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L3Cs: The Next Big Wave in Socially Responsible Investing or Just Simply Too Good To Be True?

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L^{3}CS: THE NEXT BIG WAVE IN SOCIALLY RESPONSIBLE INVESTING OR JUST SIMPLY TOO GOOD TO BE TRUE?

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I. INTRODUCTION

GateHouse Media, Inc. ("GateHouse"), which publishes over 500 publications across more than 20 states in the U.S.,[1] has been on an economic slide since its initial public offering on October 25, 2006.[2] With less than three years having passed since the company initially appeared on the New York Stock Exchange at a price of $18,[3] GateHouse now finds itself trading on the over-the-counter markets for as low as $.03.[4] This financial malaise is not manifesting itself exclusively at GateHouse and its newspapers and magazines, but rather is an overall symptom of the entire print industry.[5]

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1 Hoovers.com, GateHouse Media, Inc. Overview, http://www.hoovers.com/gatehouse-media/--ID__55842--/freeuk-co-factsheet.xhtml (last visited Mar. 6, 2009).

2 *See* Bloomberg.com, GateHouse Media, Inc. Charts, http://www.bloomberg.com/apps/cbuilder?ticker1=GHSE%3AUS (follow "3Y" button) (last visited Mar. 6, 2009).

3 Ana Campoy, *GateHouse Media IPO Prices at $18 a Share*, MARKETWATCH, Oct. 24, 2006, http://www.marketwatch.com/story/gatehouse-media-ipo-prices-at-18-a-share.

4 OTC Bulletin Board, http://www.otcbb.com/asp/Info_Center.asp (last visited Mar. 6, 2009); *see also* U.S. Securities and Exchange Commission, Division of Trading and Markets, http://www.sec.gov/divisions/marketreg/mrotc.shtml (last visited Mar. 6, 2009).

5 Shira Ovide, *More Newspapers File For Chapter 11*, WALL ST. J., Feb. 23, 2009, at B2, available at http://online.wsj.com/article/SB123524807032741025.html? mod= testMod.

The Peoria Journal Star ("Journal Star"), which was purchased by GateHouse in 2007,[6] is teetering on the brink of financial collapse.[7] The Journal Star is the victim of a widening decline in newspaper circulation due to an increase in competition from the Internet as well as cable.[8] Faced with the threat of needing to shut down its presses, a coalition of Journal Star employees along with the Peoria Newspaper Guild and community leaders have been exploring alternatives on how to save the local newspaper.[9] The alliance attempting to save the Journal Star has explored options such as co-ops and employee stock ownership plans.[10] However, the group has instead opted to pursue a long-term ownership strategy centered on making the Journal Star a low-profit limited liability company ("L^3C").[11] If things go as planned, the Journal Star will separate itself from its parent, GateHouse, and turn itself into a community-owned operation.[12]

The Journal Star is not the sole company that has sought to become a L^3C.[13] Numerous other businesses, especially non-profits, are seeking to find other means to raise capital.[14] In light of this growing popularity with L^3Cs, an examination is needed to determine whether or not these entities are the answer for cash-strapped organizations like the Journal Star.

Part II of this article provides a history of the L^3C movement. In addition, Part II offers a look at the current legal landscape of L^3Cs on a federal and state level. Part III offers a glimpse into possible problems that L^3Cs may run into, including registration and disclosure requirements with the Securities and Exchange Commission ("SEC"). In addition, Part III will examine what the fiduciary obligations will be in L^3Cs. Finally, Part III concludes by exploring the possibility of overlapping governmental policing that may occur as more of these entities sprout up.

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[6] Peoria Journal Star, Recent Timeline, http://www.pjstarpeoria.com/online/services/journalstar history.html (last visited Mar. 6, 2009).

[7] Bill Richards, *The Peoria Plan for Saving Local Dailies*, CROSSCUT, Jan. 27, 2009, http://crosscut.com/2009/01/27/seattle-newspapers/18808/; *see also* Week.com, *More Layoffs in Peoria Area*, Jan. 22, 2009, http://www.week.com/news/local/38171694.html.

[8] Annys Shin, *Newspaper Circulation Continues to Decline*, WASH. POST, May 3, 2005, http://www.washingtonpost.com/wp-dyn/content/article/2005/05/02/AR2005050201457.html.

[9] Sally Duros, *How to Save Newspapers*, HUFFINGTON POST, Feb. 9, 2009, http://www.huffington post.com/sally-duros/how-to-save-newspapers_b_164849.html.

[10] *Id*.

[11] *Id*.

[12] Richards, *supra* note 7.

[13] Mike Gallagher, *New State L3C Legislation Creates Tool for Economic Revitalization*, http://www.michiganfoundations.org/s_cmf/doc.asp?C ID=335&DID=22992 (last visited Mar. 8, 2009).

