breetz noted that broadening the Act to include charitable nonprofits would invite a "heightened level of scrutiny by the IRS at the whole form of ownership, because they would be obliged in making an analysis under an application for 501-C-3 tax exemption as to whether this LLC has as its purpose primarily a nonprofit purpose or a for-profit purpose." *Id.* at 9. He noted the interest that "substantial institutions like universities and hospitals" would have, and he commented further that:

> [T]here are just tens of thousands of little, tiny nonprofit groups all over the country who are using the Nonprofit Corporation Act as their sole means of doing business, and there are some considerable historical differences between the two forms that you're going to have to contemplate, I think, in your drafting process. Methods of control, for example. Minimum number of directorships that are part of the model act.

Id.

76. *See supra* text accompanying notes 66–69.

77. TENN. CODE ANN. §§ 48-101-701 to -708 (2011).

"disregarded entity for federal income tax purposes" and serving the parent's purposes as described above.[78] Kentucky legislation, adopted in 2006, amends the state's LLC Act to include a nonprofit limited liability company,[79] allows a nonprofit limited liability company to be formed for a nonprofit purpose,[80] and references, in the definition of "nonprofit purpose," the purposes clause of Kentucky's nonprofit corporation act.[81] Minnesota also provides explicitly for a nonprofit limited liability company, disavows that formation under its legislation is "determinative of its tax treatment," and expressly includes protective provisions of the sort that RULLCA left to other law.[82] And in 2009, North Dakota enacted its Nonprofit Limited Liability Company Act similarly expressly authorizing a limited liability company to be formed for a nonprofit purpose, incorporating by reference protective provisions found in the nonprofit corporation statute, and disavowing that formation under the Act is determinative of federal tax treatment.[83]

What is clear under these statutes and also, in truth, under statutes like RULLCA, is that assumptions about the "purpose" of an LLC are not a persuasive or acceptable basis for preventing individuals or non-501(c)(3) organizations from forming a nonprofit limited liability company that merits consideration for recognition as a tax-exempt organization. There must be another reason, other than most common usage—which is clearly for-profit—or notions of inherent purpose based on the widespread popularity of the LLC for federal tax purposes under a regime entirely different from the one governing nonprofit organizations, to preclude an LLC from being organized as a nonprofit and qualifying for tax exemption under § 501(c)(3).

78. *See supra* note 47 and accompanying text.

79. KY. REV. STAT. ANN. § 275.005 (2011). The Secretary of State's Office in Kentucky reports that 303 nonprofit limited liability companies have been formed under this statute. E-mail from J. Allen Eskridge, III, Ky. Assistant Sec'y of State, to author (Aug. 12, 2011) (on file with author).

80. KY. REV. STAT. ANN. § 275.015(18) (2011).

81. *Id.* §§ 275.015(19), 273.167.

82. MINN. STAT. §§ 322B.03, subdiv. 31a, 322B.975 (2011).

83. N.D. CENT. CODE ANN. §§ 10-36-01 to -09 (2011).

B. Is the "Management Structure" of an LLC Inappropriate for a Nonprofit LLC?

While neither § 501(c)(3) nor the IRS in its policies prescribes a particular management structure, the IRS plainly expects much of management, both in the initial showing through the completed Form 1023 and in the annual informational reports, such as Form 990.[84] "Regardless of whether a charity is a trust, corporation, unincorporated association, or other type of organization, it must have organizational documents that provide the framework for its governance and management."[85] There must be some "governing board," and the governing board is encouraged (1) to establish, adopt, regularly review, and popularize a mission statement; (2) to become and remain "active and engaged" in governance and compliance; (3) to adopt governance and management policies, especially concerning executive compensation, conflicts of interest, investments, fundraising, record keeping, document retention and destruction, and ethics and whistleblowing; (4) to ensure proper preparation of and review financial statements and Form 990 and "ensure that [the charity] abides by the requirements of state law" and federal law; and (5) to be committed to transparency and accountability to constituents.[86] The emphatic importance of good nonprofit governance to the IRS is not in doubt by any means. Any number of cases, regulations, rulings, required forms like Form 990, and more communicate that point clearly.

But there should be nothing about the management structure envisioned by state LLC acts to prevent practices along the lines described above from being adopted by those managing the limited liability company. It is true that one of the attractive features of the limited liability company under state laws is the flexibility that members have to create and tailor the management structure in a way that for them will be most effective in ensuring the successful pursuit of goals and conduct of the LLC's affairs. Those creating the LLC may choose to have it be "member-managed," in which the members have equal or whatever negotiated voice in the management of the ordinary affairs of the company, or they may choose to be "manager-managed," elect

84. *See supra* text accompanying note 53.

85. GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 2.

86. *Id.* at 2–8.

managers from their number, and have the managers manage the company as a "board of managers" or even a "board of directors."[87] Or they may allocate authority among them, drawing on particular strengths of each.[88] In any of these cases, those responsible for managing a nonprofit LLC seeking tax-exemption under § 501(c)(3) may vigorously follow the counsel of the IRS briefly described above and provide the good, sound governance the Code and the IRS expect and demand.

To be sure, *some* structure is required by § 501(c)(3) and implementing regulations, for the very terms of the Code require that the nonprofit be a "[c]orporation[, or] any community chest, fund, or foundation."[89] There must be an entity apart from individuals organized and operated exclusively as a charity; the notion of "organization" requires agreement and "a regulatory framework of government or mode of operation."[90] An LLC is an entity apart from its members, however, and LLC legislation clearly contemplates organization and management structure. It *is* an unincorporated entity, but an unincorporated nonprofit association may secure recognition from the IRS as a tax-exempt organization if it has organic rules or articles of organization and its documents contain provisions committing the association to compliance with § 501(c)(3)'s requirements.[91]

In short, the management structures open to an LLC should *not* present a problem in qualifying as a tax-exempt nonprofit organization. As a practical matter, it might be advisable to elect to be manager-managed and to constitute the managers as a "board of managers," "board of governors," or "board of directors" as the Minnesota and North Dakota LLC Acts envision.[92] Indeed, in Revenue Ruling 98-15 discussed earlier,[93] in which the IRS held

87. RULLCA § 407 (2006).

88. *Id.* §§ 110, 407; DEL. CODE ANN. tit. 6, §§ 18-401 to -404 (2011).

89. I.R.C. § 501(c)(3) (2006).

90. Trippe v. Comm'r, 9 T.C.M. (CCH) 622 (1950); *see* 4 Internal Revenue Manual-Admin. (CCH) pt. 7751, § 321.4, at 20,556 (Apr. 28, 1977) (stating forcefully, "[a] formless aggregation of individuals without some organizing instrument, governing rules, and regularly chosen officers would not be a ['corporation, community chest, fund, or foundation'] for purposes of § 501(c)(3)," and, thus, would not be a tax exempt charitable entity).

91. FISHMAN & SCHWARZ, *supra* note 1, at 49; *see also* I.R.S. FORM 1023, *supra* note 53; *see supra* Parts II (Question 3), III.

92. MINN. STAT. § 322B.03, subdivs. 7–8 (2010); N.D. CENT. CODE § 10-36-03 (2011).

93. *See supra* text accompanying notes 38–44.

that a 501(c)(3) nonprofit that entered into a joint venture in the form of an LLC with a for-profit entity would continue to qualify as a 501(c)(3) tax-exempt organization, the co-venturers forming the LLC created a "governing board." Thus, it would probably be good sense for the nonprofit LLC to be manager-managed and have a "board of managers." Given the operational necessities for larger charities—appointment and evaluation of officers, setting executive compensation, preparation and review of budgets and financial statements, assurance of compliance with applicable law, including federal tax law, to give some examples—a governing board would, as a practical matter, seem essential to the decision making and oversight that would be required to qualify for § 501(c)(3) status and that would be required under state law. But a "board" structure should not be essential. If it were member-managed, the members would be the managers. Legally, there is no prescribed size for a board,[94] just an expectation that it be effective, and depending on the number of members, the members might function like a board. While a more formal, corporate-like board structure would be advisable for larger charities, for smaller charities—of which there are many[95]—it is imaginable that there would be few organizers or governors and that the member-managed structure would be preferable and no less effective than a formal board structure.

Structure implies composition and operation, and each of these subjects is undeniably of crucial importance to qualification as a tax-exempt, nonprofit organization under § 501(c)(3). With respect to composition, the IRS expects the board to include independent members who will represent the public interest and advises that a "very small" governing board "may not adequately serve the needs of the organization."[96] Moreover, the IRS looks to

94. MNCA section 8.03 does require a minimum of three directors, but there is no equivalent provision in limited liability company acts. MNCA § 8.03 (2008). LLC legislation pointedly does not prescribe a "manager-managed" structure, but instead leaves management structure to the members to determine. RULLCA § 407(a) (2006). LLC legislation also does not prescribe a minimum number of either managers or members beyond the necessity that there be at least one member to constitute an LLC. *See, e.g., id.* § 201(a), (d)–(e) (stating that the limited liability company is formed only when it has "at least one member").

95. *See supra* text accompanying notes 5–6.

96. GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 2 ("Small boards run the risk of not representing a sufficiently broad public interest and of lacking the required skills and other resources required to effectively govern the organization."). The IRS has often emphasized the

disinterested and independent directors to ensure that there are no insider transactions that could result in misuse of charitable assets, including excessive compensation that would run afoul of the proscription on private inurement and constitute an excess benefit transaction.[97] The position taken and advice given by the IRS reflect its emphasis on good governance as a vital means to ensure compliance with the tax laws and regulations. Essentially the IRS is concerned about conflict of interest transactions. Such transactions may be beneficial to the nonprofit organization, but they may also result in private inurement or private benefit. The IRS expects to avoid the latter result through good governance and compliance with state law. That requires the presence of independent directors or "managers" to whom full disclosure of all material facts must be made and who, before they will approve a proposed transaction, will fully inform themselves about the transaction and scrutinize it to ensure that it is in the best interests of the organization. Nonprofit corporate law provides a procedure that addresses conflicting interest transactions and requires a process that includes full disclosure to and approval by "disinterested directors."[98] LLC legislation similarly does so, albeit in a more abbreviated fashion.[99] Any charitable nonprofit—large or small, in corporate form or, if available, in the form of an LLC—would have to ensure that it was not violating the private inurement and private benefit proscriptions of § 501(c)(3) or authorizing an excess benefit transaction; the form of the entity, however, is not material to whether disinterested and independent persons are included in the management. It may be that a nonprofit limited liability company might be more attractive to a "smaller charity" than a nonprofit corporation because of its fewer mandates and reduced expectation of formality—i.e., its greater flexibility. For smaller charities it might be more difficult to obtain disinterested persons to serve on a governing board and fulfill expectations under both state law and federal tax law. But in either case the nature of the entity itself does not ensure or preclude its doing so.

Structure also implies operation of the governing board. As

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importance of the board of a charitable nonprofit organization being drawn from the community and representing the public. *E.g.*, Rev. Rul. 98-15; Rev. Rul. 69-545, 1969-2 C.B. 117.

97. I.R.C. § 4958 (Supp. 2010); GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 3.

98. *E.g.*, MNCA § 8.60.

99. *E.g.*, RULLCA §§ 110(e), 409(b)(2), (e), (f) (2006).

mentioned above and as is widely known, the limited liability company frees those managing it and conducting its business and affairs from the detailed prescriptions and required formalities that are common in nonprofit corporation acts, mirroring as they often do for-profit corporate legislation. LLCs are significantly "creature[s] of contract."[100] Matters of procedure in an LLC are generally left to the parties to deal with through the operating agreement.[101] The operating agreement may be "oral, in a record, implied, or in any combination" of these.[102] Courts may give lesser weight to formalities in a small limited liability company where formalities clearly are not observed and may choose not to disregard the LLC as an entity separate from the members;[103] corporate law, for-profit or nonprofit, is different. Questions like whether directors can participate electronically or over the telephone in a board meeting; whether directors can vote by email; whether directors can take action without a meeting; and whether directors can vote by proxy, to give some examples—none of which are addressed in the typical limited liability company act—are dealt with in nonprofit corporate legislation, or if not, present serious questions.[104]

The informality and flexibility which a limited liability company may take advantage of, including charities, particularly small charities, if they were permitted to form a nonprofit LLC,

100. RULLCA § 110 cmt.; Daniel S. Kleinberger & Carter. G. Bishop, *The Next Generation: The Revised Uniform Limited Liability Company Act*, 62 BUS. LAW. 515, 545 (2007).

101. RULLCA § 110(a).

102. *Id.* § 102(13).

103. RULLCA § 304(b); CAL. CORP. CODE § 17101 (2011); *see, e.g.*, D. R. Horton, Inc.-N.J. v. Dynstar Dev., LLC, 2005 WL 1939778 (N.J. Super. Ct. Law Div. Aug. 10, 2005).

104. MNCA § 8.20 (2008). The act authorizes a director "to participate in a regular or special meeting by, or conduct the meeting through the use of, any means of communication by which all directors participating may simultaneously hear each other during the meeting" and provides that "[a] director participating in a meeting by this means is considered to be present in person at the meeting." *Id.* Section 8.24 addresses voting by directors, but is silent on voting by e-mail and does not authorize directors to vote by proxy. *Id.* § 8.24. Unless the articles require that action be taken at a meeting, directors may take action without a meeting "if each director signs a consent in the form of a record describing the action to be taken and delivers it to the nonprofit corporation." *Id.* § 8.21. Several of the questions mentioned were discussed recently on the listserv of the Nonprofit Organizations Committee of the ABA's Business Law Section. *See* Postings of Members of the Nonprofit Orgs. Comm. of the A.B.A. Bus. Law Section, bl-nonprofit@mail.americanbar.org (on file with author).

would necessarily be limited by the requirements imposed on them by § 501(c)(3) as interpreted and applied by the IRS. A 501(c)(3) nonprofit must actually be *operated for* and also *be able to demonstrate or prove such operation* in furtherance of its exempt purposes.[105] For the IRS, formalities matter and are expected to be observed. For example, minutes of meetings should be taken and preserved so that there is contemporaneous documentation of meetings and action taken by written consent without a meeting.[106] Minutes can provide useful evidence of the directors staying informed, exercising due care in decision making and oversight, and dealing appropriately with conflicts of interest, executive compensation, and similar matters.[107] Minutes and record keeping can document that a decision was made and due consideration given to it so that a court will defer to the directors' or governors' judgment. And if the question were to arise, observance of formalities can help to avoid disregard of the nonprofit entity. For the IRS, preparation and keeping records is evidence of the good governance it believes is more likely to secure, if not essential to, compliance with federal tax and other laws. Thus, on Form 990 the IRS requires a nonprofit organization that is obligated to file to answer the questions: "Did the organization contemporaneously document the meetings held or written actions undertaken during the year by the following: (a) The governing body; (b) Each committee with authority to act on behalf of the governing body?"[108] The IRS's requirement in this regard has been criticized as impractical and

105. Treas. Reg. § 1.501(c)(3)-1(a), (c) (2011); I.R.S., U.S. DEP'T OF THE TREASURY, PUB NO. 4221-NC, COMPLIANCE GUIDE FOR TAX-EXEMPT ORGANIZATIONS (OTHER THAN 501(C)(3) PUBLIC CHARITIES AND PRIVATE FOUNDATIONS) 14 (2010), *available at* http://www.irs.gov/pub/irs-pdf/p4221nc.pdf ("In general, a tax-exempt organization must maintain books and records to show that it complies with tax rules."); GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 5–6.

106. GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 5.

107. David M. Bardsley, *Composition and Operation of the Board of Directors, in* NONPROFIT GOVERNANCE AND MANAGEMENT 103, 111 (Victor Futter et al. eds., 2002); GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS 36 (George W. Overton & Jeannie Carmedelle Frey eds., 2d ed. 2002); LISA A. RUNQUIST, THE ABCS OF NONPROFITS 80–82 (2005).

108. I.R.S. FORM 990, *supra* note 53, at Part VI (Questions 8a–8b); *see also* James J. Fishman, *Stealth Preemption: The IRS's Nonprofit Corporate Governance Initiative*, 29 VA. TAX REV. 545, 568 (2010) ("All organizations that file Form 990 must complete the section, Part VI, that requests information regarding an organization's governing body and management, its governance policies, and disclosure practices.").

unnecessarily burdensome for medium-size and smaller charities,[109] but the requirement remains. Accordingly, some of the hoped-for flexibility and informality that an LLC would offer to a small charity might in certain respects be unavailable or unwise as a practical matter.

Whatever the burden of preparing minutes and other records, it would not be less if the nonprofit were in the form of a nonprofit corporation rather than an LLC. Either way the nonprofit must be able to show that it is complying with the requirements of the tax laws, and Form 990 does not depend on the nature of the entity in this regard.[110] Nothing inherent in the structure, possible composition of its management or governing board, or manner of operation of an LLC precludes recognition of it by the IRS as a tax-exempt entity if other obstacles do not appear and cannot be addressed. The IRS would, in any event, look to the duties or responsibilities of the managers or governing body to ensure compliance and continued qualification for treatment under § 501(c)(3).[111] That is the very nature of its emphasis on governance in the nonprofit sector. The important questions would be the responsibilities or fiduciary duties of the managers, to whom they are owed, and whether and how they are fulfilled and enforced. Let us turn first to the subject of fiduciary duties.

C. Fiduciary Duties and Responsibilities of LLC Management

In focusing on nonprofit governance, the IRS is recognizing and underscoring the fiduciary duties and responsibilities of the governing board or managers of a qualifying nonprofit. Prevention of unreasonable compensation, excess benefits, and conflict of interest transactions, for example, rests on fulfillment of the managers' duty of loyalty "to act in the interest of the charity rather than in the personal interest of the director or some other person or organization" and "to avoid conflicts of interest that are

109. James J. Fishman, *The IRS' Corporate Governance Initiative: Recommendations for Medium and Smaller Nonprofits*, *in* ADVISING NONPROFIT ORGANIZATIONS 299, 332–35 (2009). Professor Fishman characterizes the IRS's requirement for minutes of every meeting as "documentation run amok" and comments, "[s]maller organizations often conduct committee meetings informally. It can become a burdensome commitment of staff time to take and prepare minutes of all actions taken, particularly at the committee level." *Id.* at 332–33.

