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SECTION 501(C)(3) ORGANIZATIONS, SINGLE MEMBER LIMITED LIABILITY COMPANIES, AND FIDUCIARY DUTIES

Professor Ellen P. Aprill

SECTION 501(C)(3) ORGANIZATIONS, SINGLE MEMBER LIMITED LIABILITY COMPANIES, AND FIDUCIARY DUTIES

Ellen P. Aprill*

Author's Synopsis: Tax-exempt organizations, including section 501(c)(3) organizations and their donors, use single member limited liability companies (SMLLCs) for a variety of purposes. Exempt section 501(c)(3) nonprofit organizations—to be referred to as charities—that have a number of facilities, such as schools, hospitals, or real estate investments, may form a separate SMLLC for each of them, primarily to protect other assets from liability. Charities may wish to place an activity with a high risk of environmental or tort liability, such as an overnight summer camp, in its own SMLLC. SMLLCs may be used to isolate unrelated business activities from related activities or risky investments from more traditional ones. They may also be used to isolate risky investments from more conservative ones.

An SMLLC leads a schizophrenic existence. Although an entity under state law, it is disregarded for most purposes under federal tax law. Furthermore, the leading theoretical approaches to LLCs and to nonprofit organizations stand in sharp contrast to each other, particularly regarding the ability to rely on contract. These very different sets of applicable law and theory allow for regulatory arbitrage, which involves taking advantage of inconsistencies between the applicable rules.

LLCs, including SMLLCs, have the choice of being member-managed or manager-managed. To ensure the greatest liability protection, the member of an SMLCC may choose for it to be manager-managed. Some LLC statutes, most importantly Delaware's statute, permit the SMLCC to waive fiduciary duties. Charities, however, cannot waive fiduciary duties. This divergence in applicable rules regarding fiduciary duties could lead to conflict between the member charity and its SMLCC, such as pursuing activities inconsistent with the charity's exempt purpose or engaging in campaign intervention. To avoid such conflict, this Article recommends that the IRS issue

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guidance requiring control of the SMLCC by the charity, as it has done in the context of charitable contributions to a charity's SMLCC.

I.	INTRODUCTION	154
II.	THE DEVELOPMENT OF THE SMLLC	157
III.	GOVERNANCE AND FIDUCIARY DUTIES	161
	A. Fiduciary Duties Generally.....	161
	B. Fiduciary Duties and LLCs.....	163
	C. Fiduciary Duties and Charities	168
IV.	THE POTENTIAL FOR CONFLICT BETWEEN AN SMLLC MANAGER AND THE SMLCC CHARITY MEMBER	181
V.	TAX LAW ANALOGUES AND RECOMMENDATION	186
VI.	CONCLUSION	193

I. INTRODUCTION

Tax-exempt organizations, including section 501(c)(3) organizations and their philanthrocapitalists,¹ use single member limited liability companies (SMLLCs) for a variety of purposes.² Exempt section 501(c)(3)

¹ The term “philanthrocapitalism” gained currency after Mathew Bishop and Michael Green’s 2008 publication in the United Kingdom of *Philanthrocapitalism: How the Rich Can Save the World*. See MATHEW BISHOP & MICHAEL GREEN, *PHILANTHROCAPITALISM: HOW THE RICH CAN SAVE THE WORLD* (2008). Subsequently, the authors published a second edition in the United States in 2009 entitled *Philanthrocapitalism: How Giving Can Save the World*. See MATHEW BISHOP & MICHAEL GREEN, *PHILANTHROCAPITALISM: HOW GIVING CAN SAVE THE WORLD* (2009). Their webpage defines philanthrocapitalism at the micro-level as “a new way of doing philanthropy, which mirrors the way that business is done in the for-profit capitalist world.” PHILANTHROCAPITALISM, <http://philanthrocapitalism.net/about/faq/> (last visited May 15, 2017). Bishop and Green explain that entrepreneurs “want to be hands on, bringing innovative ideas to scale by investing their time and energy.” *Id.*

² Section 501(c)(3) of the Internal Revenue Code of 1986, as amended, (“IRC” or “Code”) exempts entities “organized and operated exclusively for one or more of the following purposes: religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition . . . or for the prevention of cruelty to children or animals . . .”; see also Treas. Reg. § 1.501(c)(3)-1(d)(i). Any references to the “Code” or “I.R.C.” refer to the Internal Revenue Code, Title 26, United State Code, and any reference to the Regulations refer to the Regulations promulgated thereunder. All Internal Revenue Code and state statutory citations in this Article refer to the current statute unless otherwise indicated. The same applies to regulations. Note that, although beyond the scope of this Article, charities with

nonprofit organizations—to be referred to as charities—that have a number of facilities, such as schools, hospitals, or real estate investments, may form a separate SMLLC for each of them, primarily to protect other assets from liability. Charities may wish to place an activity with a high risk of environmental or tort liability, such as an overnight summer camp, in its own SMLLC. SMLLCs may be used to isolate unrelated business activities from related activities or risky investments from more traditional ones. Philanthrocapitalists may structure donations through SMLLCs to control aspects of the tax exempt entity's activities. According to press reports, the Koch Brothers structure some of their own noncharitable tax-exempt entities in this way.³

An SMLLC leads a schizophrenic existence. Although an entity under state law, it is disregarded for most purposes under federal tax law. Furthermore, the leading theoretical approaches to LLCs and to nonprofit organizations stand in sharp contrast to each other, particularly regarding the ability to rely on contract. These very different sets of applicable law and theory allow for regulatory arbitrage,⁴ which involves taking advantage of inconsistencies between the applicable rules.

The potential for regulatory arbitrage is especially acute in connection with governance issues that arise when charities use SMLLCs.⁵ An entity's governing body, including that of an SMLCC, is determined in the first instance by state law.⁶ The fiduciary duties of members of the governing body to the SMLLC are also determined by state law.⁷ Some state laws permit LLCs to reduce or eliminate fiduciary duties of care and loyalty.⁸ In contrast, state law does not permit charities to eliminate

SMLLCs will also have to consider state tax laws and state property tax laws to determine whether SMLLCs are disregarded or exempt for those purposes.

³ See Kim Barker & Theodor Meyer, *Who Controls the Kochs' Political Network?* *ASMI, SLAH and TOHE*, PROPUBLICA (Mar. 17, 2014), <https://www.propublica.org/article/who-controls-koch-political-network-asmi-slah-tohe>.

⁴ See Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 229 (2010) (“[A] perfectly legal planning technique used to avoid taxes, accounting rules, securities disclosure, and other regulatory costs.”). Foreign entities similar to SMLLCs also create the potential for regulatory arbitrage, but such issues are beyond the scope of this Article, which is limited to discussion of domestic SMLLCs.

⁵ See generally *id.* at 229–31 (discussing regulatory arbitrage in general).

⁶ See 1 CARTER G. BISHOP & DANIEL S. KLEINBERGER, *LIMITED LIABILITY COMPANIES: TAX & BUSINESS LAW* § 1.01 (2010 & Supp. 2016).

⁷ See MARK A. SARGENT & WALTER D. SCHWIDETZKY, *LIMITED LIABILITY COMPANY HANDBOOK* § 3.89 (2016).

⁸ See *id.*

fiduciary duties.⁹ Moreover, charities are subject to federal tax as well as state entity law.¹⁰ Under federal tax rules, charities must serve a public purpose,¹¹ and federal tax laws themselves apply requirements regarding self-dealing.¹² In addition, the Internal Revenue Service (Service) has shown particular interest in the governance of tax-exempt organizations more generally.

This Article examines possible tensions between governance and fiduciary duties of the charity and of its SMLLC. It concludes that waiver of fiduciary duties is not appropriate for SMLLCs of charities, even if such waiver is permitted under state law. Moreover, in the case of SMLLCs of charities, the issues related to fiduciary duties have important consequences for the tax law.

Thus, this Article argues that, as the Service has in analogous situations, the Service should issue guidance requiring that the governing body of a section 501(c)(3) organization maintains control of all aspects of its activities, including those conducted by any SMLLC. This guidance should be explicit as to what control of an SMLLC entails. While the recommendation is specific, it underscores the importance of adherence to the special rules to which nonprofit tax-exempt charities are subject in order to ensure that they fulfill their important and unique role in our society.

Part II traces the development of the SMLLC, including its use by charities. Part III discusses governance and fiduciary duties in general as well as in the context of both LLCs and charities. Part IV considers potentially problematic interactions of these different sets of theories and rules regarding governance. Part V turns to tax law, in particular tax rules regarding analogous situations, and concludes that the Service should issue guidance regarding a charity's use of manager-managed SMLLCs. Part VI concludes the Article.

⁹ See, e.g., Johnny R. Buckles, *The Federalization of Fiduciary Obedience Norms in Tax Laws Governing Charities: An Introduction to State Law Concepts and an Analysis of their Implications for Federal Tax Law*, 4 EST. PLAN. & COMMUNITY PROP. L.J. 197, 198–99 (2012).

¹⁰ See *id.*

¹¹ See *id.* at 225 (citing *Bob Jones Univ. v. United States*, 461 U.S. 574 (1983)).

¹² See, e.g., *id.* at 233–35; see also I.R.C. § 4941.

II. THE DEVELOPMENT OF THE SMLLC

While entities similar to LLCs have long existed in Europe and Latin America,¹³ most scholars trace the beginnings of the modern American LLC to a 1977 Wyoming statute.¹⁴ The Service issued a private letter ruling recognizing an oil company organized under this Wyoming statute as a partnership for tax purposes in November 1980, three years after the ruling request had been filed.¹⁵ In 1980, however, the Service and Treasury proposed regulations that would tax all LLCs as corporations.¹⁶ The proposed regulations released a flood of criticism,¹⁷ and the Service withdrew them in 1983.¹⁸

On September 2, 1988, the Service issued Revenue Ruling 88-76,¹⁹ which classified a Wyoming LLC as a partnership for federal tax purposes.²⁰ At the time, under the then-applicable entity classification regulations of Treasury Regulation section 301.7701-2, categorization as a partnership or a corporation for tax purposes depended on the extent to which an entity exhibited centralization of management, continuity of life, free transferability of interests, and limited liability.²¹ Under these regulations, an unincorporated organization would be an association taxable as a corporation if it possessed more corporate characteristics than noncorporate characteristics, weighing each characteristic equally.²²

The Wyoming LLC clearly possessed limited liability.²³ However, “upon death, retirement, resignation, expulsion, bankruptcy, dissolution,”

¹³ Many scholars trace the LLC to an 1892 German law. *See* Phanor James Eder, *Limited Liability Firms Abroad*, 13 U. PITT. L. REV. 193 (1952). *See generally* William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 COLO. L. REV. 855 (1995).

¹⁴ WYO. STAT. ANN. § 17-15-103 (1977); *see* Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1465 (1998).

¹⁵ *See* Priv. Ltr. Rul. 81-06-082 (Nov. 18, 1980); *see also* Hamill, *supra* note 14, at 1467 (discussing the private letter ruling).

¹⁶ *See* Classification of Limited Liability Companies; Notice of Proposed Rule Making, 45 Fed. Reg. 75709-10 (proposed Nov. 17, 1980); Hamill, *supra* note 14, at 1468.

¹⁷ *See* Hamill, *supra* note 14, at 1468 n.35.

¹⁸ *See* Announcement 83-4, 1983-2 I.R.B. 30; Hamill, *supra* note 14, at 1469.