[14] Clara Miller, *The Equity Capital Gap*, STAN. SOC. INNOVATION REV., Summer 2008, at 41, *available at* http://www.nonprofitfinancefund.org/docs/2008/ssir_summer_2008_equity_capital_gap .pdf.

II. BACKGROUND

A. The History of L^3Cs

Congress has set the mandatory distribution rate for private foundations at five percent of the excess of the aggregate fair market value of all assets of the foundation.[15] This means that in order to maintain their tax-exempt status, all private foundations need to distribute at least five percent of the average value of non-charitable-use assets on an annual basis through qualified distributions.[16] In addition, a private foundation faces the threat of an excise tax if it participates in what the Internal Revenue Service ("IRS") deems to be a high-risk or "jeopardizing" investment.[17] One exception to this tax is a program related investment ("PRI").[18] Typically, private foundations have chosen to distribute grants, rather than undergo a lengthy and costly private letter ruling from the IRS in order to ensure that their investment constituted a PRI.[19]

In an effort to address problems he was having investing family foundation money in sustainable and effective ways, Robert Lang, CEO of the Mary Elizabeth & Gordon B. Mannweiler Foundation, devised the L^3C concept in 2005.[20] Lang believed L^3Cs to be an effective vehicle for private foundations to both earn a de-

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[15] 26 U.S.C. § 4942(e)(1) (2006); *see also* Treas. Reg. § 53.4942(a)-2(c)(5)(i)(e) (as amended in 1983).

[16] *Id*. *See also* Treas. Reg. § 53.4942(a)-3(a)(2) (as amended in 1986) *and* Community Wealth Ventures, *The L^3C: Low-Profit Limited Liability Company Research Brief,* July 2008, http://www.americans forcommunitydevelopment.org/supportingdownloads/CWVBrief-Updated.pdf (mentioning that "the minimum distribution amount is based upon a minimum investment return of 5% on the average fair market value of non-charitable-use-assets-generally those that are not currently used for a charitable purpose. Charitable-use assets include all assets purchased for exempt purposes, program-related investments and 1.5% of the average value of cash and marketable securities that are not program-related investments. PRIs are qualified distributions that can satisfy this requirement").

[17] 26 U.S.C. § 4944 (2006)*; see also* Treas. Reg. § 53.4944-1(a)(2) (as amended in 1973).

[18] Treas. Reg. § 53.4944-3(a) (1972) (defined as a (i) the primary purpose of the investment is to accomplish one or more religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition; (ii) no significant purpose of the investment is the production of income or the appreciation of property; and (iii) no purpose of the investment is used to attempt to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office); *see also* Jane M. Searing, *Capital With a Conscience*, J. ACCT., July 2008, at 54, *available at* http://www.journalofaccountancy.com/Issues/2008/Jul/CapitalWithaConscience ("A PRI is often in a risk category that could otherwise result in a jeopardizing investment excise tax penalty. Those penalties are 10% of the amount so invested for each year of a 'taxable period,' assessed against the private foundation. In addition, 10% can be assessed against any foundation manager who knowingly, willfully and without reasonable cause participates in such an investment. A taxable period begins with the making of the jeopardizing investment and ends on the mailing date of a notice of deficiency for the initial tax, the date the initial tax is assessed, or the date the investment is removed from jeopardy, whichever is earliest. An additional 25% penalty is imposed on the foundation and 5% on the manager if such investments are not removed from jeopardy within the taxable period").

[19] IRS User Fees, http://www.irs.gov/newsroom/article/0,,id=151979,00.html (last visited Mar. 7, 2009) (showing a $50,000 fee for private letter rulings for corporations); *see also* 26 U.S.C. § 6110(k)(3) (2006) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.").

[20] Duros, *supra* note 9; *see also* Robert Lang, *Charitable Returns*, WORTH, Apr. 1, 2006, *available at* http://www.worth.com/Editorial/MoneyMeaning/Philanthropy /OpportunitiesExposu res-Philanthropy-Charitable-Returns.asp.

cent rate of return and also serve the higher good.[21] L^3Cs are a hybrid entity – bringing together market-driven investors and private foundations.[22]—They are similar to limited liability companies ("LLCs") in that they offer protection from personal liability like a corporation, have the flexibility of a partnership and can be sold in pieces.[23] Under the L^3C paradigm, the private foundation may agree to make an investment based on a submarket rate of return and take the first risk in order to entice normal investors, who will look for a higher return with less risk.[24] In addition, if Lang has his way, a private foundation would no longer need to obtain a private letter ruling each time it chooses to invest in a L^3C.[25] In order for this to occur, the IRS would need to amend the rules regarding expenditure responsibility reporting in private foundations,[26] Congress would need to pass the PRI Promotion Act of 2008[27] and states would need to enact legislation recognizing L^3Cs as legal entities.[28]

B. Current Legal Landscape of L^3Cs

Although nothing has taken shape in the form of a new IRS rule or the passage of federal legislation that pertains to PRIs and L^3Cs, Lang has been successful in persuading three states to enact legislation that recognizes L^3Cs as legal corporations.[29] Vermont was the first state to enact L^3C legislation.[30] The State's Legislature has stated that "[t]he basic purpose of the L^3C is to signal to foundations and donor directed funds that entities under this provision intend to conduct their activities in a way that would qualify as program related investments."[31] Vermont has the most registered L^3Cs, with forty-three in existence as of March 1, 2009.[32] The

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21 Searing, *supra* note 18.

