

A New Form of Social Enterprise: The L3C Model & *GardnerGlobal, Inc*

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Social Enterprises & the Problem of “Two Masters”:

Social enterprises, variously described as mission-driven businesses, businesses that do well by doing good, or businesses with a ‘double bottom line,’ are essentially businesses that attempt to achieve profitability while serving a public good. The emergence of this new form of entrepreneurship, some have argued, represents a new era in the relationship between business and society. Advocates of these new hybrid organizations believe that by combining the sustainability and efficiency of for-profit organizations with the charitable goals of the non-profit sector, social enterprises will greatly augment the human and financial resources available to address social problems (Smiddy, 4).

The movement for a new organizational model that bridges the divide between nonprofit and for-profit organizations stems from the disillusionment most people feel towards the for-profit structure and the disappointment with the perceived shortcomings of traditional nonprofits. The financial scandals that have shaken the economy during the Great Recession have revealed a pervasive lack of social responsibility in much of the for-profit sector. On the other hand, charitable organizations are widely considered to be inherently inefficient, lacking any natural bottom-line and devoid of any transparent indicators of success (e.g. profits versus loss) to guide organizational decisions and strategic planning. As the economic recession has deepened, the vulnerability of charitable organizations has also been revealed. As individual wealth in the nation plummeted so did giving to nonprofits, leaving many scouring for ever-scarcer resources and left questioning whether financial sustainability is possible within the rigid legal structure of tax-exempt organizations.

Faced with these questions, hybrid organizations have emerged as an exciting opportunity to combine the best practices from both sectors. Over the last decade, more and more of the nation’s best young minds have been clamoring to develop innovative social enterprises that allow them to become wealthy while also expressing their own civic and social values through businesses with a social mission. Additionally, like their counterparts in the business community nonprofit leaders are also increasingly interested in showing their own business acumen and entrepreneurial skill (Gair, 2005; Foster & Bradach, 2005) By providing a space for those that want to “do well by doing good,”

hybrid nonprofit/for-profit models are attracting a large and incredibly talented generation of entrepreneurs into the social sector.

In practice, however, attempting to interlock the pursuit of profits with goals such as protecting the environment or serving the needy is an incredibly difficult task. Hybrid organizations are by their very nature filled with substantial risks and tensions that must be carefully considered by social entrepreneurs, investors and government regulators if they are to become a legitimate new sector.

In her article, “*Mission and Money*” Suzi Sosa identifies four key risks of hybrid organizations. First is the overarching problem of ambiguity inherent to most hybrid models. Not only does the ambiguity and dual-nature of hybrids confound and likely deter potential investors, it is also likely to confuse board members, managers, and staff members who when faced with choices between money and mission that will inevitably arise, will likely be less surefooted and purposeful in their decisions. Second, most hybrid models have no clear system of accountability. In for-profits, investors, directors and employees work with the certainty that profit maximization is the ultimate goal. Conversely those involved in nonprofits know that all actions are expected to pivot upon the organization’s social mission. However hybrid organizations instead pursue two often conflicting priorities, and usually operate without a transparent and commonly understood system to guide decision-making. The risk of misalignment is therefore very high. Third, unable to maximize either profits or social benefits, hybrids often face enormous pressure to lean in one direction, abdicating one goal for the sake of the other. Finally, as hybrids face pressures to remain financially viable they are likely to adopt many practices of traditional for-profit ventures that are likely to erode their moral legitimacy. The “clouds of confusion” that these hybrids are forced to operate under while serving “two masters” creates inherent tensions that often leave these organizations both incredibly volatile and vulnerable while walking the tightrope between money and mission (Tyler, 2010).

The L3C:

The L3C is a legal business structure that was originally created for the narrow purpose of encouraging foundations to make more program-related investments from

their yearly expenditures on mission-related activity. However, a few leading scholars and social entrepreneurs who had been searching for a more effective way to blend mission and money soon converged upon the L3C as a potential stabilizing force to the hybrid model. The L3C, it is hoped, by serving to clarify and institutionalize priorities of hybrids to both investors and directors and by making program-related investments in these businesses much easier for foundations, will help to build a more predictable hybrid model and catalyze growth in the sector. The viability of the L3C model remains to be seen, but it represents a unique opportunity to imbue the values of both profit and social mission into the institutional mechanics of hybrid organizations, and hopefully will reduce the volatility of these enterprises and make them more attractive to both profit-seeking and mission-seeking investors.