¹⁹ 1988-2 C.B. 360.

²⁰ *See id.* at 361.

²¹ *See id.* at 360.

²² *See id.* at 360-61.

²³ *See id.* at 360.

or certain other events a member ceased to be a member, and the LLC would cause a dissolution unless all remaining members agreed to continue the business.²⁴ The LLC thus lacked the corporate characteristic of continuity of life.²⁵ Moreover, a membership interest could be assigned to a nonmember only upon approval of all members.²⁶ The LLC thus also lacked the corporate characteristic of free transferability of interests.²⁷ Since the LLC did not have more corporate than noncorporate characteristics, it was taxed as a partnership.²⁸

After this revenue ruling, enactment of LLC statutes gained momentum. Two states enacted LLC statutes in 1990,²⁹ four in 1991,³⁰ ten in 1992,³¹ eighteen in 1993,³² and twelve in 1994.³³ By the end of 1996, all states had adopted LLC legislation.³⁴ Years of discussion between tax officials, taxpayers, and drafters of the Uniform LLC Act followed.³⁵

In March of 1995, the Service issued a notice that it was “considering simplifying the classification regulations allowing taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis.”³⁶ The notice explicitly referred to the fact that “almost all states have enacted statutes allowing the formation of limited liability companies.”³⁷ The Service and Treasury issued proposed regulations along these lines on May 13, 1996.³⁸

In December 1996, the Service and the Treasury issued final “check-the-box” regulations, effective January 1, 1997, for classification of

²⁴ *Id.*

²⁵ *See id.*

²⁶ *See id.*

²⁷ *See id.* at 361.

²⁸ *See id.*

²⁹ Colorado and Kansas did so in 1990. *See* Hamill, *supra* note 14, at 1470.

³⁰ Texas, Utah, Virginia, and Nevada did so in 1991. *See id.* at 1473 n.59.

³¹ *See id.* at 1475.

³² *See id.* at 1476.

³³ *See id.*

³⁴ *See id.* at 1477.

³⁵ *See id.* at 1478–82.

³⁶ Notice 95-14, 1995-1 C.B. 297, 297.

³⁷ *Id.*

³⁸ *See* Simplification of Entity Classification Rules, 61 Fed. Reg. 93, 21989–97 (May 13, 1996).

business entities.³⁹ Under these provisions, a business entity, including an LLC with two or more members, can be classified either as a corporation or a partnership.⁴⁰ An SMLLC is, under these regulations, “classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.”⁴¹ A domestic LLC with at least two members is classified as a partnership for federal income tax purposes unless it affirmatively elects otherwise; a single member LLC is treated as a disregarded entity unless it affirmatively elects to be treated as a corporation.⁴²

How to treat the SMLLC presented the drafters of the regulations with a conundrum. As two of the country’s LLC experts have explained,

[i]t is axiomatic under both state and tax law that a partnership has at least two owners. The IRS had neither the statutory nor the jurisprudential basis for announcing that an LLC with only one member would be taxed as a partnership.

The IRS’s solution was a tour de force; it cut the Gordian knot by declaring that a single-member LLC simply does not exist for federal income tax purposes. . . . The sole member of an SMLLC might paraphrase Louis XIV and say, “the entity, it’s me.”⁴³

³⁹ See Treas. Reg. §§ 301.7701-1 to -6 (1997). As noted earlier, this Article deals only with domestic LLCs. Foreign LLCs raise additional and complicated issues that are beyond the scope of this Article. For evaluation of the check-the-box regulations, including the treatment of SMLLCs, see for example, Alice G. Abreu, *Paradise Kept: A Rule-Based Approach to the Analysis of Transactions Involving Disregarded Entities*, 59 SMU L. REV. 491 (2006); Steven A. Dean, *Attractive Complexity: Tax Deregulation, The Check-the-Box Election and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405 (2006); Heather M. Field, *Checking in on “Check the Box,”* 42 LOY. L.A. L. REV. 451 (2009).

⁴⁰ See Treas. Reg. § 301.7701-2(a) (1997).

⁴¹ *Id.* An SMLLC is treated as a corporation for purposes of employment taxes if it has employees, and for certain excise taxes. See Treas. Reg. § 301.7701-2(c)(iv), (v) (1997).

⁴² See Treas. Reg. § 301.7701-3(b) (1997).

⁴³ Daniel S. Kleinberger & Carter G. Bishop, *The Single-Member Limited Liability Company as Disregarded Entity: Now You See it, Now You Don’t*, BUSINESS LAW TODAY (Aug. 23, 2010), http://www.americanbar.org/publications/blt/2010/08/07_bishop.html.

The authors continue, “Since the promulgation of ‘check the box,’ the single-member LLC has become a centrally important aspect of LLC law and practice.”⁴⁴

Such has proved to be the case for both nonprofit tax-exempt organizations and for-profit entities. The Service has explicitly announced that an LLC wholly owned by a single exempt organization may be disregarded as an entity separate from its owner; the exempt owner of a disregarded LLC is to treat the operations and finances of the SMLLC as its own for tax and information reporting purposes.⁴⁵ Form 990, the annual information return required of most tax-exempt organizations, includes special instructions regarding disregarded entities.⁴⁶ For example, Schedule R of Form 990, Related Organizations and Unrelated Partnerships, calls for disclosure of disregarded entities, which includes a description of an entity’s primary activity, total income, end-of-year assets, and direct controlling entity.⁴⁷

Private letter rulings issued by the Service give a sense of how fervently and creatively charities have embraced the use of SMLLCs.⁴⁸ Some examples include using SMLLCs to hold real estate, especially real estate that carries possible legal liability such as tort liability.⁴⁹ One charity, by using an SMLLC to finance small businesses for a low-

⁴⁴ *Id.*

⁴⁵ See Announcement 99-102, 1999-2 C.B. 545, 545.

⁴⁶ See Form 990 (2016), <https://www.irs.gov/pub/irs-pdf/f990.pdf>. Question 33 of Part IV (Checklist of Required Schedules) asks if the organization owned “100% of an entity disregarded as separate.” *Id.* If the answer is yes, the form instructs the organization to fill out Part I of Schedule R, which requires information about related organizations and unrelated partnerships. See Schedule R (Form 990): *Related Organizations and Unrelated Partnerships* (2016), https://www.irs.gov/pub/irs-access/f990sr_accessible.pdf.

⁴⁷ See Schedule R (Form 990), *supra* note 46.

⁴⁸ See *Understanding IRS Guidance – A Brief Primer*, INTERNAL REVENUE SERV., <https://www.irs.gov/newsroom/understanding-irs-guidance-a-brief-primer> (last updated July 6, 2016) (“A private letter ruling, or PLR, is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer’s specific set of facts. . . . A PLR is issued in response to a written request submitted by a taxpayer and is binding on the IRS if the taxpayer fully and accurately described the proposed transaction in the request and carries out the transaction as described. A PLR may not be relied on as precedent by other taxpayers or IRS personnel. PLRs are generally made public after all information has been removed that could identify the taxpayer to whom it was issued.”).

⁴⁹ See, e.g., Priv. Ltr. Rul. 2016-30-008 (July 22, 2016); Priv. Ltr. Rul. 2001-34-025 (Aug. 24, 2001).

income population, was able to issue equity interests to investors.⁵⁰ Another charity, through an SMLLC, constructed, owned, and leased student housing.⁵¹

The number of charities using SMLLCs continues to grow. The author of a leading reference book on tax-exempt organizations marvels that the “use of LLCs by tax-exempt organizations was unanticipated; the extent of this use is phenomenal.”⁵²

III. GOVERNANCE AND FIDUCIARY DUTIES

A. Fiduciary Duties Generally

Fiduciary obligations arise in a number of circumstances, and the applicable circumstances have grown over time. As Tamar Frankel wrote in a classic article,

[t]rustees, administrators, and bailees are of ancient origin, whereas agents appeared only at the end of the eighteenth century. In the business realm, the fiduciary duties of partners, corporate directors, and officers originated with the formation of partnerships and corporations, but majority shareholders were not subjected to fiduciary duties until this century.⁵³

Professor Robert Sitkoff explains, “The law tends to impose fiduciary obligation in circumstances that present what economists call a *principal-agent* or *agency problem*. An agency problem arises whenever one person, the *principal*, engages another person, the *agent*, to undertake imperfectly observable discretionary actions, that affect the welfare of the principal.”⁵⁴ That is, “[i]n contrast to an arms-length relationship, in which each party is free to be self-serving, in a fiduciary relationship

⁵⁰ See Priv. Ltr. Rul. 2002-49-014 (Dec. 6, 2002).

⁵¹ See Priv. Ltr. Rul. 2003-04-036 (Jan. 24, 2003).

⁵² BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 1029 (11th ed. 2015). See generally Robert R. Keatinge, *LLCs and Nonprofit Organizations—For-Profits, Nonprofits, and Hybrids*, 42 SUFFOLK U. L. REV. 553 (2009).

⁵³ Tamar Frankel, *Fiduciary Law*, 71 CAL. L. REV. 795, 795–96 (1983) (footnotes omitted).

⁵⁴ Robert H. Sitkoff, *An Economic Theory of Fiduciary Law*, in PHILOSOPHICAL FOUNDATIONS OF FIDUCIARY LAW 198 (Andrew S. Gold & Paul B. Miller eds., 2014), <https://dash.harvard.edu/bitstream/handle/1/15274343/PhilosophicalFoundationsFiduciaryLaw.pdf?sequence=1> (last accessed July 23, 2017).

the law requires the fiduciary to be other-regarding because of the potential for abuse inherent to the agency structure of the relationship.”⁵⁵

Paul Miller views the fiduciary relationship somewhat differently:

[A] fiduciary relationship is one in which one party (the fiduciary) exercises discretionary power over the significant practical interests of another (the beneficiary).

....

... [Fiduciary power] ought to be understood as a form of *authority*. . . .

....

... Fiduciary power, and by extension the fiduciary relationship, thus enables one person to act purposively on behalf of another.⁵⁶

The classic fiduciary duties are those of loyalty and care. Professor Sitkoff summarizes them well:

The duty of *loyalty* proscribes misappropriation and appropriation and regulates conflicts of interest by requiring a fiduciary to act in the “best” or even “sole” interest of the principal. The fiduciary may obtain the principal’s consent to a conflict, but only in accordance with certain procedural and substantive safeguards, chief among them full and fair disclosure by the fiduciary. . . .

The duty of *care* prescribes the fiduciary’s standard of care by establishing a “reasonableness” or “prudence” standard that is informed by industry norms and practices. The fiduciary standard of care is objective, measured by reference to a reasonable or prudent person in like circumstances.⁵⁷

As discussed below, these duties of loyalty and care play out very differently in the context of LLCs and of charities.

⁵⁵ *Id.* at 207.

⁵⁶ Paul B. Miller, *Justifying Fiduciary Duties*, 58 MCGILL L.J. 969, 1011–12, 1019 (2013) (footnotes omitted).

⁵⁷ Sitkoff, *supra* note 54, at 201–02.