22 Community Wealth Ventures, *supra* note 16 ("L^3Cs create a market for investment in financially risky, but socially beneficial activities").

23 *Id*.

24 Robert M. Lang, *Overview*, AMERICANS FOR COMMUNITY DEV., http://www.americansforcommunitydevelopment.org/supportingdownloads/ACDOverview.pdf (last visited Sept. 13, 2009) ("[B]y using the program related investment, the foundation allows the L^3C to turn the normal tranched investment structure on its head. Usually, the investor who assumes the highest risk also enjoys the highest return. With the L^3C, the ownership portions with the lowest risk can also enjoy the highest reward, making them particularly attractive to market driven investors.").

25 Searing, *supra* note 18.

26 *Id*.

27 *See* Duros, *supra* note 9 (Duros mentions that the Senate Finance Committee is currently considering draft legislation called the Program Related Investment Promotion Act of 2008).

28 *See* Searing, *supra* note 18.

29 *See* AmericansforCommunityDevelopment.org, L^3C Legislative Watch, http://americansforcommunitydevelopment.org/legislativewatch.html (last visited Mar. 7, 2009) (illustrating that Vermont, Wyoming, and Michigan have each passed a L^3C bill. In Illinois, Montana, North Carolina, North Dakota, Tennessee, and Utah a L^3C bill has been introduced. In addition, the Crow Indian Nation passed legislation that allows for L^3Cs in the Crow nation).

30 Vermont Secretary of State: Corporations Division, Low-Profit Limited Liability Company, http://www.sec.state.vt.us/corps/dobiz/llc/llc_l3c.htm (last visited Mar. 9, 2009).

31 *Id*. (noting that L^3Cs are not 501(c)(3) tax exempt entities, and a non-profit wishing to obtain such status would need to organize as a non-profit corporation).

32 Vermont Secretary of State: Corporations Division, Limited Liability Companies Database, http://www.sec.state.vt.us/corps/llc.htm (last visited Mar. 9, 2009).

other two states having passed similar legislation lag behind Vermont, with Michigan having only one[33] and Wyoming showing no registered L^{3}Cs, as of March 9, 2009.[34]

III. ANALYSIS

A. Registration Requirements

Through powers granted to it by Congress,[35] the SEC regulates the registration, offerings, purchase, and sale of securities.[36] Within both the Securities Act of 1933 (the "1933 Act") as well as the Securities Exchange Act of 1934 (the "1934 Act"), the definition of security is very broad.[37] Thus, an enterprise that has sold membership interests either in the form of shares or some other profit-sharing agreement must register with the SEC[38] Like any well-drafted piece of legislation, there are of course exceptions to this registration requirement.[39] For instance, under section 4 of the 1933 Act, security transactions are exempt from disclosure and registration if they (1) are by an issuer not involving a public offering (private placement), (2) were not sold through a general solicitation, and (3) were offers or sales by an issuer solely to one or more accredited investors and the offering price was below $5,000,000.[40] Although exemptions do exist, an organization must be very careful in making sure it squarely falls into one of the above exemptions or it could face prosecution from the SEC and Department of Justice (the "DOJ"), as well as private litigants.[41]

Therefore, the definition section in the 1933 Act should be quite instructive to issuers.[42] However, unfortunately, Congress and the SEC have chosen to leave

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[33] Michigan Department of Energy, Labor and Economic Growth, Corporate Division Business Entity Search, http://www.dleg.state.mi.us/bcs_corp/rs_corp.asp?s_ button=sword&v_ search=l3c& hiddenField=&search=Search (last visited Mar. 9, 2009).

[34] Wyoming Secretary of State's Office, Business Division: Database Download, https://wyobiz.wy .gov/Ecommerce/Database.aspx (last visited March 9, 2009).

[35] *See* 15 U.S.C. § 77s (2006); 15 U.S.C. § 78d (2006).

[36] *See generally* LOUIS LOSS ET AL., SECURITIES REGULATION (4th ed. 2006).

[37] 15 U.S.C. § 77b(a)(1) (2006). *See e.g.,* 15 U.S.C.A. § 78c(a)(10) (West 2006) (defining security as "any note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.").

[38] 15 U.S.C. § 77f (2006).

[39] 15 U.S.C. § 77d (2006).

[40] *Id*.

[41] 15 U.S.C. §§ 77x, 77y, 77z-1 (2006).