Under federal law, foundations in the United States must spend at least 5% of their assets annually on mission-related activity – an incredible amount of wealth when every foundation across the country is taken into account. The large majority of foundations spend this money on traditional grants to non-profit organizations, which have no possibility of return. Program-related investments (PRI), on the other hand, are low-interest loans, equity investments, or guarantees to either nonprofit or limited for-profit companies that advance the mission of the foundation *and* which can generate financial returns. Additionally, PRI's are not subject to excise taxes typically levied on foundation's capital gains, and they are exempted from "jeopardy investment" restrictions, allowing foundations to make riskier investments with their assets (with more potential for high returns) through PRI's than otherwise allowed by tax laws. PRI's are widely viewed as exceptional opportunities enhance the ability of foundations to benefit the larger society by allowing them to actually make financial gains while supporting socially beneficial organizations, and then re-invest their initial investments as well as their accrued returns on those investments into more social causes.

Program-related investments must be made in accordance with guidelines established by the Internal Revenue Service, which set standards to ensure that those investments in fact advance a social mission. Out of many thousands of foundations in the United States, only a few hundred make PRI's. The federal scrutiny of charities and

donations compels most foundations to seek pre-approval for PRI's in the form of a private letter ruling (PLR) from the IRS that those investments pass federal review (Lane, 2010, Galpin and Bell, 2010). But obtaining PLR's for program-related investments is an often arduous process can cost the foundation up to \$10,000 in labor and legal fees (Lane, 2010). The bureaucratic nature of process furthermore leads to the misconception among many organizations that only the most sophisticated foundations can efficiently deploy PRI's (Tyler, 2010).

The original concept of the L3C structure was to catalyze a growth in program-related investments (Lang & Minnigh, 2010). The LC3 structure, by codifying the necessary requirements for approval of a PRI into a new business form and injecting those elements into the generic code of the approval process, works to make PRI's more accessible, simpler, and less expensive to foundations (Tyler, 2010). In order to infuse the requirements of PRI's into its model, the *legal structure* of the L3C, by its very nature, requires the primacy of social mission over financial returns.

The L3C structure, however, was quickly understood to have advantages in addition to facilitating PRI's in socially responsible businesses. The primary difficulty with hybrid organizations has been the "dual masters" problem – the inherent tension between mission and money that pulls these organizations in two separate directions. Without a clearly defined priority or system of accountability, hybrid organizations often operate within a very confusing context. Directors of these agencies, as stewards of shareholder's property, have fiduciary duties that make it very difficult to take non-shareholder's needs (i.e. those served by the social mission of hybrid organizations) into account.

The L3C model, however, clearly imposes an unambiguous ordering of priorities upon the director: the profit motive must be subordinate to the charitable purposes of the organizations. Furthermore, any L3C must is expected to be able to establish that the organization was in fact founded primarily to pursue charitable or otherwise exempt objectives (as defined in IRS Rule 170). Social benefits that are a consequence of the organization's work are not sufficient; L3C's are expected to demonstrate an overriding charitable context of activity, such as by documenting that the entity would not have even been formed but for its relationship to accomplishing those purposes (Tyler, 2010).

Additionally, “no significant purpose” of the L3C enterprise can be the generation of profit or the appreciation of value. It is important to note, however, that the “no significant purpose” clause is left ambiguously defined and in fact does not limit the *amount* of profits that an L3C can make, only how it prioritizes its activities. Nevertheless, the L3C structure is considered by some in the social sector to have the potential to address the “dual masters” problem by clearly delineating organizational priorities.