B. Fiduciary Duties and LLCs

The appropriate role of fiduciary duties for LLCs is a matter of intense dispute and debate.⁵⁸ Professor Sandra Miller has described four major approaches to addressing fiduciary duties in alternative entities, including LLCs.⁵⁹ The first and traditional approach makes the duties of loyalty and care mandatory.⁶⁰ The second treats the duties of loyalty and care as default terms that can be modified but not eliminated by contract.⁶¹ The third treats the duties of loyalty and care as default terms, but default terms that can be eliminated by contract.⁶² The fourth treats the absence of fiduciary duties as the default position and requires parties to contract expressly for any desired fiduciary duties.⁶³

Professor Miller places the Revised Uniform Limited Liability Company Act (Re-ULLCA) in the second category, making duties of loyalty and care default terms while permitting modification, but not the elimination of duties.⁶⁴ In 2006 the drafters of the Re-ULLCA recognized that “[o]ne of the most complex questions in the law of unincorporated business organizations is the extent to which an agreement among the organization’s owners can affect the law of fiduciary duty.”⁶⁵ Unlike the Uniform Limited Liability Company Act, which

⁵⁸ See *Gatz Props. LLC v. Auriga Capital Corp.*, 59 A.3d 1206, 1218 n.62 (Del. 2012) (disagreeing with the Chancery Court that general fiduciary duties apply when agreement is silent and stating “the question remains open”); *Bay Ctr. Apartment Owners, LLC v. Emery Bay PKI, LLC*, No. 3658-VCS, 2009 Del. Ch. LEXIS 54 (Del. ch. Apr. 20, 2009) (unpublished). After the Supreme Court opinion in *Auriga*, the Delaware legislature answered the question by enacting the following language: “In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern.” DEL. CODE ANN. tit. 6, sec. 18-1104. See generally 1 LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES ch. 9 (2d June 2017); 2 BISHOP & KLEINBERGER, *supra* note 6, at ch. 10.

⁵⁹ See Sandra K. Miller, *Legal Realism, the LLC and a Balanced Approach to the Implied Covenant of Good Faith and Fair Dealing*, 45 WAKE FOREST L. REV. 729, 732–33 (2010).

⁶⁰ See *id.*

⁶¹ See *id.*

⁶² See *id.*

⁶³ See *id.*

⁶⁴ See Sandra K. Miller, *The Best of Both Worlds: Default Fiduciary Duties and Contractual Freedom in Alternative Business Entities*, 39 J. CORP. L. 295, 295 (2014). She is particularly enamored with the California modification of Re-ULLCA. See *id.*

⁶⁵ REVISED UNIF. LTD. LIAB. CO. ACT 77 § 110 cmt., 6C U.L.A. 267 (2016).

sought to list and codify exhaustively all relevant fiduciary duties, Re-ULLCA “un-cabins” fiduciary duty, believing that the “cabin” approach creates more problems than it solves.⁶⁶ The Re-ULLCA Prefatory Note explains that

- [t]he better way to protect the operating agreement from judicial second-guessing is to:
 - increase and clarify the power of the operating agreement to define or re-shape fiduciary duties (including the power to eliminate aspects of fiduciary duties); and
 - provide some guidance to courts when a person seeks to escape an agreement by claiming its provisions are “manifestly unreasonable.”⁶⁷

An LLC, including an SMLLC, generally has the option of being managed by a manager or being managed by its members pursuant to its operating agreement.⁶⁸ Under section 409(d) of Re-ULLCA, “[a]

⁶⁶ See Daniel S. Kleinberger & Carter G. Bishop, *The Next Generation: The Revised Uniform Limited Liability Company Act*, 62 BUS. LAW. 515, 523 (2007) (footnotes omitted) (“The ‘cabin-in’ approach ignores the implicit fiduciary or fiduciary-like duty of members to avoid oppressing fellow members, produces great difficulty in dealing with member-to-member disclosure obligations in member-to-member buy-sell transactions, and puts inordinate pressure on the concept of ‘good faith and fair dealing.’”).

⁶⁷ REVISED UNIF. LTD. LIAB. CO. ACT Prefatory Note, 6C U.L.A. 226–27.

⁶⁸ For example, Delaware statutory law states:

Unless otherwise provided in the limited liability company agreement, a member or manager of a limited liability company has the power and authority to delegate to 1 or more other persons the member’s or manager’s, as the case may be, rights and powers to manage and control the business and affairs of the limited liability company, including to delegate to agents, officers and employees of a member or manager or the limited liability company, and to delegate by a management agreement or another agreement with, or otherwise to, other persons. Unless otherwise provided in the limited liability company agreement, such delegation by a member or manager shall be irrevocable if it states that it is irrevocable. Unless otherwise provided in the limited liability company agreement, such delegation by a member or manager of a limited liability company shall not cause the member or manager to cease to be a member or manager, as the case may be, of the limited liability company or cause the person to whom any such rights and powers have been delegated to be a member or manager, as the case may be, of the limited liability company.

member in a member-managed limited liability company or a manager-managed limited liability company shall discharge the duties under this [act] or under the operating agreement and exercise any rights consistently with the contractual obligation of good faith and fair dealing.”⁶⁹ The comment to section 409(d) explains:

[T]he obligation should be used only to protect agreed-upon arrangements from conduct that is manifestly beyond what a reasonable person could have contemplated when the arrangements were made. . . . In sum, the purpose of the obligation of good faith and fair dealing is to protect the arrangement the partners have chosen for themselves, not to restructure that arrangement under the guise of safeguarding it.⁷⁰

Thus, the broad definition of operating agreement, as found in section 110, is key to Re-ULLCA. Nonetheless, section 110 imposes some limits on the extent to which the operating agreement can eliminate the duty of loyalty, the duty of care, or any other fiduciary duty.⁷¹

The late Larry Ribstein was critical of Re-ULLCA: “RULLCA muddles the definition of fiduciary duties and adds unacceptable complexity to the LLC contracting process.”⁷² He was particularly critical of its good faith provision. He explained:

The obligation of good faith and fair dealing is best viewed as a way to interpret long-term contracts, including those for business associations like limited liability companies. . . . RULLCA’s awkward formulation may

DEL. CODE ANN. tit. 6, § 18.407.

⁶⁹ REVISED UNIF. LTD. LIAB. CO. ACT § 409(d), 6C U.L.A. 323.

⁷⁰ *Id.* § 409 cmt., 6C U.L.A. 325 (quoting ULPA (2001), § 305(b)).

⁷¹ *See id.* § 110(c)(4), 6C U.L.A. 265. Under that section, if “not manifestly unreasonable,” an operating agreement may “identify specific types or categories of activities that do not violate the duty of loyalty”; “alter the duty of care, except to authorize intentional misconduct or knowing violation of law”; “alter any other fiduciary duty, including eliminating particular aspects of that duty” and “prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing. . . .” *Id.* § 110(d)(2)–(4), 6C U.L.A. 266. In addition, section 407(c) of Re-ULLCA states that in a manager-managed limited liability company, “any matter relating to the activities of the company is decided exclusively by the managers.” *Id.* § 407(c)(1), 6C U.L.A. 317.

⁷² Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 35, 62 (2008).

lead a court to apply some version of the good faith obligation that is not based on the contract whenever the parties have not addressed the good faith obligation explicitly.⁷³

As his comments demonstrate, Ribstein preferred freedom of contract and judicial interpretation.⁷⁴ Debate about the extent to which an LLC should be viewed as a purely contractual, rather than a fiduciary, relationship is long-standing. For Ribstein, “detailed case analysis reveals that the courts have done a good job of interpreting and applying limited partnership agreements under the Delaware freedom-of-contract regime.”⁷⁵ The former Chief Justice of the Delaware Supreme Court wrote, that when dealing with unincorporated business entities, “courts should look to the parties’ agreement and apply a contractual analysis rather than analogizing to traditional notions of corporate governance.”⁷⁶

Many LLCs are formed in Delaware⁷⁷ in part because Delaware LLC law proclaims its intent is “to give the maximum effect to the principle of freedom of contract”⁷⁸ Delaware falls into Miller’s third category—it permits LLCs to eliminate fiduciary duties:

To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement

⁷³ *Id.* at 72.

⁷⁴ See generally Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. CORP. L. 407 (1999).

⁷⁵ Ribstein, *supra* note 72, at 67.

⁷⁶ Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 1 (2007). Miller views Justice Steele’s position as falling into the fourth category—a default rule of no fiduciary duties. See *Legal Realism, the LLC and a Balanced Approach*, *supra* note 59, at 733.

⁷⁷ See Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 559 (2012).

⁷⁸ DEL. CODE ANN. tit. 6, § 18-1101.

may not eliminate the implied contractual covenant of good faith and fair dealing.

....

A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.⁷⁹

Recent empirical studies of publicly available LLC operating agreements have found that LLCs frequently modify fiduciary duties.⁸⁰

As the quoted provisions demonstrate, Delaware, like Re-ULLCA, relies heavily on “good faith and fair dealing.”⁸¹ According to Professor Andrew Gold, Delaware law has expanded fiduciary duties beyond the traditional duties of care and loyalty to make good faith itself a fiduciary duty:

The Delaware Supreme Court views the fiduciary good faith duty as a freestanding fiduciary duty that can be violated independently from a violation of the duties

⁷⁹ *Id.*

⁸⁰ See Michelle H. Harner & Jamie Marincic, *The Naked Fiduciary*, 54 ARIZ. L. REV. 879, 882 (2012); Manesh, *supra* note 77, at 557. Manesh found almost 75 (or 88%) of the firms he studied “either totally waive the fiduciary duties of managers or eliminate liability arising from breach of fiduciary duties.” Manesh, *supra* note 77, at 558. He finds his study to suggest “that firms have used alternative entity law to reduce managerial accountability without committing to offsetting constraints to limit or better align managerial discretion.” *Id.* at 596. As discussed *infra*, managerial accountability is crucial for SMLLCs of charities. See *infra* Part IV. Harner and Marincic find that LLC operating agreements are more likely to modify members’ duty of loyalty. See Harner & Marincic, *supra*, at 882. The Draft ALI Restatement of the Law of Charitable Nonprofit Organizations suggests that charities are more likely to modify duty of care. See RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 2.04 cmt. b (AM. LAW INST., Tentative Draft No. 1, 2016).

⁸¹ DEL. CODE ANN. tit. 6, § 18-1101.

of loyalty or care. Although the precise meaning of an independent fiduciary duty of good faith is not yet fully clear, this duty may cover instances where a fiduciary acts egregiously, intentionally abdicating their obligations in ways that do not implicate gross negligence or conflicts of interest. For example, where a duty of candor is intentionally violated, without the existence of a conflict of interest, this could be a breach of the fiduciary's duty of good faith.⁸²

The Delaware Supreme Court, however, quickly disagreed with this interpretation. In a 2006 opinion, it explained that a "failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,] i.e., a condition of 'the fundamental duty of loyalty.'"⁸³

Nonetheless, both Re-ULLCA and Delaware law assume a strong contractarian basis for LLC law. Parties are assumed to be dealing at arms-length and able to protect themselves. Members of LLCs who waive or modify fiduciary duties do not perceive themselves as being subject to a principal-agent problem.⁸⁴

C. Fiduciary Duties and Charities

In contrast to many LLCs, charities face a severe principal-agent problem. As Professor Evelyn Brody has articulated so well, governing bodies of charities generally operate as "agents without principals."⁸⁵ Most governing bodies of charities are self-perpetuating; they choose their own successors rather than face election by members.⁸⁶ To qualify

⁸² Andrew S. Gold, *On the Elimination of Fiduciary Duties: A Theory of Good Faith for the Unincorporated Entity*, 41 WAKE FOREST L. REV. 123, 133 (2006). Charitable law does not view good faith as an independent fiduciary duty. *See infra* notes 104–9.