[42] *See* 15 U.S.C. § 77b (2006).

numerous terms undefined. For example, under the 1933 Act and Regulation D "public offering" is not defined.[43] As a result, issuers and their legal counsel have to look to case law for instruction. While interpreting section 4(2) of the 1933 Act, the Supreme Court devised a test, referred to as the "Ralston test", in order to determine whether or not an offering was private.[44] The Court utilized the two-part test which requires the issuer to prove that (1) the offeree(s) was sophisticated enough to not need the protection that is afforded by the registration requirements and (2) each offeree(s) had enough access to the type of information that would be illustrated in a registration statement had it been filed.[45] The Court has held that an offeree's education, experience with investing, and sufficient bargaining power to get information determine whether the offeree is sophisticated.[46] Finally, the Court has held that whether someone had access to information regarding the offering turns on whether the offerees were insider executives, had close relationships to family members in the business, or were outsiders with the wherewithal to get information.[47]

Since *Ralston* and *Doran* were decided, courts as well as the SEC have looked to the following factors (with no single factor being determinative) in order to determine whether the *Ralston* test has been met.

- The total number of offerees and the relationship they have to each other and the issuer[48]
- The total number of securities offered[49]
- The magnitude of the offering[50]
- The manner in which the securities were offered[51]
- The overall experience and sophistication of the offerees involved[52]

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[43] *Id.*

[44] SEC v. Ralston Purina Co., 346 U.S. 119 (1953). *See generally* STEVEN DRESNER WITH E. KURT KIM, PIPEs: A GUIDE TO PRIVATE INVESTMENTS IN PUBLIC EQUITY (2003).

[45] Ralston Purina Co., 346 U.S. at 120-27.

[46] *Id*. at 126.

[47] Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977) (relying on SEC Rule 146(e) and 17 C.F.R. § 280.146(e) (1976) when stating, "[b]y a position of access we mean a relationship based on factors such as employment, family, or economic bargaining power that enables the offeree effectively to obtain such information.").

[48] DRESNER, *supra* note 44, at 111. ("This factor is significant. There is no maximum permitted number of offerees; however, the larger the number, the greater the difficulty sustaining the evidentiary burden. Offering to a large and diverse group with no preexisting relationship to the issuer suggests a public offering.").

[49] *Id*. ("The smaller the number, the less likely the offer will be deemed public and subject to registration.").

[50] *Id*.

[51] *Id.* at 112 ("There are two general conditions: (1) the offering should be made through direct communication with eligible offerees by either the issuer or the issuer's agent; and (2) the offering cannot include any general advertising or general solicitation.").

[52] *Id.* ("General business knowledge and experience usually are sufficient. Important factors to consider are education, occupation, business experience, investment experience, and net worth. An investor having a sophisticated representative probably satisfies this test."). *See also* Securities Act of 1933, Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77a *et seq*. (2006)) (stating that the purpose of the 1933 Act is to protect investors and "[t]o provide full and fair disclosure of the character of securities sold in interstate commerce and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes.").

- The information that was provided to offerees or to which they had ready access[53]
- Any actions by the issuer to prevent the resale of the offered securities[54]

In order to provide issuers greater clarity on what types of offerings are exempt from the 1933 Act, the SEC implemented Regulation D ("Reg. D").[55] Reg. D consists of eight rules, which offer an issuer exemption from registering its securities.[56] Although not exhaustive, Rule 501 does offer more guidance to issuers in its definition section than the definition sections contained in the 1933 and 1934 Acts.[57] It defines an "accredited investor" as any person who falls within the following categories:

- *Institutional investors* – such as insurance companies, banks, pension plans, etc.[58]
- *Private business development companies*[59]
- *Corporations, partnerships and tax-exempt charities* – not formed for the specific purpose of acquiring the offered securities and with total assets that exceed $5 million[60]
- *General partners, directors and executive officers of the issuer*[61]
- *Any natural person whose net worth (or joint net worth with spouse) at the time of purchase exceeds $1 million*[62]
- *Any natural person with an income in excess of $200,000 (or $300,000 joint income with spouse) in each of the two most recent years* – the investor must also have a reasonable expectation that income will meet this threshold in the current year[63]
- *Trusts* - not formed for the specific purpose of acquiring the offered securities, with total assets that exceed $5 million, and directed by a

[53] DRESNER, *supra* note 44, at 112 (noting that the disclosure information does not have to be as extensive as what a registered offering needs to show, however it must be "factually equivalent.").

[54] *Id*. ("Securities must come to rest in the hand of immediate investors. Premature resales of securities may be deemed a distribution and considered part of the offering.").

[55] *Id*. (noting that Reg. D is nonexclusive and that an issuer that has failed to satisfy the criteria of Reg. D may still rely on section 4(2) of the 1933 Act); Regulation D, 17 C.F.R. §§ 230.501-.508 (2009).