110. *See* I.R.S. FORM 990, *supra* note 53, at Part VI (Questions 8a–8b).

111. *See infra* notes 122–25 and accompanying text.

detrimental to the charity."[112] The instructions to Form 1023 include a sample conflict of interest policy, and Form 990 asks directly about the existence, substance, and enforcement of a conflict of interest policy.[113] Selection, monitoring, and evaluation of executives; determination of reasonable compensation; establishment of a budget and review of financial statements; taking care to ensure that forms and returns are accurately completed and timely filed and that the nonprofit is otherwise in compliance with the requirements of § 501(c)(3); oversight of fundraising and investments to ensure compliance with federal and state law; adoption of proper policies and procedures; preparation and retention of records; and "setting ethical standards and ensuring they permeate the organization and inform its practices"[114]—all of these require an informed, attentive, and diligent board exercising good judgment on behalf of the nonprofit and with only its best interest in mind. In short, they assume a duty of care and duty of loyalty that those responsible for governing the nonprofit will fulfill.

Are there differences between the fiduciary duties applicable to limited liability companies and the fiduciary duties owed by directors of nonprofit corporations or charitable trusts? Nonprofit corporate law imposes on directors both a duty of loyalty and a duty of care.[115] "Each member of the board of directors, when discharging the duties of a director, shall act: (1) in good faith, and (2) in a manner the director reasonably believes to be in the best

112. GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 3–5.

113. I.R.S. FORM 990, *supra* note 53, at Part VI (Questions 12a–12c); I.R.S. INSTRUCTIONS FOR FORM 1023, APPENDIX A (2006), *available at* I.R.S., U.S. DEP'T OF THE TREASURY, INSTRUCTIONS FOR FORM 1023, APPLICATION FOR RECOGNITION OF EXEMPTION, CAT. NO. 17132Z, app. A at 25–26 (2006) [hereinafter I.R.S. INSTRUCTIONS FOR FORM 1023], *available at* http://www.irs.gov/pub/irs-pdf/i1023.pdf. The IRS does not in terms require adoption of a conflict of interest policy; but the existence or nonexistence of such a policy is taken into account by the IRS in determining whether to recognize an organization as tax-exempt, and Appendix A to the Instructions for Form 1023 contains a sample conflict of interest policy that the IRS recommends be adopted. I.R.S. INSTRUCTIONS FOR FORM 1023.

114. GOVERNANCE AND RELATED TOPICS—501(C)(3) ORGANIZATIONS, *supra* note 24, at 2–7 (providing examples that are illustrated in text accompanying note 114).

115. Under RUUNAA, the members of an unincorporated nonprofit association select managers, and the managers are also subject to duties of loyalty and care. RUUNAA § 23 (2008). Section 22 provides that if the members do not select managers, the members are the managers. *Id.* § 22.

interests of the nonprofit corporation."[116] The duty of loyalty is conveyed through the obligation to act "in the best interests of the nonprofit corporation." Conflict of interest transactions are addressed directly in the statute,[117] and a separate provision offers a statutory safe harbor to a director presenting a business opportunity first to the disinterested directors, with full disclosure of material facts, who decline the opportunity.[118] Much of the law articulating and applying the duty of loyalty in the corporate context is case law.[119] The standard of care quoted above is not the same as the standard of liability. That is shaped by, among other things, the business judgment rule and is dealt with separately.[120] The business judgment rule—which may be "more appropriately known in the nonprofit context as the best judgment rule"[121]—provides a presumption that the director exercised due care in making a decision in the absence of the plaintiff showing that the director was not disinterested or was not informed to the extent the director could reasonably have believed appropriate in the circumstances.[122] As a result, it has been held in an influential

116. MNCA § 8.30(a) (2008); *see also, e.g.*, A.L.I., PRINCIPLES OF THE LAW OF NONPROFIT ORGS. §§ 300, 310, 315 (Tentative Draft No. 1, 2007) (discussing governing-board members' fiduciary duties, duty of loyalty, and duty of care). *See generally* GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS, *supra* note 107, at 17–42 (discussing the duties and rights of nonprofit corporation directors, including the duty of care and duty of loyalty); David B. Rigney, *Duties and Potential Liabilities of Officers and Directors of Nonprofit Organizations*, *in* NONPROFIT GOVERNANCE AND MANAGEMENT 83–102 (Victor Futter ed., 2002) (summarizing the duties of nonprofit organization directors and officers and analyzing standards of performance and potential liabilities).

117. MNCA § 8.60. In addition, section 8.32(a) provides that "[a] nonprofit corporation may not lend money to or guarantee the obligation of a director or officer of the corporation." *Id.* § 8.32(a).

118. *Id.* § 8.70.

119. *E.g.*, Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974) (involving transactions with conflicting interests and discussing both duty of care and duty of loyalty); Mile-O-Mo Fishing Club, Inc. v. Noble, 210 N.E.2d 12 (Ill. App. Ct. 1965) (analyzing competition with the nonprofit corporation); Ne. Harbor Golf Club, Inc. v. Harris, 661 A.2d 1146 (Me. 1995) (exploring usurpation of nonprofit corporate opportunity).

120. MNCA § 8.31 cmt. This approach follows provisions in the Model Business Corporation Act. *See* MODEL BUS. CORP. ACT § 8.31 (1984).

121. FISHMAN & SCHWARZ, *supra* note 1, at 152–53.

122. The business judgment rule has been recognized and expressed by the American Law Institute. A.L.I., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(c) (1992). The ALI adds a third prong, namely that the director must "rationally believe[] that the business judgment is in the best interests of the corporation." *Id.* § 4.01(c)(3). In section 365 of *Principles of the*

opinion that in order for a director of a nonprofit corporation to be found liable for breach of the duty of care, the director must "have committed 'gross negligence' or otherwise be guilty of more than mere mistakes of judgment."[123] In contrast, the trustee of a charitable trust has been found to breach the trustee's duty of care for negligence alone, not gross negligence.[124] According to one leading authority, however, there has been a convergence of standards, and the corporate fiduciary standards are coming to be applied to both trustees of charitable trusts and directors of nonprofit corporations.[125]

Those responsible for managing a limited liability company similarly owe duties of care and loyalty. Courts have applied common law fiduciary standards and analogized to closely held corporations in defining the fiduciary duties applicable to members or managers of an LLC.[126] Some states that have adopted nonprofit limited liability company legislation have made provisions of their nonprofit corporation law stating directors' duties applicable to nonprofit LLCs.[127] A number of jurisdictions have adopted RULLCA, which recognizes and defines a duty of loyalty[128] and a

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Law of Nonprofit Organizations, the ALI is presently articulating the business judgment rule in substantially the same terms. PRINCIPLES OF THE LAW OF NONPROFIT ORGS., *supra* note 116, § 365.

123. *Stern*, 381 F. Supp. at 1013.

124. *E.g.*, Lynch v. John M. Redfield Found., 88 Cal. Rptr. 86, 92 (Ct. App. 1970); *In re* Estate of Donner, 626 N.E.2d 922, 927 (N.Y. 1993).

125. The American Law Institute is thus not presently distinguishing between the duties of loyalty and care owed by nonprofit corporate directors and charitable trustees or other governors of nonprofit organizations. *See* PRINCIPLES OF THE LAW OF NONPROFIT ORGS., *supra* note 26, §§ 310, 315. Elsewhere it explained that the *Principles* would deal with the consequences of differences between the forms of charity on an issue-by-issue basis.

> Among the most important potential differences between charitable trusts and nonprofit charitable corporations are fiduciary standards and consequences for breach; settlor and donor control versus decisional autonomy for the governing board; and supervisory regimes. In these three important areas, however, trust and corporate law have been conforming, with the general result that corporate fiduciary standards of conduct are being applied to both trustees of charitable trusts and members of a nonprofit corporate board . . . .

Id. § 200 cmt. b.

126. Credentials Plus, LLC v. Calderone, 230 F. Supp. 2d 890, 898–900 (N.D. Ind. 2002); Purcell v. S. Hills Invs., LLC, 847 N.E.2d 991, 996 (Ind. Ct. App. 2006); Pointer v. Castellani, 918 N.E.2d 805, 815 (Mass. 2009).

127. *E.g.*, MINN. STAT. § 322B.975, subdiv. 5(a) (2011); N.D. CENT. CODE § 10-36-03(1) (2009); TENN. CODE ANN. 48-101-705(a) (2011).

128. RULLCA § 409(b)(1)–(3) (2006).

duty of care.[129] The provisions of RULLCA dealing with the duties of loyalty and care are substantially the same as those applicable to nonprofit corporations.[130] Misappropriation of LLC property or opportunities, a conflicting interest transaction, and competition with the LLC during the conduct or winding up of its affairs are actions that would violate the duty of loyalty, and the standard for liability for breach of the duty of care is essentially one of gross negligence.[131]

Any differences between the fiduciary duties of directors of nonprofit corporations and the duties of managers of limited liability companies, therefore, seem negligible in terms of the good governance expectations of the IRS for governing boards of tax-exempt charitable nonprofits. What may be of more concern is the ability of members of limited liability companies to tailor—that is, to alter, abridge, or even eliminate—the fiduciary duties owed by LLC management to the LLC and to one another. Reflecting the nature of the LLC as a "creature of contract," this ability has been one of the widely perceived benefits of selecting the limited liability company form. RULLCA allows members to alter fiduciary duties

129. *Id.* § 409(c).