This structure not only facilitates PRI’s, but it also makes these organizations more appealing to private investors outside of the social sector. Under the L3C model, private foundations typically provide the start-up capital and bear a greater portion of risk than for-profit investors (in order to conform to PRI regulations). However, while foundations accept a below-market rate of return for their investments, under the operating agreement of the L3C for-profit investors can make returns on their investments at rates comparable to the free market. Thus, in the L3C structure advocates see the possibility to not only create a more stable hybrid model, but also to attract a far greater amount of both for-profit and foundation investment into social sector.

However, numerous questions must be addressed before the L3C model can legitimize hybrid organizations to both investors and regulators. While the model explicitly prioritizes charitable purposes and stipulates that profit generation cannot represent a “significant purpose” of the organization, it is still relatively unclear how these regulations will be applied in practice. A web of standards, lines of accountability, and processes for review and oversight must be created to further develop and articulate the model, and must demonstrate the ability to hold these organizations accountable for their dual purposes. How “significant purpose” will come to be defined in terms of profit generation is still unclear. Additionally how regulators, and eventually courts, will come to define what prioritizing charitable purposes over for-profit goals looks like in practice will be very important in the development and legitimacy of the L3C model.

In practical terms, there are four possible options for enforcement of the charitable aims of the L3C model. In most businesses, shareholders or owners are the first in line to pursue claims against directors or managers who breach their fiduciary duties –

which in the case of the L3C includes prioritizing charitable purposes. However, considering these investors are likely to financially benefit from this breach of duty on the part of the directors, more mechanisms are necessary. A second option is the pursuit of criminal or civil claims for fraud or misrepresentation against directors of L3C's on the part of clients or potential investors. However this option is also dependent upon claims from parties who may not be reliable because of their conflicted interests. Another choice vests authority in the state attorney to pursue members or managers of L3Cs for *ultra vires* acts based on failure to prioritize charitable purposes. However, such an approach rests on clear definitions within states about what constitutes "charitable" activity. Finally, failure to abide by the standards in the L3C model could result in the removal of limited liability by courts. However the question would then become determining *where* would the forfeited gains of those who have breached their duties be directed – to clients who were supposed to benefit from the social mission or to investors who were duped into investing in an organization they believed was charitable in nature?

Each mode of enforcement is still untested in regards to L3C, and certainly each is problematic in some regard. Until officials determine how the primacy of charitable purposes will be enforced on L3Cs, the legitimacy of the L3C model will continue to be questioned by both investors and most especially by the non-profit sector with whom L3C's will increasingly compete for foundation monies.

There are further questions about L3C's in addition to the primacy of charitable goals, including situations in which these enterprises wish to transfer to fully for-profit enterprises. Directors of such organizations might decide to pursue a for-profit model such as an LLC, or to sell the organization to for-profit investors. L3Cs which are able to actually achieve their social mission – such as economic revitalization of a particular neighborhood – also might find themselves in the ironic position of violating L3C requirements, because the tax-exempt purposes that engendered the organization do not exist. These businesses may also look towards converting into a for-profit model (Tyler, 2010). Questions then arise over who should profit from accrued value of the organization, and the continued role foundation money will be able to legitimately have in the new business form.

There is also likely to be many people in the nonprofit world who will increasingly criticize the growth of PRI's at the expense of foundation support for traditional non-profits. Some foundations, such as REDF, argue that charitable dollars are *most* needed on efforts that cannot expect to support themselves via sales and investments (Gair, 2005). While the legal structure of L3Cs may ensure the primacy of a social mission, nonprofits are likely to point-out that burgeoning investments into social enterprises may come at the expense of services to populations that offer no opportunities for profit-generation. If foundations simply re-invest financial returns from PRI's into more for-profit entities, then these concerns may well be important. However, if foundations use these gains to augment their gifts to traditional nonprofits, then perhaps the L3Cs could catalyze growth across the entire social sector, not just in for-profit social enterprises.