[56] *Id*. at 113-14 ("Rule 501 sets forth definitions for terms used throughout Reg. D. Rule 502 sets forth the general conditions relating to integration, information requirements, limitations on manner of offering, and limitations on resale. Rule 503 requires notices for sales. Rule 504 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to $1 million. Rule 505 provides an exemption pursuant to Section 3(b) of the Securities Act for offerings up to $5 million. The rule most often relied on for an exemption under Reg. D is Rule 506, the exemption for limited offerings and sales without regard to dollar amount. Although the number of 'purchasers' under Rule 506 is limited to thirty-five, issuers may sell securities under Rule 506 to an unlimited number of 'accredited investors.').

[57] 17 C.F.R. § 230.501 (2009).

[58] *Id*. § 230.501(a)(1).

[59] *Id*. § 230.501(a)(2).

[60] *Id*. § 230.501(a)(3).

[61] *Id*. § 230.501(a)(4).

[62] 17 C.F.R. § 230.501(a)(5) (2009).

[63] *Id*. § 230.501(a)(6).

"sophisticated person"[64]

- *Any organization that consists of equity owners who are all accredited investors*[65]

Under the National Securities Market Improvement Act of 1996 as well as the federal preemption doctrine, securities that are exempt from registration under a federal securities law exemption, such as section 4(2) of the 1933 Act or Reg. D, are exempt from registration under state blue-sky laws.[66] However, even if issuers can escape the onerous registration and prospectus requirements of the 1933 Act, nothing can prevent them escaping section 10b of the 1933 Act and Rule 10b-5 liability.[67]

First, as the discussion above illustrates, meandering one's way through the U.S. securities laws can be a rather formidable task. One has to wonder whether an organization like the Journal Star would have the resources to employ an individual trained in securities laws and competent enough to make sure the organization follows all applicable laws. Organizations like the Journal Star most likely do not have anyone in-house who could manage such a task, and also lack the financial resources to hire a competent securities legal professional. Even if an organization is lucky to have a board member who is an attorney and is ready to offer his or her services pro bono, the organization still faces the threat that his or her offering will not be exempt. If this occurs and the organization needs to undergo the registration process, it will face exorbitant costs.[68] If an organization like the Journal Star is already cash strapped, it seems unlikely that it would be able to pay for the registration process.

The prospect of an organization like the Journal Star being exempt from the registration process under section 7 of the 1933 Act[69] also seems unlikely. First, an offering such as the one the Journal Star is considering would most likely fail the *Ralston* test.[70] Organizations like the Journal Star would most likely seek to have as many offerees as possible in order to raise the most capital. Furthermore, the magnitude of the offering, albeit nowhere near the size of Visa's feat,[71] could

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[64] *Id*. § 230.501(a)(7); *see* 17 C.F.R. § 230.506(b)(2)(ii) (2009). (which defines a sophisticated investor as one with "knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately prior to making any sale that such purchaser comes within this description.").

[65] 17 C.F.R. § 230.501(a)(8) (2009).

[66] DRESNER, *supra* note 44, at 120-21 (drawing a distinction between Rule 506, which was promulgated under section 4(2), and Rules 504 and 505, which were issued under section 3(b)).

[67] Rule 10b-5, 17 C.F.R. § 240.10b-5 (2009) (stating that it is unlawful for any person, directly or indirectly, to engage in fraud or deceit in the purchase or sale of *any* security).

[68] *See* ANDREW J. SHERMAN, RAISING CAPITAL: GETTING THE MONEY YOU NEED TO GROW YOUR BUSINESS 208-09 (2d ed., AMACOM 2005) (2000) (noting that organizations face a hefty expenditure between $200,000 to $500,000 in legal, accounting, appraisal, printing, consulting, and filing fees associated with a public offering--not including the underwriter's or broker's commission, which can be ten percent or more of the total offering).

[69] 15 U.S.C. § 77f (2006).

[70] Comment, *Employee Stock Offerings under the Securities Act: The Ralston Purina Case*, 21 U. CHI. L. REV. 113, 113-18 (1953) (noting that issue of employee stock offerings must be analyzed on a case by case basis, but opining that the *Ralston* decision was consistent with the underlying purpose of the Securities Act).

[71] Sam Zuckerman, *Visa Shares Soar After Biggest U.S. IPO Ever*, S.F. CHRON., MAR. 20, 2008, at

be high enough for a court to deem it a public offering. The offering will most likely fail the *Ralston* test as well due to the manner in which the securities will be offered. Because there has been so much communication in the press, while less than an advertisement but more than innocuous reporting, courts could deem the offering to have been a "communication published in any newspaper" and therefore a public offering.[72] Finally, there is reason to believe that the Journal Star will most likely be attracting sophisticated investors, like banks, as well as tax-exempt charities. However, it is also equally likely that the Journal Star and others will sell memberships to lay citizens in the community and therefore fail the *Ralston* test due to the lack of sophistication of some offerees.[73]

If an organization fails to satisfy the *Ralston* standard, it will look to Reg. D for a possible exemption from registration. However, organizations like the Journal Star will presumably fail to stay within the dollar limits ($1 million and $5 million, respectively) imposed by Rules 504 and 505.[74] In addition, although Rule 506 does not contain a dollar limit[75] and some investors will fall within the "accredited investor" exception, not all offerees of L^3C security offerings will fall into one of the defined categories.[76] As a result, organizations like the Journal Star will more than likely need to register their security offering with the SEC.