130. *See* GUIDEBOOK FOR DIRECTORS OF NONPROFIT CORPORATIONS, *supra* note 116, at 19–20, 29 (discussing nonprofit corporation directors' duties of loyalty and care); *see also* MNCA § 8.30 (2008) (covering the standards of conduct for nonprofit corporation directors).

131. RULLCA § 409(c) states the duty of care in terms similar to the formulation provided in sections 8.30 and 8.31 of the Model Business Corporation Act, but makes the duty "[s]ubject to the business judgment rule." RULLCA § 409(c) (2006); *see also* MODEL BUS. CORP. ACT §§ 8.30-.31 (1984). The intended effect of that language was to recognize a gross negligence standard where, within a state that would adopt RULLCA, that would be the effect of applying the business judgment rule. *E.g.*, Smith v. VanGorkum, 488 A.2d 858, 873 (Del. 1985), *overruled on other grounds by* Gantler v. Stephens, 965 A.2d 695, 713 n.54 (Del. 2009). That is the position taken in the *Stern* case. Stern v. Lucy Webb Hayes Nat'l Training Sch. for Deaconesses & Missionaries, 381 F. Supp. 1003 (D.D.C. 1974). At the Uniform Laws Commission 2011 Annual Meeting, the Commission approved an updated version of RULLCA harmonized with the the Commission's other unincorporated business entity acts that revises section 409 of RULLCA and explicitly adopts the standard of "refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law." *See* RULLCA § 409; UNIF. LTD. P'SHIP ACT § 408(c) (2001); REVISED UNIF. P'SHIP ACT § 404(c) (1997); *Uniform Laws Commission Wraps Up 120th Annual Meeting*, UNIF. LAW COMM'N (July 13, 2011), http://www.nccusl.org/NewsDetail.aspx?title=Uniform%20Law%20Commission%20Wraps%20Up%20120th%20Annual%20Meeting. That is the standard of care provided in section 404(c) of the Revised Uniform Partnership Act and section 408(c) of the Uniform Limited Partnership Act. UNIF. LTD. P'SHIP ACT § 408(c); REVISED UNIF. P'SHIP ACT § 404(c).

in the operating agreement,[132] subject only to a stringently defined test of manifest unreasonableness and the contractual obligation of good faith and fair dealing.[133] The Delaware Limited Liability Company Act allows members not only to restrict fiduciary duties but also to eliminate them altogether, though they may not eliminate the implied contractual covenant of good faith and fair dealing.[134] It is not clear that this can be done in the case of a nonprofit corporation.[135] However, there is authority that holds that, subject to limits, fiduciary duties of the governing board of a nonprofit organization may be modified.[136] Doing so, however, is expressly made "subject to limits," and it seems unlikely that a nonprofit limited liability company applying for recognition as a tax-exempt 501(c)(3) organization would reduce applicable fiduciary duties without very good cause. Possibly, a nonprofit might do so in order to attract to the governing board uncompensated volunteers who would provide independent and disinterested expertise and perspective. Federal[137] and state[138] law

132. RULLCA § 110.

133. *Id.* §§ 110(h), 409(d).

134. DEL. CODE ANN. tit. 6, § 18-1101(c) (2011).

135. There is nothing in Model Nonprofit Corporation Act sections discussing directors' duties giving any indication that the duties imposed by those sections may be modified, reduced, or eliminated. *See* MNCA §§ 8.30–.31.

136. PRINCIPLES OF THE LAW OF NONPROFIT ORGS., *supra* note 116, § 305. Section 305 provides:

> Fiduciary duties may be modified by or as permitted in the organizational documents, except that no modification may—
>
> (a) Reduce the duty of loyalty provided in § 310 in a manner that is manifestly unreasonable, taking into account the charitable nature of the organization.
>
> (b) Reduce the duty of care provided in § 315 so as to permit a knowing violation of law, intentional misconduct, reckless conduct, or gross negligence.
>
> (c) Absolve a fiduciary from the obligation to act in good faith.

Id.

137. The Volunteer Protection Act of 1997, 42 U.S.C. §§ 14501–14505 (Supp. 2009), provides volunteers with protection from liability to third parties "related to [their] serving nonprofit organizations and governmental entities," and it preempts inconsistent state law except to the extent the state provides additional protection from liability relating to volunteers. *Id.* § 14501(b). With some exceptions, the Act states that "no volunteer of a nonprofit organization or governmental entity shall be liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity" if (1) the volunteer was acting within the scope of the volunteer's responsibilities at the time of the act or omission, (2) the volunteer was properly licensed, certified, or authorized for the activities or practice if appropriate or required, (3) "the harm was not caused by willful or criminal misconduct, gross negligence, reckless misconduct, or a

typically provide volunteers, including directors, with immunity from personal liability except in stated circumstances, and state law also allows an organization through its articles to limit or eliminate monetary liability for any action or failure to act, again with certain exceptions. In consequence, reduction of the fiduciary duties of members of the governing board of charitable nonprofit organizations—as could be done under many states' LLC laws and certainly RULLCA—should not be necessary. Moreover, any reduction of the standards for the duty of care or duty of loyalty would surely draw close scrutiny from the IRS in evaluating the completed Form 1023, and a nonprofit LLC would be unlikely to do so without clear and persuasive justification. The authority that those organizing an LLC have to modify the duty of care and the duty of loyalty, therefore, should not present problems that cannot be addressed or avoided.

There is still another duty that should be mentioned. Directors of a nonprofit corporation are said to owe a duty of obedience to the organization to carry out its purposes as expressed in the articles of organization or certificate of incorporation[139] and ensure that the organization "operates to further its stated objectives in compliance with applicable legal requirements."[140] According to one court, the "duty of obedience"

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conscious, flagrant indifference to the rights or safety of the individual harmed by the volunteer," and (4) the harm was not caused by the volunteer operating a motor vehicle, vessel, aircraft, or other vehicle for which the State required the operator or owner to possess a license or to maintain insurance. *Id.* § 14503(a)(1)–(3). The Volunteer Protection Act of 1997, however, does not address or affect the responsibility of volunteers *to* a nonprofit organization or governmental entity under applicable State law: "Nothing in this section shall be construed to affect any civil action brought by any nonprofit organization or any governmental entity against any volunteer of such organization or entity." *Id.* §§ 14501–14505.

138. At the option of the nonprofit organization, state nonprofit corporation law typically does provide directors and officers with a shield from personal liability for monetary damages for breach of their duties to the corporation and its members, but subject to exceptions for conflict of interest transactions, breach of the duty of loyalty, acts or omissions not in good faith involving intentional misconduct or knowing violation of law, and unlawful distributions. *E.g.*, MNCA § 2.02(b)(8), (c) (2008); REVISED MODEL NONPROFIT CORP. ACT § 2.02(b)(5) (2002). According to one authority, "Approximately one-half of the states protect all uncompensated volunteers regardless of their position." FISHMAN & SCHWARZ, *supra* note 1 (*citing* Jill R. Horwitz & Joseph Mead, *Letting Good Deeds Go Unpunished: Volunteer Immunity Laws and Tort Deterrence*, 6 J. EMPIRICAL LEGAL STUD. 535 (2009)). Iowa Code section 613.19 is an example of such a statute.

139. *See* FISHMAN & SCHWARZ, *supra* note 1, at 199–202.

140. Rigney, *supra* note 116, at 83, 87. The authors of *Nonprofit Law and*

requires directors "to ensure that the mission of the charitable corporation is carried out" and to "be faithful to the purposes and goals of the organization."[141] Not all agree that a duty of obedience exists,[142] and in the developing *Principles of the Law of Nonprofit Organizations* the American Law Institute ("ALI") declines to recognize it except as a part of the duty of loyalty.[143] The ALI explains that while the governing board "must adhere to the organizational documents," the board has an obligation "to keep the purpose of the charity current and useful," which may require amendment.[144]

Regardless of whether there is a duty of obedience, the duty of loyalty would command the managers or governors of a nonprofit

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Litigation express this same view: "Thus, a nonprofit's unique accountability to the public and to its donors imposes an additional *duty of obedience* that dictates how each director exercises the duty of care and demonstrates loyalty to the organization." F. Brooks Cowan et. al, *Nonprofit Law and Litigation*, *in* 2 ANNUAL REVIEW OF DEVELOPMENTS IN BUSINESS AND CORPORATE LITIGATION 1453, § 23.2 at 1459 (2011). In the recently published third edition of *Nonprofit Governance and Management*, the authors recognize that there is disagreement whether a duty of obedience separate from other duties exists but state, "In either case, adherence to or support of the organization's mission is a fundamental expectation of nonprofit directors." NONPROFIT GOVERNANCE AND MANAGEMENT 11 (Cheryl Sorokin et al. eds, 3d ed. 2011).

141. Manhattan Eye, Ear & Throat Hosp. v. Spitzer, 715 N.Y.S.2d 575, 593 (App. Div. 1999) (citation omitted).

142. *See* FISHMAN & SCHWARZ, *supra* note 1, at 202.