⁸³ *Stone v. Ritter ex rel AmSouth Bank Corp.*, 911 A.2d 362, 369–70 (Del. 2006) (footnote omitted).

⁸⁴ *See* Gold, *supra* note 82, at 133–38 (discussing contractual rights and the use of good faith as a gap filler).

⁸⁵ Evelyn Brody, *Agents Without Principals: The Economic Convergence of the Nonprofit and For-Profit Organizational Form*, 40 N.Y.L. SCH. L. REV. 457, 465 (1996).

⁸⁶ *See* Donald W. Kramer, *Nonprofit Board of Directors 101: What You Must Know*, 2014 Ann. Meeting 16 (Aug. 9, 2014) (citing *The Key Question: Whose Organization is It?*, NONPROFIT ISSUES, Feb. 2013), https://www.americanbar.org/content/dam/aba/events/gpsolo/2014/08/2014_aba_gpsolo_annual/gpsolo_2014_annual_cle_materials.auth_checkdam.pdf ("Usually ['best practices' commentators] envision a self-perpetuating Board of Directors drawn from the community to serve a limited number of terms and

as a charity, an organization must serve a large and indefinite charitable class.⁸⁷ Such beneficiaries cannot sue to require charities to carry out their exempt purpose. Unlike the case with private trusts, there are no identifiable beneficiaries able to sue to ensure that a charity's governing board fulfills its obligations.

Donors are another potential source of charitable oversight. Whether donors can exercise oversight by reserving standing to enforce their own charitable gifts is currently a matter of intense debate.⁸⁸ Many gift agreements now include enforcement rights, but donor standing can also depend on whether the charity is organized as a nonprofit corporation or as a trust. Section 405 of The Uniform Trust Code confers donor standing to enforce charitable trusts⁸⁹ and Restatement (Third) of Trusts section 94(2) does the same.⁹⁰ "A majority of states now grant standing to plaintiffs based on their status as donors to charitable trusts."⁹¹ Courts have not extended the same across-the-board standing rights for donors to nonprofit corporations.⁹² Moreover, a right to enforce a particular charitable gift, whether under trust law or a gift agreement, does not grant the donor the authority to enforce the organization's charitable purposes more generally.

In fact, Henry Hansmann, probably the leading theorist of nonprofit law, concludes that nonprofit firms are particularly appropriate:

[I]n situations characterized . . . as 'contract failure'—that is, situations in which, owing either to the nature of the service in question or to the circumstances under which it is produced and consumed, ordinary contractual

then rotate off the Board. They reflect an assumption that the directors represent 'the public' and run the organization in the public interest.").

⁸⁷ See Charitable Class Requirement, IRM 7.25.3.37 (Feb. 23, 1993); Ellen P. Aprill, *Charitable Class, Disaster Relief, and First Responders*, 153 TAX NOTES 949 (2016).

⁸⁸ See, e.g., Reid Kress Weisbord & Peter DeScioli, *The Effects of Donor Standing on Philanthropy: Insights from the Psychology of Gift Giving*, 45 GONZ. L. REV. 225 (2010); Iris Goodwin, *Donor Standing to Enforce Charitable Gifts: Civil Society vs. Donor Empowerment*, 58 VAND. L. REV. 1093 (2005); Brian Galle, *Valuing the Right to Sue: An Empirical Examination of Nonprofit Agency Costs*, 60 J.L. & ECON. (forthcoming 2017).

⁸⁹ See UNIF. TR. CODE (amended 2010), 7C U.L.A. 485–88 (2006).

⁹⁰ See RESTATEMENT (THIRD) OF TR. § 94(2) (AM. LAW INST. 2012).

⁹¹ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 5.03 (AM. LAW INST., Tentative Draft No. 3, 2016) (on file with author).

⁹² See *id.*

devices in themselves do not provide consumers with adequate means for policing the performance of producers. . . .⁹³

Hansmann further explains: “[T]he individuals who receive the services in question have no connection with the individuals who pay for them.”⁹⁴

As a result, the need for fiduciary duties for nonprofit managers is pronounced. According to Hansmann,

[t]he advantage of the nonprofit form in such circumstances is that it makes the producer a *fiduciary* for its purchases, and thus gives [both donors to nonprofit organizations and consumers of their goods or services] greater assurance that the services they desire will in fact be performed as they wish.

. . . .

. . . In such situations, the nonprofit form offers consumers the protection of another, broader ‘contract’—namely the organization’s commitment, through its nonprofit charter, to devote all of its income to the services it was formed to provide.⁹⁵

He asserts that, in a nonprofit, “the fiduciary obligations imposed on controlling persons are for the benefit of the organization’s patrons—that is, its donors and customers.”⁹⁶ He believes that “the essential role of the

⁹³ Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 505–07 (1981). Similarly, Lester M. Salamon writes that nonprofits are often chosen when there is market failure, where information asymmetries exist, and where the purchasers of services are not the same as the consumers. “In such situations, the purchasers unable to assess the adequacy of services themselves, seek some substitute for the market mechanism, some provider they can trust. Because nonprofits do not exist principally to earn profits, they often are preferred providers in such situations.” LESTER M. SALAMON, *AMERICAN’S NONPROFIT SECTOR: A PRIMER* 12 (2d ed. 1999).

⁹⁴ Hansmann, *supra* note 93, at 505.

⁹⁵ *Id.* at 504, 507 (emphasis added). Hansmann’s approach has a number of critics. See Richard Steinberg & Bradford Gray, “*The Role of Nonprofit Enterprise*” in 1993: *Hansmann Revised*, 22 NONPROFIT & VOLUNTARY SECTOR Q. 297 (1993); Rob Atkinson, *Altruism in Nonprofit Organizations*, 31 BOS. C. L. REV. 501 (1990); Ira Mark Ellman, *Another Theory of Nonprofit Corporations*, 80 MICH. L. REV. 999 (1982).

⁹⁶ Hansmann, *supra* note 93, at 568.

nonprofit organization is to serve as a fiduciary for its patrons in situations of contract failure.”⁹⁷

In most states, the state Attorney General is responsible for ensuring that controlling persons of nonprofits fulfill their fiduciary duties.⁹⁸ In many states, however, Attorneys General lack resources to do so.⁹⁹ Given the limited ability of mechanisms to police the managers of nonprofits, Hansmann argues for “a stronger, clearer rule of fiduciary conduct for managers of nonprofit corporations than for managers of business corporations.”¹⁰⁰

Professor Paul Miller and Professor Robert Sitkoff’s understanding of fiduciary duties illuminates Hansmann’s argument. On one hand, Hansmann appears to treat patrons as principals with little, if any, ability to control nonprofit managers as their agents.¹⁰¹ Under this view, fiduciary duties resolve the principal-agent problem.¹⁰² On the other hand, Hansmann’s patrons are so far removed from nonprofit managers that we could describe him as taking the position that, regarding nonprofit organizations, fiduciary duties substitute for rather than reinforce the principal-agent relationship.¹⁰³ That is, like Professor Paul Miller, Hansmann seems to see fiduciary duties as giving nonprofit managers authority to act purposively on behalf of others even in the absence of a clear principal-agent relationship.

Under either view, application of the traditional duties of loyalty and care is crucial for the operation of nonprofit organizations. In the case of charities, the duties of care and loyalty owed by members of the governing body of a charity ensure that the organization carry out its exempt function for the benefit of its current and future beneficiaries.

⁹⁷ *Id.* at 508–09.

⁹⁸ *See generally* MARION FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION ch. 6 (2004).

⁹⁹ *See id.* 301–427; Lloyd Hitoshi Mayer, *Fragmented Oversight of Nonprofits in the United States: Does It Work? Can It Work?*, 91 CHI.-KENT L. REV. 937, 939–41 (2016); CINDY M. LOTT ET AL., STATE REGULATION AND ENFORCEMENT IN THE CHARITABLE SECTOR, 10–12 (URB. INST. 2016), <http://www.urban.org/sites/default/files/publication/84161/2000925-State-Regulation-and-Enforcement-Charitable-sector.pdf>.

¹⁰⁰ Hansmann, *supra* note 93, at 568–69.

¹⁰¹ *See id.* at 568.

¹⁰² *See id.*

¹⁰³ *See id.* 568–69.

These fiduciary duties involve a requirement of good faith.¹⁰⁴ Given the prominence of good faith under Re-ULLCA and Delaware LLC law, how charitable law understands good faith is particularly important. The 2016 Draft ALI Restatement of the Law, Charitable Nonprofit Organizations¹⁰⁵ (Draft ALI Restatement) instructs that charitable fiduciaries must “act in good faith and in a manner the fiduciary reasonably believes to be in the best interests of the charity in light of its purposes”¹⁰⁶ and that the “twin duties of loyalty and care address the obligations that fiduciaries owe to advance a charity’s purpose.”¹⁰⁷

Indeed, according to the Draft ALI Restatement,

[t]he requirement “to act in good faith” is neither an independent fiduciary duty nor a separate requirement of the duty of loyalty. Rather, a threshold requirement for fiduciaries is that they hold a subjective belief that they are acting in the best interests of the charity in light of its purposes. Acting in good faith also means that a fiduciary cannot act with conscious disregard for the charity’s best interests, meaning that a fiduciary must be faithful in defining and carrying out the charity’s purposes. A fiduciary’s good-faith belief in what is the best interest

¹⁰⁴ See generally 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, 723–25 (2008); Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Proposed Reforms*, 23 J. CORP. L. 631, 644 (1988); Thomas Lee Hazen & Lisa Love Hazen, *Punctilios and Nonprofit Corporate Governance—A Comprehensive Look at Nonprofit Directors’ Fiduciary Duties*, 14 U. PA. J. BUS. L. 347, 349, 385–86, 397 (2012).

¹⁰⁵ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. (AM. LAW INST., Tentative Draft No. 1, 2016). The very purpose of an ALI Restatement is to “address uncertainty in the law through a restatement of basic legal subjects that would tell judges and lawyers what the law was.” AM. LAW INST., *Institute Projects*, <https://www.ali.org/about-ali/institute-projects/>. The Draft ALI Restatement seeks to make the rules for charities organized as trusts and those organized as corporations as similar as possible: “The black letter rules in this Restatement generally apply to all entities meeting the definition of a charity regardless of their legal form.” RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 101 cmt. b. Not all agree with such a goal. The Draft ALI Restatement recognizes that differences remain between corporations and trusts, in particular the manner in which entities in each category are created. See *id.* The author of this Article is one of the advisers for the Draft ALI Restatement.

¹⁰⁶ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 2.02(a).

¹⁰⁷ *Id.* § 2.02 cmt. a.

of the charity must be objectively reasonable in light of its purposes.¹⁰⁸

The Draft ALI Restatement later reiterates, “The requirement to act in good faith is not a separate duty, but rather an element of the duties of care and loyalty.”¹⁰⁹

For charities, “[t]he duty of loyalty ordinarily encompasses fraud, self-dealing, and improper diversion of corporate assets or corporate opportunities when a fiduciary’s interests conflict with the interests of the charity to its detriment.”¹¹⁰ In the case of nonprofit organizations, understanding of fiduciary duty has been further complicated by the fact that exempt organizations are organized as trusts as well as corporations; thus, questions arise as to whether fiduciary duties differ across various organizational forms.¹¹¹

Robert K. Sitkoff asserts that “trust fiduciary law, especially the duty of loyalty, is stricter and more prophylactic than the fiduciary law of other organizational forms.”¹¹² Under what has long been known as the “no further inquiry rule,” a trustee is per se liable so long as a beneficiary shows that the trustee had a personal interest in the transaction; harm to the trust is irrelevant.¹¹³ In such a case, the trustee must disgorge any profits from a self-interested transaction.¹¹⁴

Restatement (Third) of Trusts section 78(2) states that a “trustee is strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee’s fiduciary duties and personal interests.”¹¹⁵ A comment to this section explains that “it is immaterial that the trustee may be able to show that the action in question was taken in good faith, that the terms of the transaction were fair, and that no profit resulted to the trustee.”¹¹⁶ There

¹⁰⁸ *Id.* § 2.02 cmt. c.