B. Disclosure Requirements

While the 1933 Act is most concerned with the offering and registration process, the 1934 Act deals with secondary trading.[77] However, just like the 1933 Act, the 1934 Act was based on a concern that investors in securities were not satisfactorily protected against manipulative schemes, misrepresentation, and inadequate disclosure.[78] The main thrust of the 1934 Act lies within section 10b and

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C-1, *available at* http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2008/03/19/BURLVMIOK.DTL (highlighting Visa's sale of 406 million shares for just under $18 billion).

[72] *See* DOUGLAS L. HAMMER ET AL., U.S. REGULATION OF HEDGE FUNDS 213 (2005). The following factors are usually considered when determining whether a solicitation or advertisement violates Rule 502(c): "[t]he relationship, if any, between the issuer and the person making the communication, [t]he relationship, if any, between the issuer and the person receiving the communication, [t]he timing of the communication, and [t]he subject matter of the communication." *Id.* at 214.

[73] *See* Richards, *supra* note 7, (noting "Peoria Newspaper Guild official Jennifer Towery will describe ... how a community coalition is pushing legislation to turn her city's struggling privately owned paper into a 'low profit' L3C community-owned operation.").

[74] Rules 504-05, 17 C.F.R. §§ 230.504-.505 (2009).

[75] Rule 506, 17 C.F.R. § 230.506 (2009).

[76] Rule 501, 17 C.F.R. § 230.501 (2009).

[77] Securities Exchange Act of 1934, 15 U.S.C. § 78a-mm (2006).

[78] S. REP. NO. 73-792, at 3-4 (1934), *reprinted in* 5 LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Securities Exchange Act of 1934, Item No. 17 (J.S. Ellenberger & Ellen P. Mahar eds., 1973); *see also* Wallis K. Finger, Note, *Unsophisticated Wealth: Reconsidering the SEC's "Accredited Investor" Definition Under the 1933 Act*, 86 WASH U. L.R. 733, 737 n.30 (2009) (noting that "the 1934 Act has four purposes: 'to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the markets; to regulate the securities markets; and to control the amount of the Nation's credit that goes into those markets.'") (quoting LOUIS LOSS ET AL., SECURITIES REGULATION 328 (4th ed. 2006)).

Rule 10b-5, which was promulgated under the 1934 Act.[79] These far-reaching laws make it unlawful for any person who in the connection of the purchase or sale of any security, defrauds, makes any untrue statement of a material fact, or omits to state a material fact.[80] In addition to its aim to protect investors from fraud, the 1934 Act also seeks to mandate adequate disclosures from companies that are registered with the SEC under sections 12, 13, and 15.[81] These sections impose reporting requirements upon companies that are either listed on stock exchanges or sold over-the-counter.[82] However, not all securities that are sold over-the-counter are required to register.[83] If a company ultimately registers with the SEC, then it must make annual as well as quarterly reports to the SEC.[84] In addition, a company must file a "current report" if a significant event occurs.[85] Preparing and filing these reports can run a company thousands of dollars.[86]

Even if an organization like the Journal Star is able to escape the registration requirements under the 1933 Act, it still may face registration obligations under the 1934 Act. This is mainly due to the size of the offering. Given the fact that organizations like the Journal Star may wish to sell membership rights to community members, it is not unfathomable for such an offering to grow to be greater than $10 million and 500 shareholders and therefore fall within the scope of the 1934 Act. If this occurs, the organization must register the offering with the SEC and file costly periodic financial reports until the company effectively "goes dark."[87]

C. Fiduciary Duties

Courts have held that, in a broad sense, officers and directors of a corpora-

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[79] 15 U.S.C. § 78j(b) (2006); Rule 10b-5, 17 C.F.R. § 240.10b-5 (2009).

[80] § 204.10b-5.

[81] 15 U.S.C. §§ 78l, 78m, 78o (2006).

[82] 15 U.S.C. § 78l(a), (b), (g) (2006); Rule 12g-1, 17 C.F.R. § 240.12g-1 (2009).

[83] § 240.12g-4. A company that has less than $10 million in assets and fewer than 500 shareholders is exempt from registration. *Id.* In addition, the following are also exempt from registration requirements: securities of organizations operated exclusively for religious, educational, or charitable purposes; securities of investment companies; and securities of savings and loan companies that are regulated by state or federal agencies. *Id.*

[84] 15 U.S.C. § 78m (2006) (outlining Forms 10-K, 10-KSB, 10-Q, and 10-QSB).

[85] *Id.* (mentioning Form 8-K).