143. PRINCIPLES OF THE LAW OF NONPROFIT ORGS., *supra* note 116, § 300 cmt. g (3). The comment addresses the requirement of good faith in the exercise of the duties of loyalty and care, and it provides:

> As part of their duties of loyalty and care, board members may not knowingly cause or permit the charity to violate the law or the charity's organizational documents and policies. . . . Moreover, the board must take reasonable steps to ensure that management is legally and ethically compliant and that management has established internal controls that permit the board to determine compliance . . . and to remedy wrongdoing by management . . . .
>
> Some commentators place the obligation to obey the law and the organizational documents and policies under a third duty unique to charity fiduciaries—the "duty of obedience." Substantively, to these commentators, such a duty embraces a faithfulness to the purposes of the charity. These Principles, however, do not employ the terminology of a duty of obedience. While the members of the governing board must adhere to the organizational documents, they also have the obligation to keep the purpose of the charity current and useful. Accordingly, the board must amend the stated purposes when necessary and appropriate to do so, in accordance with the law and the existing organizational documents.

Id.

144. *Id.*

limited liability company to further the exempt and charitable purposes of the organization and comply with state law governing the organization and federal tax law providing the exemption for which the nonprofit was seeking to qualify. For a nonprofit limited liability company formed under state law not specifically providing for a nonprofit LLC, that creates a problem. It would be easy enough to include in the articles and operating agreement the required, standard provisions attesting that the organization was organized exclusively and would exclusively be operated for exempt purposes, and that on dissolution its assets would be distributed to further the same or similar exempt purposes, or to another exempt organization, or to government. But even if these provisions are included in the organizational documents—the articles or certificate and the operating agreement—the question is, as the IRS expressed it in its *Limited Liability Company Reference Guide Sheet,* can the LLC represent "that all of its organizing document provisions are consistent with state LLC laws, and are enforceable at law and in equity?"[145]

D. State LLC Laws and the Requirements for a 501(c)(3) Nonprofit Organization

The language of § 501(c)(3) is unqualified and clear, and it is axiomatic that "no part of the net earnings [may] . . . inure[] to the benefit of any private shareholder or individual."[146] It is the practice to include such a provision in the articles of organization of a nonprofit seeking to qualify under § 501(c)(3), and an organization would fail the operational test if any part of its earnings are distributed to a private shareholder or individual. Moreover, "An organization is not organized exclusively for one or more exempt purposes unless its assets are dedicated to an exempt purpose," and it will also fail the organizational test "if its articles or the law of the State in which it was created provide that its assets would, upon dissolution, be distributed to its members or shareholders."[147] Thus, it is standard practice, and the IRS, in its instructions to organizations completing Form 1023 and applying for recognition as a tax-exempt organization, counsels to include

145. *See* GUIDE SHEET, *supra* note 48, at 2; *supra* text accompanying notes 84–86.

146. I.R.C. § 501(c)(3) (2006).

147. Treas. Reg. § 1.501(c)(3)-1(b)(4) (2011).

an acceptable "dissolution clause" in the articles or certificate of organization, providing that upon dissolution the assets of the organization will be distributed for one or more exempt purposes, or to one or more organizations that are 501(c)(3) organizations, or to state or local government.

The laws governing organizations under which those forming a charitable nonprofit historically have proceeded are consistent with these requirements of § 501(c)(3). State nonprofit corporation laws, such as the MNCA, contain provisions that proscribe both distribution of earnings to private individuals and transfer of the assets of the organization upon dissolution to a purpose or organization other than one that would meet the requirements of § 501(c)(3).[148] The Revised Uniform Unincorporated Nonprofit Association Act ("RUUNAA") is to the same effect. It prohibits an unincorporated nonprofit association from paying dividends or making distributions to a member or manager, and it provides that property neither needed for payment of debts nor subject to other instructions from the donor or in a trust document "be distributed . . . as required by law other than this [act] that requires assets of an association to be distributed to another person with similar nonprofit purposes."[149] With the doctrine of cy pres, trust law is the same. Where it "becomes unlawful, impossible, or impracticable to carry out" the designated charitable purpose, or where it would be "wasteful to apply all of the property to the designated purpose," a court is directed to apply "the property or appropriate portion thereof to a charitable purpose that reasonably approximates the designated purpose."[150]

Four states have adopted nonprofit limited liability company acts that contain the required provisions[151] and thus the LLC should be available for nonprofit organizations in those states no less than the nonprofit corporation, charitable trust, or unincorporated nonprofit association. The acts address the organizational and operational tests the IRS has articulated, and in fact these statutes reflect the IRS *Reference Guide Sheet* instructions.[152]

148. MNCA §§ 6.40(a), 14.05 (2008).
149. RUUNAA §§ 26, 29 (2008).
150. RESTATEMENT (THIRD) OF TRUSTS § 67 (2003).
151. KY. REV. STAT. ANN. §§ 275.015(18)–(19), 275.025, 275.520, 275.530, 275.535, 275.540 (2011); MINN. STAT. §§ 322B.03 subdiv. 31a, 322B.975 (2011); N.D. CENT. CODE §§ 10-36-01 to -09 (2011); TENN. CODE ANN. §§ 48-101-702 to -704 (2011).
152. *See* GUIDE SHEET INSTRUCTIONS, *supra* note 47 and accompanying text.

The North Dakota Nonprofit Limited Liability Company Act states flatly, "An individual may not be a member of, or own any financial rights or governance rights in, a nonprofit limited liability company."[153] In a similar vein, the Kentucky Nonprofit Limited Liability Companies Act provides, "A nonprofit limited liability company shall not have or issue membership interests in the limited liability company, and no distribution shall be paid, and no part of the income or profit of the limited liability company shall be distributed to its members or managers."[154] The Tennessee Nonprofit Limited Liability Companies Act envisions and is limited to the situation of a single-member nonprofit LLC where the sole member is a nonprofit corporation.[155] Minnesota incorporates formation of a nonprofit LLC into its general limited liability company act and has a separate section stating the non-distribution constraint and limitation on distribution of assets on dissolution, and incorporating provisions that would apply to a nonprofit corporation (e.g., provisions addressing conflicts of interest).[156]

Most states, however, have not adopted separate acts or

153. N.D. CENT. CODE ANN. § 10-36-05. It does not, however, limit membership to 501(c)(3) organizations or governmental entities or units, as the Instructions do. *See* GUIDE SHEET INSTRUCTIONS, *supra* note 47, at 3. One or more 501(c)(3) organizations could utilize the statute to form a tax-exempt nonprofit LLC, and non-501(c)(3) organizations could presumably utilize the statute to form an LLC that would seek exempt status under a provision of § 501(c) other than (c)(3). Organizers have formed eight nonprofit LLCs under the North Dakota Nonprofit LLC Act. E-mail from Clara M. Jenkins, Dir., Bus. Sys. & Programs, Office of N.D. Sec'y of State, to author (Aug. 16, 2011) (on file with author).

154. KY. REV. STAT. ANN. § 275.520(1). In truth, this seems to be an anomalous provision because the Act otherwise defines a limited liability company as one "formed under this chapter having one (1) or more members." *Id.* § 275.015(11). Nonetheless, the Office of the Kentucky Secretary of State reports that 303 nonprofit LLCs have been formed in Kentucky. E-mail from J. Allen Eskridge, III, Ky. Assistant Sec'y of State, to Tom E. Rutledge, Member, Stoll Keenon Ogden PLLC (Aug. 8, 2011) (on file with author).

155. TENN. CODE ANN. §§ 48-101-702(3), 48-101-704. The Tennessee Act authorizes an existing nonprofit corporation to form a nonprofit limited liability company "[w]hose sole member is a nonprofit corporation" and which therefore will be "disregarded as an entity for federal income tax purposes." *Id.* § 48-101-702(3). An LLC that is a disregarded entity under the "check-the-box" regulations does not need to file a Form 1023 and seek recognition as a tax-exempt entity. *See supra* text accompanying notes 44–48. At the same time, the LLC would be a separate entity for liability purposes and would thus shield the parent from liabilities arising out of activities of the LLC or its ownership of property. *Id. See generally* James M. McCarten & Kevin N. Perkey, *Tennessee Nonprofit LLCs—A New Option for Tax-Exempt Organizations*, 3 TRANSACTIONS: TENN. J. BUS. L. 15 (2001) (discussing the nonprofit LLC option available to tax-exempt organizations).

156. MINN. STAT. § 322B.975 (2011).

provisions concerning nonprofit LLCs and instead have provisions like those found in RULLCA.[157] Specifically, RULLCA envisions individuals as members who make contributions that are not dedicated to exempt purposes, and who have management rights giving them control over those assets.[158] Other than insolvency,[159] there is no constraint on distributions to members, and instead RULLCA explicitly authorizes the making of distributions of earnings or assets to members before dissolution of the LLC.[160] Nor does RULLCA contain language requiring distribution of assets on dissolution to a 501(c)(3) organization or otherwise for exempt purposes in the event the LLC was formed as a nonprofit. Instead, like other state LLC statutes, RULLCA provides for distribution of assets to the members after obligations to creditors—including members who are creditors—are discharged.[161] State LLC statutes, therefore, do not contain the protections for charitable assets that are found in nonprofit corporation statutes, the RUUNAA, trust law, or state nonprofit limited liability company acts as discussed above. It would seem too plain for words that LLCs formed under these state statutes would fail the "organizational test" and the "operational test" of § 501(c)(3).