¹⁰⁹ *Id.* § 2.02 cmt. (c)(8).

¹¹⁰ *Id.* § 2.02 cmt. a. Parts of the following discussion of self-dealing rely on my own earlier work.

¹¹¹ See generally Ellen P. Aprill, *Reconciling Nonprofit Self-Dealing Rules*, 48 REAL PROP. TR. & EST. L.J. 411 (2014).

¹¹² Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 680 (2004).

¹¹³ See Melanie Leslie, *Helping Nonprofits Police Themselves: What Trust Law Can Teach Us about Conflicts of Interest*, 85 CHI.-KENT L. REV. 551, 556 (2010).

¹¹⁴ See *id.*

¹¹⁵ RESTATEMENT (THIRD) OF TR. § 78(2) (AM. LAW INST. 2007).

¹¹⁶ *Id.* § 78 cmt b.

is no need for the beneficiaries to prove damages for the trustee to be guilty of a breach of loyalty and for the trustee to be required to disgorge any profit.¹¹⁷ “Courts invalidate a conflicted transaction without regard to its merits—‘not because there *is* fraud, but because there *may* be fraud.’”¹¹⁸

The prohibition against self-dealing by trustees is not absolute.¹¹⁹ Beneficiaries can ratify such self-dealing transactions.¹²⁰ Trust law permits transactions between a trust and a trustee if the settlor authorizes self-dealing in the trust instrument or if the trustee, after full disclosure, obtains advance approval of the trust beneficiaries or a court.¹²¹ Moreover, trust settlors often have modified the duty of loyalty itself, including exculpatory provisions.

Most tax-exempt organizations, however, are formed as nonprofit corporations.¹²² In the case of state nonprofit corporate law, the requirements for allowing self-dealing are generally easy to satisfy.¹²³ The 1987 Revised Model Nonprofit Corporation Act, for example, permits approval of a transaction in which a director has an interest if: (1) approval is obtained in advance by vote of the board, and (2) either the material facts of the transaction and the director’s interest are disclosed or known to the board or committee of the board, or (3) the directors approving the transaction in good faith reasonably believe that the transaction is fair to the corporation.¹²⁴ Under the 2008 Model Nonprofit Corporation Act, a self-dealing transaction is not voidable if the material facts are disclosed or known, a majority of disinterested directors or of members vote affirmatively, or if “the contract or transaction is fair as to the corporation

¹¹⁷ See Leslie, *supra* note 113, at 556.

¹¹⁸ John H. Langbein, *Questioning the Trust Duty of Loyalty: Sole Interest or Best Interest*, 114 YALE L.J. 929, 931 (2005) (quoting *Piatt v. Longworth’s Devises*, 27 OHIO ST. 159, 195–96 (1875)).

¹¹⁹ See Leslie, *supra* note 113, at 558.

¹²⁰ See MARION FREMONT-SMITH, *FOUNDATIONS AND GOVERNMENT* 136 (1965); see also MARION FREMONT-SMITH, *supra* note 98, at 196 (describing the change in modern trust law away from an absolute prohibition on self-dealing).

¹²¹ See Leslie, *supra* note 113, at 556.

¹²² See Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1429 (1998).

¹²³ See *id.* at 1424.

¹²⁴ See REVISED MODEL NONPROFIT CORP. ACT § 8.31 (AM. BAR ASS’N 1987). About half the states have adopted the Revised Nonprofit Model Corporation Act. See RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 1.02 reporter’s notes cmt. b(2)(11) (AM. LAW INST., Tentative Draft No. 1, 2016).

as of the time it is . . . approved”¹²⁵ That is, fairness of the transaction is not required, but it serves as an alternative basis for protecting the transaction.¹²⁶

In the case of tax-exempt charities, tax law provides its own set of requirements regarding the duty of loyalty.¹²⁷ Since the Tax Reform Act of 1969, section 4941 of the Code has forbidden almost all self-dealing, direct or indirect, between a disqualified person and a private foundation¹²⁸ other than reasonable compensation for services.¹²⁹ There is no way to obtain approval for such a transaction before or after the fact.¹³⁰ Section 4958 and the applicable regulations, known as the intermediate sanction regime, establish a series of substantive and procedural requirements to ensure that the value of any benefit received by directors and other insiders of a public charity (or a section 501(c)(4) organization) does not exceed the consideration received by the organization receiving the benefit.¹³¹ A set of two-tier excise taxes sanctions violations of both sets of rules.¹³²

¹²⁵ MODEL NONPROFIT CORP. ACT § 8.60(a) (AM. BAR ASS’N 2008).

¹²⁶ As discussed *infra* Part IV, whatever state law provides, the directors of private foundations cannot engage in self-dealing transactions.

¹²⁷ See generally Johnny R. Buckles, *The Federalization of the Duty of Loyalty Governing Charity Fiduciaries Under United States Tax Law*, 99 KY. L.J. 645 (2011).

¹²⁸ Private foundations are those section 501(c)(3) organizations that, in general, receive their support from a single individual or corporate source or family group and make grants to other operating charitable organizations. See I.R.C. § 509(a). Private foundations are subject to a set of excise taxes that operate as prohibitions. Certain traditional charities, such as schools, hospitals, churches, charities that receive broader support from the public or the government, and charities with certain close relationships to publicly supported charities are known as public charities. See *id.*

¹²⁹ See I.R.C. § 4941(d)(2)(E).

¹³⁰ See Buckles, *supra* note 127, at 678. Professor Buckles calls this stringent self-dealing rule for private foundations a “supra-trustee” standard. *Id.*

¹³¹ An unreasonable benefit is called an “excess benefit.” See *id.* at 667. Under the intermediate sanction rules, the category of disqualified persons who are subject to tax for engaging in an excess benefit transactions includes “any person who was, at any time during the 5-year period [preceding the excess benefit transaction] . . . in a position to exercise substantial influence over the affairs of the organization.” I.R.C. § 4958(f)(1)(A); Treas. Reg. § 53.4958-3(a)(1). The category also includes certain members of the family of a disqualified person and certain controlled entities. See I.R.C. § 4958(f)(1)(B)–(C); see also Treas. Reg. § 53.4958-3(b). Officers, directors, and trustees are per se disqualified persons. See Treas. Reg. § 53.4958-3(c)(1)–(3). Whether other individuals or entities are disqualified persons because they exercise substantial influence is a matter of facts and circumstances, see Treas. Reg. § 53.4958-3(e), with exceptions including whether an individual receives economic benefits less than the amount for a

The Draft ALI Restatement follows the language of the Revised Model Nonprofit Corporation Act and defines the duty of loyalty:

A fiduciary has a duty to:

- (a) act in good faith and in a manner the fiduciary reasonably believes to be in the best interests of the charity in light of its purposes;
- (b) address reasonably situations that involve the potential for self-dealing in which the interests of a fiduciary or related person may conflict with the interests of the charity; and
- (c) seek court application of the doctrine of cy pres or deviation when such relief is appropriate.¹³³

Some would add a special duty of obedience. In *In re Manhattan Eye, Ear & Throat Hospital v. Spitzer*,¹³⁴ the court found that the duty of obedience requires the directors of a charity that was a corporation to remain faithful to the corporation's purposes and goals.¹³⁵ Daniel Kurtz has defined the duty of obedience as prohibiting charitable fiduciaries from deviating in any substantial way from the purposes of the charity.¹³⁶ Others, including the Draft ALI Restatement, reject the concept of a separate duty of obedience and, instead, define "the duty of loyalty broadly to include a duty to assure that charitable purposes continue to benefit the community, which is the ultimate beneficiary of all charities, when changed circumstances require their modification."¹³⁷

highly compensated employee under I.R.C. section 414(q)(1)(B)(i); see Treas. Reg. § 53.4958-3(d)(3)(i).

¹³² See I.R.C. § 4941(a)(1) (setting an initial tax of 10%); I.R.C. § 4941(b) (levying a 200% second tier tax if self-dealing uncorrected); I.R.C. § 4958(a)(1) (setting an initial tax of 25%); I.R.C. § 4958(b) (levying a second tier tax of 200% if self-dealing is uncorrected).

¹³³ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 2.02 (AM. LAW INST., Tentative Draft No. 1, 2016).

¹³⁴ 715 N.Y.S.2d 575 (N.Y. Sup. Ct. 1999); see DANIEL L. KURTZ, BOARD LIABILITY 84–85 (1989); see also Rob E. Atkinson, *Obedience as the Foundation of Fiduciary Duty*, 34 J. CORP. L. 43 (2008); Linda Sugin, *Resisting the Corporatization of Nonprofit Governance: Transforming Obedience into Fidelity*, 76 FORDHAM L. REV. 893 (2008).

¹³⁵ See *Spitzer*, 715 N.Y.S.2d at 593.

¹³⁶ See KURTZ, *supra* note 134, at 84–85.

¹³⁷ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 2.02 reporter's notes cmt. 3(c).

The duty of care is a duty to oversee the charitable organization. “It is sometimes known as the duty of attention and characterized as including a duty to be adequately informed when making important decisions for the charity.”¹³⁸ Again, trustees have traditionally been held to a high standard of care. Restatement (Third) of Trusts section 77 requires a trustee to “administer the trust as a prudent person would, in light of the purposes, terms, and other circumstances of the trust” and to exercise “reasonable care, skill, and caution.”¹³⁹ Settlers, however, often provide relief from the strict standard of prudence for trustees. As Professor Brody has written, “[T]he modern trust standard—whether because of settlor direction, legislation, or even court decision—less frequently operates more ‘strictly’ than the corporate standard.”¹⁴⁰

Following *Stern v. Lucy Webb Hayes National Training School for Deaconesses*,¹⁴¹ courts have generally applied the duty of care developed for business corporations to nonprofit corporations. As the Uniform Prudent Management of Institutional Funds Act observes, the duty of care derived from the Revised Model Nonprofit Act of 1987 “is consistent with the business judgment standard under corporate law, as applied to charitable institutions.”¹⁴² That is, courts take into account the corporation’s purpose when applying fiduciary standards.

The Draft ALI Restatement follows the standard of corporate law and the Revised Model Nonprofit Corporation Act, although, unlike them, the Draft ALI Restatement separates the duty of care from the duty of loyalty.¹⁴³ Moreover, the Draft ALI Restatement applies the standard to all charities regardless of legal form.¹⁴⁴ It articulates the duty of care and business judgment rule as follows:

- (a) A fiduciary of a charity has a duty to act in good faith with the care a person of ordinary prudence in a like position would exercise under similar circumstances.

¹³⁸ *Id.* § 2.03 cmt. a.

¹³⁹ RESTATEMENT (THIRD) OF TR. § 77 (AM. LAW INST. 1990).