Gardner Global & The L3C Model:

Gardner Global, LLC was started in late 2009 by Jaebediah (J.B.) Gardner. J.B. had spent the previous four years working in real estate development projects for Turner Construction. Having grown up in a low-income neighborhood in Los Angeles, J.B. witnessed the often deplorable living conditions in public housing projects and in privately owned properties rented to low-income families. As an employee at Turner he furthermore observed many practices in the real estate development industry that he believed to be both unethical and financially irresponsible, especially the over-reliance on debt-financing in property acquisition and the resulting need to push low-income families out of redeveloped areas. When the housing market collapsed at the onset of the Great Recession, J.B. was struck watching the accrued debt taken-on by real estate developers and homeowners send shockwaves through the market and destroy many of the lives of both homeowners and tenants.

Jaebediah's hope was to create a responsible and financially sustainable real estate company that would provide comfortable homes to low-income families. By purchasing and refurbishing housing properties debt-free, he hoped to create a more financially sustainable and ethically responsible business. In the absence of incredibly

large mortgage payments, the business would be able to be more patient in seeking returns, and rent properties for lower rates to low-income families.

In 2009 J.B. moved to Grand Rapids Michigan to attend law school and attempt to build *Gardner Global*. Grand Rapids was an ideal location for the social venture. The city had a long history of environmentally-friendly building construction, and housing prices in Michigan were exceptionally low due to the Recession and decline in the manufacturing industry, making it far easier to purchase housing properties debt-free.

J.B. soon brought in law school-classmate Jonathon Herpy as a business partner, who also had experience in the real estate industry and was interested in a social enterprise in the sector. The two began by sending sent surveys to community members about their perceptions of the real estate industry (which were uniformly negative), met with established developers in the Grand Rapids area, and decided that their business concept was viable. After crafting numerous reiterations of a business proposal vetted by advisors they had assembled from their law school faculty and real estate connections, they launched the company in late 2009.

In 2010, the business acquired its first property. After refurbishing the two-story duplex, *Gardner Global* rented the units to two low-income families at a monthly rate more than \$100 below market value. When choosing renters, J.B. and John were careful to choose low-income families who they believed were genuinely in need of the reduced rate. Currently, *Gardner Global* is seeking more investors to expand its number of properties and rent more housing units to low-income families in need of comfortable homes.

The Potential of Nonprofits & L3C's in the Real Estate Market:

In order to understand why non-profits or hybrid organizations like the one J.B. has created may have a space in the real estate market, it is helpful to place an organization like *Gardner Global* in economic and conceptual frameworks of the non-profit field outlined by Peter Frumpkin and Henry Hansmann.

In his book, *On Being Nonprofit*, Peter Frumpkin identifies four components of non-profit organizations: service delivery, civic and political engagement, social entrepreneurship and (the expression of) values and faith. Organizations like *Gardner*

Global, although they are for-profit, represent a space for talented individuals to engage in social entrepreneurship and express their values. For both Jaebediah and John, the lure of starting a business was augmented by the challenge of creating one that was both financially successful and sustainable *and* one that was socially responsible. *Gardner Global* has been able to pull-together a team of advisors and interested investors due in part to the fact that many of these people would find the opportunity to help build and mold a unique kind of real estate business far more exciting than traditional investing. The interest in such a business is likely to have been engendered in part by the collapse of the housing market and the desire for some traditional real estate investors to seek other potentially more stable investments.

The most important component of *Gardner Global* however is the ability for both J.B. and John to express their values through its hybrid business model. While they had the capital and the real estate background to start a strictly for-profit business, both J.B. and John explained that they would not have found any fulfillment enjoyed creating a profitable business through the traditional practices that they felt were irresponsible and unethical. In the low-profit space, however, both men are able to express their own personal values – specifically the importance of providing low-income families with decent housing, of environmentally-conscious housing development, and of businesses that take some responsibility for the well-being of the communities that they profit from. By investing in an organization like *Gardner Global* instead of a strictly for-profit business where they might see higher rates of returns, investors are *also* able to express those same values themselves while seeking returns on their capital. *Gardner Global* is a for-profit business and works to provide investors financial returns, thus it seeks and attracts a different type of investor than non-profits. But the ability for both its owners and its investors to express certain values through the business model gives *Gardner Global* and potentially similar real estate businesses a unique space in which to grow within the for-profit sector.