Yet the LLC remains "a creature of contract," and RULLCA's provisions on distributions—either during the conduct of the LLC's business and affairs or upon dissolution—are in fact default provisions that may be varied by agreement.[162] Accordingly, there is nothing in state law that would preclude persons forming a nonprofit LLC from varying these default provisions and incorporating in both the articles of organization and the

157. *See, e.g.*, D.C. CODE § 29-801 (2011); IDAHO CODE ANN. § 30-6-101 (2011); IOWA CODE § 489.101 (2011); NEB. REV. STAT. § 21-101 (2010); UTAH CODE ANN. § 48-3-101 (2011); WYO. STAT. ANN. § 17-29-101 (2011).

158. *See* RULLCA §§ 401–02, 407 (2006).

159. *Id.* § 405.

160. *Id.* § 404. RULLCA does not have a provision on allocation of profits and losses, but other states do. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-503 (2011).

161. RULLCA § 708; *see, e.g.*, DEL. CODE ANN. tit. 6, § 18-804.

162. RULLCA §§ 110, 404, 708. Section 110 provides that the operating agreement governs the relations among the members and between the members and the LLC and also the activities of the company and the conduct of those activities. *Id.* § 110 (a)(1)–(3). The Act only governs "[t]o the extent the operating agreement does not otherwise provide for a matter." *Id.* § 110 (b). Moreover, while the Act states certain provisions that the operating agreement may not vary, none of the mentioned provisions in the text are among them. *See id.* § 110 (c)(1)–(11).

operating agreement standard provisions of the sort that a practitioner would unfailingly include in the articles and bylaws of a nonprofit corporation in preparation for seeking recognition as a tax-exempt nonprofit organization and that are in fact generally provided for by statute. Thus, arguably the articles and operating agreement of the nonprofit LLC *would* satisfy the organizational test, and assuming compliance with the articles and the operating agreement, the operational test should be met, too.

Would the organizational documents be "consistent with state LLC laws," however, and be "enforceable in law and equity," as the IRS has instructed that applicants should be able to show?[163] Since the provisions in the statute regarding distributions of earnings and assets and control over assets are default provisions that may be varied and thus displaced in the articles and operating agreement, they would seem to be consistent with state law in the sense that state law is not contravened by them.[164] But would the provisions precluding distribution of earnings to members or private individuals and dictating distribution of assets on dissolution to tax-exempt purposes or organizations be enforceable? What would prevent the governing board from amending the organizational documents, as LLC legislation allows,[165] to become a for-profit entity and secure the earnings and assets for themselves?

One response is that the governing board members owe a duty of loyalty to the nonprofit limited liability company, including for this purpose surely a duty of obedience to the purposes articulated in organizational documents—and if not to the specific purposes articulated in the original documents perhaps years ago[166]—then at least to tax-exempt purposes and the preservation of the company's qualification as a tax-exempt organization. One question to be asked is, who would enforce that duty?[167] Is there a way to prohibit

163. *See* GUIDE SHEET INSTRUCTIONS, *supra* note 47; *see supra* text accompanying note 50 (specifically, the twelfth condition).

164. *See* RULLCA § 708 (b)–(d) cmt. (stating that the provisions provide "default rules" although they are subject to the provisions on "charging orders"); *id.* § 503 (explaining and defining "charging orders").

165. *See id.* §§ 110(a)(4), 407(b)(5), (c)(4)(D).

166. *See supra* text accompanying notes 139–43.

167. The problem of who will enforce this duty is a question that needs to be addressed, because neither donors, nor beneficiaries, nor members of the community or the public have standing to sue for breach of governing board members' duties in regard to charitable assets. *See infra* Part III.E.; FISHMAN & SCHWARZ, *supra* note 1, at 238 ("The general rule . . . remains that, absent a statutory right, there is no private enforcement of a charitable trust, a nonprofit

amendment of the organizational documents, at least in this fashion, without notice to state authorities and the opportunity to resist? Kentucky does just that.[168] It requires that anyone seeking to amend the articles to eliminate nonprofit status and nonprofit purpose give ten days' notice to the Attorney General; given notice, the Attorney General could seek injunctive relief to ensure protection of charitable assets.[169] Most states, however, do not have such a provision in their LLC statutes.[170] A second response would come from the IRS itself. Any such change in the articles and operating agreement eliminating nonprofit purpose would be cause for revocation of tax-exempt status, even retroactively.[171] Yet that would not preclude the governing board from doing so under state law, and circumstances in which it would be worth the while of the governing board members are readily imaginable.[172]

Still another possibility would be for the articles of organization and the operating agreement to contain a clause precluding them from being amended to eliminate the nonprofit purpose of the company without notice to or the approval of a third person, for example, the Attorney General or the appropriate court. That seems to be the intended effect of the Kentucky provision. Similarly, while some states' nonprofit corporation laws do not require the board to give notice to the Attorney General or seek court approval where the board seeks to amend the articles to modify the nonprofit purpose,[173] where the board proposes to take

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trust, or a nonprofit corporation.").

168. KY. REV. STAT. ANN. § 275.025(6) (2011) ("If the limited liability company is a nonprofit limited liability company, then the articles of organization shall state that fact and its nonprofit purpose. This provision of the articles of organization shall not be removed from the articles of organization without written notice to the Attorney General of Kentucky given not less than ten (10) business days prior to the filing of the amendment."). The same result would likely occur in Minnesota. *See* MINN. STAT. §§ 317A.811, 317A.813, 322B.975(6) (2011).

169. KY. REV. STAT. ANN. § 275.025(6).

170. The states which have adopted nonprofit limited liability company legislation have such provisions. *See, e.g.*, KY. REV. STAT. ANN. § 275.025(6); MINN. STAT. §§ 317A.811, 322B.975(6); N.D. CENT. CODE §§ 10-36-06, 10-33-102 (2011); TENN. CODE ANN. §§ 48-101-707 (2011). But they are the exception and not the rule.

171. I.R.S. Priv. Ltr. Rul. 200842047 (Oct. 17, 2008).

172. An example of such a situation would be where the amount that individuals would have to pay as a result of retroactive revocation of tax-exempt status and consequent imposition of personal taxes would be substantially less than the profits they would earn and appreciation that might occur if they converted to a for-profit entity, for example, in the health care field.

173. MNCA § 10.05 (2008). The position taken in the ALI's *Principles of the*

action that would eliminate the entity's nonprofit purpose altogether and convert it to a for-profit entity,[174] notice to the Attorney General and authorization from the appropriate court is generally required.[175] RULLCA offers a solution along the lines suggested by the Kentucky Nonprofit LLC Act and state nonprofit corporation law. It authorizes the operating agreement to "specify that its amendment requires the approval of a person that is not a party to the operating agreement or the satisfaction of a condition,"[176] which could be the Attorney General or the appropriate court. It could be argued that giving "approval" authority for such an amendment to the Attorney General would inappropriately make the Attorney General "a 'super' member of the board," which is not the Attorney General's role.[177] Oversight and prevention of wrongdoing by nonprofits' boards is the Attorney General's role. However, the issue here—whether or not to approve amendment of the articles and operating agreement essentially to authorize conversion of a 501(c)(3) nonprofit to a for-profit entity, leading to distribution of earnings and diversion of charitable assets in contravention of the nondistribution constraint that identifies the entity as a nonprofit—is not simply one of amending the LLC's purposes to reflect evolution of a nonprofit purpose and its adaptation to the times.[178] The issue is whether assets dedicated to the public interest will remain so. That calls for a provision placing amendment beyond the governing board's

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Law of Nonprofit Organizations is that notice to the Attorney General of amendment to the articles is not required in the event the entity is a nonprofit corporation, but is required if the entity is a charitable trust. PRINCIPLES OF THE LAW OF NONPROFIT ORGS., *supra* note 26, §§ 230, 240.

174. *See, e.g.*, KY. REV. STAT. ANN. § 275.025(6); MINN. STAT. §§ 317A.811, 322B.975; N.D. CENT. CODE §§ 10-36-06, 10-33-102.

175. *E.g.*, MNCA §§ 9.03(b), 9.30(a), (c). The Revised Model Nonprofit Corporation Act, still the law in many states, explicitly provided that prior approval of the appropriate court was required, after a proceeding in which the Attorney General had been given written notice, in the event of a merger of a public benefit corporation with any entity other than another public benefit corporation. REVISED MODEL NONPROFIT CORP. ACT § 11.02 (2002).

176. RULLCA § 112(a) (2006). Similarly, section 10.05 of the MNCA provides that the board of directors may amend the articles of a nonmembership corporation—which a 501(c)(3) nonprofit would be—but an amendment must also be approved "by a designated body whose approval is required by the articles of incorporation or bylaws." MNCA § 10.05(1). This is the principle at work in RULLCA § 112.

177. *See* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 938, 976 (2004).

178. *See supra* text accompanying notes 139–43.

control and requiring review by the Attorney General and the Attorney General's approval, or a court's. RULLCA section 112 would authorize that option.