¹⁴⁰ Evelyn Brody, *Charity Governance: What’s Trust Law Got to Do with It?*, 80 CHI.-KENT L. REV. 641, 652 (2005).

¹⁴¹ 381 F. Supp. 1003 (D.D.C. 1974). The case is generally known as the *Sibley Hospital* case.

¹⁴² UNIF. PRUDENT MGMT. OF INST. FUNDS ACT § 3 cmt. (UNIF. LAW COMM’N 2006).

¹⁴³ See REVISED MODEL NONPROFIT CORP. ACT § 8.30 (AM. BUS. ASS’N 1987).

¹⁴⁴ *See id.*

(b) A fiduciary of a charity who makes a business decision in good faith will not be subject to further review for breach of the duty of care under subsection (a) for a particular decision if, at the time the decision is made, the fiduciary:

(1) has no interest, direct or indirect, in the subject of the business decision and is otherwise able to exercise independent judgment;

(2) is reasonably informed with respect to the subject of the decision using material information reasonably available under the circumstances; and

(3) reasonably believes that the business decision is in the best interests of the charity in light of its purposes.¹⁴⁵

Importantly for this Article, the governing documents of a charity may modify both the duty of care and of loyalty or provide exculpation for certain breaches of fiduciary duty.¹⁴⁶ Traditionally, without modification of the governing instrument a trustee could be held liable for a negligent violation of a fiduciary duty—even if the fiduciary acted in good faith¹⁴⁷—while a fiduciary of a nonprofit corporation was liable only for gross negligence or acts performed in bad faith.¹⁴⁸ Organizing documents of trust, however, commonly modify fiduciary duties to the extent possible.¹⁴⁹

According to the Draft ALI Restatement,

[a]lthough charities are most likely to relax the duty of care, courts will uphold modifications to duties of both care and loyalty. Modifications to the duty of care typically are allowed when there is no evidence of bad faith or attendant violations of the duty of loyalty involving self-dealing. Charities generally are less likely

¹⁴⁵ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 2.03 (AM. LAW INST., Tentative Draft No. 1, 2016).

¹⁴⁶ *See id.* § 2.04.

¹⁴⁷ *See id.* § 2.04 cmt. (a)(3).

¹⁴⁸ *See id.*

¹⁴⁹ *See id.*

to modify, and are often prohibited from modifying the duty of loyalty. Weakening the duty of loyalty too much would allow the members of the board to benefit themselves rather than the charity and would, therefore, fundamentally undermine the goals of fiduciary duties.¹⁵⁰

Delaware is particularly permissive regarding the corporate duty of loyalty regarding business opportunities.¹⁵¹ Under Delaware law applicable to both for-profit and nonstock corporations, a corporation has the power to

[r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.¹⁵²

Delaware also permits the articles of incorporation of a corporation, including charities, to include, with certain restrictions, “[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.”¹⁵³

Delaware law, however, also provides that provisions exculpating fiduciaries of a corporation for violations of fiduciary duties may

not eliminate or limit the liability of a director: (i) [f]or any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; . . . or (iv) for any transaction from which the director derived an improper personal benefit.¹⁵⁴

¹⁵⁰ *Id.* § 2.04 cmt. b.

¹⁵¹ Delaware does not have a separate nonprofit statute but only provisions within its corporate code that refer to nonstock corporations.

¹⁵² DEL. CODE ANN. tit. 8, § 122(17).

¹⁵³ *Id.* tit. 8, § 102(b)(7).

¹⁵⁴ *Id.*

Thus, the Delaware corporate standards are stricter than those in its LLC provisions.

As Professor Brody has written about charities, “both trust and corporate law demands certain minimum fiduciary standards that cannot be waived or exculpated, and these minimum fiduciary standards seem to be the same for both charity trustees and directors.”¹⁵⁵ Such a regime stands in sharp contrast to much of LLC law, as discussed above. The Draft ALI Restatement offers the following as black letter law regarding modification of fiduciary duties and exculpation of fiduciaries:

The governing documents of a charity may contain provisions modifying the duties of its fiduciaries, but may not modify fiduciary duties or exculpate a fiduciary for violation of these duties in a manner that:

- (a) permits intentional, knowing, reckless, grossly negligent, or illegal misconduct;
- (b) permits any actions in bad faith or with disregard for the purposes of the charity; or
- (c) nullifies the duties of care or loyalty.¹⁵⁶

Furthermore, while issues of governance of nonprofit organizations have been “traditionally nearly the sole province of state law,”¹⁵⁷ the Service in recent years has involved itself in the governance of tax-exempt organizations beyond the federal tax provisions regarding self-dealing discussed earlier.¹⁵⁸ Applicable Treasury regulations provide that an organization will not qualify for exemption under section 501(c)(3) “unless it serves a public rather than a private interest.”¹⁵⁹ The Service 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.”¹⁶⁰

¹⁵⁵ Brody, *supra* note 140, at 645; *see also* Brody, *supra* note 122, at 1428–29.

¹⁵⁶ RESTATEMENT OF THE LAW OF CHARITABLE NONPROFIT ORGS. § 2.04 (AM. LAW INST., Tentative Draft No. 1, 2016).

¹⁵⁷ BRUCE R. HOPKINS, *THE LAW OF TAX-EXEMPT ORGANIZATIONS* 127 (9th ed. 2007); *see also* Buckles, *supra* note 127, at 645.

¹⁵⁸ *See* Brody, *supra* note 140, at 1414.

¹⁵⁹ Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

¹⁶⁰ *Governance and Related Topics–501(c)(3) Organizations*, INTERNAL REVENUE SERV. (Feb. 4, 2008), https://www.irs.gov/pub/irs-tege/governance_practices.pdf.

To this end, Form 990 asks a number of questions regarding governance and management.¹⁶¹ For example, for organizations with local chapters, branches, or affiliates, a question in the Governance, Management, and Disclosure section of the Form 990 specifically inquires, “[D]id the organization have written policies and procedures governing the activities of such chapters, affiliates, and branches to ensure their operations are consistent with the organization’s exempt purposes?”¹⁶² The instructions to that question state that if the answer is no, the organization needs to explain on the catch-all Schedule O how it “ensures that the local unit’s activities are consistent with the organization’s tax-exempt purposes.”¹⁶³

Another question in the Governance, Management, and Disclosure section of Form 990 requires disclosure of delegation of responsibilities “customarily performed by or under the direct supervision of officers, directors, or trustees, or key employees to a management company or other person,” including disclosure of the management company or other person.¹⁶⁴ But nothing on the Form 990 asks how the organization ensures that the management company or other person acts to carry out the organization’s exempt purpose. As the discussion of manager-managed SMLLCs above makes clear, such protection is critical, since state law does not necessarily provide it.

IV. THE POTENTIAL FOR CONFLICT BETWEEN AN SMLLC MANAGER AND THE SMLLC CHARITY MEMBER

For an SMLLC, conflicts involving fiduciary duties have the potential to arise in manager-managed SMLLCs because managers can bind the SMLLC.¹⁶⁵ If the SMLLC is member-managed, there would not be any conflict or principal-agent issues between the member-manager and the single member because both would be the same person. A member managed LLC might protect the charity from no-fault environmental or

¹⁶¹ See I.R.S. Form 990, (2016), <https://www.irs.gov/pub/irs-pdf/f990.pdf>.

¹⁶² *Id.*

¹⁶³ *Instructions for Form 990 Return of Organization Exempt from Income Tax*, INTERNAL REVENUE SERV., <https://www.irs.gov/instructions/i990/ch02.html> (last visited Aug. 27, 2017).

¹⁶⁴ *Id.*; see also Schedule R, *supra* note 46.

¹⁶⁵ See REVISED UNIF. LTD. LIA. CO. ACT, prefatory note 6C U.L.A. 227–28 (2016) (describing the ability of a manager to bind the SMLLC as one of the noteworthy provisions of the new act).

products liability, but not from fault-based liability.¹⁶⁶ A member-managed LLC does not protect from fault-based liability because the charity, as the member, would manage the LLC and likely would participate in the activity that caused the claim.¹⁶⁷

Thus, to obtain the greatest liability protection, a charity would use a manager-managed LLC with a manager who is not also an officer or executive employee of the charity. The LLC often carries directors and officers liability insurance to cover claims against the manager.¹⁶⁸ A claim against the LLC in this situation is not likely to be successfully asserted against the charity.

That is, the potential for divergence from the purposes and obligations by an SMLLC to its member arises with manager-managed SMLLCs, particularly if fiduciary duties are modified or eliminated.

Nonetheless, based on an informal survey of practitioners,¹⁶⁹ many charity SMLLCs are manager-managed, as the best way to isolate liability for fault-based claims. If the managers of these SMLLCs do not owe fiduciary duties to its charitable member and the charity's exempt purposes¹⁷⁰ there is the potential for "adverse tax consequences" as well as "acrimonious litigation or regulatory action."¹⁷¹

The potential for a conflict between the charity and its SMLLC has been identified and discussed in the literature regarding fiscal sponsors.¹⁷² In a fiscal sponsorship,

¹⁶⁶ See generally 2 RIBSTEIN & KEATINGE, *supra* note 58, § 12.1.

¹⁶⁷ See generally *id.* §§ 12.1–12.2, 12.4.

¹⁶⁸ See 2 BISHOP & KLEINBERGER, *supra* note 6, ¶ 10.08. Without this coverage, a well-advised person or entity is unlikely to agree to serve as manager.

¹⁶⁹ To date, I have not been able to find Forms 990 data bases coded to permit me to access data regarding use of SMLLCs by section 501(c)(3) organizations.

¹⁷⁰ The issues involving possible conflicts because of inconsistent fiduciary duties between a manager-managed SMLLC and its charitable member closely resemble those that arise with sole corporate members of a nonprofit health care system. See Dana Brakman Reiser, *Decision-Makers Without Duties: Defining the Duties of Parent Corporations Acting as Sole Corporate Members in Nonprofit Health Care Systems*, 53 RUTGERS L. REV. 979, 994–1026 (2001). The New York Attorney General recently filed suit against The Lutheran Care Network, Inc. and its directors and officers for breaches of law and duty in its role as sole corporate member of Coburg Village, Inc., which is a senior independent living residence in New York. See Robert Gavin, *Coburg Village Managers Sued by Attorney General for Illegal Display of Power*, TIMESUNION (Oct. 1, 2016), <http://www.timesunion.com/local/article/Housing-officials-ouster-sought-9518064.php>.

¹⁷¹ See Keatinge, *supra* note 52, at 586.

¹⁷² See, e.g., GREGORY L. COLVIN, FISCAL SPONSORSHIP: SIX WAYS TO DO IT RIGHT (1993); Erin Bradrick, *Fiscal Sponsorship: What You Should Know and Why You Should*

a Section 501(c)(3) public charity extends the umbrella of its tax-exempt status to a previously unaffiliated project, as a valuable tool for charitable entrepreneurs who want to attract tax-deductible donations from the public and facilitate grants from private foundations without going through the time and expense, at least initially, of obtaining in tax-exempt status for a new organization.¹⁷³

Such fiscal sponsors often mentor the project's development and prepare it to become its own free-standing tax-exempt organization.