[86] *Analysis of Small Business Advocacy Review Panels as Required Under the Small Business Regulatory Enforcement Fairness Act of 1996 Before the Subcomm. on Gov't. Programs and Oversight and the Subcomm. on Reg. Reform and Paperwork Reduction*, 105th Cong. (1998), *available at* http://www.sba.gov/advo/laws/testimony/test3-18.html (statement of Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Business Administration) ("[A] study of 265 companies showed that reporting costs for quarterly 10-Q and annual 10-K reports were over $50,000. The disclosure requirements impose a heavier burden on small companies than on large companies because the costs are largely fixed."), *but see* Cyanotech Corp., Annual Report (Form 10-K), at 63 (Aug. 16, 2007), *available at* http://www.sec.gov/Archives/edgar/data/768408/000110465907063150/a07-17460_110k.htm (showing that small businesses can incur costly filing fees since the fees incurred by Cyanotech Corporation "for professional services rendered for the audit of the Company's annual financial statements and timely quarterly reviews for the fiscal year ended March 31, 2007 and 2006 were $361,600 and $162,700, respectively.").

[87] *See* 17 C.F.R. § 240.12g-4 (noting that a public company can go private if the outstanding securities are less than $10 million and it has less than 500 shareholders for the last 3 years or if at the beginning of the fiscal year it is held by less than 300 persons.

tion are in fact agents of that corporation.[88] Despite the fact that officers and directors are not considered to be trustees,[89] they are deemed to hold a fiduciary relationship with the shareholders and public corporation as a whole.[90] Other courts have gone even further and have held that a fiduciary duty exists even in closely-held companies.[91] Furthermore, directors and officers within non-profit entities have been considered to also have fiduciary relationships with the organization as well as the people they serve.[92] Although each state has a slightly different variation, there are generally three broad duties that officers and directors owe to a corporation, including the duty of loyalty,[93] the duty of care,[94] and a duty of good faith.[95] In addition to these well-established fiduciary duties, Congress passed the Sarbanes-Oxley Act of 2002 ("SOX"),[96] which aims to restore investor confidence in the markets.[97] The additional regulation added extra compliance and governance costs for public companies, which were already spending thousands of dollars in order to meet their reporting requirements.[98] However, these changes did not only affect public companies, they also influenced nonprofit organizations as well.[99]

If the Journal Star and others, who wish to become L^3C entities, end up having to register their security offerings with the SEC, they face crippling costs associated with disclosure requirements. This could seriously hamstring these small businesses and prevent them from carrying out their missions. As a result, these organizations may find it difficult to attract more investors and ultimately may

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[88] *See* In re Allegheny Int'l, Inc., 954 F.2d 167 (3d Cir. 1992) (applying Pennsylvania law); *see also* Jordan v. Hunter, 865 P.2d 990 (Idaho Ct. App. 1993).

[89] *See* Jackson v. Ludeling, 88 U.S. (21 Wall.) 616 (1874).

[90] United States v. Byrum, 408 U.S. 125 (1972).

[91] Donahue v. Rodd Electrotype Co. of New England, 328 N.E.2d 505 (Mass. 1975).

[92] Kelley v. Astor Investors, Inc., 478 N.E.2d 1346, 1348 (Ill. 1985); *see also* MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 15 (2004) (noting that although fiduciary duties do exist, since so many protections or "shields" for directors' services in non-profits also exist, it is often difficult for an attorney general to build a strong case alleging a breach of fiduciary duty).

[93] Marciano v. Nakash, 535 A.2d 400, 403 (Del. 1987); *see also* Stone v. Ritter, 911 A.2d 362 (Del. 2006).

[94] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[95] *In re* Abbott Labs. Derivative S'holder Litig., 325 F.3d 795 (7th Cir. 2003).

[96] Sarbanes-Oxley Act of 2002, 15 U.S.C §§ 7241-7244, , 7261-7262, 7264-7265 (2007).

[97] *See* John C. Coates IV, *The Goals and Promise of the Sarbanes–Oxley Act*, 21 J. ECON. PERSP. 91, 91 (2007) ("At its core, the Sarbanes–Oxley legislation was designed to fix auditing of U.S. public companies, which is consistent with the official name of the law: the Public Company Accounting Reform and Investor Protection Act of 2002. By consensus of investors and Wall Street professionals alike, auditing had been working poorly. Sarbanes–Oxley created a unique, quasi-public institution to oversee and regulate auditing, the Public Company Accounting Oversight Board (PCAOB).").

[98] *See* William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private*," 55 EMORY L.J. 141, 148 (2006). A 2004 study found that total compliance with SOX has an average cost of $3.14 million for each large company, plus an additional $1,037,100 in software costs. *Id.* Furthermore, a 2002 study estimated $250,000 in average costs for a small company. *Id.* at 148 n.58.