If this option were pursued, persons seeking to form a nonprofit LLC could include a provision in the articles and operating agreement specifying that neither the articles nor the operating agreement could be amended without the approval of the Attorney General or the appropriate court. That kind of clause should be enforceable and prevent amendment of the documents and distribution of the LLC's earnings and assets contrary to 501(c)(3) and the requirements of the IRS.

A problem would be that some Attorneys General might not accept that role, and others might allocate or have available too few resources to fulfill it meaningfully for the IRS's purposes.[179] More basically, however, even if the IRS could be persuaded through one or more of these means that the organizational and operational tests were satisfied, intervention of the Attorney General that is only available when amendment of the articles or operating agreement is sought would not provide the kind of oversight or protection of charitable purpose and charitable assets in other contexts to assure the IRS that tax-exempt purposes will not be compromised. What protection of the nonprofit's purposes and assets is available where a nonprofit LLC may be formed under general limited liability company legislation?

E. Do State LLC Acts Allowing Formation of a Nonprofit LLC Offer Necessary Protection of Charitable Assets?

The assets of a charitable nonprofit organization are dedicated to public use and for the benefit of the community. That is the

179. *See* Carter G. Bishop, *The Deontological Significance of Nonprofit Corporate Governance Standards: A Fiduciary Duty of Care Without a Remedy*, 57 CATH. U.L. REV. 701, 703 (2008). In a survey to the states asking, among other things, how many attorneys were dedicated to charity oversight, if any, seventy-four percent of the states responding reported that they had one or no full-time attorneys assigned to nonprofit oversight (seventeen states reported none). Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128–29 tbl.1 (2007). On the willingness of Attorneys General to accept regulatory roles, "an investigation by the staff of the Pennsylvania Assembly into the spectacular collapse of the Foundation for New Era Philanthropy found that the failings of the Attorney General's office were not so much the fault of inadequate staffing as deference to a well-connected, charismatic founder." Brody, *supra* note 177, at 949.

very purpose of the nondistribution constraint under state law[180] and the requirement in § 501(c)(3): "no part of the net earnings of which inures to the benefit of any private shareholder or individual." That is why the IRS insists upon a dissolution clause in the articles of organization, without which the application for recognition as a tax-exempt organization will be denied because it will fail the organizational test.[181] A nonprofit organization will fail the organizational and operational tests "unless it serves a public rather than a private interest."[182] In short, these are organizations intended to benefit the public.

The public therefore has a strong interest in the assets of a nonprofit 501(c)(3) organization being effectively devoted to the organization's exempt purposes, and not diverted, misapplied, or wasted. That is certainly true where the nonprofit receives gifts or grants from donors who contribute or make grants or buy services from nonprofits with an expectation that revenues generated will be devoted to exempt purposes and not misappropriated or diverted. Accordingly, accountability of those governing the nonprofit, enforcement of their duties, and protection of charitable assets are matters of real importance. No individual member of the community or the public, however, nor even a donor or beneficiary, generally has standing to sue to prevent breach or to enforce duties and obtain a remedy for breach.[183] Yet, there must be some means by which to protect against breach of fiduciary duties.[184]

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180. *See supra* text accompanying notes 15–18.

181. *See* I.R.C. § 501(c)(3) (2006); I.R.S. FORM 1023, *supra* note 53, at Part III.

182. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2011).

183. FISHMAN & SCHWARZ, *supra* note 1, at 231–38. There are limited exceptions, but "[t]he general rule . . . remains that, absent a statutory right, there is no private enforcement of a charitable trust, a nonprofit trust, or a nonprofit corporation." *Id.* at 238.

184. See LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 160 (2010), where, in commenting upon the possibility of no-owner and nonprofit firms, including nonprofit LLCs, the author states, "Without economic owners who have incentives to protect their interests in profits, the firm also would need devices to protect donors from misconduct by managers. That is why nonprofit corporations have to form under special statutory provisions and are subject to special state supervision." See also REVISED MODEL NONPROFIT CORP. ACT introductory cmt., at xxvi–xxvii (1987):

> Since members of public benefit corporations have no economic interest in their corporations, they have no personal economic incentive to monitor corporate activities and prevent abuses. Many public benefit corporations do not even have members. While contributors have an incentive to monitor corporate activities, they may have no practical

It is the state Attorney General to whom state law generally assigns the responsibility for oversight of nonprofit organizations.[185] Thirty-seven states provide by statute for the Attorney General to have oversight responsibility for charitable assets.[186] The specific powers vested in the Attorney General vary but typically require that notice be given to the Attorney General of certain critical events, especially ones such as dissolution or the transfer of all or substantially all assets,[187] and in many cases amendment of the organization's purposes where property is held in trust.[188] The Attorney General may sue for injunctive relief and to remove directors or trustees who have violated their duties of care or loyalty.[189] While the principle of oversight responsibility and authority of the Attorney General has historically been expressed in nonprofit corporation statutes, in those states that have specifically authorized nonprofit limited liability companies, the legislation has given the Attorney General the same authority with respect to LLCs as is authorized for nonprofit corporations.[190] As Evelyn Brody, Reporter for the ALI's project on *Principles of the Law of Nonprofit Organizations* has expressed it, the Attorney General's role is not decision making but is "to provide oversight of the charitable sector," "to guard against charity fiduciaries' wrongdoing," and "to seek to correct breaches of fiduciary duty that have not otherwise been remedied by the board."[191] For the IRS, which counts on continuing satisfaction of the organizational and operational tests and enforcement of organizational documents, and the state law with which those documents must be consistent,[192] the accountability provided by the Attorney General has to be regarded

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means of doing so. . . .

The Revised Act . . . [filled] this void by statutorily clarifying existing common law and statutory authority of the attorney general.

185. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 301–06 (2004).

186. *Id.* at 306.

187. *E.g.*, MNCA §§ 12.03(a)–(b), 14.05(c)–(d) (2008).

188. MNCA § 10.09.

189. *E.g.*, MNCA § 1.51; MINN. STAT. §§ 322B.975 subdiv. 6, 317A.811–.813 (2011); Committee to Save Adelphi v. Diamandopoulos, *available at*, https://folio.iupui.edu/bitstream/handle/10244/502/THE%20COMMITTEE%20TO%20SAVE%20ADELPHI.pdf?sequence=1 (last visited Oct. 4, 2011).

190. *E.g.*, KY. REV. STAT. ANN. §§ 275.025(6), 275.540 (2011); MINN. STAT. § 322B.975 subdiv. 6 (2011); N.D. CENT. CODE § 10-36-06 (2011); TENN. CODE ANN. § 48-101-705(d) (2011).

191. *See* Brody, *supra* note 177, at 1034.

192. *See supra* notes 56–57, 84–86 and accompanying text.

as essential to tax-exempt status of the nonprofit organization.

Most state statutes that would allow a limited liability company to be formed for any lawful purpose, regardless of whether for profit, do not contain provisions giving the Attorney General the authority that the Attorney General has with respect to nonprofit corporations. RULLCA contains none, for the decision was made early in the revision process to leave protective provisions to other law. That appears to be one reason why Nebraska, which adopted RULLCA, struck the language "regardless of whether for profit," leaving section 104(b) to say only that a limited liability company could be formed for "any lawful purpose."[193]

Assuming that the IRS would otherwise be willing to move beyond the position it stated in its *Limited Liability Company Reference Guide Sheet* and allow individuals to form a tax-exempt nonprofit LLC much as they could form a nonprofit corporation, is this absence of protective provisions likely to be fatal to recognition as tax-exempt? In truth, the absence of such provisions is not limited to RULLCA and like LLC legislation. The most recent edition of the Model Nonprofit Corporation Act does not require, and instead leaves optional, provisions relating to the role of the Attorney General:

> The decision of the drafting committee to mark as optional the provisions relating to the role of the attorney general was based on the fact that charitable organizations may not necessarily be structured as a corporation, with the result that supervisory provisions for them might be inadvertently omitted from a state's statutory scheme. Charities may be organized as unincorporated nonprofit associations or, under the law of some states, as limited liability companies, and to cover some other forms of entities requires a statute with broader scope.[194]

The choice to bracket and thus make optional the provisions relating to the Attorney General has been prominently criticized, for example, for failing to appreciate the significance of adhering to state law to be in compliance with federal tax law.[195] Moreover,

193. E-mail from Julie Karavas, Chair of the Neb. Bar Ass'n Bus. Law Section, to the author (on file with author).

194. MNCA Foreword, at xxiii (2008).

195. Evelyn Brody & Marion R. Fremont-Smith, *Draft Model Nonprofit Act Revision Needs Coordination with Tax Code*, 119 TAX NOTES 617 (2008).

while some states do permit nonprofit limited liability companies to be formed under their LLC acts, some of those states specifically incorporate by reference into their LLC legislation provisions regarding the role of the Attorney General found in the nonprofit corporation statutes; and for those that do not, they only raise the question whether the state law provides an adequate framework on which recognition of the organization formed under that law as tax-exempt can rest. Yet it is in fact true that unincorporated nonprofit association statutes have not articulated a role for the Attorney General,[196] and it should also be noted that not all states' nonprofit corporation statutes articulate a role for the Attorney General as described above.[197] "[T]o cover some other forms of entities," as the Foreword to the third edition of the MNCA quoted above candidly states, there *should be* "a statute with broader scope."[198]

The Uniform Laws Commission completed work on and approved such a law in the summer of 2011. It is the Model Protection of Charitable Assets Act.[199] While extended discussion and analysis of this Act is beyond the scope of this article, it is relevant that the Act is addressed to the protection of charitable assets held by a person, regardless of the form of entity,[200] so that it would apply where charitable assets were held by a nonprofit

196. Neither the Uniform Laws Commission's Uniform Unincorporated Nonprofit Association Act—adopted in twelve jurisdictions—nor its Revised Unincorporated Nonprofit Association Act—adopted in four jurisdictions (two of which adopted the 1996 Act)—includes a provision stating the Attorney General's role with respect to the nonprofit. *See* RUUNAA (2008); UNIF. UNINCORPORATED NONPROFIT ASS'N ACT (1994).