One common model of fiscal sponsorships—as Gregory Colvin has taught the exempt organization practitioner community—has been for the project to become an internal program of the sponsoring charity, with project staff as employees or volunteers of the sponsor, and the sponsor establishing a restricted fund for donations and grants intended for the project. That is, the project becomes a division of the sponsor. As soon as the sponsorship agreement is signed, the project can begin to solicit funds eligible for the charitable contribution deduction.¹⁷⁴

Recently, Steven Chiodini and Gregory Colvin have suggested a new Model L for fiscal sponsorships.¹⁷⁵ In this model, the charity acts as the sole member of an SMLLC within which the sponsored project is conducted. They particularly recommend this model when the new project carries a high potential for tort liability or when the project fears the fiscal sponsor parent faces tort liability.¹⁷⁶

Know It, BUS. L. TODAY (A.B.A., May 2015), http://www.americanbar.org/publications/blt/2015/05/04_braddock.html (discussing broadly the types of fiscal sponsorships, including SMLLCs).

¹⁷³ Steven Chiodini & Gregory L. Colvin, *The Use of LLCs in Fiscal Sponsorship—A New Model*, 22 TAX'N EXEMPTS 6, 7 (2011) [hereinafter *Use of LLCs*].

¹⁷⁴ See generally COLVIN, *supra* note 172, at 14–16.

¹⁷⁵ See generally *Use of LLCs*, *supra* note 173; Steven Chiodini & Gregory L. Colvin, *Using LLCs in Fiscal Sponsorship: An Update on “Model L,”* BUSINESS LAW NEWS, THE ST. B. OF CAL. (2014), [hereinafter *An Update on Model L*], [https://adlercolvin.com/pdf/Using%20LLCs%20in%20Fiscal%20Sponsorship_Update%20on%20Model%20L%20\(00647565xA3536\).pdf](https://adlercolvin.com/pdf/Using%20LLCs%20in%20Fiscal%20Sponsorship_Update%20on%20Model%20L%20(00647565xA3536).pdf).

¹⁷⁶ See generally *An Update on Model L*, *supra* note 175. Chiodini and Colvin caution that this approach is appropriate in jurisdictions, such as Delaware and Nevada, where creditors' sole remedy is a charging order against a debtor's interest in a partnership. See *id.* at 31–32. A detailed discussion of a creditor's rights regarding the assets of an SMLLC is beyond the scope of this Article.

In this Model L, the SMLLC would generally be manager-managed by those establishing the new project. Chiodini and Colvin recognize the risks of such management. Although all of the SMLLC's income and activities are attributable directly to the fiscal sponsor for federal tax purposes, the SMLLC could "go rogue by . . . using its funds for unapproved non-charitable purposes, operating out of its own bank account" or putting the sponsor's own tax exemption at risk by engaging in prohibited political campaign activity.¹⁷⁷

In other contexts, charities may delegate to manager-managed SMLLC's to encourage the managers to have responsibility—both programmatic and financial—for the development of various assets or areas of operation with more autonomy than afforded the head of a division or department. One practitioner, for example, has described to me setting up a manager-managed SMLLC for all of a charity's technology and intellectual property. In all cases, the member charity needs to ensure that the manager-managed SMLLC operates consistently with its exempt purposes and not take any action to endanger its exemption.

Moreover, it is easy to imagine a philanthrocapitalist who makes a large donation to a public charity for a particular project to demand that the project be run from an SMLLC of which the philanthrocapitalist is named the manager. The philanthrocapitalist could well ask that the SMLLC be formed in a jurisdiction that permits waiver of fiduciary duties and that such duties be waived. This arrangement would allow the philanthrocapitalist to control the activities of an operating public charity free of the constraints of the stringent restrictions applicable to private foundations under the tax law, including the strict limits on self-dealing

¹⁷⁷ *Id.* at 31. Difficulties, Chiodini and Colvin point out, could also arise if the project's relationship with the sponsor sour. *See id.* Chiodini and Colvin explain that the fiscal sponsor sole member "would typically be able to remove" the project leaders as managers for any reasons, while project leaders value "portability"—the ability to require a fiscal sponsor to transfer the project to a new sponsor. *Id.* This potential tension may call for a side agreement that "provides for liquidated damages if the sponsor unreasonably refuses to transfer its LLC interest to a new fiscal sponsor." *Id.* If, however, all goes well and the SMLLC is ready to become a freestanding exempt organization, the fiscal sponsor would assign its membership interest in the SMLLC to the new nonprofit corporation. *See Use of LLCs, supra* note 173, at 14. The new nonprofit corporation may decide to liquidate the SMLLC or, if the liability protection of the LLC remains desirable, continue to hold the SMLLC membership interest. In the latter case, the new nonprofit organization would have to decide whether the SMLLC would be member or manager managed. The operating agreement with the fiscal sponsor would need to anticipate and allow for all these options.

and excessive business holdings.¹⁷⁸ Without care in the operating agreement and management agreement, such an arrangement would carry the risk that the SMLLC would engage in activities inconsistent with the charitable member's exempt purpose, activities that could both endanger exemption and lead to Attorney General action for violation of fiduciary duties.

There could be investment risks as well. The philanthrocapitalist might also wish to control the investment of funds used for the SMLLC and invest them in a way inconsistent with the charitable member's investment policy, including keeping the funds in the stock of the philanthrocapitalist's own privately held business in what would be a violation of the excess business holding rules if the SMLLC were a private foundation.¹⁷⁹

In short, the ability under state law for LLCs to waive fiduciary duties is neither appropriate for nor consistent with the requirement of public purpose applicable to tax-exempt nonprofit charities, whether they are organized as trusts with their traditional high standards for fiduciary duties or as corporations.¹⁸⁰ Waiver of fiduciary duties could well violate the organization's fiduciary duty of care under state law. In addition, a number of federal tax laws impose their own fiduciary duties.¹⁸¹ As discussed below, guidance from the Service regarding control of

¹⁷⁸ Private foundations are subject to a number of excise taxes. *See* I.R.C. § 4940 (imposing an excise tax based on investment income); I.R.C. § 4941 (imposing an excise tax on self-dealing); I.R.C. § 4942 (imposing an excise tax on failure to distribute certain income); I.R.C. § 4943 (imposing an excise tax on excess business holdings); I.R.C. § 4944 (imposing an excise tax on investment which jeopardize charitable purpose); I.R.C. § 4945 (imposing an excise tax on taxable expenditures). These excise taxes operate to regulate the behavior of private foundations. *See generally* BRUCE R. HOPKINS & JODY BLAZEK, *PRIVATE FOUNDATIONS: TAX LAW AND COMPLIANCE* (4th ed. 2014).

¹⁷⁹ As discussed *infra* notes 201–3 and accompanying text, the Service's Notice 2012-52 requires that the charitable member have control of any funds donated to an SMLLC, but that notice, which focuses on deductibility of assets under section 170 when first donated, does not discuss funds donated to the charitable member and then transferred to the SMLLC. *See* Notice 2012-52, 2012-35 I.R.B. 317. In such a situation, it is possible that the step-transaction doctrine would apply to require control. Notice 2012-52, as discussed *infra* notes 202–3 and accompanying text, does not define "control."

¹⁸⁰ *See generally* *Bob Jones University v. United States*, 461 U.S. 574 (1983). There the Court found "unmistakable evidence that, underlying all relevant parts of the I.R.C. is the intent that entitlement to tax exemption depends on meeting certain common-law standards of charity. . . ." *Id.* at 575. The Court also wrote, "The origins of [tax] exemptions lie in the special privileges that long have been extended to charitable trusts." *Id.* at 588.

¹⁸¹ *See generally* Buckles, *supra* note 127.

SMLLCs would help charities to avoid such problems, including possible confrontations with philanthrocapitalists.

V. TAX LAW ANALOGUES AND RECOMMENDATION

In other, somewhat analogous contexts, tax law requirements seek to guarantee that actions of exempt organizations are consistent with exempt purposes. In a number of areas in which a charity deals with separate persons, whether an individual or an organization, tax law has established rules to ensure control by the charity. These include restricted gifts, community foundations, donor advised funds, joint ventures, and donations to SMLLCs. The rules applicable to these situations offer a model for charities' use of SMLLCs, especially those that are manager-managed and thus have some degree of independence from the charitable member.

One set of rules apply to transactions between an individual and a charity. If restricted gifts are too restrictive, including earmarking the gift for specified individuals, the donor can lose the charitable contribution deduction or the donee organization its exemption. As one private letter ruling¹⁸² explains, the exempt organization must have such "control of the donated funds, and discretion as to their use, so as to insure that they will be used to carry out its functions and purposes."¹⁸³

Tax regulations applicable to community foundations restrictions provide another model. Under Treasury Regulation section 1.170A-9(e), a trust or fund cannot be treated as a component part of community foundation if its assets are subject directly or indirectly by the transferor to any material restriction or condition.¹⁸⁴ The term "material restrictions" is defined by cross-reference to Treasury Regulation section 1.507-2(a)(8).¹⁸⁵ These regulations specify that "[w]hether or not a particular condition or restriction imposed upon a transfer of assets is material (within the meaning of this paragraph (a)(7)) must be determined from all of the facts and circumstances of the transfer."¹⁸⁶ The regulations list some of the more significant facts and circumstances to be considered in making such a determination:

¹⁸² Priv. Ltr. Rul. 2005-30-016 (July 29, 2005).

¹⁸³ *Id.*

¹⁸⁴ See Treas. Reg. § 1.70A-9(e).

¹⁸⁵ See Treas. Reg. § 1.507-2(a)(7).

¹⁸⁶ *Id.*

(A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation;

(B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes;

(C) Whether the governing body of the public charity has the ultimate authority and control over such assets, and the income derived therefrom; and

(D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.¹⁸⁷

The regulations under Code section 507, which deal directly with transfer of assets from a private foundation to a public charity in connection with termination of private foundation status, also list adverse factors. These include a situation where

the transferor private foundation, a disqualified person with respect thereto, or any person or committee designated by, or pursuant to the terms of an agreement with, such a person . . . reserves the right, directly or indirectly, to name . . . the persons to which the transferee public charity must distribute, or to direct the timing of such distributions. . . .¹⁸⁸

Laws enacted by Congress in 2006 to ensure accomplishment of charitable purpose for contributions to donor-advised funds constitute another parallel.¹⁸⁹ Under Code section 4966, the donor or donors to donor-advised funds, which are separately identified funds or accounts maintained and operated by a section 501(c)(3) public charity “with

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ The National Philanthropic Trust describes a donor-advised fund: “A philanthropic giving vehicle administered by a charitable sponsor. A donor-advised fund allows donors to establish and fund the account by making irrevocable, tax-deductible contributions to the charitable sponsor. Donors then recommend grants from those funds to other charitable organizations.” NAT’L PHILANTHROPIC TR., 2015 DONOR-ADVISED FUND REPORT 2 (2015).

respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor."¹⁹⁰ That is, the donor must cede legal control to the exempt organization sponsoring the fund. "If formal legal control were not vested in the sponsoring organization, the gift would not be considered complete and would fail."¹⁹¹

A revenue ruling that involves both LLCs and management agreements offers further potential guidance.¹⁹² Revenue Ruling 98-15¹⁹³ addressed joint ventures between tax-exempt and for-profit entities. The ruling considered two situations in which an acute care hospital exempt under section 501(c)(3) formed an LLC with a for-profit corporation and then contributed its hospital and all of its other operating assets to the LLC, which then operated the hospital.