[99] *See generally* Francie Ostrower & Marla J. Bobowick, *Nonprofit Governance and the Sarbanes-Oxley Act*, 2006 THE URB. INST., *available at* http://www.urban.org/UploadedPDF/311363_nonprofit_governance.pdf.

need to shut down their operations. In addition, given that L^3Cs will be profit-generating entities, it is highly unlikely that states will grant these organizations "shield laws"[100] that serve to protect directors and officers from personal liability. As a result, it will be difficult for L^3Cs to attract top talent who would rather either make more money at another for-profit organization or be protected from liability at a nonprofit.

D. Overlapping Policing

In order to be legally recognized in the U.S., a business must register with a secretary of state's office.[101] Once organized, both the federal and state government then regulate the business.[102] The U.S. Department of Labor does the majority of regulating of businesses on the federal level,[103] while each state has the authority to regulate businesses[104] as long as those regulations do not impede interstate commerce.[105] The policing of businesses in the U.S. usually falls within the purview of either the U.S. Office of the Attorney General[106] or each state's attorney general's office. In addition, if an organization is a nonprofit entity, it will also receive attention from the Internal Revenue Service.[107] This governance is of course in addition to any regulation that the SEC exercises if any securities are offered by a business.

Since the main purpose of the L^3C structure is centered on attracting market-driven investors as well as non-profit foundations, there is a strong chance that U.S. tax dollars will be wasted in the duplicative policing of these organizations. The redundancy of regulating these organizations on both the state and federal level would appear to not have even a modicum of rationality particularly given the current financial status of the United States.[108] This potential redundancy could

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[100] *See* J. STEVEN OTT, UNDERSTANDING NONPROFIT ORGANIZATIONS: GOVERNANCE, LEADERSHIP, AND MANAGEMENT 78 (2001).

[101] *See* MICHAEL SPADACCINI, INCORPORATE YOUR BUSINESS: IN ANY STATE 41 (2007).

[102] *See generally* Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1 (1824) (holding the power to regulate interstate commerce was granted to Congress via the Commerce Clause of the U.S. Constitution.); *see also* Business.gov, http://www.business.gov (last visited Mar. 11, 2009) (educating business owners on important laws including advertising, employment, environmental, finance, patents, trademarks, copyright, privacy, Uniform Commercial Code as workplace safety and health laws).

[103] *See* United States Department of Labor, http://www.dol.gov/ (last visited Mar. 11, 2009).

[104] *See* JOHN E. MOYE, THE LAW OF BUSINESS ORGANIZATIONS 159 (Delmar Cengage Learning 6th ed. 2004) (1974) (noting that "[t]he law of corporations was developed by each state to regulate the internal affairs of the corporations that state had chartered to do business within its boundaries.").

[105] *See* United States v. Lopez, 514 U.S. 549, 579-80 (1995) (reminding the reader that "there is widespread acceptance of our authority to enforce the dormant Commerce Clause, which we have but inferred from the constitutional structure as a limitation on the power of the States. One element of our dormant Commerce Clause jurisprudence has been the principle that the States may not impose regulations that place an undue burden on interstate commerce….").

[106] *See generally* United States Department of Justice, http://www.usdoj.gov/ag/ (last visited Mar. 11, 2009).

[107] *See generally* IRS.gov, Tax Information for Charities & Other Non-profits, http://www.irs.gov/charities/index.html (last visited Mar. 11, 2009).

[108] *See, e.g.,* Sara Murray, *State Budget Deficits Continue to Widen*, WALL ST. J, Feb. 3, 2009, http://blogs.wsj.com/washwire/2009/02/03/state-budget-deficits-continue-to-widen/ (noting that "[a]lready 34 states are predicting budget gaps totaling $84.3 billion for fiscal 2010"), *see also* Jeff Ba-

help to thwart the adoption of these organizations by states that already have their hands full.[109] This does not bode well for the Journal Stars of the world.

IV. CONCLUSION

There is no arguing that L^3Cs may someday offer organizations like the Journal Star access to capital that has not been traditionally available. However, without some measures put in place, there is a strong likelihood that this organizational structure will not help organizations like the Journal Star survive. This is due to the onerous registration and disclosure requirements of the SEC, the costly compliance requirements of SOX, as well as the lack of officer and director liability protection. Furthermore, given the fact that these organizations will most likely come into the purview of numerous governmental agencies, at both a federal and state level, states may be reluctant to adopt this organizational structure until there is a clearer picture as to how efficient governance of L^3Cs will occur.

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ter, *U.S. Posted $192.78 Billion Total Budget Deficit in February*, WALL ST. J, Mar. 11, 2009, http://online.wsj.com/article/SB123679494938097961.html?mod=googlenews_wsj.

[109] *See, e.g.*, WSJ Staff, *Buffett Says Economy Has 'Fallen Off a Cliff'*, WALL ST. J., Mar. 9, 2009, http://blogs.wsj.com/economics/2009/03/09/buffett-says-economy-has-fallen-off-a-cliff/.