Economic theories that have been used to describe the non-profit sector also explain the potential for hybrid organizations like *Gardner Global* to enter the real estate market. The *public goods theory* states that the government will only provide public goods at the level that satisfies the median voter (Hansmann, 1987), and thus some

citizens who demand increased quantity or quality of these public goods will support nonprofits. The housing of low-income families is seen by many Americans to be a *public good*, as it increases community stability and reduces crime rates. However, the government historically has provided low-income families with poorly constructed and horribly managed public housing units, which have been enough to satisfy median voters but which have been often horrible for low-income families. Similar to donors who provide money to arts organizations because they believe the level of art supported by the government is insufficient, some believe that low-income families have the right to more humane housing for low-income families than that demanded by the median voter. Therefore there is a space for either non-profits or hybrids like *Gardner Global* to provide more quality housing for low-income families and attract those investors not satisfied by the current provisions of government.

Additionally, one of the most salient lessons J.B. and John learned from their survey of community members regarding perceptions of real estate businesses was an enormous lack of *trust*. The *contract failure theory* states that some markets, such as childcare and nursing homes, are ripe for the existence of nonprofits because consumers in these markets are less able to evaluate the quality of service that firms produce for them and thus seek firms they can trust. Because of the *nondistribution constraint*, those that control the organization are unable to benefit personally by providing low-quality services. Although the purchasers (renters) of housing units are obviously more able to judge the quality of their product, there is nevertheless widespread skepticism about landlords in low-income communities as there is a long history of shady landlords taking advantage of poor families. This skepticism becomes especially salient when most renters are expected to sign a 12-month lease. Perhaps most importantly, the broader communities in low-income areas, who can often block or stall property acquisitions by real estate developers, are themselves highly suspicious of for-profit real estate developers, given the historical patterns of gentrification. Thus, due to *contract failure* a limited for-profit firm or a nonprofit organization is likely to be in an advantageous position in comparison to strictly for-profit firms in the rental and real estate development market in low-income communities.

Conversion to an L3C:

The dual-nature of Gardner Global is clear in their mission statement:

The mission of Gardner Global is "**to provide the highest long term yield for financial growth in real estate with the priority of raising the standard in sustainable living. We focus on capitalizing non-leveraged and secured asset opportunities, creating tangible community results. We believe strengthening our communities through real estate investments and partnerships will contribute to the economic vitality of our global community. Partnerships and wealth are derived from within the communities which we serve and work. It is our steadfast approach to provide contemporary affordable living, work and social space to those who have been traditionally excluded.**" (website, emphasis added)

Currently, *Gardner Global* is organized as an LLC business, and lacks *structural* mechanisms to ensure that the social-mission of the organization is accomplished. The absence of such mechanisms is not at the moment problematic due to the small size of the company and the flexibility of its owners to remain patient in their investments. Because J.B. and John control every decision personally, and founded the organization with a social mission in mind, it is easy for *Gardner Global* to sustain the primacy of mission over profits. Additionally, because both J.B. and John are still in law school, they are less concerned about turning profits on their investments than they would be if they were running a full-time business, and in fact have turned down investors who wanted too large of rates of return on their investments for *Gardner Global* to use those investments to accomplish the business' social mission.

However, if the company begins to expand, and J.B. and John begin working for the business full-time, the tension between mission and money will begin to grow. *Gardner Global* is thus considering converting to an L3C model to imbed its social mission into the structure of the organization. Beyond institutionalizing the social mission the L3C model will also make it far easier to solicit needed investments from foundations in the form of PRI's.

On the surface, conversion to an L3C model may appear to be an easy choice for *Gardner Global*. The organization was founded primarily to develop a sustainable approach to providing more-humane housing for low-income families, and the social mission has in fact taken primacy over profits in decisions the company has made in regards to potential investors. Additionally with the dearth of PRI's that are annually made by foundations in the U.S., there is a great opportunity to tap the market of

program-related investments and acquire more properties, especially considering the incredibly low price of housing properties in the Grand Rapids area and throughout Michigan. Finally, the distrust of the real estate industry may create very viable opportunities for businesses like *Gardner Global* if they can effectively build a sense of trust within the communities in which they operate and clearly articulate the primacy of their social mission to potential tenants.