197. Iowa's nonprofit corporation statute was amended in 2004 to address mergers of a nonprofit corporation with or into any one or more business corporations or nonprofit corporations or limited liability companies. IOWA CODE § 504.1101(1) (2011). Prior approval of the district court is required if a public benefit corporation will merge with an entity other than a public benefit corporation, IOWA CODE § 490.1102–1103, but Iowa law does not provide for notice to, or a role for, the Attorney General. The Iowa Attorney General may, however, have authority to intervene. *See id.* § 13.2(b) (authorizing Attorney General to prosecute and defend in any court or tribunal "in which the state may be a party *or interested, when, in the attorney general's judgment, the interest of the state requires such action*" (emphasis added)).

198. MNCA Foreword, at xxiii.

199. MODEL PROT. OF CHARITABLE ASSETS ACT (2011). The author was a member of the Drafting Committee for this Model Act.

200. *Id.* § 2(1)–(2); MODEL PROT. OF CHARITABLE ASSETS ACT Prefatory Note (2011) (Annual Meeting Draft approved by the ULC but not yet finalized) (on file with the author).

corporation; a charitable trust; an unincorporated nonprofit association; a limited liability company; or, for that matter, a for-profit corporation if the assets held were indeed "charitable assets." In addition, the Act explicitly states, "The [Attorney General] shall represent the public interest in the protection of charitable assets," and it provides the Attorney General with authority to seek to prevent or to remedy breaches of fiduciary duty that would result or have resulted in diversion, misapplication, or waste of charitable assets.[201] It would fill the gap noted above in RULLCA and in other state laws under which a nonprofit organization might be organized. Thus, if a nonprofit LLC were to be organized in a state which adopted legislation like the Model Protection of Charitable Assets Act, the reservation or objection that the state LLC law lacks necessary protection for charitable assets would be answered, and a remaining obstacle to recognition of the LLC as a tax-exempt organization would be overcome.

IV. CONCLUSION

Nonprofit limited liability companies are presently being organized and serve important purposes in the nonprofit world as joint ventures involving a 501(c)(3) organization and as subsidiaries where the LLC's sole member is a nonprofit, 501(c)(3) organization.[202] Its use as a single member LLC formed by a parent 501(c)(3) particularly offers advantages in that the LLC is a disregarded entity and does not have to file its own Form 1023 or Form 990, yet limits the exposure of the parent to liability.[203]

Beyond these contexts, use of the LLC to secure recognition as a nonprofit 501(c)(3) organization is presently not a realistic choice under most states' LLC laws.[204] The evolution of the LLC suggests that will change. A strong source of the LLC's appeal, whether it is a nonprofit entity or a for-profit entity, is its flexibility and the tailoring that is possible because it is a creature of contract.[205] That "inherent plasticity," as one author has described it, is the LLC's single theory that explains its flexibility and its evolving adaptability to situations beyond those originally

201. MODEL PROT. OF CHARITABLE ASSETS ACT § 3(a)(2)–(3) (2011).
202. *See supra* notes 45–47 and accompanying text.
203. *See supra* notes 46–47 and accompanying text.
204. *See supra* Part III.D.
205. *See supra* notes 100–102 and accompanying text.

conceived for it.[206] Organizers are better able to structure their arrangement and operate to further their mission and reach goals. This flexibility and adaptability would make the limited liability company a very valuable choice of form for numerous small- to medium-sized 501(c)(3) nonprofit organizations if state and federal law recognized it as such. Nearly seventy-five percent of *reporting* 501(c)(3) nonprofit organizations—representing more than 250,000 public charities—have budgets of less than $500,000 a year.[207]

As a practical matter, however, the IRS appears to limit the use of LLCs to situations where one or more members is a 501(c)(3) organization and none of the members is an individual.[208] Challenging the IRS on this point may not be worth the expense, time, and effort that would be entailed, especially because the nonprofit corporation is a readily available choice whose requirements, formalities, and procedures conform to regulatory requirements—not by accident, of course.

But the IRS's position in this regard can be readily explained on the basis of LLC law at the time it communicated its twelve conditions and issued its *Reference Guide Sheet* and *Instructions.* Historically, LLCs could only be formed for a business purpose; the law provided for individual members who made contributions and had contractual rights to share in profits, receive distributions, control assets, and have assets distributed to them on dissolution after creditors were paid.[209] Nothing could be farther from the nondistribution constraint, prohibition of inurement and private benefit, and requirement that assets on dissolution be transferred only for public, exempt purposes, or to other 501(c)(3) entities, or to government.

Yet limited liability company legislation has evolved since that time, and the "inherent plasticity" with which it imbues the LLC makes it possible to consider an LLC as a 501(c)(3) nonprofit

206. Thomas Earl Geu, *A Single Theory of Limited Liability Companies: An Evolutionary Analysis*, 42 SUFFOLK U. L. REV. 507, 551 (2009).

207. Wing et al., *supra* note 5, at 3 fig.1. "Reporting" 501(c)(3) nonprofit organizations are those that collected more than $25,000 in gross receipts and filed a Form 990 with the IRS. According to this study by the Urban Institute's Center on Nonprofits and Philanthropy, there were more than 600,000 public charities that were *not* reporting nonprofit organizations. In consequence, the number of "small" 501(c)(3) organizations is far greater than the 250,000 reporting pubic charities. *Id.* at 2.

208. *See supra* note 49.

209. *See supra* notes 158–61 and accompanying text.

organization. LLC laws increasingly allow an LLC to be organized for any lawful purpose, "regardless of whether for profit."[210] Management may be structured as members or organizers choose, perhaps preferably as manager-managed with a "board of managers," but there must and will be a "governing body" that can operate the LLC in compliance with federal tax law and state LLC law.[211] The fiduciary duties of managers of LLCs under state law could fully meet the demands of the IRS for good governance in nonprofits.

That is not to say that there are not serious issues that need to be addressed. The default provisions of almost all LLC statutes *assume* that inurement and distribution of earnings and assets will occur.[212] The distribution of earnings and assets to members as owners is irreconcilable with 501(c)(3) and would have to be addressed in the articles and in the operating agreement.[213] They can be. LLC provisions in these respects are default provisions.[214] Moreover, since LLC legislation does not presently contain the constraints imposed by nonprofit corporation law,[215] some way would have to be found to ensure that the governing board could not simply amend these to circumvent the constraints. One way that some states have selected is simply to adopt nonprofit LLC acts that contain the necessary provisions.[216] Another way that this article suggests is through provisions in the articles and the operating agreement prohibiting amendment of either of them without the approval of a third party acceptable to the IRS, for example, the Attorney General.[217] Similar provisions are lawful and enforceable in other contexts and should be enforceable with respect to LLCs if states were to adopt RULLCA or amend their LLC acts to include a provision like RULLCA section 112.[218] An additional, serious issue that impedes recognition of nonprofit LLCs as tax-exempt is the absence of provisions regarding the Attorney General's role from most state LLC statutes.[219] But that,

210. *See supra* notes 66–69 and accompanying text.
211. *See supra* note 86 and accompanying text.
212. *See supra* notes 158–61 and accompanying text.
213. *See supra* notes 146–47, 162–64 and accompanying text.
214. *See supra* note 162 and accompanying text.
215. *See supra* notes 157–62 and accompanying text.
216. *See supra* notes 151–56 and accompanying text.
217. *See supra* notes 168–76 and accompanying text.
218. *See supra* notes 157–78 and accompanying text.
219. *See supra* Part III.E.

too, may be addressed. Four states have done so in separate nonprofit limited liability company legislation, and certainly this concern would be addressed if states adopted the Model Protection of Charitable Assets Act.[220]

Until the changes suggested above occur, other than in the situations the IRS currently approves, the choice to organize a nonprofit that can secure recognition as tax-exempt under § 501(c)(3) as an LLC is unlikely and will be an uphill battle probably not worth pressing. Consideration of an LLC in other than presently sanctioned contexts, however, reveals changes in the law that some states have made and responsive structuring in practice that can readily be accomplished. Doing so would bring the structural and operational advantages of the LLC to the nonprofit sector—a sector of dynamic growth—and that prospect seems certain to cause further consideration of what needs to be changed to bring about that result and why that change should occur.

220. *See supra* notes 196–99 and accompanying text.