In Situation 1, the LLC's Articles of Organization and Operating Agreement provided that the LLC would be managed by a governing board of three, with two chosen by the exempt hospital and one by the for-profit entity. The exempt hospital was to appoint community leaders experienced in hospital matters, but independent of the exempt hospital. Moreover, the LLC's Articles of Organization and Operating Agreement required that the LLC operate any hospital it owns "in a manner that furthers charitable purposes by promoting health for a broad cross section of its community."¹⁹⁴ Thus, "in the event of a conflict between operation in accordance with the community benefit standard and any duty to maximize profits, the members of the governing board are to satisfy the community benefit standard without regard to the consequences for maximizing profitability."¹⁹⁵

¹⁹⁰ I.R.C. § 4966(d)(2)(A)(iii) (2006).

¹⁹¹ Roger Colinvaux, *Donor Advised Funds: Charitable Spending Vehicles for 21st Century Philanthropy*, 92 WASH. L. REV. 34, 44 (2017). Many assert, however, that donors retain effective control. See MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONGRESSIONAL RESEARCH SERVICE, AN ANALYSIS OF CHARITABLE GIVING AND DONOR ADVISED FUNDS 3 (2012). See generally DEP'T OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS (Dec. 2011).

¹⁹² A revenue ruling is an official announcement of the Service's interpretation of the law. See UNDERSTANDING IRS GUIDANCE: A BRIEF PRIMER, <https://www.irs.gov/uac/understanding-irs-guidance-a-brief-primer>.

¹⁹³ 1998-1 C.B. 718. The subsequent discussion and analysis refer to Revenue Ruling 98-15. Only direct quotations have been cited.

¹⁹⁴ *Id.* at 718.

¹⁹⁵ *Id.*

The LLC also entered into a management agreement for a five-year term with a management company unrelated to the exempt or for-profit entity to provide day-to-day management services. The agreement was renewable for five-year periods by mutual consent. The management fee was to be based on the LLC's gross revenues. The terms and conditions of the management agreement, including the fee structure and the contract term, were reasonable and comparable to what other management firms received for similar services at similarly situated hospitals. The management agreement could be terminated for cause. The exempt hospital intended to use any distributions it received from the LLC to fund grants to support activities that promote the health of its community and to help the indigent obtain health care.

In Situation 2, the for-profit entity was a for-profit hospital corporation that owned and operated a number of hospitals and provided management services to several hospitals that it did not own. It was interested in providing financing for the exempt hospital if it could earn a reasonable rate of return. In this situation, the LLC's Articles of Organization and Operating Agreement provided that the LLC was to be managed by a governing board composed of three individuals chosen by the nonprofit and three individuals chosen by the for-profit. The nonprofit intended to appoint community leaders with experience in hospital matters but independent of the nonprofit hospital. The LLC's Articles of Organization and Operating Agreement required approval of the majority of the board on certain major decisions. They included no reference to operating for charitable purposes.

The LLC entered into a management agreement with a wholly-owned subsidiary of the for-profit entity to provide day-to-day management services to the LLC. The management agreement was for a five-year period, renewable at the discretion of the for-profit management subsidiary. The nonprofit also agreed to approve individuals who formerly worked for the for-profit as the LLC's CEO and CFO.

Revenue Ruling 98-15 concluded that the nonprofit hospital in Situation 1 would continue to qualify as tax-exempt. The ruling emphasized that in Situation 1 the LLC's governing documents committed the LLC to providing health care services for the benefit of the community as a whole and to give charitable purposes priority over maximizing profits. In particular, the nonprofit hospital's appointment of the majority of the LLC's boards ensured that the assets it owns through the LLC and the activities it conducts through the LLC will be used primarily to further exempt purposes.

In contrast, the ruling concluded that the nonprofit hospital in Situation 2 would not continue to qualify for exemption because it could not establish that it will be operated exclusively for exempt purposes. The LLC's governing documents lacked any binding obligation to serve charitable purposes or otherwise provide services to the community. The nonprofit hospital did not control the LLC. Moreover, the management company had broad discretion over the LLC's activities and assets.

The ruling pointed to the fact that the management company in Situation 2 could unilaterally renew the management agreement. In connection with its analysis of management agreements, the revenue ruling posits that a section 501(c)(3) organization

may enter into a management contract with a private party giving that party authority to conduct activities on behalf of the organization and direct the use of the organization's assets provided that the organization retains ultimate authority over the assets and activities being managed and the terms and conditions of the contract are reasonable, including reasonable compensation and a reasonable term.¹⁹⁶

Although the management agreement in the revenue ruling involved management of the assets in the LLC rather than management of the LLC itself, it nonetheless offers useful guidance for manager-managed SMLLCs of charities.

Revenue Ruling 98-15 involved what is known as a whole hospital joint venture, that is, a situation in which the nonprofit exempt hospital contributes all of its assets and its participation in the joint venture becomes its sole activity. It did not analyze ancillary joint ventures in which an exempt nonprofit entity establishes a joint venture with some of its assets, such as those of a particular activity. Ancillary joint ventures offer a close analogy to use of an SMLLC by a charity, since the SMLLC is a separate entity from the charity under state law and the SMLLC can operate specific activities of the charity.¹⁹⁷

Revenue Ruling 2004-51¹⁹⁸ involved such a situation—a section 501(c)(3) entity that created an LLC with a for-profit corporation by contributing a portion of its assets to and conducting a portion of its

¹⁹⁶ *Id.* at 721.

¹⁹⁷ Textual discussion of Revenue Ruling 98-15 ends here.

¹⁹⁸ 2004-1 C.B. 974. The subsequent discussion and analysis refer to Revenue Ruling 2004-51.

activities through the LLC. In the revenue ruling, a university exempt under section 501(c)(3) sought to expand the reach of summer seminars designed for elementary and secondary school teachers by forming an LLC with a for-profit corporation that specialized in interactive video training programs. The sole purpose of the LLC was to offer teaching training seminars using interactive video technology. The nonprofit university and the for-profit corporation each had a fifty percent ownership interest in the LLC. The LLC was to be managed under its governing documents by a board consisting of three directors chosen by the university and three directors chosen by the for-profit corporation. The governing documents also provided that the LLC's activities would be limited to teacher training seminars and that it would not engage in any activities that would endanger the university's exemption. The university had the exclusive right to approve the curriculum, training materials, and instructors, as well as to determine the standards for successful completion of the seminar.

The university's participation in the LLC would be an insubstantial part of its activities. As a result, its participation in the LLC did not affect its continued qualification for exemption. The Service, however, also ruled that the activities conducted through the LLC were substantially related to the organization's exempt purpose and thus were not subject to the unrelated business income tax. The LLC's activities expanded the reach of the university's training seminars, for example, by reaching those who could not travel to the university campus and thus contributed importantly and were related to the accomplishment of the university's educational purposes.

The ruling reached these decisions even though the university did not control the LLC's governing board. Under the governing documents, the university alone could approve the curriculum, material, instructors, and standards for success. These powers, even without control, were deemed sufficient to ensure that the LLC's activities advanced the exempt purpose of the university. As Michael Sanders wrote, this revenue ruling teaches that "governing documents should ensure that the exempt organization has full control over the substantive exempt function activities of the joint venture."¹⁹⁹ This revenue ruling offers a possible model for guidance regarding the use of SMLLCs by charities.²⁰⁰

¹⁹⁹ MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX EXEMPT ORGANIZATIONS 385 (4th ed. 2013).

²⁰⁰ Textual discussion of Revenue Ruling 2004-51 ends here.

The Service has issued one piece of Service guidance that specifically concerns SMLLCs of section 501(c)(3) organizations. It thus serves as an important precedent. Notice 2012-52²⁰¹ permitted donations to an SMLLC to be deemed donations to its charitable member and thus eligible for the charitable contribution deduction:

If all other requirements of § 170 are met, the Internal Revenue Service will treat a contribution to a disregarded SMLLC that was created or organized in or under the law of the United States, a United States possession, a state, or the District of Columbia, and is wholly owned and controlled by a U.S. charity, as a charitable contribution to a branch or division of the U.S. charity. The U.S. charity is the donee organization for purposes of the substantiation and disclosure required by §§ 170(f) and 6115. To avoid unnecessary inquiries by the Service, the charity is encouraged to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity. The limitations of § 170(b) apply as though the gift were made to the U.S. charity.²⁰²

This Notice requires, but nowhere defines, control of the SMLLC by the charity.²⁰³

The Service would be well-advised to issue a revenue ruling regarding the control required by a charity of its member-managed SMLLCs. Control would require that the SMLLC governing documents—which would include both the operating agreement and the management agreement—give the charity the right to terminate the manager without cause because the ability to terminate is crucial.²⁰⁴

The guidance, however, might well go further. Control should also require that the SMLLC act consistently with the charity's exempt

²⁰¹ Notice 2012-52, 2012-35 I.R.B. 317.

²⁰² *Id.* at 317.

²⁰³ *See id.* This Notice was issued by the Office of Associate Chief Counsel (Income Tax and Accounting), and not by Chief Counsel lawyers in Tax Exempt and Government Entities Office. Issues defining control belong in the latter, not former, Office of the Associate Chief Counsel.

²⁰⁴ *See* Revenue Ruling 98-15, Situation 2, where the manager had the option to renew the management agreement unilaterally.

purposes, require that the SMLLC not engage in any activity forbidden to the member charity, such as substantial lobbying or political campaign intervention,²⁰⁵ and give the member charity the right to inspect the books and records of the SMLLC as well as to receive reporting from the SMLLC.²⁰⁶ In short, it should forbid waiver or modification of fiduciary duties. Here, as in other instances, federal tax law would override state law governance rules.²⁰⁷ Individual practitioners may well wish to include additional provisions in their operating and management agreements, such as limits on unrelated business income or compliance with terrorist guidelines for charities operating abroad. Such requirements, however, should be designed for a particular set of circumstances and not required as part of the definition of control.

VI. CONCLUSION

Robert Keatinge wrote:

The flexibility of LLCs is both a blessing and curse. . . . It is uncertain whether the freedom to tailor the structure of an LLC to accomplish the precise goal of the organizers is a beneficial or harmful thing for nonprofits. . . . [A]s with any gift or benefit the flexibility should be used carefully and thoughtfully.²⁰⁸

As I know from a number of discussions, many exempt organization practitioners already take pains to use SMLLCs carefully and thoughtfully and to ensure control by the charitable single member when adopting manager-managed SMLLCs. Guidance from the Service will make it easier for them to convince clients of the importance of such control and thus limit abuse. Guidance could also prevent loss of charitable control in other cases and avoid both revocation of exemption

²⁰⁵ Fiduciary obligations of a charity's governing board include assuring that the entity act consistently with applicable law, including limitations imposed under section 501(c)(3) of the Code.

²⁰⁶ See Priv. Ltr. Rul. 2001-34-025 (May 22, 2001). The operating agreement for each SMLLC established by the charity included provisions to restrict the SMLLC to activities that were carried on for the exclusive benefit of the charity and mandated that the SMLLC exercise only powers that were in furtherance of the charity's exempt purposes. See *id.* Each SMLLC was required to follow the dictates of section 501(c)(3), including preventing private inurement, prohibiting campaign intervention, and limiting lobbying. See *id.*

²⁰⁷ Cf. I.R.C. §§ 4958, 4941.

²⁰⁸ Keatinge, *supra* note 52, at 586.

and violation of state fiduciary obligations. More generally, this examination of use of SMLLCs by charities highlights the need for regulators to remain diligent to ensure that such organizations fulfill the unique role that our society has granted these organizations to serve a public purpose, a role deemed important enough to subsidize through tax-exemption and the ability to accept tax-deductible contributions.