Many questions remain, however. Although the founders clearly wish to advance a social mission and hope that *Gardner Global* will demonstrate a more ethically responsible way to invest in real estate, it is not certain from either their mission or their business plan that the business fits the requirements of the L3C model. When marketing to potential investors, *Gardner Global* is careful to emphasize that the rates of return are likely to be lower due to the social mission of the organization. However they *do* in fact continue to advertise that investors can expect to see stable returns on their investments. Under the L3C model, the social mission of the organization *must* be prioritized over profit generation, and “no significant purpose” of the organization should be devoted to for-profit activities.

As an L3C, growth at Gardner Global would also become more difficult to manage. Currently, the owners’ personal passion sustains the primacy of the social mission. But if the business begins to grow to include many more properties, expands outside of Grand Rapids, and/or hires additional employees, hoping that their internal culture will be enough to ensure the primacy of the social mission in every transaction the company takes may be overly optimistic. Currently the organization does not use (or need) any metrics to evaluate its progress towards its social mission. But as it grows, it will become increasingly important to evaluate quantitatively whether or not it is prioritizing and/or accomplishing its mission to both regulators and potential investors. Finally, as Tyler (2010) notes, an interesting paradox may arise if Gardner Global actually begins to achieve substantial social impact. If its tenants are able to utilize the benefits of this more humane relationship with their landlords to mitigate their own poverty, *would Gardner Global* need to ask them to leave their homes if other more needy residents are clamoring to rent the units? If *Gardner Global* actually succeeds at revitalizing certain neighborhoods in Grand Rapids (or elsewhere) that it invests in, will it find itself actually

violating its obligations as an L3C company once the social mission has been accomplished?

If *Gardner Global* is to successfully adapt the L3C model, it must take steps to first ensure that the social mission of the organization will maintain primacy in strategic decisions, even if it means the company will thus not be able to produce the marketed returns to investors. The company should therefore communicate a clear priority of mission over money in its marketing on the website, and clearly define what the social mission of the organization is and how it will be evaluated. In order to ensure that the social goals of the business remain tantamount as the organization grows, J.B. and John must develop metrics to measure the company's progress towards those goals, make strategic decisions based on those metrics, and evaluate the performance of their employees, partnerships with property managers, and investment decisions based on those indicators. If the company wishes to court more traditional investments as well, perhaps the business can be split into two arms: one a more traditional for-profit with an LLC legal structure that is socially responsible, and another an LLC that courts program-related investments, clearly communicates to private investors the primacy of its mission, and imbeds mechanism to *ensure* the primacy of that mission.

Conclusion:

Considering the often incredible lack of ethics in the for-profit sector, the fragility of the nonprofits and the frustrating inefficiency and politicization of government services, hybrid for-profit/nonprofit firms are an exciting development. However, attempts to blend social missions into for-profit activities in practice have been largely unstable and unsustainable. The L3C model, originally developed to help facilitate more program-related investments, soon became recognized as a potential platform on which to build more sustainable hybrid models. By institutionalizing the social mission of businesses over their goals of profit generation, the model may in fact help stabilize the hybrid firms and make them more legitimate to both investors and regulators and hopefully catalyze an exciting new sector of truly socially-conscious businesses. However, many questions remain, including defining the fiduciary accountability that will dictate the roles of L3C directors, the meaning of “no significant aspect” in regards

to profit-making as an aspect of the business, and how the prioritizing of mission over money will be defined and enforced by regulators.

Firms like Gardner Global are representative of both the incredible potential of this sector as well as its continued ambiguity. Although this uncertainty is concerning, similar ambiguity surrounded the *LLC* through the 1980's and 90's, which is now a burgeoning business model. Considering the irresponsibility that has been so clearly demonstrated as of late by the for-profit sector, the promise of socially responsible businesses like Gardner Global should far outweigh the risks associated with these firms operating in a nebulous field.

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